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JOINT COMMITTEE PRINT

THE UNITED STATES
BALANCE OF PAYMENTS

STATEMENTS BY ECONOMISTS,
BANKERS, AND OTHERS
ON
THE BROOKINGS INSTITUTION STUDY,
"THE UNITED STATES BALANCE OF
PAYMENTS IN 1968"

MATERIALS SUBMITTED TO THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES



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LETTER OF TRANSMITTAL

NOVEMBER 12, 1963.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the Joint Economic Committee and other Members of Congress is a compendium of statements prepared for our committee by economists, bankers, and others commenting on the Brookings Institution study, "The United States Balance of Payments in 1968." The 68 contributions included herein discuss various problems raised in the Brookings study and assess the likelihood that the study's balance-of-payments projections for 1968 will actually be realized. The materials in this volume thus supplement our committee's hearings on July 29 and 30, 1963, when we heard from several of the Brookings authors and four expert witnesses on the outlook for the U.S. balance of payments.

These statements, of course, do not necessarily reflect the views of the committee or any of its members.

Faithfully,

PAUL H. DOUGLAS, *Chairman.*

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INTRODUCTION

On July 29 and 30, 1963, the Joint Economic Committee held hearings on the outlook for the U.S. balance of payments. These hearings were devoted principally to a study prepared under the direction of Walter S. Salant of the Brookings Institution entitled "The United States Balance of Payments in 1968." At that time, some of the authors of the study—Walter S. Salant, Emile Despres, Lawrence B. Krause, and Alice M. Rivlin—appeared before the committee to present, summarize, and discuss their work. In addition, the committee heard discussions of the study by four expert witnesses—G. A. Costanzo, vice president, First National City Bank of New York; Hal B. Lary, associate director of research, National Bureau of Economic Research; Walther Lederer, Chief, Balance of Payments Division, U.S. Department of Commerce; and Gardner Patterson, director, Woodrow Wilson School of Public and International Affairs, Princeton University.

In view of the seriousness of the U.S. balance-of-payments position, the committee regards the Brookings Institution study as a work of major importance for policymakers and the public. The committee therefore considered it desirable to assemble additional critical views to place the study in better perspective and help responsible officials and others to judge the degree of reliance which might properly be placed on the study's projections.

Accordingly, Chairman Douglas wrote to a large group of qualified individuals and invited contributions for a compendium to be published by the committee. In his letters, Chairman Douglas stated that he did not wish to preclude comments on the Brookings authors' policy recommendations, but that the committee's "primary interest is to assess the likelihood that the study's projections will be realized." He requested contributors to address themselves "primarily to the scope, assumptions, methods, inferences, and findings of the study."

The committee greatly appreciates the cooperation it has received in this project. It has published all statements received before the final publication date. Publication by the committee, however, does not imply endorsement by the committee or any of its members of the comments made by any of the contributors.

THE UNITED STATES BALANCE OF PAYMENTS

STATEMENT BY JOHN H. ADLER

Director, Economic Development Institute, International Bank for Reconstruction and Development, Washington, D.C.

The invitation of the chairman of the Joint Economic Committee to prepare a critical analysis of the balance-of-payments study of the Brookings Institution proposes that the analysis "address itself primarily to the scope, assumptions, methods, inferences, and findings of the study" and "to assess the likelihood that the study's projections will be realized." The invitation does not ask for views on the findings regarding the problem of the national liquidity, closely associated with the U.S. balance-of-payments problem. In line with this request I arrange my comments under four headings: (a) Method of analysis; (b) assumptions of the study; (c) validity of alternative projections, and (d) implications of alternative policies.¹

I. METHOD OF ANALYSIS

The Brookings study constitutes a major contribution to the understanding of the U.S. balance of payments. It is the first attempt to prepare a comprehensive analysis, taking account of all factors bearing on the subject, since 1943, when the study, "United States in the World Economy," by Hal B. Lary was published. It is a model of an economic empirical analysis because its findings are based on meaningful relationships of observed economic variables. It succeeds to a remarkable extent in isolating significant causal relationships and it sets forth clearly, and most of the time convincingly, the arguments for accepting past relationships as the bases for projections, or for modifying these relationships. It is comprehensive in two respects: it takes account of all variables which directly affect the various components of the balance of payments and it sets forth all assumptions regarding the factors which determine the macro-economic framework within which the balance of payments develops.

The authors of the study have introduced into the analysis at least two major innovations. The first is the distinction between changes in realized output attributable to changes in demand and changes in output due to changes in supply capabilities. This distinction, which is presumably a generalized application of the experience of the reconstruction of the economies of Europe, is, I submit, not only important for an understanding of the growing independence of the economies of Western Europe from the Ameri-

¹ This paper reflects my personal view as a professional economist and does not purport to represent in any way the views of the International Bank for Reconstruction and Development.

can economy, which supported the economies of the Western European countries through Marshall plan and other aid through the postwar reconstruction period. It is equally valid, though perhaps with some modification regarding its time dimensions, for underdeveloped countries—a fact which is probably not immediately relevant for the task at hand, i.e., to project the U.S. balance of payments for the year 1968, but is bound to be of growing importance as the industrial capabilities of the countries of the underdeveloped world become stronger.²

The second innovation of the study is that it takes account, in quantitative terms, of the feedback effects of the various components of the balance of payments on others. These feedbacks have been known for a long time; they are an essential part of the classical and neoclassical long-run adjustment mechanism of the balance of payments—long run in the sense that they exclude changes in foreign exchange holdings. But aside from a few previous attempts, to which the Brookings study gives generous credit, this is the first time that a comprehensive analysis of the American balance of payments takes account of the feedbacks and their effects and beyond that distinguishes between their immediate and delayed effects. This part of the analysis is particularly important because it does away with the uncertainty with which the empirical analyst has been left by theoretical reasoning, however valid, regarding the importance of such feedback responses.

The preceding comments are a strong endorsement of the method of analysis of the Brookings study and, by implication, of its findings with respect to the development of the U.S. balance of payments in the future. The criticisms of the analysis and of the findings in at least two important respects, which I offer below, are I believe compatible with my positive reaction to the study. They are based on differences in views and emphasis, and differences of judgment. Their objective is not to show that the study is “wrong” in important respects, but to point out that there are some areas of doubt and uncertainty which I believe need further investigation and analysis. It may even be that these doubts and uncertainties cannot be resolved at the present juncture and that all that is possible now is to call attention to the issues and to suggest that they may have to be resolved if further complications and a further deterioration in the U.S. balance of payments are to be avoided.

II. ASSUMPTIONS OF THE STUDY

The major findings of the study that under the initial assumptions the deficit of the basic balance will turn into a surplus of \$1.9 billion by 1968 as well as the results under the alternative assumptions, that

² There exists of course a link between the two determinants of the important demand which the study distinguishes, the changes in demand and changes in supply capabilities. Insofar as the changes in supply capabilities are the result of an addition to the stock of capital, the demand for investment goods is likely to induce an increase in the demand for imports and thus have the same effects as other changes in demand. This is especially true in countries which on account of their industrial structure or for other reasons (e.g., economies of scale) do not produce investment goods. It would go beyond the scope of this appraisal of the Brookings study to elaborate at length the implication of this proposition. In the short run, i.e., over the next decade or so, it implies that an increase in the supply capabilities of underdeveloped countries is likely to be associated with an increase in the demand for capital goods from countries producing capital goods, including the United States. In the long run it may have important effects on the composition of U.S. exports, bringing about a relative decline of exports of capital goods and a relative increase of other exports.

the basic balance will show a very small improvement, are based on the contention that the competitive position of the American economy in the world will be appreciably improved by relative price movements. U.S. export prices are projected to increase by 4 percent per year while prices of exports from Western Europe are projected to rise by 11 percent under one set of assumptions and 7 percent under the other. The study points out that for either of the projections, which differ chiefly with respect to assumptions regarding the growth of GNP in the United States and in Western Europe (and different rates of price increases in Western Europe) these price assumptions are the most important single component in the projected changes in the balance of payments.³

For a variety of reasons these price assumptions must be questioned. The Brookings study takes pains to point out that at least until 1958 or 1959 the competitive position of the United States, as reflected in the unit value indexes of manufactured exports, steadily deteriorated vis-a-vis Western Europe and Japan. It explains the high degree of stability of European and Japanese export prices as reflecting sharp rises in the productivity in export industries and price policies of exporters who quote export prices below those charged in their domestic markets. The study also expresses the view however that since 1959 the situation has "changed drastically." This view is based on movements of prices of capital goods both in the United States and in Europe. The authors of the study discount the fact that movements in the indexes of export prices continue to be unfavorable from the point of view of American competitiveness. Throughout the discussion of price movements the study emphasizes the unreliability of export price indexes because of their inadequate coverage and differences in the composition of exports country by country.

The argument that the price levels of Western European countries, including the level of export prices, are likely to rise faster than those of the United States is essentially based on three propositions. One is that the rapid gains in productivity resulting from the introduction of new techniques of production and economies of scale are coming to an end. Another is that with the high level of employment expected to prevail in Western Europe, the slow growth of the labor force (which has already resulted in labor shortages and heavy reliance on foreign workers) will force wages up and bring about increases in the cost of production over and above productivity gains. Third, the authorities committed to pursue full employment policies will continue these policies in spite of these price increases.

There is I believe much room for doubt that Western European export prices will move as indicated in the study. The argument that productivity gains will fall short of wage increases in Western Europe is, to say the least, hazardous. The argument that the slow growth of the labor force will exert upward pressures on wages is plausible. But it is much less certain that this upward pressure will drive up the cost of production in export industries. It may be argued—though any statistical verification would be difficult—that

³ I have omitted references to any specific passages or tables in the study, assuming that these comments are of interest only to persons fully familiar with the Brookings study.

labor shortages and wage increases will occur chiefly in the service industries and those manufacturing industries in which productivity gains and wage increases have been smallest; and it may well be that wage increases in export industries will be sufficient to attract enough workers on the one hand and not exceed productivity gains on the other, so that cost of production remains unchanged.

It may also be argued that the projection of European export prices fails to take account of the possibility that European exporters would not raise export prices even if domestic prices increase. This is, I believe, a distinct possibility in some major European export industries such as steel and automobiles because, the rapid growth of the domestic market notwithstanding, excess capacity may continue or develop. If it does and, it might be added, if as a result of a gradual substitution of capital for labor (induced by higher wages or the threat of higher wages) the break-even point in some export industries declines, European exporters may find it to their advantage to meet American competition by continuing, or even increasing, their policy of differential pricing.

Finally, it may be argued that the Brookings study is on uncertain grounds in its arguments that the authorities of the Western European countries will be inclined to forsake price stability in order to achieve and maintain full employment. True, in the last 12 or 18 months the cost of living indexes of some European countries, particularly of France and Italy, have shown upward movements, while those of others (e.g., Germany, the Netherlands, the United Kingdom) have remained rather stable. But the drastic reversal of monetary policies announced recently by the French authorities suggests that price stability is still considered a major objective of economic policy and that the authorities are ready to take measures to prevent price increases. It would, of course, be wrong to conclude from the recent French action that European countries are willing to sacrifice a high rate of growth to the objective of price stability if the attainment of a high rate of growth would be incompatible with a reasonable degree of price stability; this issue has not arisen as yet. But it does indicate that the political appeal of stability is still considered strong by the authorities and cannot be easily disregarded.⁴

Doubts regarding the price developments projected in the Brookings study do not invalidate its findings, but they underscore the riskiness of the projections, which the authors of the Brookings study themselves have repeatedly stressed. In the last analysis the acceptance or rejection of the findings cannot be based on scientific arguments, but involves personal judgment based on a complex and inevitably subjective assessment of probabilities. I for one would be reluctant to rely in the projection of a substantial improvement in the American balance of payments so heavily on assumptions regarding relative price movements which would greatly enhance the competitive position of the United States in the world economy. I would not, however, disregard completely the possibility of price movements favorable to the development of the American balance of pay-

⁴ I have phrased my doubts regarding the projected price developments entirely in terms of movements of European prices. I disregarded the possibility of increases in U.S. export prices in excess of 4 percent, as assumed in the study, although this possibility must not be ruled out, particularly in the event that European export prices rise as projected.

ments over the next 5 years. That is to say, I would not want to eliminate the entry "improvement of U.S. competitive position" in the projections. But I would discount its quantitative significance, given as \$4.8 billion under the initial assumptions, and \$2 billion under the alternative set of assumptions regarding GNP movements. And I would take issue with the conclusion of the projection that the "best guess was that the basic deficit will be eliminated."

III. VALIDITY OF ALTERNATIVE PROJECTIONS

This raises in my opinion another, more fundamental, question regarding the validity of the projections, or in terms of the invitation to comment on the study, regarding "the likelihood that the study's projections will be realized."

The study indicates from the outset that the conceptually significant balance in the international transactions of the United States is the basic balance, which differs from the net balance by the exclusion of short-term capital movements, net errors and omissions, and some other items, chiefly of a nonrecurrent nature. The omission of these transactions is justified on the ground that they cannot be projected in any systematic fashion since they are either nonrecurrent or because they are themselves "induced" by movements in the basic balance of payments.

Nevertheless, the fact that these components of the total balance cannot be projected does not dispose of them. In any comprehensive appraisal of the balance-of-payments outlook they have to be taken into account. It may be argued that, in line with some of the introductory remarks of the study, they may be disregarded if there are clear indications that the deficit in the basic balance is being eliminated, as the conclusion of the study, at least under the first set of assumptions, indicates. If one concludes however that the foreseeable "automatic" forces determining the balance of payments will not in themselves eliminate the basic deficit, then the total net balance must remain the subject of policy concern. If the conclusion of the study under the second set of assumptions is more correct than the conclusion resulting from a preference of the first set, or if the relative prices do not behave as the assumptions of the study suggest, then the conclusion is inevitable, it seems, that short-term capital movements more likely than not will aggravate the balance-of-payments picture. It is because of the expectation that these short-term capital movements may be superimposed on the deficit of the basic balance that the projections are not likely to be realized and measures to improve the balance of payments will have to be taken before 1968—before the projections "have a chance" to be realized.

IV. IMPLICATIONS OF ALTERNATIVE POLICIES

It would go beyond the scope of these comments to make recommendations regarding specific policy measures. It seems appropriate, however, to conclude the comments with a remark about the basic alternatives of such measures.

The fundamental issue facing policymakers with respect to the balance of payments is whether balance should be achieved at a high level of international payments and receipts, or at low level. Measures

to reduce payments, or at least to prevent their increase, will obviously have to be combined with measures to increase receipts; but there is a choice open as to how restrictive measures are to be combined with measures aiming at our expansion of receipts. I am convinced that (a) the objective of balance-of-payments policy should be to achieve balance at a high level of international transactions and (b) that this objective can be achieved.

As to the first point, I want to stress the importance of continuing the flow of American financial resources, through loans, direct investments, and grants to underdeveloped countries. I believe there is no need to argue here the proposition that the development of the less developed areas of the world is and should remain, on political, economic, and humanitarian grounds, one of the objectives of American foreign policy. But it may be useful to indicate the importance of the support, through direct investment, loans and grants from abroad, to the development efforts of the less developed countries of the free world. Some rough calculations indicate that gross investment in the less developed countries outside the Soviet bloc has in recent years been of the order of \$24 billion.⁵ According to rather accurate estimates of the (net) flow of long-term loans and official grants to less developed countries, prepared by the Organization for Economic Cooperation and Development (OECD) \$7.5 billion, or not quite one-third, of this total has been accounted for by the (net) inflow of resources from the members of OECD and Japan. The rate of growth of output of the less developed countries as a whole in recent years has been of the order of 3.5 to 4 percent. Against this rate must be set the rate of population growth, which according to all indications exceeded 2 percent and probably has been close to 2.4 percent, so that per capita income has increased by, say, 1.2 percent per annum, or one-third of the aggregate rate of growth. It is an oversimplification, which I submit has nevertheless much meaning and significance, to conclude from this constellation of figures that if it had not been for the flow of foreign capital from private and public sources (including international institutions) and official grants, the per capita income of the less developed countries would have remained unchanged in recent years. In some countries growth of per capita income would undoubtedly have continued—perhaps at a slower rate—but there are many countries in which per capita income would have remained unchanged, or gone down, if foreign capital had not been available.

It may be argued in this connection that underdeveloped countries must increase their own efforts to expand production and to raise the level of domestic savings; that a decline in the rate of population growth would leave more room for increases in per capita income; and that the share of the United States in the net flow of capital and grants to underdeveloped countries could be reduced without reducing the total net flow of resources to the less developed countries. All this is true; but it is difficult to see how efforts to make more effective use of domestic resources of the less developed countries and to reduce the rate of population growth can bring major results in the next 5 years. As to the reduction of

⁵ Equivalent to 12 percent of \$200 billion, a rough guess of the aggregate GNP of the less developed countries.

the U.S. share in the total supply of foreign resources to underdeveloped countries, I merely want to point out that the scope for more equitable "burden sharing" is limited; several countries already make a larger proportion of their national product available to underdeveloped countries than the United States.⁶

It follows from these arguments that attempts to eliminate the deficit in the U.S. balance of payments by means of reducing the flow of investments, loans and grants to underdeveloped countries would be decidedly undesirable. As the study points out and as recent proposals indicate, a curtailment of military disbursements and of capital movements to advanced countries is possible. But if the flow of financial resources to underdeveloped countries is to develop along the lines indicated in the projections of the study, it becomes the more necessary to increase the foreign earnings of the American economy. The desirability of increasing American exports in particular has been recognized by the official sponsorship of export drives and more recently by plans to provide special incentives to American producers to expand exports. I believe that determined efforts to expand American export earnings can become the single most important factor in the elimination of the balance-of-payments deficit. It is not sufficient however to promote exports by exhortations, improved information services provided to exporters and potential exporters and other nonmaterial incentives. If exports are to increase beyond the level projected in the Brookings study measures will have to be devised by which American producers will be given financial inducements to devote more attention and efforts to their actual and potential export markets.

The Brookings study points out that the competitive position of the American producer and of the American economy as a whole is adversely affected by price policies of foreign producers who are accustomed to charge lower prices for exports than for deliveries to the domestic market. These policies of differential pricing are supported by exemptions and rebates of taxes levied on goods sold in the domestic markets. Tax incentives given to American producers would at least in part redress these disadvantages in the competitive position and thus help to bring the balance of payments problem under control. The most important result of such incentive measures would be to induce the multitude of American manufacturers to become more "export minded," i.e., to pay more attention to foreign markets, to treat them as an outlet different from the all-important domestic market and to cater more to foreign tastes and preferences than hitherto. American enterprise has been remarkably ingenious in devising constantly new appeals to the American consumer. It needs apparently special inducements to apply the same ingenuity and inventiveness to foreign markets.

⁶ I disregard in this argument the feedback effects of foreign aid expenditures, i.e., that more than three-fourths of them will result in additional U.S. exports.

STATEMENT BY ROBERT Z. ALIBER

Staff Economist, Committee for Economic Development, Washington, D.C.

I am happy to have the opportunity to comment on the report presented by the Brookings Institution on the U.S. balance of payments in 1968. The central impression from reading the report is the immense, the nearly insuperable, difficulty of projecting the major components of the U.S. balance of payments and the U.S. basic balance 5 or 6 years into the future. The basic balance is the residual of many different factors—changes in national incomes, in relative prices, in tastes, in factor mobility, in capital flows, and in military expenditures and foreign aid. Small changes in these variables, not in themselves large enough to cause major concern, can exhaust the ability of particular countries to finance the imbalance and even threaten the ability to maintain the established exchange rate. This is the most important conclusion for its policy implications.

The authors of the Brookings report worked under many handicaps—limitations of time, money, personnel, and data. Nevertheless their accomplishments are extremely impressive; the report establishes a new and more advanced benchmark for the analysis of the U.S. balance of payments; and it provides a new basis for future research.

The report can be examined at four different levels. The first is the view of the international economy in 1968, especially the level of incomes and prices in the United States and Western Europe in comparison with current levels. The Council of Economic Advisers (CEA) furnished one set of estimates. The authors developed a set of alternative assumptions, which they believed more realistic, based on lower rates of growth of U.S. and European incomes and a less rapid increase in European prices.

The second level of the report centers on the model of the international economy. This model presents a set of logical relationships—the dependence of imports on the level of domestic income, the dependence of exports on the relation between export prices and price levels abroad, the dependence of capital flows on expected profit levels and on interest rate differentials, the relation between capital flows and exports, the relation between changes in the imports of other countries and U.S. exports, and other relationships.

The third level of the report concerns the empirical values attached to these logical relationships, such as the import on U.S. exports of an increase in European incomes and of an increase in Western Europe prices relative to U.S. export prices, and the capital flows associated with various constellations of incomes and profit expectations and interest rates.

The fourth level of the report concerns Government policies adopted to affect both the balance of payments, or other economic

NOTE.—The views in this paper are not necessarily those of the Committee for Economic Development or of any of its subcommittees.

variables which in turn affect the balance of payments. These include the type of tying mechanism used by the U.S. Government in its foreign aid program, the international reserve policies of other countries, and the impact of commodity price stabilization programs.

The major conclusion of the Brookings report, on the basis of the CEA assumptions was that the U.S. basic balance would improve by \$2.7 billion between 1961 and 1968, so that there would be a surplus of \$1.9 billion in the basic balance in 1968. On the basis of the alternative assumptions, the report projects an improvement in the U.S. basic balance of \$0.2 billion between 1961 and 1968, and a deficit of \$0.6 billion in the basic balance in 1968. Most of the difference between these conclusions is attributable to variations in the projected improvement in the U.S. competitive position which in turn reflects differences in the rate of increase of European prices relative to U.S. prices. The improvement in the U.S. competitive position is expected to lead to an increase in U.S. exports of \$4.8 billion between 1961 and 1968 under the CEA assumptions, and of \$2.0 billion under the alternative assumptions.

1. THE MAJOR ASSUMPTIONS OF THE BROOKINGS REPORT

The major assumptions of the Brookings report concern levels of United States and West European incomes and United States and West European prices in 1968. The CEA assumptions projected that U.S. national income would grow at an average annual rate of 4.8 percent between 1961 and 1968, that European income would grow at an average annual rate of 4.3 percent, and that European prices would increase at an average annual rate of 2.75 percent. The alternative assumptions project an average annual increase in U.S. income of 4.2 percent a year, in European income of 3.8 percent a year, and in European prices of 1.75 percent a year.

U.S. prices were assumed to increase at the rate of 1.5 percent a year under both sets of assumptions.

Small differences in the assumptions about these rates of change of price and income levels significantly affect the 1968 basic balance. Each 0.1 percent decline (increase) in the U.S. average annual growth rate between 1961 and 1968 reduces (increases) the U.S. commodity imports in 1968 by \$190 million. Each 0.1 percent decline in Europe's growth rate reduces U.S. exports in 1968 by \$120 million. Each 0.1 percent increase in the average annual rate of increase in the GNP price level in Europe leads to an increase in U.S. exports of \$280 million in 1968 from improved price competitiveness.

Both the CEA assumptions and the alternative assumptions about the income levels in the United States and Western Europe in 1968 appear reasonable. Indeed the range of reasonable assumptions appears somewhat larger than the range between these two sets of assumptions. While it is more hazardous to project changes in prices, the CEA assumptions do not appear unreasonable. European prices have increased by about 15 percent since 1960; they could increase at a substantially lower rate between 1964 and 1968 and still reach the CEA estimate for 1968. The validity of the projections for U.S. exports and imports, however, also depends on the relationships between changes in incomes and prices, and changes

in imports and exports which are more fully discussed in the next several sections.

The choice of either the CEA assumption or the alternative assumption for European growth rate does not precondition the assumption about the U.S. growth rate. Thus if European incomes grow at an average annual rate of 3.8 percent projected under the alternative assumptions, while U.S. income grows at the 4.8 percent projected under the CEA assumption, the U.S. trade balance might be in deficit by \$2 billion in 1968. The matrix below indicates the U.S. trade balance for different combinations of growth rates in the United States and Western Europe. The matrix allows for assumed changes in U.S. price competitiveness as the growth rates vary.

U.S. commodity trade balance in 1968, assuming different combinations of annual average growth rates between 1961 and 1968 for GNP in the United States and in Western Europe

[Billions of dollars]

		U.S. Growth Rate							
		Percent	5.0	4.8	4.5	4.2	4.0	3.8	3.5
European Growth Rate	5.0	6.80	7.18	7.76	8.33	8.72	9.10	9.68	
	4.5	2.96	3.34	3.92	4.50	4.88	5.26	5.84	
	4.3	1.42	1.80	2.38	2.96	3.34	3.72	4.30	
	4.0	-.88	-.50	.08	.65	1.04	1.42	2.00	
	3.8	-2.42	-2.04	-1.46	-.88	-.50	-.12	.46	
	3.5	-4.72	-4.34	-3.76	-3.19	-2.80	-2.42	-1.84	
	3.0	-8.56	-8.18	-7.60	-7.03	-6.64	-6.26	-5.68	

The report also makes other assumptions about the international economy of 1968—that the selling prices of primary producing countries will be the same as in 1961; and the gold and foreign exchange reserves of the rest of the world, and the pattern of imports of the rest of the world will remain unchanged.

The report does not explicitly deal with the rapid disappearance of the dollar shortage. One factor was the deterioration of the terms of trade—the unit price of exports relative to the unit price of imports—of the less developed countries and the improvement of terms of trade of Western Europe. Western Europe imports from the rest of the world, excluding the United States, were \$21 billion in 1961. The index of Western Europe's import prices from all countries, including intra-European trade, was 103 in 1953 and 105 in 1956; in 1961 it was 97 (1953=100). About half of Western Europe's imports came from within Western Europe. Since Western Europe's

export prices remained unchanged, it appears that its import prices from the rest of the world fell by about 15 percent and reduced the cost for West European imports by about \$3.1 billion. Each reduction of 1 percent in Western Europe's import prices reduces its import bill by \$210 million; it also reduces the import-financing ability of the countries exporting to Western Europe, and their imports from the United States. On the basis of the estimate that 42.5 percent of their imports came from the United States, the decline in Europe's import prices resulted in a decline in U.S. exports of \$1.3 billion. Each decline of 1 percent in Western Europe's import prices results in a decline in U.S. exports of \$100 million. (There would be a partial offset, since U.S. import prices would be higher—however, U.S. import prices from the rest of the world have fallen by much less than European import prices, and U.S. imports from the rest of the world are about half those of Western Europe.)

The report assumes that primary product prices in 1968 will be the same as in 1961—that the export prices of the less developed countries will remain unchanged, while the export prices of both Western Europe and the United States will increase. Changes in prices of primary products depend importantly on the rate of growth of demand in industrial countries.

During the 1955-61 period, the GNP of the combined OECD countries increased at an average annual rate of 3.1 percent in real terms; the combined European GNP increased by 4.4 percent while U.S. GNP increased by 2.3 percent. If the CEA assumptions prevail between 1961 and 1968, GNP of OECD countries will increase at an average annual rate of 4.6 percent; if the alternative assumptions prevail, at about 4.1 percent. The OECD index of industrial production increased at a rate of 4.2 percent between 1955 and 1961. If the OECD index of industrial production bears the same relationship to OECD GNP between 1961 and 1968 as it did in the 1955-61 period, then the index should increase at an average annual rate of nearly 6 percent. It seems unlikely that output of primary products will increase at anywhere near this rate. While there will be further economies in the use of raw materials, it does not seem unreasonable to expect that Western Europe's import prices will increase, which in turn will benefit the U.S. exports. An increase in Europe's import prices from the rest of the world of 1 percent a year between 1963 and 1968 might lead to increased U.S. exports to the rest of the world of \$500 million by 1968.

Moreover, changes in European import prices from the rest of the world would appear to increase the proportion of rest of world's imports from the United States and decrease the proportion of its imports from Europe.

In its estimates of changes in price competitiveness, the report compares U.S. export prices with European GNP prices for U.S. exports to Europe, European export prices to U.S. GNP prices for European exports to the United States, and U.S. export prices and European export prices for U.S. exports to the rest of the world. The report derives its estimates of changes in export prices from changes in GNP prices—but the relationship between GNP prices and export prices appears complex. It is striking that European export prices are now at their 1960 levels, although GNP prices are 15 percent higher than in 1960. While it appears unlikely, at

least in Europe, that export prices will increase if GNP prices do not increase, it is possible that GNP prices might reach CEA projected levels without significant increase in European export prices. If this is the case, then gains in U.S. exports to the rest of the world from an increase in competitiveness will be smaller than estimated, while the increase in U.S. imports will be larger than estimated.

2. THE MODEL OF THE INTERNATIONAL ECONOMY, PAST AND PROJECTED

The major determinant of changes in the U.S. basic balance are changes in U.S. exports and U.S. imports and the imports and exports of Western Europe. The report implicitly attributes nearly all of the prospective changes in U.S. and European trade balances to either price or income changes (a major exception is foreign aid, and a minor exception is trade discrimination). The report uses relationships obtained from changes in national incomes, prices, imports, and exports for the 1948-61 period to project changes in United States and Western Europe's imports and exports for 1968 on the basis of assumed changes in prices and incomes.

The approach may tend to result in relatively high price elasticity for U.S. exports; e.g., the change in U.S. exports resulting from more rapidly rising prices in Europe than in the United States may be high. This approach also may result in a high estimate for the relationship between changes in U.S. imports and changes in U.S. incomes, and a low estimate for the relationship between changes in incomes and imports in Western Europe. These possible biases in the estimates made in the report reflect that it slights structural changes associated both with the dollar shortage of the early postwar period and with the disappearance of the dollar shortage in the 1950's.

That the inferences based on attributing changes in imports and exports solely to changes in incomes and prices may not always be fully satisfactory is illustrated by the use of this approach to explain changes in Japanese exports. Japanese exports have increased at an average annual rate of 18 to 20 percent a year in the postwar period, more than three times as rapidly as the growth in income of the rest of the world and world trade. An explanation of the growth of Japanese exports solely in terms of increases in foreign income and the increased price competitiveness of Japanese goods neglects that in the beginning of the postwar period many Japanese products were greatly underpriced in comparison with competitive products abroad. Japanese exports would have grown rapidly even if incomes in the rest of the world had remained unchanged and if the price of Japanese exports had not declined.

World trade patterns were greatly distorted in early postwar years, both because of shortages of various goods and trade barriers. In 1938, European exports (including intra-European exports) accounted for 45 percent of world exports; in 1948, 32 percent. In 1938, Western Europe imports accounted for 54 percent of world imports; in 1948, 42 percent.

European output lagged the foreign demand for these goods. The economic dislocation in Europe in the early postwar years resulted in many shortages. As European output increased, the Europeans were able to regain some of their prewar share of world export mar-

kets with the result that European exports increased more rapidly than world exports. In a world where goods are traded on the basis of price and availability and reflect factor endowments in different countries, it was to be expected that Western Europe would import commodities which it could not produce efficiently and export those which it could produce efficiently. As more and more goods became available, and as the trade-limiting financial and commercial restrictions were reduced, the pattern of world trade would tend to return toward the prewar pattern. And it was also to be expected that European exports, having declined more rapidly than European imports between 1938 and 1948, then would increase more rapidly and that the U.S. share of world markets, and of the market in Western Europe, would tend to decline as the share of Western Europe increased. Western European exports may have increased for other reasons than the return to the prewar trade pattern.

Factor endowments suggest that postwar trade patterns resemble the prewar pattern, but they need not be identical. Whether the return to the approximate prewar trade pattern is complete is now conjectural; European exports in 1962 were about 47 percent of world exports, not very different from their 1938 levels.

One cause of rapid growth of U.S. imports from Western Europe during the 1950's was the increasing availability of European goods, and the return to more normal, peacetime trade patterns. Even in the absence of an increase in U.S. incomes or of changes in prices favorable to the Europeans, U.S. imports from Europe would have increased substantially as the European capacity and output increased.

During this same period tastes for foreign goods have changed, both in the United States and Europe. One example is the increase in the U.S. demand for European autos. U.S. imports of automobiles from Europe were \$330 million in 1957; in 1959 they were \$825 million. Although U.S. imports declined subsequently to \$500 million in 1962, they nevertheless remain high and account for 10 percent of U.S. imports from Western Europe. U.S. imports of autos from Europe comprise 4 percent of the U.S. market. While this proportion may change in the future, it is unlikely to increase at anywhere near the rate in the 1955-61 period. Although increased U.S. imports of autos were partly related to changes in relative prices and the growth of U.S. incomes, the major cause of this increase would appear to be a shift in demand in reflection of a change in tastes.

A shift in demand is a one-time event, rather than a continuing factor. Changes in demand are likely to occur in the future; as incomes increase, consumers have greater leeway in their budgets. It is questionable, however, whether changes in the trade structure in the past which can be attributed to changes in demand should be attributed instead to changes in relative prices and income. The increasing supply capabilities of Western Europe and the changes in U.S. tastes both suggest that the estimates of the sensitivity of U.S. imports to changes in U.S. incomes and the sensitivity of U.S. imports to changing relative prices may be high.

During the early postwar years, the United States exported many goods to Europe, not because the United States had a comparative

advantage in the production of these goods relative to Western Europe, but because European supply capabilities were inadequate to meet European demands fully. In part Marshall plan aid helped finance the purchase of these goods. If European gold holdings had been larger so that Marshall plan aid was unnecessary, or if the Europeans had otherwise been able to obtain the necessary financing, these goods still would have been purchased in the United States—the United States was the largest outside source of supply. As European output increased, Western Europe was able to reduce its imports of some commodities from the United States. As European incomes increased, its imports of other goods from the United States increased, and the decline in imports of goods in the first category may have obscured the more normal relationships between changes in income and changes in imports. For this reason the computed European income elasticity of imports may tend to be too low.

During much of the postwar period, European imports from the United States were limited by exchange controls and quantitative restrictions, and these measures were used to discriminate against extra-European imports. As the international reserve position of these countries improved, most of these restrictions were progressively eliminated (although some were restored at the time of the Suez crisis). The reduction of these barriers permitted an increase in West European imports from the United States; in the absence of these restrictions, and on the basis of the then current prices and incomes, European imports from the United States would have been larger than they actually were. As import barriers were removed, European imports from the United States increased. This increase could not be attributed to changes in European incomes. For this reason an econometric approach may tend to overstate the relation between changes in European incomes and imports. Taken together with the argument of the previous paragraph that greater availability may tend to underestimate this relationship the net result is unclear.

Many of these structural changes, particularly those associated with postwar shortages, are probably no longer important. Inferences based on an aggregative econometric approach which do not consider the impact of these important structural changes on the basic parameters must be used cautiously. The empirical values are more fully discussed in the next section.

3. THE EMPIRICAL VALUES OF THE BROOKINGS REPORT

The econometric model used in the report leads to the conclusion that the U.S. marginal propensity to import (the ratio of changes in U.S. imports to changes in U.S. income) is 3.59 percent, that the marginal propensity to import in Western Europe is 4.44 percent, and that the price elasticity of substitution for U.S. imports is 4.0. The authors of the report, however, believe that this price elasticity was too high, and that a value of 2.5 was more reasonable. If the price elasticity is 2.5, then it suggests either that the computed relation between changes in U.S. exports and changes in European incomes would appear to be too low or that a new variable or variables need to be introduced into the equation. The changes in availability and changes in tastes discussed in section 2 suggest that the price elasticity of 4.0, and probably of 2.5, is too high, and that the U.S. income elasticity is also too high.

To obtain a positive and acceptable relationship between changes in European incomes and changes in European imports, the report relied on a 3-year moving average. Although European income increased at a steadier pace than U.S. income, an econometric approach relating changes in European imports and changes in European income on a year-to-year basis apparently did not yield a statistically significant result.

The model implicit in the Brookings report focuses on changes in imports as related to changes in income; the emphasis was on marginal relationships rather than on the relationship of average values. Since structural changes may tend to distort the marginal relationship, it may be useful to compare the relationships implicit in the report with those obtainable on the assumption that average import-income relationship in 1961 also will prevail in 1968.

On this basis U.S. merchandise exports receipts from Western Europe will be \$9.5 billion under the CEA assumptions and \$9.2 billion under the alternative assumptions, while U.S. payments for imports from Western Europe would be \$5.7 billion under the CEA assumptions about income and \$5.5 billion under the alternative assumptions. The U.S. bilateral trade surplus with Western Europe would be \$3.8 billion under the CEA assumptions and \$3.7 billion under the alternative assumptions, in contrast with a bilateral U.S. trade surplus of \$3 billion in 1961, and a projected surplus of \$1.5 billion under the CEA assumption and \$1.7 billion under the alternative assumptions. Moreover the U.S. trade surplus with the rest of the world would also prove higher.

If the average import-income relationships remain unchanged, the U.S. trade balance will be more favorable than that projected by the report. The larger part of the difference in the conclusion based on the 1961 average import-income relationship and that of the Brookings report—roughly two-thirds—is attributable to differences in the projections of U.S. imports from Western Europe. In this sense the conclusion is consistent with the argument in section 2 that the econometric approach resulted in too high an estimate of the relationship between changes in U.S. incomes and changes in U.S. imports from Western Europe; on the basis of the computed marginal relationship, the report estimates that U.S. imports will increase nearly 40 percent more rapidly than U.S. income. In contrast the report estimates that European imports will increase less than 50 percent as rapidly as European incomes.

If the suggested 1961 average relationships between the imports and income prove valid, the improvement in U.S. trade balance with Europe which Brookings authors obtain largely as a result of price developments would instead be obtained largely from changes in national income. The consequence for the U.S. trade balance of a more rapid growth in the United States than in Europe, and of a higher GNP in the United States than in Europe, is more than offset by the much higher ratio of imports to income in Western Europe than in the United States.

Changes in relative price may improve the U.S. trade surplus by a larger amount, but the data available for determining price elasticities of substitution are so questionable that no estimate is attempted here. Two points might be noted. The first is that changes in relative prices

affect imports and exports with a lag, and relatively little is known about the time characteristics of the lag. The second is that the report's estimate of the price elasticity of substitution is based on Western European imports, at a time when U.S. prices were increasing more rapidly than prices in Western Europe—computed for U.S. imports. In projecting the improvement in the U.S. competitive position on the basis of assumed price changes, the report assumes the price elasticity is reversible, and that there will be comparable gains from an increase in European prices relative to U.S. prices. Both factors may prove valid, but they are unsubstantiated empirically.

4. THE POLICY PROJECTIONS OF THE REPORT

The report devotes one chapter to the problem that the other countries might suffer from a shortage of international reserves if the U.S. basic balance improves in accordance with the projections based on the CEA assumptions. The report only briefly considers the impact of various policies adopted between 1963 and 1968 on the U.S. payments balance in 1968. The trade-diversion impact of the Common Market, the consequences of various types of aid-tying policies, and the projected decline in U.S. military expenditures abroad are noted. The report does not consider the possibility that some European governments might adopt policies to limit the inflow of foreign capital. It does not consider the impact on the U.S. payments balance of international commodity stabilization programs. Since international payments can be affected by many policies, these considerations, even though they tend to increase the uncertainty of achieving the 1968 projections, were beyond the responsibility of the report.

To achieve the basic balance projected for 1968 on the CEA assumptions requires that European governments not adopt measures to reduce their deficits in their basic balances. Even though they might be able to finance this deficit with an inflow of short-term funds, they may take measures to reduce their basic deficits. If this happens, it will be all the more difficult for the United States to achieve a surplus in its basic accounts in 1968. Since there is now a substantial bias in overstating payments deficits and understating payments surpluses, it is possible that the Europeans will react restrictively to any tendency toward a deficit.

Projections of the U.S. balance of payments in 1968 necessarily involve much uncertainty. The projections require assumptions about the changes in income, prices, and profits, and the impact of these changes on both trade flows and capital flows. The projections also will be affected by changes in Government policies. Relatively small differences in the assumptions result in substantial differences in the payments balance, and it is primarily the lack of financing which prevents the development of the really large payments imbalances that can easily be projected.

The authors of the Brookings report in their policy recommendations stress the need for new reserve-providing arrangements to help finance the imbalances they project in 1968 and thereafter should the United States achieve a substantial payments surplus. New reserve-providing arrangements might also help finance the U.S. deficit. If these arrangements are not developed, the report proposes as a second

best solution a flexible exchange rate between the United States and Great Britain on one side, and continental European countries on the other.

New reserve-providing arrangements, however, might still prove inadequate unless the supplies of credit for financing imbalances are extremely large, for credit is only a partial substitute for adjustment policies to restore satisfactory payments equilibrium after imbalances occur. Much more attention should be given to policies for adjustment to payments imbalances.

STATEMENT BY WILLIAM R. ALLEN

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I

The Brookings report is a reasonably systematic effort (given the magnitude of the project relative to the time available for its completion) on an impossible task which should be unnecessary and appears to be quite useless with respect to the purposes for which it was commissioned.¹ The question which was put to a capable research group was absurd; it follows that the lengthy report—despite the fact that being systematic and not ridiculously injudicious almost inevitably makes its conclusions plausible—must be assigned a zero value in the context of its seeming purpose, viz, to provide a basis of policy. Genial tolerance may permit saying that the Council of Economic Advisers (along with the Treasury and the Bureau of the Budget) was quaintly naive in putting the question and that the Brookings authors indulged in amiable, even if reluctant and guarded, quackery in preparing their answer, but it must be stated forthrightly that predicating policy on the basis of the answer could constitute appalling irresponsibility.

The balance-of-payments deficit is “an urgent problem * * * to which an appropriate solution must be found. * * * To be appropriate, the solution must be based on a valid appraisal of the outlook for the balance of payments over the next few years” (p. 2). With regard to major objectives of national policy * * * the outlook for the balance of payments is important (p. 211). Now, doodling on the possible configuration and component magnitudes of the balance of payments 5 years hence may amuse some and awe others—and in this allocation of resources, as in others, let consumer sovereignty reign. But it is simply dismaying that matters of high public policy would be determined on the basis of such Ouija board meditations.

Some of us have long been asking what is the balance-of-payments “adjustment mechanism” under the International Monetary Fund. And the answer seems to be, in general, that it is a thoroughly bastardized version, or parody, of the classic (pre-1914) gold standard.² But at least if there is no genuine automaticity left in the “mechanism” (which really is to say that there is no genuine mechanism at all), one still could hope for discretionary policy to be conceived and administered in a commonsensical fashion, employing some considerable amount of developed wisdom and judgment. But there is little commonsense or cultivated wisdom in forming policy on the basis of a so-called 5-year projection of the balance of payments.

¹ This paper is an irreverent critique of Walter S. Salant et al., “The United States Balance of Payments in 1968” (Washington, D.C.: the Brookings Institution, 1963), but it is not by intent disrespectful. For the protection of both the distinguished authors of the Brookings report and the author of the critique, it should be noted that the report is of book-length and the time available for preparing the commentary was short, enhancing the always present possibility of misinterpretation at various points.

² My views on this are summarized in “The International Monetary Fund and Balance of Payments Adjustment,” *Oxford Economic Papers*, 13 (June 1961), pp. 149–165.

II

In the report, (*a*) what is being measured, (*b*) how is it being measured, and (*c*) what are the general conclusions of the measurement?

(*a*) Senator Douglas notes that "in view of the seriousness with which the United States balance-of-payments position must now be viewed, the Brookings projections are of major importance for policy-makers and the public," and the main task here is to "judge the degree of reliance which might properly be placed on these projections." It is appropriate to survey first just what is being "projected."

The report acknowledges that "most analyses deal with the 'net total balance'" (p. 2), otherwise known as the "overall" balance and associated with the Department of Commerce, but in the report emphasis is on the "basic" balance apparently favored by the Treasury and the Federal Reserve. Perhaps a sense of delicacy precluded mentioning that there are still other "balances" advocated in balance-of-payments interpretation: it is, or should be, a cause of substantial embarrassment to economists that even the analytic conception, much less the empirical measurement, of balance-of-payments imbalance or disequilibrium (are "imbalance" and "disequilibrium" synonyms?) are still in a state of conspicuous nebulosity.

The "total" balance is rejected (pp. 2-5), because (*a*) it "does not show satisfactorily the presence or absence of pressure on the dollar" and (*b*) it includes components, viz., U.S. short-term capital outflow and errors and omissions, which "may have so large a transitory element that it is difficult to analyze the outlook for their future." And the "basic" balance is adopted (pp. 5-9), although (*a*) "an improvement in the basic balance implies even less than does an improvement in the total balance that pressure on the dollar will relax" and (*b*) "the basic balance * * * does not succeed in excluding all transactions that are substantially influenced by transitory considerations" and "conversely, it does not include all transactions that are not transitory."

To make the passing suggestion that the focus on the basic balance has been inadequately defended is not necessarily to suggest that the focus should have been on the total balance. Presumably, the particular mode of balance-of-payments analysis which is appropriate is to be determined by the specific purposes of the analysis and the possibly unique perspective of the analyst in question. In the recent voluminous writings on the U.S. balance-of-payments "deficit," authors have rarely felt it incumbent upon them to lay out precisely why the deficit is significant. If the deficit persists, who loses, what is the nature of the loss, and what are the consequences of the loss continuing indefinitely?

To the extent that the deficit is "financed" by a net short-term capital inflow (basic balance) or by an inflow of foreign short-term capital into the United States (total balance), as opposed to a gold outflow, does the deficit itself constitute a direct and immediate problem? To be sure, a welfare cost may be discerned in a deficit conspicuously characterized by large outflowing unilateral transfers, the financing of the deficit taking the form of an increase in foreign short-term claims on the United States and/or a decrease in U.S. short-term claims on the rest of the world. But where is the immediate financial cost? A financial problem would consist of a gold outflow. Indeed, the rationale of including foreign short-term capital flow into the

United States in the financing of the total balance is simply because it supposedly represents potential gold outflow. The gold export, in turn, is important, not because of the providential and unalterable design of the universe, but because of man-made and alterable institutional arrangements. Still, given the arrangements, for good or ill, the gold drain is—or can soon become—serious. But gold movements are not included in the calculated projections of the Brookings report.

There is no attempt to quantify the likely net gold movement of 1968 although “the international financial problem of the United States * * * consists of the constraints imposed on the United States in its efforts to attain the more basic objectives of policy,” and “it is the changed position of the dollar—the loss of foreigners’ desire to continue accumulating dollars—which imposes these constraints” (p. 241). Indeed, after 240 pages of agonizing over the nature of the future balance of payments, it is concluded that “the present problem is not primarily a balance-of-payments problem” (pp. 242–43). We are told that “no position of the balance of payments—whether surplus, deficit, or balance—would simultaneously free the United States from undesirable constraints and provide for needed expansion of international monetary reserves” (p. 242), which surely suggests the question of why the authors bothered writing the report. The real problem is “the basic inadequacy of the international monetary mechanism,” which gives rise to “an excessive preoccupation in the advanced countries with balance-of-payments objectives” (p. 243). In some seemingly minority (but respectable) circles, the huzzahs for this conclusion are succeeded by groans upon presentation of the proposed reformation of the international monetary mechanism, of which more later.

(b) The authors “project” the U.S. current account (and several of its components), private long-term capital, and Government transfers and loans. The projections are calculated partly with the aid of previous work by various scholars and based on data from the late 1940’s or early 1950’s up to 1960 or 1961. Derived equations are utilized by inserting assumed data for 1968. There is no problem of the various pieces of the balance of payments fitting together, for there are no projections of short-term capital, gold, and errors and omissions, thus leaving the balance of payments “open ended.”

The “analysis and conclusions about the outlook for the U.S. basic balance are based on * * * assumptions concerning the future course of the U.S. economy and that of Western Europe” (p. 213). Two alternative sets of assumptions are employed. The “initial” assumptions, “suggested” by the Council of Economic Advisers, supposedly call for annual rates of increase of (a) 4.8 percent in real GNP, 1.5 percent in general prices (GNP deflator), and 0.5 percent in export prices for the United States and (b) 4.2 percent in real GNP, 2.75 percent in general prices, and 1.5 percent in export prices for Europe. A number of comments are in order.

1. There is some confusion on the calculation of rates of increase. Although the text of the report refers to an assumed growth rate of 4.8 percent for U.S. real GNP, table VIII-1 (p. 215) indicates an increase of 43 percent from 191 to 1968, which implies an annual rate of 5.24 percent. A second discrepancy of smaller magnitude is in the rate for the European GNP deflator: The text refers to a rate of 2.75 percent, whereas the table implies a rate of 2.64 percent.

2. A real GNP growth rate of 4.8 (much less 5.24) percent maintained over a 7-year period would be a striking performance. It represents a presumably delectable wish, but it is a poorly founded expectation and thus no reasonable basis at all for policy formulation. To illustrate the impressiveness of a real GNP growth rate of roughly 5 percent over a period of 7 years, consider the annual rates over earlier 7-year periods since World War II:

	<i>Percent</i>		<i>Percent</i>
1946-53 -----	3.9	1951-58 -----	2.3
1947-54 -----	3.7	1952-59 -----	2.8
1948-55 -----	4.3	1953-60 -----	2.5
1949-56 -----	4.6	1954-61 -----	3.0
1950-57 -----	3.6	1955-62 -----	2.8

The average of these 10 rates, as well as the overall rate for the entire 1946-62 period, is 3.3 percent, i.e., some two-thirds of the rate utilized in the initial projection. (It may be noted that from 1961 through the first half of 1963, the annual rate of increase was 4.4 percent—although, as the authors of the report observe in other contexts, changes over only a year or so are unreliable indicators of trend.)

3. Along with the assumption of a GNP growth rate which is very high by historical standards, there is the assumption of a GNP price deflator growth rate which is very low. Whereas the general price index is assumed to increase at only 1.5 percent annually, it rose at a rate of 2.8 percent from 1946-62 and at 2.1 percent from 1955-62. For real GNP to grow roughly half again as fast from 1961-68 as it has during the post-World War II period while the general price level increases at around two-thirds the past rate would be highly gratifying, indeed—and highly surprising, as well.

4. It speaks well for the Brookings authors that they were sufficiently suspicious of the initial assumptions to calculate a projection with an alternative set of assumptions. U.S. price increases (both the GNP deflator and export prices) are the same in the alternative set as in the initial; European prices rise less in the alternative set than initially (although European export prices still rise by substantially more than do U.S. export prices). In the alternative version, real GNP increase is smaller for both the United States and Europe, but the alternative increase for the United States is only 6.25 percent smaller than initially, with an annual rate of increase of 4.5 percent compared to 4.8 (?) percent, whereas the European increase is 10 percent smaller (again there is a discrepancy: the data of table VIII-1 imply 11.9 percent), with the annual rate of increase now being 3.78 percent instead of 4.2 percent.

It may be suggested that the new set of assumptions does not constitute a dramatically different alternative to the initial set. While the less exuberant figure for United States GNP is a modification in the appropriate direction, the use of 4.5 percent instead of 4.8 percent is a very cautious substitution. Is it unreasonable to envisage a rate of GNP increase of, say, only 3 percent? Or, to reverse the question, is it reasonable to assign an extremely high probability (seemingly equal to unity) to the rate of increase actually falling within the narrow and high-level range of 4.5 to 4.8 percent? It would surely have been of interest to calculate the extreme values of the balance of payments

deficit-surplus which would be yielded by much wider ranges of the variables, e.g., with both United States and European GNP growth rates between 2 and 6 percent and with the general price level rates of increase between 0.5 and 3 percent. Failure to consider a wider range of variables suggests that the supposedly neutral projection is camouflage for what actually comes very close to being a prediction—a prediction which, in this instance, seems highly dubious.

(c) After all the labor and ingenuity embodied in the report, the results are frustrating, the basic balance changing within limits of (i) minuscule improvement, leaving an appreciable deficit, and (ii) a very considerable improvement, generating a substantial surplus. More specifically, the authors measure a deficit of \$0.8 billion in 1961, and their calculations yield a surplus of \$1.9 billion under the "initial" assumptions and a deficit of \$0.6 billion under the "alternative assumptions. As a ratio of the improvement in the basic balance to the original deficit, the range of improvement is 25 to 337.5 percent, and the absolute difference of the deficit-surplus under the two methods of calculation is \$2.5 billion. Although the projections indicate an improvement in the basic balance, the authors agree, in a bit of an understatement, that "the degree of the improvement must be regarded as uncertain" (p. 230). They offer a "best guess" that the deficit will be eliminated, but we may reasonably indicate that these results hardly constitute a useful guide or basis for policy: only barely do they disclose even the direction of appropriate policy, much less the magnitude. And it should be kept in mind that this rather considerable range of results is the consequence of two alternative sets of assumptions which do not strikingly differ. If a more reasonably wide range of assumptions were employed, presumably even the direction of policy would be ambiguous.

The authors themselves note "the sensitivity of projections of net balances of international payments" (p. 31). The total absurdity of taking seriously such projections for policymaking purposes would be apparent, if it is not already, if more wide-ranging sensitivity tests had been made. It is agreed that year-to-year forecasts are "extremely hazardous"—but "projection of the effects of fundamental forces" is supposedly feasible (p. 14). But "it should be emphasized that projections of net balances in international payments, even of net balances in basic transactions, are highly speculative, even more so than economic forecasts in general" (p. 31; also p. 211). In addition to the formidable problems of discerning and projecting economic "fundamental forces," there are the difficulties of numerous exogenous impinging factors, including those of politics, security, and ideology. In the calculation of projections, do we have a well-defined and measured equational variable representing the actions of General de Gaulle?³ And which variable neatly represents the influence of the Diem family on appropriations of foreign aid?

The question, of course, is not one of the competence of the study group, for it consisted of very able people; rather, the concern is with

³ " * * * we conclude that the net effect of the underlying factors taken into account in the projections will be pressure toward a basic surplus * * *. [However,] under existing monetary arrangements, the size of the actual U.S. surplus would be limited by policies in Western Europe designed to limit the deterioration in the balance of payments that a large shift in the basic balance would almost certainly imply" (p. 225; also p. 242).

the immediate, direct usefulness of the results of the study for policy purposes. Actually, "the results," especially if a somewhat wider range of assumptions were run through the calculator, are not a narrowly circumscribed quantification, but rather suggest that pretty much anything can happen. Nor can we salvage much by choosing a single set of assumptions and staying with it heroically. Making such a commitment can be defended only in terms of the "plausibility" of the result, but "plausible" means simply that the result is "imaginable" and "not clearly unreasonable." Unfortunately, a very wide range of results is "plausible"; indeed, some of us may find the results of the alternative assumptions, in which a slightly reduced deficit prevails, somewhat more plausible than the results of the initial assumptions, in which a sizable surplus obtains—even if we do not put much weight on our own powers of discerning different degrees of plausibility in this type of exercise.

After candidly, even if somewhat briefly, noting the difficulties in projecting and forecasting, the authors find comfort in the thought that "the value of the projection lies less in its quantitative result than in the process of obtaining the result" (p. 31). Some would have supposed that the sponsoring agencies and the Congress would be a good deal more interested in the "quantitative result" than in the study group's methodology and technique and in the very general influences operating on the balance of payments which supposedly have been made clear.

III

What is desired is not projections, however ingenious and plausible, but a genuine mechanism of balance-of-payments adjustment. We may reasonably put faith in a market mechanism; it is at best ludicrous—and more generally dismaying—for the Government to try to project the unguessable, presumably in order better to engage in such discretionary statesmanship as decreasing nondutiable imports by American tourists, tightening "voluntary" curbs on certain foreign exporters, and taxing the American purchase of foreign securities.

The authors agree that "it is clearly in the interest of the United States to make every effort to develop an international monetary mechanism that will permit adjustments to take place without compromising other goals" (p. 245). In that connection, "fixity of exchange rates is a virtue," for it contributes to removing "uncertainty" and thus to increasing the volume of international transactions and thereby the efficiency of world resource allocation. "The more certain it is that the rates will be maintained, the greater are these advantages" (p. 245), so presumably it should be convincingly avowed that rates will never be altered; and this appears actually to be the view of the authors (see p. 247). If exchange rates are permanently pegged—not to be changed even in the face of "fundamental" imbalances—then what are to be the "adjustment" variables in the "international monetary mechanism"? Deflationary measures are not acceptable; neither are trade restrictions, direct payments controls, nor curtailment of foreign aid, Government foreign spending, or lend-

ing to underdeveloped countries.⁴ (Interestingly, even if discouragingly, under both the initial and the alternative assumptions, there is calculated almost a 30-percent reduction in net private long-term capital outflow from 1961 to 1968 but almost a 60-percent increase in net Government transfer and loan outflow.)

There would seem to be few adjustment possibilities left. The report alludes to altering interest rates and thus influencing capital movements, but this presents delicate problems of coordination with fiscal policy if national income is to be stabilized, and the policy of controlling capital movements might be ineffective anyway (“* * * higher interest rates, while discouraging domestic investment, may not be effective in attracting capital to a weak currency when strong currencies are available” (p. 246)). But the great emphasis of the report is on time—and the importance of additional “liquidity” in providing adequate time. If lots of time is available, balance-of-payments troubles may just go away. If they do not disappear of their own cyclical accord, time will permit necessary “structural” changes in the economy, induced either by competitive pressures or by Government policies to stimulate and to direct investment, as well as changes in the Government’s own international transactions.

It certainly must be granted that, with a system of fixed exchange rates, time is a necessary condition for adjustment, but it must be granted also that time is not a sufficient condition. Indeed, time can permit a further deterioration as well as improvement in the situation. (That time alone is not a sufficient condition for adjustment is presumably illustrated by the experience of the United States: we are now in the 14th year of “total” deficit, with only one of those years showing a surplus, and the 16th year of “basic” deficit, with the last 6 years having very large deficits.) The question is, what is done or what happens during the time provided? And the brief suggestions of the authors seem to suggest only ad hoc, discretionary activities which scarcely constitute a “mechanism” of adjustment.

Without pursuing the matter at length, it should be noted that the authors provide us with “an alternative international monetary mechanism” (see pp. 258–262), viz, “a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc,” with “relatively fixed rates within each bloc and flexible rates between them” (p. 259). This alternative is made to look very attractive: (a) “in contrast to a fixed-rate system, a system of flexible rates has the advantage that both the short-run competitive position can be changed and the longer run structural adjustments can be made without general deflation of money costs in deficit countries and general inflation in surplus countries”; (b) “it would allow the United States to pursue most of its national objectives without undesirable balance-of-payments constraints”; and (c) “such a flexible exchange rate system would also reduce the need for international reserves”

⁴ There is a curious exception to the denunciation of direct controls: “We * * * reject the alternative of using comprehensive controls over imports of goods and services and over capital movements in order to maintain a fixed exchange rate, although this does not exclude the possibility of informal restraints on U.S. purchases of new issues of Western European securities” (p. 259). There are always those who are willing to make such restraints both formal and central in our balance-of-payments policy. But it is nothing less than disgraceful when the vice president of a Federal Reserve bank announces that “insistence on confining policies to those which are in consonance with ‘free market principles’—whatever they are in today’s world—unnecessarily hobbles us. * * * Some forms of restrictions and controls are in order” (quoted in a newspaper account).

(pp. 259-60). Unsurprisingly (to some of us), the authors can find little to object to in a system of fluctuating rates; surprisingly, they consider such a system to be only a "second-best" proposal.

IV

"Our projections indicate a tendency toward substantial improvement in the U.S. balance of payments by 1968" (p. 241). Such a happy result may come to pass. No one can say with justified confidence that it will not— or that it will. The conclusion of "substantial improvement" might be more acceptable if simply predicated as a necessary result rather than as one obtaining from "projections." That is, it might have been more interesting to stipulate a desired status of the balance of payments (a zero basic balance?) and then to investigate possible alternative values of adjustment variables, both in the balance of payments ("external" variables) and in the national income accounts ("internal"), which would be consistent with the stipulated components of the balance of payments. This approach would suggest the costs to be borne and the conditions to be satisfied in order to attain the desired balance of payments; a discussion of costs and conditions could be both more feasible and more fruitful than a discussion focused on (dubious and partially arbitrary) statistical projections.

The authors seem to suggest that with an adequate adjustment mechanism, there is no need to play around with projections of the balance of payments—and if they do not mean to say that, they should. But it is doubtful that they have succeeded in outlining an adequate mechanism—except in their "second-best" proposal of freely fluctuating exchange rates.

STATEMENT BY JAMES W. ANGELL

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The Brookings Institution study¹ is a most elaborate and carefully documented attempt to forecast the U.S. national balance of payments, and despite the criticisms suggested below, the authors deserve the heartiest congratulations on their resourcefulness and imagination. All or nearly all of the important relevant factors seem to have been taken into account in one way or another. Any serious disagreement with the main conclusions themselves must hence be based on objections either to the forecasts of changes in particular major components of the balance of payments as a whole, or to apparent inconsistencies between two or more components as forecast.

I. CONCLUSIONS OF THE STUDY

Since certain misunderstandings seem to have arisen already, it is first necessary to make clear what the study does and does not say and do.

First, it is concerned almost entirely with the "basic" international balance, defined as the net total of credit and debit payments for goods and services (including investment income), private long-term capital movements, and Government loan and grant programs and other transfers. This definition (see p. 5) represents an attempt to focus attention on the net effects of the underlying and presumably long-lasting forces and factors which affect a country's international payments position over time, and hence to measure the presence or absence of payment equilibrium in some "real" sense. This is clearly important. It should be emphasized, however, that other definitions of equilibrium in international payments are equally defensible and for some purposes more useful; and that the existence of a basic balance equilibrium does not necessarily mean that the country's central monetary authorities no longer have serious problems in the international field. To cite only two examples, transactions in U.S. Government securities (omitted from the "basic" balance), or autonomous speculative short-term capital movements, can create persistent and severe "actual" international deficits or surpluses which the central authorities must recognize and try to deal with.

Second, the study presents not one but two sets of projections of the basic balance in 1968, which are based on assumptions that are respectively more and less optimistic (p. 216). The first forecasts a surplus in 1968 of \$1.9 billion, an improvement over actual 1961 of \$2.7 billion (though the improvement may not become substantial until 1965 or 1966: see p. 231). An improvement of this size would effectively get rid of our present actual deficits, of course, and might

¹ Salant, W. S., and others: "The U.S. Balance of Payments in 1968." (Materials presented by the Brookings Institution to the Joint Economic Committee, Washington, 1963.)

even revive the postwar problem of dollar scarcity. The second and less optimistic projection, however, forecasts a basic balance deficit in 1968, of \$600 million—an improvement over actual 1961 of only \$200 million. This improvement is so small as to be negligible. If this is all the gain that the United States can hope for in the next 5 years, then—though the authors of the study do not say so—we should clearly begin at once to try to develop major new policies and measures.

The authors do not seem to indicate which projection they regard as more likely to be realized. Public attention and criticism have been concentrated chiefly on the first and more optimistic estimate, but this is unfair. The two should be given equal weight.

II. CRITIQUE OF THE PROJECTIONS

The first projection, to repeat, forecasts an improvement in the basic balance of \$2.7 billion by 1968. The largest single element in this is a projected improvement in the merchandise balance of trade (p. 216). By 1968, in this projection, merchandise exports are expected to rise to \$31.4 billion as against \$20.2 billion in 1961, or by 55 percent, and imports to \$23.3 billion as against \$14.5 billion, or by 61 percent. The excess of exports would hence increase from \$5.7 to \$8.1 billion, or by 42 percent.² These forecasts seem to me questionable on several grounds, however, especially with respect to exports. They rest primarily on estimates of future changes in total output and in prices in the United States as against those in Western Europe.³ Output in the United States is expected to rise by 43 percent by 1968, in Western Europe by only 33 percent (p. 215)—primarily because many of the latter countries are already beginning to press against the current upper limits of work force expansion. On the other hand, partly for this reason and partly because of the resultant weakening of governmental and private business controls over wage demands, prices are expected to rise much more in Western Europe: for the GNP deflators, 20 percent in Western Europe by 1968, as against 11 percent for the United States; for export prices, 11 percent against 4 percent.

These price and output forecasts can doubtless be challenged, especially those for outputs. The forecast for the United States implies a substantially higher rate of growth than what has been experienced since 1953, for Western Europe a lower rate. The price forecasts seem more plausible, especially in view of the recent price surges in France and Italy and the apparently impending problems of Western Germany.

Even if one accepts the forecasts unequivocally, however, it is difficult to understand why U.S. exports should be expected to increase by \$11.2 billion, or 55 percent, by 1968 (p. 216). This projected increase is made up of two parts, an increase in exports to Western Europe of \$5.8 billion, and to the rest of the world of \$4.9 billion

² The discrepancies with respect to exports between the table on p. 216 and that on p. 90 are presumably due to military grants and economic assistance items.

³ The study concludes from the record of 1950-62 (p. 25) that changes in the basic balances of the underdeveloped countries have little persistent influence on the basic balance of the United States, and hence that attention can be focused on the relations between the United States and the industrialized countries alone, particularly those of Western Europe.

(p. 90). The latter figure, entailing an increase of 45 percent over 1961, is consistent with the projected increase in exports from the rest of the world to the United States. But the figure for U.S. exports to Western Europe in 1968 projects an increase of \$5.8 billion or 82 percent, despite the fact that the total output of Western Europe is expected to rise by only 33 percent. The chief explanation of the apparent discrepancy is relative price changes (p. 90). But the projected differential in favor of the United States (changes in U.S. export prices versus those in the Western European GNP deflator: p. 215) is only 15 percent. The combined effect of this price differential and the expected increase in total Western European output would hence produce a projected increase in the dollar volume of U.S. exports to Western Europe of only 53 percent, not of 82 percent. Nor do I share the belief that U.S. technical efficiency in producing exports, relative price changes apart, will increase a great deal more rapidly than efficiencies in Western Europe (see ch. III): certainly not enough to account for the difference between 53 and 82 percent. On these several grounds, the projection for U.S. exports to Western Europe, and hence the projection for total U.S. exports, therefore look unrealistically high—and this merely on the basis of the quantitative data and estimates given in the study itself. The overestimate may be as high as \$2 billion.

The study also gives projections for U.S. imports. On the more "optimistic" assumptions, they are expected to increase from \$14.5 billion in actual 1961 to \$23.3 billion in 1968, or by 61 percent. This increase reflects the expected combined effects of the increases in U.S. total output and in GNP-deflator prices. This implies that the GNP elasticity of imports is substantially unity. But this assumption may be somewhat too optimistic. Since 1954, U.S. imports have fluctuated cyclically somewhat more than in proportion to GNP, and the average imports-GNP ratio has even shown a slight increase. The imports projection may therefore be a little too low.

Finally, it does not seem to me likely that Western Europe will, if it can help it, allow so large a further increase—42 percent—in the already-large U.S. excess of merchandise exports, as that which is here projected. Instead, the outcome is quite likely to be increases in relative European tariff and other discriminations against U.S. products,⁴ especially on the part of the European Economic Community; and to combat U.S. competition in the rest of the world, increases in European governmental assistance to exports.

On balance, I thus feel that the "optimistic" projection of the future increase in the U.S. merchandise export surplus is far too large. The less optimistic projection, which actually forecasts a slight decrease in the surplus (from a surplus of \$5.7 billion in 1961 to \$5.4 billion in 1968) seems substantially closer to the probable outcome. We shall be lucky if we end up with any material increase at all.

The second major element in the improvement in the basic balance which is projected for 1968 is the anticipated increase in gross U.S. investment income. This is expected to rise from \$3.8 billion in 1961 to \$5.8 billion in 1968, an increase of 53 percent. The estimate is reached under both the first or more optimistic set of assumptions, and

⁴ Perhaps particularly agricultural products (see p. 221). France is also beginning to complain about steel, though this is not a major U.S. export.

under the second set (p. 216). The percentage increase is somewhat larger than that projected for gross private U.S. investment abroad, of 48 percent (p. 150), and the difference is not accounted for by U.S. Government interest receipts (pp. 185, 190). But the projected increase in U.S. private investment abroad, from \$48.9 billion in 1961 to \$72.5 billion in 1968, itself seems improbably large. The expected more rapid increase of total output in the United States than in Western Europe, with its probable consequence of increased relative profitability of investment in the United States; the similar effects of rising relative costs in Europe; the considerable possibility of a sustained increase in U.S. interest rates relative to European rates (p. 126); the effects of threats of renewed inflation in parts of Western Europe, and of rising nationalistic sentiments in various American countries; and the proposed interest equalization tax, if approved by the Congress—these and other factors all suggest strongly that the actual increase in U.S. private foreign investment, and hence in U.S. investment income from abroad, are likely to be much smaller than what is here projected.

Moreover, the size of the increase in income as thus projected seems inconsistent with the projected decrease in net private long-term capital exports, which is presented in the summary projected basic-balance table (p. 216). This decrease is a third important element in the projected improvement in the basic balance itself. Under both sets of assumptions, these private capital exports are expected to fall from a net figure of \$2.1 billion in 1961 to \$1.5 billion in 1968. But earlier in the study (p. 150) it was estimated that the net private foreign investments of the United States (our investments abroad minus foreign investments here) would increase between 1961 and 1968 by \$15.2 billion. This is an average increase for the period of \$2.2 billion a year, which is larger than the actual net capital export for 1961. Now if actual 1961 was a little below the projected average, and if projected 1968 is a good deal below it, this implies a very peculiar pattern of behavior: a great bulge in net capital exports in the period from 1963 to 1966 or 1967, and a sharp drop in 1968. Such a pattern seems clearly implausible. One must therefore conclude either that the projected net capital export figure for 1968 which is shown on page 216 is much too low, probably by \$600 million or more, or, if this 1968 figure is correct, then that the net private investment income projected on page 151 for 1968 is too high, perhaps by \$200 million or more; and hence that the gross U.S. investment income figure shown in the projected basic-balance table on page 216 is also too high. In either event the net basic balance projected for 1968 seems substantially too favorable, so far as it is affected by these private investment factors. This is true under both the more optimistic and the less optimistic set of assumptions, since the same investment figures are used in both.⁵

The projection of foreign investment and of investment income is admittedly difficult and hazardous, and I do not venture to argue that one set of estimates is necessarily "better" than the other. But the capital export and the income figures must be reasonably consistent;

⁵ Investment income payments by the United States to foreigners are expected to increase by 87 percent from 1961 to 1968. This is much more than in proportion to the expected increase in foreign investment here, and may be too high. A downward revision would somewhat reduce the correction in the basic balance proposed above. (These payments are not included in the figure for projected investment income receipts by the United States, on p. 216, which are gross.)

whereas I think it has been demonstrated above that in the present study they are not. Correction of the inconsistency—whether by revising the projection for net capital exports, or for investment income, or for both—will require a downward revision⁶ of both of the projected basic balance figures shown on page 216, by between \$200 million and as much as \$600 million.

Finally, the study projects a very large increase by 1968 in the annual net total of Government loans, grants and other transfers, from \$3.7 billion in 1961 to \$5.8 billion in 1968 (p. 216). This is an increase of \$2.1 billion a year. But, despite this enormous estimated expansion, which is based on official projections, it is asserted that the net effect on the balance of international payments will be to reduce the size of the deficits which are traceable to these operations. It is expected that practically all of the projected increase in the programs for foreign economic assistance will be “tied,” so that the basic balance deficit will not be increased on this account by as much as \$400 million (p. 189). Defense expenditures abroad, the other major component in the Government’s foreign operations, are actually expected to fall by 1968, while receipts from sales of U.S. military goods and services to other countries are expected to rise substantially. The net upshot is a projected decrease in the international deficit which is due to defense expenditures of \$1.1 billion by 1968 (p. 207). The combined effect of the projected changes in these expenditures plus those for foreign economic assistance is hence a projected net improvement in the basic balance, as compared with 1961, of around \$700 million by 1968. But this surprisingly favorable result, which accounts for over one-quarter of the total improvement in the basic balance which is projected for 1968 on the more “optimistic” set of assumptions (p. 216), is largely the consequence of the projection for greatly increased foreign sales of U.S. military goods and services. This projection seems a bit hazardous. The development of adverse political or economic climates abroad, such as could easily appear, could radically change the situation, and for the worse.

III. CONCLUSION : THE DEFICIT WILL NOT CURE ITSELF

The conclusions reached to this point with respect to the first or more “optimistic” projection of the U.S. basic balance in 1968 can be summarized as follows: (1) The projected figure for U.S. merchandise exports is a good deal too large, perhaps by \$2 billion or more, even if one appraises it only on the basis of the data and estimates given in the study itself. (2) It is also unlikely that the Western European countries—especially those of the EEC—will allow as large an increase in U.S. exports as that which is projected, and still less so large an increase in the U.S. export surplus, to be realized if they can help it. Instead, they are likely to retaliate with increased trade restrictions and with export subsidies or equivalent measures, thus reducing the expansion of U.S. exports. (3) On the other hand, if the projected increases in U.S. output and in domestic prices develop, the increase in U.S. merchandise imports may be somewhat larger than projected. (4) The projections for U.S. investment income from abroad and for net U.S. long-term private capital exports seems to be

⁶ The projected figure for U.S. receipts of investment income can hardly be too small, in view of the considerations outlined above.

mutually inconsistent. Correction of the inconsistency would move the projected net basic balance for 1968 unfavorably, by \$200 to \$600 million. This correction also applies to the second or less "optimistic" set of projections of the basic balance. (5) The expectation that the Government's foreign loan and grant programs, despite large projected increases in their dollar totals, will impose a much smaller burden on the balance of payments by 1968—smaller by some \$700 million a year—rests on extremely favorable forecasts, especially with respect to sales of U.S. military goods and services abroad, that may easily fail to be realized.

Taking these various proposed revisions and reservations together, it thus seems likely that the more "optimistic" projection of the net basic balance in 1968, which shows a surplus of \$1.9 billion and an improvement over 1961 of \$2.7 billion, is too favorable by some \$2.2 to \$2.6 billion. The corrected "optimistic" projection shows not a basic balance surplus but a deficit of \$300 to \$700 million—an improvement over actual 1961 which is only trivial. If other countries react to the projected expansion of our merchandise exports by increasing the severity of their trade restrictions and export subsidies or the equivalent, then even on the "optimistic" projection the basic balance deficit in 1968 will be substantially larger than in 1961.

If, instead of this, we take the alternative and less optimistic set of projections, the outlook of course becomes still worse. On these assumptions, the net basic balance deficit in 1968 will be not \$600 million but, at the least, between \$2.8 and \$3.2 billion; and if other countries respond adversely to our export expansion, the deficit will be still larger.

Even if one makes all reasonable allowance for the uncertainties attending such complex forecasts and the corrections proposed above, the outlook is thus hardly reassuring. We have a major international basic-deficit problem now, and unless drastic action is taken the deficit is likely to be substantially worse, not better, by 1968.

What all these figures, analyses, and conclusions do and do not mean, however, must be clearly understood. They do not mean that the United States is inevitably condemned for the next 5 years or more to a regime of international deficits, and perhaps to a progressively closer approach to international bankruptcy. What they do mean is that if the basic factors in our international economic and financial position remain unchanged, then we do indeed face real trouble. Neither the continuance of all of the present policies of our Government and of governments abroad, nor the so-called automatic working of economic forces—markets, prices, private enterprise initiatives, and the like—will bring any substantial improvement in our international position. Then what are we to do?

IV. PROPOSED CORRECTIVE MEASURES

On the crucial and final question of policy recommendations, I think the study here under examination goes off on the wrong track. It does so precisely because of what seems to me to be its major mistake: its conclusion that the U.S. basic balance position will be improved by 1968 without any important change in our present policies. The projected improvement will be large or only rather trivial, depending

on the assumptions chosen, but it will assuredly appear. On my own view, as just stated, this is quite wrong. I think that the data and estimates submitted in the study indicate that our basic balance position is likely to be substantially worse in 1968.

Because of this erroneous conclusion—as I see it—about the prospects for the U.S. balance of payments, nearly all of the chapter on policy recommendations (ch. IX) is concerned not with measures to improve the balance of payments itself, but with ways to improve the international monetary mechanism. Now I agree completely that this mechanism needs extensive revision and perhaps rebuilding, and have stated so in several publications.⁷ But such reforms, however desirable in themselves, do not and cannot offer enduring solutions for protracted balance-of-payments disequilibria. All that any international monetary mechanism can really do, in and of itself, is to provide time within which corrective processes initiated in other areas can work themselves out. An improved mechanism can provide more liquidity, and hence more time, but it is still always only a temporary buffer, a stopgap. Especially in the case of a severe payments disequilibrium which has lasted a long time—is “fundamental”—like that of the United States, improving the international monetary mechanism can at best only postpone the day when more drastic measures must be taken. Indeed, improving it may even act as a tranquilizer, a soporific, and thus allow the real disease to get worse.

I am sure that the authors of the study would agree with these last few sentences. They devoted so much attention to the international monetary mechanism simply because they had concluded that the basic balance deficit would cure itself anyway, or at least improve greatly. If one takes a less optimistic view of the future of the deficit, as I do, then it becomes necessary to examine carefully the measures which are required to cure it. This we shall do next.

As is clear from the data presented in the study (see especially p. 216 again), the essential character of the present U.S. international-payments disequilibrium is simple. Our transactions in merchandise on private account show large and continued export surpluses, and our service transactions come fairly close to equilibrium, but we are very heavy net exporters of capital, on both private and governmental account. These capital exports are where our international deficits chiefly come from. But the Government's capital exports are almost completely immune to the effects of changes in domestic economic activity, price levels, interest rates or other manifestations of either “automatic” or deliberately imposed balance-of-payments disciplines. As to private capital exports, they are not completely immune, but still contractions in domestic activity—such as balance-of-payments disciplines might induce—often tend to stimulate them rather than to discourage them. And in any event, most of our “direct” investments are undertaken on the basis of quite long-run estimates of relative profitability, not of month-to-month or even year-to-year changes.

These two main causes of our international deficits, however, will not cure themselves automatically under the existing circumstances. They must instead be tackled head on. Put summarily, and without supporting argument here, what must be done is to: (1) Exert much

⁷ See my articles in the *Economic Journal*, December 1961; *Science*, Dec. 7, 1962; and (in press) in *Rivista Internazionale di Scienze Economiche e Commerciali*.

greater effort to cut down still farther the foreign currency expenditures entailed in our mutual defense and foreign economic assistance programs, and to reduce the waste they presumably also contain; (2) granting that these programs are essential, and that their total volume should not be cut materially, exert much greater pressure than hitherto on the other "Western" industrial countries (including Japan) to increase heavily their own participation in these programs—both in common equity, and to help avoid the destructive effects on themselves, which a collapse of the U.S. dollar would bring; (3) if the U.S. deficit is not sharply reduced soon, install machinery to appraise and as far as necessary to restrict all new long-term private capital exports by Americans, "direct" as well as portfolio;⁸ and (4) if necessary to make this last step effective, especially by preventing leaks through the short-term markets, impose an appropriate form of exchange control over all purchases abroad by Americans, both of foreign assets and of goods and services.⁹

The stimulation of economic growth and the reduction of unemployment are even more important objectives than curing our international deficits. But there is nothing to prevent the adoption of the fiscal, monetary and other measures appropriate to achieve these objectives simultaneously with the adoption of the measures to cure the international deficits which have just been listed. They are not mutually inconsistent. In other words, there is no fundamental reason why we cannot have economic growth, rising employment, and substantial equilibrium in our international payments, all at the same time.

⁸The proposed interest-equalization tax is an attempt to move in this direction. But the proposal does not seem well conceived. It seems to contain many loopholes; many exceptions have already been conceded, notably to Canada; and its final effect on our international payments does not seem likely to be large.

⁹But withdrawals of dollar assets by foreigners would, of course, be unrestricted, short of an impending complete collapse of the dollar. The third and fourth steps proposed would evoke strong protests from parts of the American financial community. But the international deficit problem is no longer a trivial matter, and it is unlikely to be solved either by neglect or by wishful thinking.

STATEMENT BY ROGER AUBOIN

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1. The report contains a detailed study of the factors that have affected the U.S. balance of payments from 1947 to 1962 and an attempt at projections for the period until 1968 based on various assumptions (chs. I-VIII). A final chapter contains recommendations regarding the international monetary system. The following observations relate to the first eight chapters.

The report emphasizes the importance of Western Europe and Japan for the U.S. balance of payments. Having been personally associated with the reestablishment of European currencies from the end of the war until the restoration of convertibility in 1958, my comments are inspired mainly by the success and failures witnessed in that period.

2. The main lesson that can be drawn from these is, in my opinion, that the development of a country's external balance of payments is influenced primarily by the domestic monetary and fiscal policy that it itself pursues. It has, moreover, been observed that selective measures designed to bear directly on the various items of the balance of payments without any change in overall monetary and fiscal policy have, in times of peace and flourishing international trade, invariably yielded disappointing results.

The detailed study of the factors affecting the U.S. balance of payments between 1947 and 1962 is certainly of very great interest and the report makes many pertinent comments on this subject. I feel, however, that it is hardly possible to draw from these data conclusions about what the position will be in 1968 without taking into account the measures that may be called for in the more immediate future to correct the situation.

In this matter experience has repeatedly shown that if appropriate steps are not taken in due time there is a danger that the situation will sooner or later deteriorate cumulatively. As soon as effective measures are taken, however, the trend is decisively and often spectacularly reversed. The idea, which seems to emerge from the report's conclusions, of a virtually certain, and so to speak automatic, progressive improvement in the U.S. balance of payments appears to me contrary to all the observable facts and for this fundamental reason to be extremely risky, and perhaps even dangerous if it tended to delay the measures that the situation demands.

3. My second observation concerns a factor which has proved to be of the greatest importance in regard to the correction of a persistent deficit; namely, the way investments are financed, which necessarily involves the structure of interest rates. The report does not seem to me to take sufficient account of what has happened in practice in this field in other countries.

U.S. savings are undoubtedly very large. It would, however, be as well to check more closely the assertion—sometimes put forward as self-evident—that such savings far exceed domestic requirements and justify, or even necessitate, the currently observable large-scale exports of public and private capital. The fact that long-term interest rates remain relatively low is not convincing proof of this, by very reason of the measures taken to keep them at that level.

Rather than an excess of savings, the present situation seems to point to an excess of liquidity. The practical problem raised by the persistent deficit in the U.S. balance of payments is precisely that of the flow to foreign central banks of that part of their dollar assets which private holders consider to be in excess of their needs. The existence of a special market outside the United States known as the "Euro-dollar" market is a sign in the same direction.

4. In these circumstances a very close watch would seem called for to insure that bank credit and the possibilities of monetizing the public debt do not exceed the working capital required and that investment, both public and private, is in fact financed by real savings.

In such conditions any excessive export of public or private capital endangering the position of the dollar would be bound to give rise to a natural increase in long-term interest rates—a development that could be a powerful factor in restoring equilibrium, if it were not systematically checked by an easy-credit policy.

In other countries the abandonment of the "cheap money" principle and the return to a flexible credit policy permitting an interest-rate structure appropriate to the circumstances has been one of the essential conditions of success. The object of interest-rate adjustment is not only to eliminate undesirable disparities with rates abroad but also, and above all, to bear in the domestic economy on the over-all equilibrium between savings and investment.

5. The report contains judicious observations on the balance of payments, the strength or weakness of the dollar and the drawbacks inherent in letting the deficit run on indefinitely. Nevertheless I feel that the report as a whole bears the mark of a certain reluctance to contemplate deliberate action to restore the dollar to its position as a currency of unquestionable soundness.

The report is, indeed, based on a number of ideas, put forward as axiomatic, which, in the light of the facts, appear highly questionable.

The first of these is that the need for firm measures to end the U.S. external deficit is incompatible with the pursuit of the major objectives of U.S. policy—full employment, Western defense and aid to underdeveloped countries. The idea that any firm and effective monetary policy gives rise to unemployment and stagnation is not new. It was rife in Europe after the war and recurs at every opportunity. But it is nevertheless at variance with any observation of the facts that is at all objective. To take but a single example, it is difficult to maintain that the spectacular economic expansion of Western Germany has been based on a policy of monetary ease and on the "cheap money" principle.

It is forgotten, indeed, that a firm monetary policy exerts its influence not by "checking expansion" but by maintaining or restoring the necessary link between money and real factors, between the

cheques drawn on the economy and the resources at its disposal. And, to attain the major objectives of U.S. policy, what is needed is not nominal credits but real resources.

6. A second axiom implicit in the report is that a decisive strengthening of the dollar's position runs the risk of creating serious difficulties for other countries which, if the supply of surplus dollars dried up, would be driven either to stagnation or to the adoption of restrictive measures.

It is certainly in everybody's interest that countries that are rich in capital, productive capacity and banking experience should constitute financial centers whose currencies and credits are used throughout the world. The United States is unquestionably in the front rank.

It is wrong, however, to conclude that, in order to play their role, such countries are necessarily bound to incur unlimited short-term indebtedness and thus jeopardize their currencies. Before 1914 the pound sterling was of unquestionable soundness and yet the United Kingdom traditionally held a very small gold reserve. This was because the London market maintained substantial holdings of short-term claims on foreign countries. Its creditor position enabled it to adjust according to circumstances the size and distribution of these holdings at any time by way of appropriate changes in interest rates.

The U.S. net claims on foreigners are considerable, but claims and debts are not well balanced. In that event it is as if final expenditure and long-term foreign investments were financed to an appreciable extent by gold sales and the accumulation of short-term liabilities. That, in fact, is the whole problem of the U.S. "deficit."

But why should such a situation be inevitable? Why, above all, should its correction and the resultant readjustment of maturities and interest rates create dangers for other countries, and primarily for the industrialized countries of Western Europe, which the report says would be the first to suffer?

On the contrary, it is seen that it is the persistency of an excessive U.S. deficit over the last 6 years that has presented the industrialized countries with insoluble problems. They have the greatest concern for a decisive strengthening of the dollar, as they have shown by their close cooperation with the U.S. authorities. The continuation of the present situation puts them, in fact, in a most difficult position and compels them to make a choice between two evils—either to submit to all the ills of imported as well as domestic inflation or, as Western Germany and the Netherlands had to do, not without misgivings, 2 years ago, to raise their exchange rates.

It would undoubtedly be wiser to make all together a bold effort to restore the situation to a sound footing.

7. The report assumes in its conclusions that the U.S. deficit will more or less spontaneously, decline between now and 1968 or even give way to a surplus because inflation and the actual depreciation of money will accelerate in Western Europe while the pace of this process in the United States will be contained, the dollar losing 7 or 8 percent of its value in 5 years while the currencies of France, Germany, and Italy lose more than 20 percent.

The least that can be said is that such a hypothesis is extremely hazardous and that a policy based on it would deliberately carry with it the risk of a dramatic crisis for the Western World.

STATEMENT BY THOMAS BALOGH

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I. INTRODUCTORY AND CONCLUSIONS

1. I have been asked to comment on the momentous publication presented to the Joint Economic Committee, U.S. Congress, by the Brookings Institution, "The United States Balance of Payments in 1968,"¹ materials for consideration in connection with the committee's study of the U.S. balance of payments.

2. That study can conveniently be divided into an analytical part, mainly contained in chapters 1 and 9 and parts of chapter 4, and certain estimates or projections concerning the year 1968 which are contained in the rest.

3. I have no doubt that the statistical effort represented by the main body of the report is the best which could be attempted on the basis of our present statistical knowledge, both theoretical and factual, on the theme of the report. It is nevertheless my considered opinion that the analytical parts of the report show conclusively the fundamental and inevitable weaknesses of econometric exercise and forecast. These, in my opinion, render such statistical efforts, not merely in practice, but also in theory and principle, worthless.

4. On the other hand, I feel very strongly that the analytical parts of the document, and the conclusions to which it comes, are sound, and must be emphatically commended to the Senate, and through the Senate to the American administration and general public. They show an urgent need for decisive action in increasing the international liquidity available to the non-Soviet orbit through a reform of the international monetary system. This seems essential if the weaknesses of the international monetary system, which have become apparent, are not to throttle the much needed effort of the non-Soviet world to match the ever-increasing acceleration of Soviet production. If we take into account the fact that in recent years the absolute growth of Soviet production in terms of American prices was greater than the increase in American production, and if furthermore we take into account the fact that a totally planned system has a much firmer command over the increment of production than a private enterprise system based on markets and individual decision by producers and consumers, the immense danger of this development must be apparent.

5. I am equally convinced that they are sound in thinking that, in the absence of international monetary reform, it will eventually be found necessary to prevent the countries of the Economic Community of Europe² from denuding the world of its liquid resources by some alternative method that would exert direct pressure on their exports. I find it somewhat surprising, however, that the experts of the Brook-

¹ Quoted below as the "report." Washington 1963.

² And any other country or group of countries.

ings Institution have put forward a scheme by which the United States and the United Kingdom would attain this end by performing their rates of exchange to fluctuate toward the European Economic Community. The drawbacks of this scheme are clear. It introduces an added risk in internal trade, a risk which would certainly reduce the attractiveness of investment in those industries which depend for their markets on countries in the other of the two blocs. Inasmuch as trade between the European Economic Community and the rest of the non-Soviet world has very much increased of late, this would be an odd way of stimulating all-round expansion.

6. The proposal, coming as it does from American sources, is the more surprising as it would involve either the violation or profound alteration of the Bretton Woods final act, neither of which would seem to be appropriate for the preeminent power of the non-Soviet world. This is the more odd as it was the unique contribution of the American experts to the wartime settlement to insist on a perfectly serviceable scheme to deal with the emergence of persistent creditor countries. This scheme was the scarce currency clause. This clause provides for the imposition of import controls against the exports of those countries whose currency has become scarce in the fund as a result of their running a persistent export surplus.

7. This clause was ineffectual in the period in which it was the American dollar which threatened to become scarce, because under the rules of the fund it would have taken several years for the dollars in the fund to run short even if all members outside the dollar area had drawn their full yearly entitlements. The arithmetic relations being as they are, the United States and the United Kingdom could within a few months create a situation in which the countries of the European Economic Community would be confronted with an acute dilemma of either having to provide more currency to the International Monetary Fund, that is increasing world liquidity, or suffering a painful cut in their exports against which they could not retaliate.

8. I feel that this provides a much more hopeful pressure point to persuade the countries of the European Economic Community to move forward to such a solution of the international problem of liquidity as would render unnecessary any such brutal interventions in international trade as would be a fluctuating exchange or the invocation of the scarce currency clause.

9. The present paper will deal first with the problem of the concept of the American balance of payments, which is seriously deficient in my opinion, and needs drastic revision. I shall then turn to the problem of the methodology of the econometrics of the U.S. foreign payments, and to the evaluation of the material on the basis of which these estimates actually have to be made; and end up with a discussion of the international liquidity problem.

II. A MISLEADING CONCEPT

10. The present tribulations of the free world due to the scarcity of international liquidity relative to needs, and the consequential embarrassments of the U.S. administration, have been, if not caused, seriously aggravated by the psychological impact of the peculiar and economically misleading concept of the balance of payments now used in the United States. Such is the mechanism of financial statistics that

changes in gold holdings are given wide publicity by a news-hungry press week by week, and, for good sociologico-political reasons, not countered with sufficient energy by those responsible for monetary management. The offsetting changes in U.S. income earning assets are published once yearly and do not receive publicity and attention. Indeed their relevance, even, to the present problem is hardly mentioned.

11. It is obviously in the interest of the managers of the monetary system, the Treasury and the Federal Reserve Board, to be able to assert primacy in decisionmaking for their own field. Thus they tend to give special importance to monetary phenomena, which, admittedly, often reflect and influence the real position, but which on occasion, such as this important case, give a distorted and misleading picture of reality.

12. The two concepts of the balance of international payments as they have been evolved in the United States are not—I repeat, “not”—economic concepts.³ They are purely monetary and banking concepts.

13. Economically both the so-called “total balance,” and the modified “net basic balance,” are hybrids. They consist of certain, and from an economic viewpoint arbitrarily picked, range of payments singled out for special attention, and include both current and capital items. They do not reflect changes in long-run basic U.S. economic strength.

14. The total balance thus embraces “whatever is financed by a combination of sales of U.S. monetary reserve assets and/or increases U.S. liquid liabilities to foreign governments and monetary authorities and to the private citizens of foreign countries.”⁴

15. The net basic balance, though somewhat less arbitrary is equally lopsided. It only excludes U.S. private short-term capital, the flow of foreign capital in the form of commercial credits, and the net errors and omissions. It still represents a mixture of the current and capital balance. It has economically little long-run significance.

16. Now I admit readily that, for purposes of short-run monetary management, both concepts have some relevance. They show the possible impact on the banking authorities of the United States of the increase of short-term foreign claims and loss of liquid reserves, whatever this is due to.

17. But, even from this point of view, they do not represent very useful tools or indexes. For the accumulation in foreign hands of American long-term assets would, in case of a loss of confidence, mean as great or greater a danger to American stability than the accumulation of short-term claims. As was shown after 1931, the liquidation of long-term assets of foreigners can play a decisive role in aggravating the American business cycle. It would not only cause losses of gold but upset the stock markets. The combined effect of an external confidence crisis and a stock market crash would have extremely serious effects on the psychology of U.S. entrepreneurs. Thus even from a sterile banking point of view the concepts now in use in America are incomplete.

18. It is obvious, however, why the concepts of a “total balance” have evolved as it has. It was initiated by the Federal Reserve who regarded the immediate liquidity position from an old-fashioned

³ This is made clear in the first chapter, especially pp. 2-9 of the report.

⁴ Report, p. 3.

banker's point of view, and must have found it very useful in its struggle against what in the last century might have been called "populist," and in this century "inflationist" pressures.

19. From an economic viewpoint, however, and this the report makes quite clear in its homely simile, the concept is misleading. When it is said (p. 4) that on the basis of this kind of concept—

* * * a family whose only transaction consisted of buying a house for cash would have a deficit equal to the price of the house; one which financed the purchase wholly by a mortgage would have no deficit.

One would have thought that this would be enough to settle the matter. On the basis of the type of policymaking and statistics on which the U.S. balance-of-payments concept has been evolved, modern banking could not have developed in London in the 19th century. This was only possible because the rigorous 100 percent gold cover for bank notes of the Bank of England was in fact superseded by the emergence of deposits at the Bank of England as the basis of the credit structure of Britain, and, at that time, the whole world. If the Bank of England liabilities had been scrutinized on the sort of basis on which the gold reserves of the United States are now scrutinized, and compared with changes of various liabilities, the Bank of England would have been confronted with an immediate run, and the expansion of the world economy under the leadership of Great Britain would have been brought to a halt.

20. What is one to make of a concept which calls it a deficit when the United States surrenders gold or low interest rate bearing liabilities in exchange for assets yielding, according to the Department of Commerce, well over 15 percent per annum? Even President Kennedy's recent statement, which recalled vigorously the immense strength of the United States, grievously understated that strength. It quoted the value of American direct investments abroad as only \$35 billion. This represents their book value, in which, one presumes, the whole Holden Car Co. of Australia assets of General Motors, worth tens of millions, would figure as a few million dollars (mainly represented by used machine tools).

21. In the long run, and unless we expect a wave of depression and liquidation akin to the 1929-33 depression, the U.S. international economic strength will be determined by its basic economic capacity, i.e. its current balance consisting of goods and services and private remittances. Private long-term capital investment, Government capital grants, and even short-term capital movements, may disturb the basic picture, may lead to banking embarrassment, but ought not to obscure the fundamental and overwhelming economic strength of the United States. It is true of course that long-term capital export increases the positive U.S. current balance. But it is certainly not true that their decline or purposive cut will lead to an equal decline in the current surplus. This is especially the case of portfolio investments and short-term capital movements which have to a large extent been responsible for the loss of gold (and the accumulation of short term liabilities). The present U.S. concept of the balance of payments is a reflection of the attitude that nothing can or must be done directly to strengthen the liquidity position of the country, e.g., by limiting outflows of capital which do not serve to increase U.S. economic strength. The differential taxation on foreign portfolio investments

was the first, rather timid, breach in this principle. It still has not been applied to banking transactions. The inference is that U.S. current surplus should be adjusted to this outflow. As we shall see, this would have serious implications on the steadiness of growth at home and abroad.⁵

22. It is essential that this truth should be learned by those who are responsible for the administration of American policy, for it is the unwarranted inferiority complex which has beset American decision-making in the last few years that has made the American policy sound like an uncertain trumpet. This is not justified by any sane economic analysis which lifts its eye beyond the narrow horizon of the petty counting house. I venture to claim that the American position is one of immense potential strength, which will become evident unless short-term and short-sighted banking considerations by artificially damping down activity prevent that efflorescence of American technical ingenuity and superiority, through innovation which has been the basis of the vast exports of manufacturers, especially capital goods. Indeed, the further disproportionate increase in American relative strength, the immense increase in the liabilities of foreign countries to the United States, and the recurrence of a dollar shortage, due to the cumulative increase of the U.S. income from foreign investment, is a far more basic menace to the evolution of a well balanced and more equal unity of nations in the non-Soviet orbit.

I feel very strongly that this basic truth should be brought out clearly in American Government statistics which have been rather masochistically managed to reflect an ebbing of the American gold reserve week by week, instead of emphasising the immense increase day by day in American wealth and productive power at home and abroad.

23. My analysis will show that a great deal of the short-term embarrassments of the United States have been caused partly by the sociological situation abroad, especially in Western Europe, which results in a need for certain countries to run a persistent export surplus and to accumulate liquid reserves in order to maintain growth. This need is not mechanically determined but depends on the social and political framework and therefore on the range of policy means available to the main countries of the Western World. Partly it has been due to (the related) fact that the capital markets in Europe are much more imperfect (and therefore costly) than in the United States. Both surely could more properly be dealt with by a reform of the international monetary arrangements as both are essentially liquidity problems.⁶

24. Even Mr. Rueff, an apostle of the primitive laissez-faire school of the 19th century, has grasped this basically and politically determined need for greater liquidity which is the ultimate cause of the deterioration in the American balance of payments which is now so deplored. His suggestion of an increase in the price of gold reflects a saner appreciation of the causes of our present discontents, even though it is the stupidest way of meeting the demand for higher liquidity, benefiting Russia and South Africa, i.e., countries which have no special claim to international charity. I do not claim that a mere rectification of a statistical blunder would result in allaying

⁵ Cf. below, par. 45 and following.

⁶ Cf. below par. 95.

the baseless fears about the dollar but it certainly would be an important, if not a sufficient, condition of the victory of saner views.⁷

III. A FALSE MEASURE

25. The main body of the report consists of an attempt to forecast, on the basis of a precise system of quantitative relationships, the probable change in the balance of international payments of the United States between 1961 and 1968. These estimates include not merely visible trade but also invisibles, such as even interest, dividends, and other services.

26. This exercise follows the present fashion of econometrics in deriving extremely simple, yet precise quantitative relationships between complex macroeconomic factors on the basis of a relatively short period, 1948-60, without any attempt at a serious analysis of the impact of structural change and evolving political attitude, both within that period, and in the future period that is to be studied, on the probable evolution of these factors and thus on the balance of payments.

27. It is the report itself, especially chapter 2, which reveals conclusively the basic methodological weaknesses of this method whose consequences add up to a complete lack of scientific sense in the result. Whatever the relationships eventually turn out to be in 1968, the one thing which we know is that it is in the highest degree improbable that they will be the same as they were in a past period, such as 1948-60.

28. These basic weaknesses, so well brought out by the critical discussion of the report itself, can be subsumed into three groups. There is, first, a paucity of factors taken into account. This results in the well-known logical fallacy of false concretisation. The second is the paucity of observations as contrasted with the violence of the structural change.⁸ Finally, there is a lack of meaningfulness in some of the statistical material used.

29. One might suspect that this attempt at econometrical forecasting is due to the passionate desire of economists to eschew political controversy by becoming, or rather by appearing to become, "scientific" and "objective," by refusing to discuss sensitive topics and restricting themselves to "quantitative analysis." The refusal to discuss structural and institutional change, to take into account technical dynamism and socioeconomic policy renders these constructs of no heuristic value. But the authors, priding themselves on the elegance of the construct, can confidently count upon academic advancement on the basis of reciprocal admiration, completely divorced from the utility of the procedure.⁹ If economics were dedicated to the construction of rather primitive mathematical equations systems, and did not claim

⁷ What is one to make of a policy which tries to sell American assets likely to appreciate immensely, in order to stem the loss of gold? On the basis of this type of concept the Chase Manhattan Bank would be adjudicated completely bankrupt, burdened with "deficits" as its deposits increase, as it will not increase its liquid reserves by more than a fraction of the new liabilities incurred; yet it is the basis of its earning capacity that it should not so increase its reserves.

⁸ This fallacy has already been committed by the author of the present equation systems, Mr. Polak, in his previous studies, e.g., "An International Economic System," and also mars the work of Professor Tinbergen. The "world multiplier" which Mr. Polak then established has already gone astray. The indefatigable production of models, however, keeps turning up fresh fallacies, and the role of the critic is reduced to trotting breathlessly after the last pseudomathematical hare, having shot the previous one.

⁹ Indeed the failure of these constructs instead of leading to their discard has given rise to laudatory explanations of the failures.

any insight into reality and assert its right to make recommendations, this pride in the mathematical "accomplishment" might be forgivable, if ridiculous. As it is, the claims are preposterous and the procedure scientifically indefensible.

(i) *The paucity of factors*

30. The future evolution of the imports of the main power groupings in the Western World are estimated on the basis of an equation which contains the income of the importing country and relative prices in the importing and in the exporting countries. It should be noted that the value of imports of any one grouping does not seem to be influenced by the income of all countries but only by the income of the importing country. Yet it is clear that the increase in income in an important country will have immediate repercussions in other countries (as is acknowledged in appendix of ch. VI),¹⁰ and the cumulative processes which might be started would have momentous effects reversing the initial charge. Moreover, income of the importing country will mainly influence imports through its relation to productive capacity, and its growth, and through the rate of innovation which brings this growth about.¹¹ Therefore, the movement of income (and demand) will have a disproportionate impact as full employment is approached—if the dynamism of the system is insufficient to stretch productive power. The linear relationship postulated has no relevance to reality. Moreover, it is quite illegitimate to use relative prices as an index of competitive power, a fact to which reference will be made below.¹²

31. Thus the equation system used cannot, by any stretch of the imagination, be said to be a "model." A model, after all, means an image, in simplified form, of something which exists in reality. Mr. Polak's equations, like most of Professor Tinbergen's before him, do not qualify.

32. As we shall presently demonstrate, the balance of payments will be influenced by a great number of factors, themselves unstable and reacting on one another. The relationship between members of the non-Soviet orbit—even if one does not accept the report's simplification grouping them into only three sets of countries (the United States, Western Europe, and the rest) but admits some independence among leading nations within each—is one of reactions not among the many but among the few. It is a typical problem of oligopoly, the outcome of which only can be gaged by a shrewd political guess at the character of the game played between the countries, the aims of the main participants, and the means at their disposal. It is a question not of mechanistic extrapolation of relations experienced; not of equations derived from a historical past with which the present has little, and the future hardly any, relationship; but of a problem akin to a game in which action and reaction in a changing structural framework and sociopolitical content affect the nature and rules of the game and the purpose of the participants. The attempt to quantify it leads merely to ridiculous simplification and misleading forecasts which pay little attention to the consciousness of macroeconomic decisionmaking, and the consequent changeability of economic relations, indeed of the economy itself.

¹⁰ See also W. Beckerman (*Econometrica* 1956).

¹¹ Cf. below sec. III, pars. 36-40.

¹² *Ibid.*

(ii) The paucity of observations

33. Far graver even than the neglect of a great number of important factors is the choice of the period on the basis of which the extrapolation has been made. This period, 1948-60, even if it had been relatively untroubled and showed no basic changes, would be far too short to gather any conclusive evidence for such complex relationships as the balance of payments. Anyone who merely reflects how physical laws are elaborated and tested would marvel at the audacity, or absence of scientific responsibility, of statisticians and econometricians who wish to put forward claims to have established a relationship stable enough for long-term extrapolation, on the basis of 12 yearly observations.

34. And what 12 years they were. They saw the fall of the British share in world trade by more than a quarter, the rise of Germany's portion from practically nil to preeminence, the recreation of Japan as an industrial exporter, the rise of France, after a long eclipse, as a first-class industrial power, its balance of payments first menaced then supported by an innate craving for security and savings. It saw the emergence of Italy from a state of devastated underdevelopment, characterized by "The Bicycle Thieves," to a first-class industrial innovator. It saw the relentless improvement in the terms of trade of primary producers in its first quarter, which led frantic econometricians to pronounce weightily on the irresistible secular movement against the fully industrialized countries.¹³ Hardly was the ink dry, when the wind of change blew away the paper and the forecast. An improvement of the prices of manufacturers set in which has in its turn been elevated into another law, only to be challenged by the impact on prices of the immense purchases, by the two Communist worlds, of sugar and wheat, to be followed by who knows what else tomorrow. New secular econometric laws are nevertheless pouring out relentlessly from universities, foundations and institutes, the most typical products of the affluent society.

35. The dynamism of change through innovation, through the sharp fluctuation of the availability of supplies relative to demand, the immense political changes which first reduced trade union demands in Western Europe only to let them flare up without the restriction of self-discipline, which might have resulted from free acceptance of the dignity of the worker, and which led to an accelerated rise in wages, which might yet bring hope to Britain and America, all this has fundamentally changed the very character of the international economic relations and the problems of the free world. To form a continuous time-series of data referring to such completely different situations and manipulate them gaily is like adding apples to pears, and finding the answer in terms of elephants. It is devoid of meaning.

(iii) The meaninglessness of statistics

36. This brings me to the next point. The report, and especially the appendix to chapter 3, shows how little trust can be put in index numbers of certain magnitudes, especially prices. The problems of weighting, the changing composition, the different impact of demand relationships, make export price indexes uncertain reflections of the basic position. The difference between the alternative results¹⁴ are

¹³ Sir Arthur Lewis, "Manchester School": Colin Clark, "The Economics of the 1960's."

¹⁴ Report, p. 270.

sufficient to reverse various conclusions arrived at on their basis.

37. This would be true even if prices were a significant indication of competitive power, and thus, of the export potential. They are not. Machines and durable consumer goods in particular have become an increasingly large part of foreign trade. In this context, comparisons of prices paid, even if some sense could be attributed to the index number, mean less and less. The American imports of small European cars were not due mainly to price but to convenience and taste. The impact of the Volkswagen, now almost irreversible, need never have happened had American compact cars been available. Competition with America in machine tools in third markets depends on the general attractiveness of foreign machine tools and not merely on price. Availability, knowledge, delivery periods, credit, servicing, and above all quality, the embodiment of new technical knowledge, these and not merely price are the determinants of competitive supremacy. To neglect this is to neglect the change of modern techniques.¹⁵ How little reliance can be placed on such confident predictions is shown by the resilience of British and German exports in 1963, after confident "econometric" predictions to the contrary, and demands for devaluation in one case, and assertions that the German revaluation worked.

38. The model of the American balance of payments reminds one of the bucolic days of Smith and Ricardo when port wine was exchanged for woolens. And even then a change in tastes, a refinement of quality, might have destroyed the simplicity of the vision. Modern techniques of salesmanship, the subtle playing on human frailty with style, status symbolism, and changes in taste, all these render the flat-footed equation system wholly irrelevant as a scientific basis for a quantitative forecast.

39. All these observations are of course derived from the report itself, which is only too overtly critical of the task that was imposed upon its sophisticated authors.

40. I would, however, mention in this context the mechanical way in which the report ¹⁶ deals with the problem of the need for reserves. As we shall discuss in the following section, this cannot be derived in any rigid proportion from the growth of trade. Indeed the report itself shows this by its brilliant analysis of the reciprocal relationship between the EEC countries and the United States in the game for gaining reserves. All other countries—whose trade obviously increased immensely—have remained quiescent in their demand for reserves. The pressure of their expansion was sufficient to increase their imports as soon as an improvement of exports permits it. It is fascinating that the report, which analyzes so closely the relationship between policy and the reserve requirement, should, in its practical application of this lesson pay so little regard to the dependence of the whole problem on deliberate policy. Truly the stormy desire for nonpolitical objectivity can be said to have overwhelmed scientific self-criticism.

IV. THE NATURE OF THE INTERNATIONAL MONETARY PROBLEM

41. The report gives tantalizing glimpses of an acute perception of the nature of the international economic and monetary problem

¹⁵ Cf. the brilliant demonstration of Dr. T. Barna in *The Times* (London) Aug. 12, 1963.

¹⁶ Report, p. 234 *passim*.

concerning the non-Soviet world. Unfortunately these glimpses, however deep the insight they show, are glimpses only, and one does not have a positive statement of the nature of the challenge confronting us. Yet only such a statement would give us a solid and satisfactory basis for policy recommendations and the outline of a solution.

(i) *The historical needs of the non-Soviet world*

42. Before I embark upon this task I should like to call attention to the political framework within which this solution is to be sought. The dominant fact of the world today is the rise of an alternative socioeconomic system, the totally planned economy, which has proved to be on the industrial side more dynamic than our own, even though in agriculture it has as yet not been able to provide any solution at all.

43. The advance of Russia (already before automation became a practical possibility there and after the sputniks and luniks, who can doubt Russia's capacity in that field?) was astonishing. Even at a very low estimate it must have been 6 percent per annum, or a multiple of the West European achievement which in turn far surpassed the recent record of the United States and Britain. Only Japan has paralleled this exploit.

44. This has created a most intriguing situation in the world economy, unparalleled in history. While in the non-Soviet world the increase in the comparative ease of producing agricultural commodities in fully developed areas has surpassed even industrial progress, in Russia the reverse has happened. Isolated as they are by a complete Government monopoly of foreign trade, this has as yet had no impact on our markets. It is clear that a menacing situation is being built up for those fully industrialized countries which are deficient in primary goods. At some point, the Russians will realize the handicaps imposed by climate and soil on their capacity as agricultural producers and will turn to a full exploitation of their newly established industrial prowess. At that point tremendous and extraordinary changes will come upon the Western World. The American capacity to produce primary goods will then reassert her primacy in exports and the intractable farm problem will prove to be the most powerful single element in buttressing the American balance of payments.

45. Nothing strikes a detached foreign observer as more tragicomic than the attitude of American writers and politicians to the miracle of the bountifulness of American agriculture. Instead of buttressing and treasuring it as a possible main source of help to the underdeveloped world, and thus an assured basis of American influence, the most desperate attempts are made to undermine American productive power which in the long run will, in my opinion, prove the most important single factor of strength in the American balance of payments. Once Russia begins to trade in primary produce the change in price relations might be as startling as it was with sugar and is about to be with wheat. In the meantime, the careful husbanding of this priceless asset enables America to play a role in aiding poor countries corresponding to the dignity of her political pre-eminence.

46. It should also be noted, however, that the industrial prowess of the two Communist worlds will have most unfortunate effects on fully developed areas if industrial progress is to be interrupted by

restrictive policies imposed upon the individualist system working at the risk of single entrepreneurs and firms. It is an essential political precondition of Western survival not to permit any interruption of steady progress in economic matters. It is from this viewpoint that the present situation must be regarded. The contemporary fashion has reverted to an excessively simple view of the nature of the working of the international monetary system. At the same time they condemned any rise in prices in the gold-gaining countries. This was due to consequences of the rising prices which have been experienced ever since the end of the war. Thus a limping readjustment, solely by the gold-losing country would result with disastrous effects on the expansion of the non-Soviet world. Attempts by the United States to match the capital outflow by an export surplus might well be effective. Certain changes in most EEC countries seem at present to encourage it. On the other hand, any cuts in defense expenditure and aid would obviously create pressure, in the latter case especially, in the most vulnerable part of the world economy. But even an increase in exports, if it is brought about by displacing those of others, would exert a net deflationary impact. The U.S. capital outflow is in the nature of a banking transfer and does not increase demand outside the United States, while the improvement in the current balance will actively depress it.¹⁷

(ii) *Reserves and the functioning of the international payments system*

47. The basic view of most practicing bankers and Treasury officials of the relationship between reserves and the system of payments is an exceedingly simple one. On the one hand there has been a surprising resurgence of the belief in that it is now fashionable to call the Hume mechanism international balance of payments; on the other hand, a mechanistic way of determining the need for reserves has got about which is based on a rigid relationship between the total volume of payments and the reserves held. It seems as if the Keynesian revolution in this respect, as in so many others, has completely passed way, leaving little enlightenment behind it, because even the new techniques which have surged up in its wake have now crystallized into the sort of formalism which was the reason for the basic discontent and revolt of Keynes.

Let me take these two points one by one.

48. The system or mechanism on which the policy precepts of orthodox bankers and Treasury officials are based is derived straight from the classical "two country model" of the world economy: If monetary circulation in one country rises above the "legitimate" level, prices rise and specie flows out. The rise in prices is automatically checked through the diminution of the means of payment. In the other country—originally having "low" prices—on the other hand, prices rise as a result of the inflow of "bullion." Thus equilibrium is restored and the volume of reserves in both countries automatically attains "equilibrium" level. Provided convertibility of the currency into gold is maintained and provided no budget deficit is allowed, all will be well. Most continental central bankers of the orthodox type. (Professor Hol-

¹⁷ Compare below, par. 95. Thus a restriction on capital outflow would be the only appropriate U.S. measure. This would not affect demand.

throp of the Netherlands, for instance) really hold this viewpoint, even though on cross-examination they would stoutly deny belief in such primitive doctrines.

49. The "model" on which this theory is based, of course, leaves out of account—

(a) the dynamism of the system; and both reserves and economic activity, including international trade and payments, are increasing (with some interruptions due to cyclical fluctuations themselves engendered by the failings of the monetary mechanism);

(b) the fact that import surpluses tend to damp down demand and export surpluses tend to increase demand in the countries experiencing them.

50. Thus for any given historical moment exports and imports will be related to—

(i) the relative money income at home and abroad;

(ii) the relative price at home and abroad of goods and services which enter international trade, which again will be related to;

(iii) the relation of demand to productive capacity at home and abroad, itself strongly influenced by the rate of savings and investment at full employment level (or by the rate of investment below that); and finally

(iv) the policies of the dominant countries.

51. It should be noted that the relative income at home and abroad is inextricably related to price. Equally, the interaction between price, income, and demand will differ according to the historical configuration of a particular situation, because international trade and the money economy make prices depend not only upon current supply and demand but also upon price expectations. Thus stability itself becomes codetermined by historical antecedents. This introduces a second fundamental kind of indeterminacy.

52. The "equilibrium theory" postulates that if all individuals take the right decision in some sense in a competitive framework, equilibrium and optimum will prevail. This presupposes that there is an independently given and determinate set of right decisions. But there is no such set. What will happen depends on what people do now, and what people do now depends on what they expect to happen, which in turn depends on what has happened in the past. Where prices are the function of price expectations, the optimum is not only clouded by the ignorance of the future, but it is indeterminate. Finally, as we saw, all this is related to accumulation and technical progress which are also historically determined.

53. The assumption that international trade is conducted by individual firms, with the role of the monetary mechanism being restricted to transmitting automatically impulses originating on the "real" side, depends on the acceptance of the existence of rigid rules governing that mechanism. This was, perhaps, accurate, in the first instance, with a coin standard. So long as central banks were "politically" independent, and merely registered gains and losses of gold, the Hume mechanism could still be thought of as, to some extent, effective. It was already being increasingly modified by the differences in the "efficiency" of using gold, the rate of growth of international liquidity (gold and formerly also silver), and the rate of

growth of capital (which was considerably influenced by it). This phase of development had already ended before 1914, even in Western Europe—and in large parts of the world it was inapplicable even earlier. Since the First World War the theoretical framework became completely at variance with reality. Conclusions based on it are thus fallacious.

54. When monetary and fiscal policy becomes subject to volition, single producers and consumers in any one country will be affected in the same way (though of course not to the same degree) by those policies, and their actions will come to depend on those policies. The rigid framework of the quantity theory disappears. Consequently, countries rather than microeconomic entities, entrepreneurs, become the proper object of study.

55. Once it is recognized that the first effect of changes in international trading will be on countries (through their balances of payments) and it is countries that will react, the whole problem appears in a new light. If the relationship of individual producers in highly developed areas cannot be analyzed in terms of atomistic, perfect competition, how much less is it applicable to relations of a very restricted number of countries to one another, each of them exporting a more or less limited specialty of products of which it is an important supplier.

56. The reaction of a country to, e.g., a balance-of-payments deficit, will be determined partly by the automatic effect (both price and income) of that balance on domestic economic affairs, partly on the deliberate reaction of the government (including the central bank), and the degree of its liberty of action.

57. The latter will be influenced by—

(a) the principles of policy pursued; to what extent does the government of the given country want, for example, to—

- (i) stabilize employment;
- (ii) maintain reserves;
- (iii) maintain the stability of prices;

(b) the latitude of choice open politically to the governments concerned among policy means in carrying out their policy, e.g., whether they are restricted to "global" monetary controls, or capable of instituting direct controls;

(c) the degree of dependence of the country on foreign trade (because great dependence might make compensatory policies difficult, if not impossible) and on the relative availability of liquid reserves.

58. Generalizations will be difficult. It might be suggested that if the majority or the most powerful and economically independent countries are bent on (a) (ii) or (iii), i.e. do not primarily aim at maintaining employment, a deflationary bias is likely to be imported to the world system as a whole. It is, generally speaking, easier to enforce deflation than employment stabilization. The risk of losing all reserves before the world situation changes is obvious and immediate. There are no obvious and immediate financial risks incurred by toleration or promotion of gains of reserves. The risk consists of forgoing growth and that will become obvious in the longer run only and responsibility for it can be explained away.

59. It takes deliberate action to counteract a gain in reserves by an increase in demand when the world as a whole suffers from deflation;

from a general deficiency of demand; while passivity will probably lead to further gains. Thus in an oligopolistic struggle or game situation, the ultimate retreat will always be toward maximizing reserves and minimizing gold losses. The traditional language which talks about the "strength" of currencies, the need for "conserving reserves" and which greets the inflow of gold as a favorable balance, and the exchange of non-income-bearing gold for high-income-bearing assets as a "crisis" will strengthen this bias. It could be overcome but probably only by supranational action.

60. We may conclude therefore that the impact of foreign trade on the development of weaker countries will depend—

- (i) on the relative size and character of the leading country (i.e. whether it is foreign trade sensitive);
- (ii) on its economic policies, especially whether it is primarily aiming at stabilizing reserves or employment;
- (iii) on the intensity of technical progress and its bias relative to international trade;
- (iv) on the absolute magnitude of comparative cost differences;
- (v) on the existence of international agreements or institutions to mitigate international inequality through increased investment in poor areas, and adequate means to aid them.

61. It will depend on the same factors how much international liquidity will be needed for international stabilization of employment and growth.

62. So long as Britain, with its great international sensitivity and sluggish industrial performance, was the leading financial power, the need for liquid reserves was less than in a world in which the United States is dominant, and these in turn may be less than those required in a world in which the EEC power achieves a dynamically commanding position.

63. It is obvious that the need for liquidity is a combined function of—

- (i) the size of likely balances, that is, of the volume of international payments, and
- (ii) the magnitude and duration in which exports and imports can differ from one another.

64. Fundamentally, both are determined—

- (i) by the social framework and thus by differences in policy concepts and priorities between leading members of the international system;
- (ii) by differences in their dynamism and also on the rate of technical change experienced by the system as a whole; and
- (iii) by the nature of the dominating country of the system in its relation to foreign trade. The larger the country the more naturally or artificially self-sufficient it is, that is, the greater its national economy and investment relative to its international transactions, or alternatively the less willing it is to tolerate a rise in internal demand, the greater will be the likely balances that will emerge in its relation to the world as a whole.¹⁸

65. It should be noted (and the report has noted it), that a very

¹⁸ I demonstrated in 1946 in criticizing Keynes (Bulletin of the Oxford University Institute of Statistics reprinted in "Unequal Partners," Vol. II, Essay No. 12) that the change of the dominance from the United Kingdom to the United States would require far more reserves than were made available by the establishment of the IMF. This demonstration was amply vindicated by the 1947 crisis. Fortunately U.S. statesmanship saved the non-Soviet world from the consequences of the failure of Bretton Woods.

large proportion of total trade and payment is concentrated among a few major powers. The number of these effectively independent systems is further reduced by groupings. The more—

- (i) complementary, i.e., self-sufficient, the regional grouping;
- (ii) the freer it is in its choice of policy means¹⁹ or, alternatively;
- (iii) the less determined it is to achieve policy aims of a progressive character, for example, the maintenance of full employment;
- (iv) the more the policy aims are shared by the rest of the world, the smaller is the need for reserves.

66. Shared policy goals, whatever their character, that is, whether a "progressivist" desire to avoid unemployment or an orthodox refusal to tolerate gold losses, will reduce the need for reserves of the system. The conventional thesis that the pursuit of "sound" policies all round would reduce the need for reserves is quite accurate. It amounts to the basic principle that countries will not attempt to maintain employment if some powerful ones refuse to do so.

67. If, on the other hand, full employment is a universally declared policy, and governments are able and willing to intervene promptly in case of a deflationary or inflationary shock by all appropriate means, including controls and fiscal policy, the minimum safe levels of reserves will be far smaller than in a system in which prolonged unemployment is tolerated (or even induced, in order to insure price stability) in dominant countries while others try to avoid competitive deflationary policies. A system which freely permits capital movements, even if they are of a speculative nature, will, under modern conditions, require far higher reserves than a system where speculative capital movements are severely discouraged. It is the volume of payments and instability, and not merely that of visible trade, which is the rational determinant of reserve requirements.

68. Countries will trim their behavior to one another. The discouraging feature of this relationship is that, so long as international reserves are scarce, behavior which will induce gains of gold will be at a premium, because severe losses of gold must induce others to follow suit in such policies (the recent behavior of European countries when the United States was embarrassed by gold losses is an excellent example). Thus scarcity of reserves is likely to aggravate itself; and uncertainty about strong countries' monetary strategy would have the same result. Safety first would counsel deflation.

69. There is a further reason why it is only too likely that the system will have a bias against full growth and employment and in favor of avoiding gold losses at whatever cost in terms of expansion. Under modern conditions adherence to the "classic" rules which demand symmetrical expansion as well as contraction might seem incompatible with domestic stability, especially price stability. If the problem of domestic inflation cannot be solved by policies not impinging on the balance of payments (by their employment effects), a balanced functioning of the world payments system will not prove possible. Any increase in reserves will then represent a deflationary impact abroad because it originates in a cut in demand.

70. If reserves are kept in assets of another country total international liquidity is increased, as the accumulation of gold exchange is

¹⁹ E.g., prepared to apply direct controls on imports or capital exports.

the alternative to acquiring gold. This introduces a further complication because the acquisition of these assets (instead of gold) has a (relatively) inflationary impact, their repayment a deflationary impact. If the former happened in a situation of all-round full employment, and if the financial center disregarded in its policymaking the increase of its liabilities, the process might facilitate general inflation. This danger has been much emphasized. Less attention was paid to postwar waves of liquidation of gold exchange reserves. This happened at almost regular 2-year intervals in the case of Britain, and contributed much to the severity of the balance-of-payments crises which caused interruptions of expansion in this country. There has also been at times some liquidation of dollar balances. If this process were to gather momentum it might well result in a general deflationary pressure.

71. An overall shortage of liquidity will make itself felt by simultaneous pressures on the reserve position of a number of countries while no major country deems it advisable to permit the loss of gold reserves in accordance with the "classic" rules of the gold standard.

72. This might force deflation on a number of others to prevent their losing gold. An oligopolistic struggle might arise; attempts at increasing reserves would cancel each other. The reserve position of individual countries would not improve. But the general deflationary pressures would leave all worse off in terms of increased unemployment and fallen national incomes. The costless provision of additional reserves, e.g., by an increase in the price of gold or the creation of additional internationally accepted means of payment, would then be the proper response, which should be contrasted with efforts of single countries to raise their reserves by attempts at redistributing existing reserves. On the other hand, no amount of additional reserve can be "sufficient" if the losing countries continue policies which lead to deficits in their balance of payments.

73. If the rate of increase in international liquidity permits the achievement of full employment, any further increase of reserves must be sterilized to avoid inflation. At this point some rules of discipline will have to be evolved stabilizing the rate of investment and consumption.

74. The holding of "own" reserves (in contrast to standby credits) might be confined to richer countries. Their redistribution between "richer countries" through international lending operations, and from poorer to richer countries through permission to use reserves for an increase in investment, might be used to speed up development in poor areas and concentrate burdensome reserves in the hands of rich, and, possibly, of middle-class countries, which can afford them. Thus an international cooperative reform of reserve policy would have contributed to the equalization of the rate of investment and growth, while minimizing the overall need for reserve holding.

75. Thus a balanced system would seem to require an international agency which can exert an impartial influence against both deflation and inflation.²⁰

(iii) Historical reflections

76. These considerations make it plain that the need for reserves, and, hence, the policies affecting balances of payments of the non-

²⁰ The Keynesian Clearing Union and certain of the new reform proposals (e.g., Professor Triffin's) because they are mechanistic, suffer from an inflationist bias.

Soviet orbit must have undergone startling changes since the end of the war, and that therefore a mechanical extrapolation of the need for reserves on the basis of a rigid relationship between them and the volume of payments can yield no valid results.

77. In the first period after the war when Anglo-American illusions about the nature of the postwar monetary problem were still rife, reserves sufficient to assure stability on the basis of convertibility and nondiscrimination would have been vast, far greater than at any time before the war when world monetary dominance was shared between the United States and Britain. This followed from the fact that the United States was in itself a regional block buttressed by natural self-sufficiency due to the riches and variety of her natural resources and the ingenuity of its people. This was reinforced by an effective system of protection, of which tariffs formed only one part. Automatic reactions to fluctuations in her balance of payments would be negligible; her monopoly in industrial and primary production at that point of time was overwhelming.

78. Critics of the Bretton Woods agreement, of whom I was one, forewarned that breakdown of the system was inevitable as the vast balances were likely to emerge which could not be met unless mass unemployment was to be tolerated in the weak areas. This appreciation of the future was completely vindicated. Despite the very large American loan to Britain and the generous help which had already been given to the rest of Europe in this phase, the postwar monetary settlement broke down completely and irrevocably in 1947. The loan to Britain which was to suffice for years was exhausted in a matter of weeks, if not days.

79. American statesmanship acknowledged this breakdown and revised policy. This revision reduced the need for reserves in Europe by permitting discriminatory policies which would favor self-sufficiency and reduce the possible deficit in the trade with America. In addition the momentous organization of Marshall aid, a unique gesture of generosity in peacetime, enabled the European powers, as it did later Japan, to make full use of these policy possibilities. Thus the vast American surpluses on current account were met without denuding still further the reserves of the penurious countries.

80. The present phase of relative stagnation and unbalance in the Anglo-Saxon countries was ushered in by the Korean war and unfolded itself fully when the American policy through Marshall aid proved successful beyond any expectation in restoring the productive power of Western Europe and Japan. From about 1952, the American outpayments exceeded inward payments and the vast accumulation of gold, the result of the war, was redistributed. The fully developed countries outside the United States were further permitted to replenish their liquid currency reserves by an increase in their holdings of liquid dollar assets. This increase in dollar assets ipso facto increased international liquidity. This process bears out the statesmanlike attitude in international economic affairs of the U.S. Government after the short period, between 1944 and 1947, of dominance of irrelevant dogmatism. Until 1957 the increase and redistribution of liquid reserves through U.S. policies did not cause any weakening of confidence. On the contrary, even the most conventional greeted it as a healthy process that would enhance the capacity of the free world to accelerate its economic progress.

81. This was not to last. Since 1957, the dollar has joined sterling in being "talked about" and, as we have said already, this was very much encouraged by the unfortunate presentation of the American balance of payments by the monetary and financial authorities of that country.

82. With the recover of Western Europe and, more especially, with the encouragement of the formation of a European Economic Community, in which the American administrations have taken a leading role, a new and sinister phase of the monetary history of the non-Soviet world opens. In Europe, too, a relatively self-sufficient vast natural unit is being built up. It would be self-sufficient even without much artificial buttressing. Substantial artificial buttressing, however is only too likely; partly because it will be profitable for a large number of vested interests and partly because this bond is politically useful if not necessary to accomplish the difficult process of integration.

83. The domestic economic activity of the countries of the Continent, once united, will (like the United States) not easily be affected by changes in foreign transactions. Moreover (and far worse than the United States) they have a sociopolitical bias against expansionary readjustment, a bias which has not altogether disappeared, even when full employment has been reached as a result of a long period of export surpluses. While this has strengthened the trade union movement in these countries, it has been—as yet anyhow—insufficient to reverse gold flows.

84. This socio-economic bias comes from the accelerated growth, in itself due to an unequal distribution of income, favoring profits. The devaluation practiced by the three main countries of EEC, Germany, Italy, and France in that order, enabled these high profit margins to be established through foreign trade and in each of these countries trade unions were hampered in their efforts to readjust the situation. In France, General de Gaulle's victory, in Italy the existence of a large unemployed labor reserve, and in Germany the flow of Germans from the East, and, more recently, organized immigration from the poverty stricken countries of southern Europe, enable the employers to keep wages in check. At the same time the high investment rate and technical progress resulted in very sharp rises in real wages without endangering the balance of payments. This reduced the urgency of trade union demands.

85. The upshot was that until recently employment and growth was maintained by export surpluses. Thus demand was not maintained by internal expansion, by a rise in wages and thus of imports. The advantages of this system to the entrepreneur are obvious. The external competitiveness of the economy can be taken for granted. Optimal sized plants can be established despite the fact that internal demand is relatively low because wages are low. But low wages buttress competitiveness and assure high profit margins. Relatively little risk is combined with high profits. Saving and investment are high and thus the workers also benefit by the rapid rate of advance of productivity and real wages. This reduces the pressure for increases in money wages.

86. Effective measures by the United States and Britain to reduce their loss of gold, or prevent an increase in foreign liabilities would

inevitably strike a body blow at the basis of Western European prosperity. We already see that the relatively minor measures taken by the Anglo-Saxon countries have resulted in violent reaction in terms of restrictive policies both in France and in Italy, reminiscent of those taken in Britain in really critical situations, with the reserves far less relative to obligations than the continental countries now still possess. In Germany, too, Herr Erhard's tantrums last summer show that even the old Hume mechanism is not going to be allowed to work smoothly and symmetrically. The gold gaining countries of the Continent did not tolerate an increase in their internal demand and prices. Now that their costs are rising they try to counteract the trend. It is as if all adjustment is to be undertaken by the gold losing countries. This would place an intolerable strain of the international monetary system.

87. It could be argued that it is not incumbent upon the French, Germans or the Italians to finance American capital exports and aid. Superficially much can be said for this view. Analytically it is clear, however, that the U.S. finance of capital exports is mainly due to fact that, for socio-political reasons, the continental countries are unwilling to readjust their balance of payments in an expansionary sense, and that their capital markets are far more imperfect than those of the United States. Unless the continental countries either permit an increase in their domestic demand or consent to an increase in total international liquidity, the struggle for reserves will go on and this is a game in which only the Russians will be the gainers. The present attitude of continental bankers and financial authorities reminds one of the dog in the manger. They do not wish to finance oversea development²¹ or tolerate an increase in their own demand, and they will not permit a reasonable policy arrangement by which an increase in the demand of other countries could be financed.²² The only alternative would be a direct restriction of U.S. capital exports. This, surely, the banking fraternity would dislike even more.

88. The essential fact to note then is that the increased importance of the continental countries has resulted in a large increase in the demand for liquid international reserves in the non-Soviet orbit.

89. A shortage of international liquidity can be said to exist in circumstances in which countries suffering from unemployment do not feel free to pursue policies of expansion which they would pursue if their international reserves were higher than they are now. An overall shortage of liquid resources will make itself felt by simultaneous pressure on the reserves of a number of countries, while no major gold gainer feels it advisable (at present mainly for internal reasons) to expand. Can we doubt that last winter a severe shortage of liquidity existed?

90. It is obvious (and obviously true) that the concept of shortage of international liquidity is intimately bound up with international monetary and economic policy and especially with the policy of creditor (gold gaining) countries.

91. The more shortsightedly conservative are the latter the greater the need for liquidity. In this sense we are much worse off than we

²¹ Which would decrease the "deficit" of the Anglo-Saxon countries.

²² From this point of view, as we have already said, the attitude of arch-Conservatives, like Mr. Rueff, is less incomprehensible than the negativism of those who have formalised the Keynesian concepts into a classical mould. Unless the demand for and supply of liquid resources is brought into an equable relationship, the future of the non-Soviet world is in grave danger.

were when the Americans were the creditor country: they initiated the Marshall Plan, while the Germans and the French can barely be persuaded to give tied commercial credit. Moreover, the more open the system, the less is the scope for direct measures (e.g., quota and exchange restrictions) the greater must be the amount of liquidity. Thus the process of liberalization since 1952, especially by making possible disruptive capital movements (both short and long term), enormously increased the need for international liquidity, if full employment is to be assured all round.

92. With increasing trade and an increasing liberalization of payments, the need for liquid reserves rises very considerably. The movement of capital—hot money—from country to country upsetting the steadiness of policy, which was so awkward a feature of the prewar decade has been in the forefront of monetary problems. Britain, America and a number of smaller countries have been the victims of these bouts of speculation. Since 1957, or thereabouts, central banks, especially on the Continent, have been increasingly insisting on having gold, and both sterling and the dollar in which a large part of their reserves had been kept, have come under suspicion. This means that the growth of reserves is limited to gold production. At times, moreover, only (a small) part of the newly mined gold has been available as private hoarding soared during severe bouts of shock to confidence. During and after the war it was hoped that exchange control would eliminate this danger. Indeed Keynes succeeded in making exchange control indirectly mandatory to countries who borrowed from the International Monetary Fund by providing that borrowing from the fund must not be used for facilitating the export of capital. This sage provision has been honored more by breaches than by compliance: the financiers of the world practically enforced a return to the prewar gold standard.

93. Under these conditions it is not astonishing that the accumulation of reserves has become the aim of most countries: so long as most countries feel that their reserves are insufficient they will do their utmost to gain gold. Severe losses of gold by some must induce others to watch their step, thus scarcity of reserves is likely to aggravate itself. Uncertainty about strong countries' monetary policy would have the same result.

94. In this respect the prospects of the non-Soviet orbit have become much graver in the last few years. The Americans in their day of dominance at least attempted to redress the unbalance of gold reserves (mainly because of cold war reasons). They increased foreign expenditure and aid and did not indulge in deflationary policies even when these policies in the end resulted in losses of gold they did not deflate.

95. The Germans and French, on the other hand, who have recently been controlling the monetary destinies of the non-Soviet world did not expand, even when their gold gains were colossal. A general bias against employment and accelerated growth, and a reluctance to lose gold, even when this reluctance stops expansion, was forced on the Western economies. This may in the end recoil on the present creditors. On the other hand, it is equally clear that this attitude will not change so long as there is a threat of a prolonged increase in prices due to a rise in (wage) costs. The conclusion is inescapable

that the achievement of steady expansion in a nontotally planned system necessitates a far more conscious management of incomes than has hitherto proved possible in the free world. Now that the Italian and French governments are frantically groping toward a solution of their cost-push inflationary problem by the worn old formulae of economic policies which have proved so signally unsuccessful in the United States and in Britain, it is time to insist once more (especially as this whole problem is to be investigated by the Ten in Washington,) on the absolute necessity of bringing the internal monetary problem under control without indiscriminate deflationary means. An income policy is obviously the precondition for an intelligent solution of the international monetary problem.

OUTLINE OF A SOLUTION ²³

96. A satisfactory solution must be capable of being used to prevent inflation as well as deflation.

97. It must in particular—

(i) offer a possibility of creating a sufficient volume of international liquidity to

(a) stifle any possible attack on an important currency;

(b) maintain expansion at a steady pace all round despite the sociological inhibitions in the main creditor countries to maintain sufficient expansion to aid in restoring the balance in international payments;

(ii) enables the use of idle productive capacity in fully industrialized countries to increase aid to underdeveloped areas to the utmost, and yet

(iii) contribute through this process to the balancing of accounts between the fully industrialized countries, without an internecine struggle for markets which might lead to cumulative deflation, devaluations and default.

98. The fulfilment of these requirements would, incidentally, satisfy the need of the (socially backward) persistent creditor countries to maintain export surpluses without leading to a denuding of the others of all their liquid reserves. This means that schemes which are based on creating borrowing facilities rather than enabling countries to increase their fully owned liquid reserves will not solve the problem of scarcity. For the need for repayment will influence policy. This is the criterion on the basis of which the various schemes that have been put forward need to be evaluated.²⁴ None of them quite meets these requirements.

99. Those plans which provide a sudden arbitrary increase in reserves might meet the secular increase of the demand for liquidity for a time. They obviously could deal with panics and depressions if they were sufficiently large, but as the secular increase in demand is continuous and the addition is once for all, they do not provide a long-term solution. Conversely large-scale additions to reserves might prove inflationary if there is substantial full employment in large parts of the world economy, or if the addition to liquidity enables

²³ The following section is based on M. H. Wilson's speeches in Washington (U.S. Congressional Record, Apr. 8, 1963, pp. 5512-5514) and to the Anglo-American Chamber of Commerce in London.

²⁴ For a more exhaustive discussion see "Unequal Partners," vol. II, sec. 7, especially essay No. 24, pp. 245-253 and postscript 254-257.

some countries to increase their demand for imports beyond the level of current demand for additional reserves by the creditor countries.

100. Alternative schemes provide reciprocal (standby) credits from creditors to debtors. They might be able to deal with confidence crises, and with demand for liquidity arising out of depressions provided the character of the sudden demand is correctly diagnosed at an early date. They cannot deal with the secular increase of demand because the standby credit is not counted (for policy purposes and from the viewpoint of creating confidence) into total reserves. They cannot provide an answer to the need for international reserves arising out of a structural (long-term) failure of creditor countries to increase demand, probably the most important of the threats to stability and growth.

101. Plans based on the creation of new liquidity in prescribed proportions and based on the willingness of central banks to keep part of the funds thus created at an international institution (International Monetary Fund) represent a solution of the problem of the secular increase in demand. They are likely to be insufficient for dealing with any of the other disturbances that demand a sudden and massive increase in liquidity; moreover, they offer insufficient safeguards against inflationism in periods of exhilaration.

102. Plans which link the creation of liquidity rigidly with grants to underdeveloped areas might solve the problem of secular demand and depression but could not deal with a confidence crisis or with long-term structural defects of the world monetary system. They might moreover be far too inflationary in times of full employment.

103. An optimal solution would seem to depend on giving full central banking powers to a reformed International Monetary Fund. Only if an international organ has the capacity to create additional liquid reserves can the twofold task be assured—

(i) the defeat of sudden confidence crises, and

(ii) the relief of the slowly working strangulation of growth through a long-run deficiency of liquid reserves which forces central banks to take deflationary measures prematurely, i.e., when there is still unemployment. The latter can only be achieved if the newly created international reserves are not subject to repayment; e.g., *à la* Maudling, but are left to accumulate.

104. It is clear that the International Monetary Fund would have to have a new, much more positive and constructive approach to the world economic problem than hitherto. The basic condition of success is that some discretion must be given to the management of the International Monetary Fund for otherwise the supple adaptation to violently changing demand for international liquidity would not be possible.

105. A reformed IMF would be able to create credit certificates in terms of gold and equivalent to gold. With these certificates it would buy Government obligations of any country, thus increasing its gold reserves and enabling it to continue to expand—so long as there is unemployment. These certificates could be used by the country receiving them to meet its balance-of-payments deficit. Thus it would increase the total liquidity of the non-Soviet world and end all possibility of a shortage. The unnecessary and artificial financial obstacles in the way of continued growth would be eliminated.

106. It must be understood that the deficit countries would have to restrain the increase in their domestic demand (relative to the increase in their productivity) if this mechanism is to yield a balance at full employment and not a cumulative inflation. This is one more reason for holding that the management of IMF must be reliably progressive, as they would have to have very extensive powers.

107. The credit creation of the Fund should not be entirely bound up with aid to underdeveloped areas. A scheme based on such an exclusive connection could not deal with sudden crises of confidence, when massive financial support is required for a key currency to stop the confidence crisis, and yet no increase is possible in the productive capacity available for aid (i.e. there is no productive capacity which is not used for other purposes and lying idle). Adequate financial support would then mean harsh inflationary pressure.

108. Nor am I in favor of linking too closely aid and unemployment in the fully developed part of the world. It would mean a stop-and-go policy in the reverse. Rather I am in favor of assigning a fixed proportion of the national income of the affluent societies over a longish future period to contribute to well-thought-out long-term development plans. Without fairly long commitments, good planning in the poor countries will not be possible, and great waste will be unavoidable.

109. We could, however, contribute relatively small, though important amounts to development, perhaps as much as £200,000 to £300,000 per annum by the Fund assigning credit certificates to an International Investment Fund to take over the functions of IDA. These should be spent in fully developed debtor countries, countries which suffer from unemployment (as Britain and America did last winter). This balancing technique would help in maintaining balance, maintaining full employment and promoting greater international equality.

110. If such a reform took place we could look forward with greater equanimity to the future. Our expansion would accelerate and we could bind the countries of the non-Soviet orbit together in greater equality and prosperity. European countries would be well prepared for any worsening of our terms of trade, due to the incursion of the Soviet, and use fully our productive capacity to the benefit of all.

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ASSUMPTIONS AND FINDINGS

The study of the U.S. balance of payments in 1968 was undertaken by the Brookings Institution at the request of the Council of Economic Advisers to determine the effect of an increase in the rate of economic growth necessary to reduce unemployment to 4 percent. The initial assumptions for projecting the balance of payments are those of the Council. The authors of the Brookings report also made projections on the basis of alternative assumptions of their own. The initial assumptions involve a very high rate of growth of output in the United States, a substantial but lower rate of growth in Western Europe, a moderate of U.S. prices and a considerable rise of European prices. The alternative assumptions involve a lower rate of economic growth in the United States and Western Europe, the same moderate rise of U.S. prices, but with prices rising somewhat less in Europe than under the initial assumptions.

Assumptions on changes in output and prices, 1961-68

[Percent change]

	Initial assumptions	Alternative assumptions
Total output:		
United States.....	+43	+36
Western Europe.....	+33	+29
Ratio of relative output in 1968-61.....	+8	+5
Prices:		
United States:		
GNP implicit price deflator.....	+11	+11
Export prices.....	+4	+4
Western Europe:		
GNP implicit price deflator.....	+20	+11
Export prices.....	+11	+7
Rest of world: Export prices.....	0	0

To find a workable means of dealing with the complex data, the Brookings report made some additional assumptions regarding prices and trade in the rest of the world. The exports of the rest of the world to the United States and Western Europe are assumed to depend on output in these areas. Their imports from the United States and Western Europe are assumed to equal their exports, after making allowance for changes in other receipts and payments. And the export prices of the rest of the world are assumed to be unchanged under both the initial and alternative assumptions regarding output and prices in the United States and Western Europe.

With these assumptions, the Brookings report made projections of the trade of the United States and Western Europe with each other

and with the rest of the world on the basis of the experience of 1948-60. This involved four steps: (1) U.S. exports to Western Europe and imports from Western Europe were projected to reflect the assumed increases in output without allowing for price changes. (2) The projections were then adjusted to the assumed rise of export prices in both areas. (3) The projections were again adjusted on the basis of the changes in relative prices in the United States and Western Europe. (4) Imports of both areas from the rest of the world were determined by the increase in their own demand; but their shares in exports to the rest of the world were determined by the relative changes in their export prices.

Projected changes in U.S. exports and imports, 1961 and 1968¹

[In billions of dollars]

	Actual trade 1961	Estimated trade, 1968	
		Initial assumptions	Alternative assumptions
Exports to Western Europe.....	6.98	12.74	10.42
Exports to rest of world.....	11.00	15.90	14.57
Total exports.....	17.98	28.64	24.99
Imports from Western Europe.....	3.98	8.11	7.84
Imports from rest of world.....	10.49	15.23	14.54
Total imports.....	14.47	23.34	22.38
Excess of exports.....	3.51	5.30	2.61

¹ Projections exclude aid-financed trade and make no allowance for the restrictive effect of the Common Market on U.S. exports.

The net effect of changes in all other transactions (that is, excluding trade) in the balance of payments projected in the Brookings report is small, although some individual items show large changes. The 1961 deficit of \$750 million in service transactions (including military expenditures) would be converted into a 1968 surplus of \$1.1 billion under the initial assumptions and of \$1.3 billion under the alternative assumptions. Net payments on private long-term capital and U.S. Government grants and loans would increase by nearly \$1.5 billion under both assumptions. Thus, all nontrade transactions, which showed net payments of \$6.5 billion in 1961, are projected to show net payments in 1968 of \$6.2 billion under the initial assumptions and \$5.9 billion under the alternative assumptions.

The principal factors in the improvement of the service accounts are increased investment income (\$1,920 million), increased military receipts (\$600 million), and reduced U.S. military expenditures abroad (\$370 million under the initial assumptions and \$480 million under the alternative assumptions). These and other improvements in the service accounts are only partly offset by increased investment income of foreigners (\$520 million), increased travel in Western Europe (\$490 million), and increased transportation payments to Western Europe (\$360 million).

The estimated decline of net payments for private long-term capital consists of a decrease of \$530 million in U.S. private investment abroad and an increase of \$110 million in foreign investment in this country.

Capital movements, even long-term capital movements, are notoriously volatile and it is difficult to assume a downward trend over the next few years. It is even more difficult to project U.S. Government grants and loans. However, with greater tying of aid and with most of the increase going to Latin America, any substantial change in projected U.S. aid would be largely offset by a corresponding change in U.S. exports.

U.S. basic balance of payments, 1961 and projected 1968

[In billions of dollars]

	Actual, 1961	1968 Initial assumptions	1968 alternative assumptions
Merchandise exports ¹	20.2	31.4	27.8
Investment income.....	3.8	5.8	5.8
Other services projected.....	1.8	2.9	2.9
Services not projected.....	2.5	2.5	2.5
Total exports of goods and services.....	28.3	42.6	38.9
Merchandise imports.....	-14.5	-23.3	-22.4
Military expenditures.....	-2.9	-2.6	-2.4
Other services projected.....	-2.5	-4.1	-4.0
Services not projected.....	-3.4	-3.4	-3.4
Total imports of goods and services.....	-23.3	-33.4	-32.2
Net private long-term capital.....	-2.1	-1.5	-1.5
Government transfers and loans.....	-3.7	-5.8	-5.8
Basic surplus (+) or deficit (-).....	- .8	+1.9	- .6

¹ Merchandise exports include aid-financed shipments and an allowance of \$600,000,000 on the initial assumptions and \$550,000,000 on the alternative assumptions for the restrictive effect of the Common Market on U.S. exports to that area.

OBSERVATIONS ON THE PROJECTIONS

As virtually all of the change in the U.S. basic balance of payments projected in the Brookings report is attributable to the trade accounts with Western Europe and the rest of the world, it is necessary to consider the reasonableness of the assumptions and of the methods used in projecting U.S. exports and imports. The initial assumptions regarding output and prices in the United States are for a special purpose—to see whether the balance of payments would be adversely affected by a determined effort to accelerate economic growth and to reduce unemployment. These assumptions are intended to be normative rather than predictive. The projections could not be used as a basis for U.S. policy, however, if the assumptions regarding output and prices in Western Europe were not realistic.

The initial assumptions involve a large increase in output and a sharp rise of prices in Western Europe. It is difficult to believe that the Western European countries, with their great abhorrence of inflation, would tolerate a rise of 20 percent in GNP prices and 11 percent in export prices. Conceivably, a sharp rise of prices in one or two countries could raise the average for Western Europe to the assumed extent; but, if that were so, it would almost certainly be accompanied by severe restrictions on trade directed more against the United States than against countries in the Common Market. The alternative assumptions regarding output and prices in the United States and Western Europe provide a more satisfactory basis for balance-of-payments projections.

The Brookings report assumes that the rest of the world will spend all of their net foreign exchange receipts on imports from the United States and Western Europe. While the low-income countries have not accumulated reserves over the past 12 years, five of the high-income countries have made substantial additions to their reserves since 1958. The combined gold and foreign exchange reserves of Japan, Canada, Australia, New Zealand, and South Africa have increased from \$4.54 billion at the end of 1958, when they were at a cyclical low, to about \$6.90 billion in mid-1963. If these countries continue to accumulate reserves, it would reduce their imports below the Brookings projections and much of the reduction would be from the United States. Canada and Japan are the two largest importers of United States goods. The other three countries are in the sterling area and their accumulation of reserves would reduce their imports from the United States and the United Kingdom, our third largest importer.

The Brookings report also assumes that the export prices of the rest of the world would be the same under either the initial or the alternative assumptions. The report recognizes that prices of raw materials depend on the expansion of industrial production. Nevertheless, the projections are based on no change in the export prices of the rest of the world, whether output in the major industrial areas increases considerably more and prices are much higher as in the initial assumptions, or output increases less and prices are somewhat lower as in the alternative assumptions. High export prices of basic commodities would be favorable to the U.S. balance of payments, not only because our exports include a large proportion of such commodities, but because higher prices for raw materials have an adverse effect on the balance of payments of Western Europe. The initial assumption is probably mistaken and the alternative assumption is probably more nearly right.

The effect on trade of the assumed changes in output and prices in the United States and Western Europe is determined on the basis of equations derived from the experience of 1948-60. This is not a satisfactory basis for making projections in the future. U.S. exports to Western Europe were very high in the early postwar period because they were financed by Marshall plan aid and European output was abnormally low. It would have been difficult for U.S. exports to rise very much with the increase of European output in the 1950's. On the other hand, U.S. imports from Western Europe were very low in the early postwar period because European output was abnormally low and a larger proportion had to be absorbed in home consumption and investment. As supplies increased in the 1950's, U.S. imports from Western Europe rose rapidly. With more normal conditions hereafter, it would be expected that U.S. exports to Western Europe would rise somewhat more relative to European output and that our imports from Western Europe would rise somewhat less relative to U.S. output than during 1948-60.

The bias inherent in these equations can be seen from a comparison of the increases of trade and output in the United States and Western Europe. Under the initial assumptions, at constant prices, U.S. imports are projected to rise by 84 percent from Western Europe and by 45 percent from the rest of the world with an increase of 43 percent in U.S. output. On the alternative assumptions, U.S. imports are projected to rise by 72 percent from Western Europe and by 39 percent

from the rest of the world with an increase of 36 percent in U.S. output. On the other hand, U.S. exports to Western Europe are projected to rise by 27 percent with an increase of 33 percent in European output under the initial assumptions and to rise by 23 percent with an increase of 29 percent in European output under the alternative assumptions. The estimated effect of increased output in Western Europe on U.S. exports to that region appears to be too low. The estimated effect of increased U.S. output on imports from Western Europe is much too high.

U.S. trade in 1968 allowing for assumed changes in output and prices

[In billions of dollars]

	Actual trade 1961	Projected trade in 1968 allowing for changes in		
		Real income	Export or import prices	Relative prices
Initial assumptions:				
Exports to Western Europe.....	6.98	8.85	9.20	12.74
Exports to rest of world.....	11.00	14.65	14.65	15.90
Total exports.....	17.98	23.50	23.85	28.64
Imports from Western Europe.....	3.98	7.31	8.11	8.11
Imports from rest of world.....	10.49	15.23	15.23	15.23
Total imports.....	14.47	22.54	23.34	23.34
Excess of exports.....	3.51	.96	.51	5.30
Alternative assumptions:				
Exports to Western Europe.....	6.98	8.57	8.91	10.42
Exports to rest of world.....	11.00	14.04	14.04	14.57
Total exports.....	17.98	22.61	22.95	24.99
Imports from Western Europe.....	3.98	6.85	7.33	7.84
Imports from rest of world.....	10.49	14.54	14.54	14.54
Total imports.....	14.47	21.39	21.87	22.38
Excess of exports.....	3.51	1.22	1.08	2.61

The methods used to determine the effect of relative prices on exports and imports are also open to question. The volume of exports and imports projected on the basis of the assumed increase in output is first adjusted to reflect the correspondingly higher prices. Exports and imports are then adjusted to reflect substitution between imports and domestic goods in response to changes in relative prices. The Brookings report assumes that the competitive position is determined by the relation of import prices to GNP prices. This has the illogical effect that both Western Europe and the United States can simultaneously improve their competitive position in each other's markets. The competitive position of the two regions in each other's markets is better determined by a comparison of import prices with wholesale prices of domestic goods. As there is a much greater difference in the assumed behavior of United States and Western European export prices than in GNP prices, the measure of competitiveness used in the Brookings report is less favorable to the United States. The competitive position of the United States and Western Europe in the rest of the world is determined by relative export prices. There is a large increase in the U.S. share of exports to the rest of the world on the

initial assumptions and a moderate increase on the alternative assumptions.

The projected increase in total U.S. trade is enormous for so short a period. On the initial assumptions, projected exports in current dollars would increase by 59 percent (early 7 percent per annum) and projected imports would increase by 61 percent (over 7 percent per annum). On the alternative assumptions, projected exports would increase by 39 percent (nearly 5 percent per annum) and projected imports would increase by 55 percent (nearly 6.5 percent per annum). Such a large increase in U.S. trade by 1968 is hardly credible.

It is worth seeing what U.S. trade with Western Europe would be if the substitution of imports for domestic goods were based on relative export prices and if U.S. imports from Western Europe had a smaller response to output. With the revised measure of price competitiveness, U.S. exports to Western Europe would be \$2 billion less under the initial assumptions and about \$900 million less under the alternative assumptions. The combined effect of a lower response of U.S. imports to output and of the revised measure of price competitiveness would be to reduce U.S. imports from Western Europe by \$2.2 billion under the initial assumptions and by \$1.9 billion under the alternative assumptions. Most of the estimated reduction in U.S. imports is attributable to the revised definition of competitiveness.

U.S. trade with Western Europe in 1968 under various assumptions

[In billions of dollars]

	Actual 1961	Brookings report		Modified projections	
		Initial assumptions	Alternative assumptions	Initial assumptions	Alternative assumptions
U.S. exports.....	6.98	12.74	10.42	10.75	9.55
U.S. imports.....	3.98	8.11	7.84	5.88 ¹ (6.38)	5.92 ¹ (6.47)
Export surplus.....	3.00	4.63	2.58	4.90 ¹ (4.37)	3.63 ¹ (3.08)

¹ Based on an assumed output elasticity of 1.2 instead of 1.1 for U.S. imports. This is only slightly less than the elasticity used in the Brookings report

The effect of the changed assumptions regarding price effects on U.S. exports and price and income effects on U.S. imports are partly offsetting. The trade surplus with Western Europe would be about the same as in the Brookings report on the initial assumptions and somewhat larger—by \$500 million to \$1 billion—on the alternative assumptions. The growth of trade with Western Europe would be much less than projected in the Brookings report. U.S. exports to Western Europe would increase by \$3.77 billion (54 percent) instead of \$5.76 billion (82 percent) on the initial assumptions, and by \$2.57 billion (37 percent) instead of \$3.44 billion (49 percent) on the alternative assumptions. U.S. imports from Western Europe would increase by \$1.87 billion (48 percent) instead of \$4.13 billion (104 percent) on the initial assumptions, and by \$1.94 billion (49 percent) instead of \$3.86 billion (97 percent) on the alternative assumptions.

SIGNIFICANCE OF THE BROOKINGS PROJECTIONS

The Brookings report shows that the basic international transactions of the United States would have a surplus of \$1.9 billion in 1968 on the

initial assumptions and a deficit of \$600 million on the alternative assumptions. What significance can be attached to these projections? On this the report states:

[The projections] are conditional forecasts, designed to present estimates of the basic balance of payments in 1968 if GNP and the GNP price deflators [and also export prices] in the United States and Western Europe take certain assumed values. If in 1968 these variables do not in fact have the values assumed, the projections of the basic balance of payments in 1968 cannot be regarded as estimates of the actual basic balance in that year.

As the report points out, the percentage effect of a given error in projecting receipts and payments is greatly magnified in the net balance. If U.S. receipts from goods and services were 2 percent less than projected and if U.S. payments for goods and services were 2 percent more than projected, the basic balance of payments would change adversely by \$1.5 billion.

In fact, the projections of the Brookings report do not provide a balance of payments in the real sense. They show the behavior of the transactions in goods and services, private long-term capital, and Government transfers and loans. They do not include net payments on short-term capital movements and unrecorded transactions which from 1960 to 1962 averaged \$2 billion a year. Admittedly, these volatile components of the balance of payments cannot be projected. Nevertheless, their omission means that the basic balance of payments must be used with great caution in making policy decisions.

With the enormous importance of price changes in the projections of the U.S. trade balance, the authors should have been particularly concerned to see that policies are followed that would assure the price relationships essential to the strengthening of the U.S. balance of payments. Without the assumed changes in prices, the U.S. trade balance would have been \$4.3 billion less on the initial assumptions and \$1.4 billion less on the alternative assumptions. We cannot count on a large inflation in Europe as the sole means of improving the U.S. competitive position. We must ourselves make sure that wage rates do not rise more than the increase of productivity in the export industries and that export prices do not rise at all. On this the report states: "Restraint on wage and price increases extended through persuasion, application of the guidelines set forth in the last two annual reports of the Council of Economic Advisers, and similar methods will benefit the U.S. competitive position without retarding economic growth." But the authors want no steps to hold down liquidity, which could avoid a rise in export prices, for fear of restraining the level of economic activity.

Effect of projected changes in prices on U.S. exports and imports in 1968

[In billions of dollars]

	Initial assumptions	Alternative assumptions
Increase of exports to Western Europe.....	3.89	1.85
Increase of exports to rest of world.....	1.25	.53
Total increase of exports attributable to price changes.....	5.14	2.38
Increase of imports from Western Europe.....	.80	.99
Increase of imports from rest of world.....	0	0
Total increase of imports attributable to price changes.....	.80	.99
Improvement of trade balance attributable to price changes.....	4.34	1.39

The most startling statement in the report is the opening sentence in the section on "Measures To Improve the Balance of Payments." "We do not recommend," says the report, "that the Government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves." It is difficult to take such a recommendation seriously. The projections in the report show only a moderate improvement in the basic balance on the initial assumptions and virtually no improvement on the alternative assumptions. The report takes no account of the large net payments on short-term capital outflow and unrecorded transactions. The report says nothing of the balance of payments in the 5 years prior to 1968. Unfortunately, the U.S. Government must deal with the actual balance of payments as it emerges in 1963, 1964, 1965, 1966, and 1967. It cannot simply wait for the 1968 projections in the Brookings report to materialize, particularly as they provide no assurance that the balance of payments will not be in deficit then.

FINANCING THE PAYMENTS DEFICIT

"Even if our more optimistic projection is realized," says the Brookings report, "there probably will be deficits in the U.S. balance of payments for the next several years." As it is recommended that no measures be taken to reduce the deficit, it will be necessary to use enormous resources to finance the deficit. The authors of the report believe that "despite the substantial reduction in U.S. monetary reserves and the large increase in foreign holdings of liquid dollar claims over the past dozen years, U.S. reserves and other resources for meeting continuing deficits * * * remain very great." If the United States were to follow the advice of the Brookings report, it would soon find that the resources to which the report refers are not enough and are not available.

1. The United States holds more than \$15 billion of gold. In theory, it could use all this gold to meet the deficits of the next 5 years. In practice, that would be quite impossible. Foreign countries held \$21 billion of short-term and liquid dollar claims at the end of 1963. These dollar claims are held because there is confidence abroad that the United States will take measures to restore its balance of payments. If it were believed that the United States will wait for inflation in other countries to bring about a near-balance in 1968, on assumptions that may never be realized, there would be large conversions of dollars into gold. The gold reserves would not be available for meeting deficits; they would be needed for meeting a flight from the dollar, by foreigners and by Americans.

2. Treasury and Federal Reserve holdings of convertible currency are relatively small, but standby facilities for swaps with foreign central banks amount to \$1.5 billion. Half of the resources provided by these arrangements are through swaps with Canada and the United Kingdom. These countries have no reserves to spare, and swaps with them could not be used to finance a U.S. deficit with other countries. Furthermore, all of the swaps are short-term reciprocal credit agreements. They are intended to meet temporary pressures in exchange markets and to be reversed as soon as possible. The agreements would almost certainly be terminated, or become inactive, if the United States were to take the view that the resources they provide could be used to finance its payments deficits over the next 5 years.

3. U.S. drawing rights on the International Monetary Fund amount to over \$1 billion for the gold tranche and about \$5.2 billion for all tranches. The gold tranche is available almost automatically. Still, if the United States were to draw on the Fund, it would have to observe the conditions regarding the use of such resources. First, repayment would have to be made within 3 years, with an outside limit of 5 years, and this applies to the gold tranche as well as to other drawings. Second, when making drawings in excess of the gold tranche, the United States would have to show that it is taking the measures necessary to restore its balance of payments. The Fund holds only \$1.1 billion of the currencies of the principal European creditor countries and \$2.3 billion in gold. Very large drawings by the United States would necessitate calling on the special resources under the Paris Agreement and the European countries providing these resources would expect some commitment by the United States on balance-of-payments policy.

4. The report speaks of the ability of the United States to obtain foreign exchange through further prepayment of long-term debts of Western European governments and, if necessary, by the sale of securities for foreign currencies. The European governments, other than the United Kingdom, Turkey, Spain, and Yugoslavia, have only about \$1.3 billion of outstanding debt to the U.S. Government. There is no basis for expecting large prepayments in the next few years. The special securities issued by the United States in foreign currencies and in U.S. dollars amount to about \$1.3 billion, but these are held by foreign official institutions. It might be possible for the United States to sell its bonds to other foreign buyers, but it would have to be at much higher rates of interest, or tax free, and even if denominated in foreign currencies, it would require greater confidence in the U.S. balance of payments than at present.

The report makes the recommendation that the United States sell a substantial amount of gold, say \$3 billion to \$5 billion, for foreign currencies. This would be dramatic, but ineffective. The countries that hold dollar balances would not be impressed by this gesture, particularly if it is intended to emphasize that the United States will use gold but will not take action to restore the balance of payments. Other countries would be much more persuaded of the desirability of helping the United States, without massive gold sales, if we took measures to reduce and eliminate the payments deficit. There are other reasons why a massive sale of gold would be a poor tactical move. Discussions on reform of the international monetary system are proceeding in a quiet way. These discussions may involve the future role of gold in the settlement of international transactions. The United States will be better able to negotiate a satisfactory arrangement if it holds gold reserves of \$15 billion rather than \$10 billion.

The United States no longer has the option of doing nothing and waiting for the balance of payments to correct itself by a large inflation in Western Europe over the next 5 years. A good part of our gross reserves has been used up waiting until now. Even the substantial reserves we still have would not be sufficient to finance continuing deficits of the magnitude of recent years. The United States must have a program for restoring the balance of payments that offers reasonable promise of being successful, not in 1968, but by 1965 or sooner.

INTEREST RATES AND THE BALANCE OF PAYMENTS

The only recommendation on policy, as distinguished from reform of the international payments system, is negative in character. The report states "that it is inadvisable to raise interest rates in an attempt to affect international flows of capital, unless as seems unlikely at present, the adverse effects of higher rates can be fully offset by fiscal expansion." The authors of the report believe that the balance of payments has played an important role in the failure to achieve maximum production and employment. "The expansionary fiscal policy needed to restore high employment has been delayed and made more difficult to achieve by fears that expansion would make the balance of payments worse. The lowering of interest rates to levels which promote high domestic investment and growth has been inhibited by apprehension about capital outflow." It is not true that the difficulty in getting tax reduction has been caused by fears about the balance of payments; and it is open to question whether monetary policy has really been restrictive.

The increase in the gross national product and in industrial production from the cyclical peak of 1960 to the present has been greater, in absolute amount, in aggregate percentage, or in per annum growth, than at any time in the past 10 years. The slowdown of U.S. economic growth from 1955 to 1960 is not the consequence of a restrictive monetary policy in that period. It is the result of a change in the trend cycle in some of the major sectors of the U.S. economy. The trend cycle is again changing and that is one reason why the expansion has continued so long and why output has increased so much in recent years. Interest rates have not hampered the current expansion, particularly if they are considered in conjunction with other policies of the administration to increase the profitability of business.

Even from the point of view of maintaining domestic price stability, credit policy has been very easy over the past 3 years. The level of free reserves is greater now than at any comparable stage of the cycle since 1949. In spite of the balance-of-payments deficit, free reserves have averaged \$100 million in recent weeks—after 31 months of expansion. In previous cycles, free reserves were negative from July 1952 to May 1953, from August 1955 to December 1957, and from December 1958 to June 1960. In the past 3 years, any decline in bank reserves due to the payments deficit has been promptly offset by the Federal. This has made possible the greatest expansion of bank credit in the postwar period. From June 1960 to June 1963, loans and investments of commercial banks increased by \$51.9 billion, of which \$29.8 billion was in loans. This compares with an increase of \$21.7 billion in loans and investments, of which \$18.2 billion was in loans, from June 1949 to June 1952, a period that included the Korean war and much of which preceded the Treasury-Federal Reserve accord on credit policy.

Interest rates, except money market rates, have shown no cyclical rise since the recession of 1960-61. The market yield on 3-month Treasury bills has gone up from 2.24 percent in January 1961 to about 3.40 percent at present. Even this rise is at least in part the consequence of the pull of foreign money rates which have drawn U.S. funds out of the bill market. The prime rate on bank loans has remained at 4½ percent since August 1960 when it was reduced to this

level in the midst of the depression. The average yield on long-term Government bonds has risen from 3.73 percent in May 1961 to about 4 percent in June 1963. On the other hand, the average yield on all corporate bonds was 4.54 percent in March 1961 and 4.47 percent in June 1963. The average yield on all State and local government securities was 3.53 percent in December 1960 and 3.31 percent in June 1963. The average interest rate for first mortgages on new homes has declined from 6.15 percent in the first quarter of 1961 to 5.82 percent in June 1963. This is the first period of expansion in which there has been no cyclical rise in interest rates—the special case of U.S. Government securities aside.

The effect of interest rates on the economy depends not on their absolute level, but on their relation to prospective profits, and in this relationship, interest rates are the less important factor. As Keynes stated in the "General Theory" (p. 145) :

The schedule of the marginal efficiency of capital is of fundamental importance because it is mainly through this factor (much more than through the rate of interest) that the expectation of the future influences the present.

This administration has already done much to raise the profitability of investment. The investment credit and the new depreciation guidelines have had about the same effect on the present value of the cash flow of a typical investment in equipment as a reduction of 2 percent in the interest rate. The proposed tax reduction, if it were enacted, would be an even more powerful force for raising the profitability of business and encouraging investment.

The surest way to reduce the payments deficit promptly is to have some tightening of credit now. This could stem the outflow of short-term funds and reduce the net payments on unrecorded transactions. In conjunction with fiscal policy, it could, by reducing liquidity, hold down the pressure on prices and wages without affecting economic activity adversely. There is no basis for the statement in the Brookings report that "higher interest rates, while discouraging domestic investment, may not be effective in attracting capital to a weak currency when strong currencies are available." If the return on covered interest arbitrage were higher in the United States than in Canada and the United Kingdom, there would be less inducement for U.S. funds to move abroad and more inducement for foreign funds to stay here.

REFORM OF THE INTERNATIONAL PAYMENTS SYSTEMS

The main emphasis of the Brookings report is not on correcting the U.S. balance of payments, but on reforming the international payments system in order to avoid the need for corrective measures. There can be no quarrel with the principle that the international monetary system "must provide enough liquidity at the outset to finance substantial imbalances while adjustments are taking place, and it must provide for increases in liquidity as the need for liquidity grows." What is in question is the meaning that the report attaches to these terms.

The need for additional resources could be provided by gradually enlarging the present quotas in the International Monetary Fund. There is much to be said for the point that "substantial amounts should be obtainable automatically by deficit countries"—that is, within the

quota limits. There is nothing to be said in favor of the proposition that such drawings should have no fixed repayment dates. Under these conditions, the resources provided by the Fund to finance a persistent deficit would not be reserve credit. The essence of reserves is that they should be used when necessary and restored as soon as possible. If resources from the Fund did not have to be repaid in a reasonable time, some countries would use up these reserves without making any effort to restore their payments position.

The Brookings Report recommends that "additional amounts should be made available to countries with particularly intractable balance-of-payments problems if appropriate measures for dealing with these problems are being taken." This is what the special resources available to the International Monetary Fund under the Paris agreement are already designed to do. And yet the United States would not qualify for use of these additional resources if it followed the recommendations of the Brookings report. It is difficult to argue that waiting for inflation in Western Europe constitutes appropriate measures for dealing with the U.S. balance of payments. And it is impossible to say that a country that has had average net payments of \$2 billion a year on short-term private capital outflow and unrecorded transactions should do nothing to raise interest rates.

There are difficult reserve problems. These problems cannot be met simply by a massive expansion of liquidity. The reserve problems are particular problems and they require particular solutions. The first is the need for the regular growth of the resources of the Fund and for assurance that drawings within quota limits may be made automatically, but with the present reasonable provisions for repayment. The second is the need to reduce dependence on gold in international settlements and to standardize the composition and use of gold and foreign exchange in the reserves of the large industrial countries. The third is the need to find a substitute for reserve holdings by underdeveloped countries so that they can offset a temporary fall in their exports without forcing a sharp decline in their imports. The Fund has already set aside one tranche of the quotas to be used virtually automatically for compensatory financing of a decline in exports.

The Brookings report recognizes the great advantages of fixed exchange rates, although it does not approve of the discipline that such a system imposes on domestic policy. If there were vast resources for financing deficits, the Brookings report would favor an even more rigid commitment to fixed parities. Even so, the report states that it would be useful to widen the limits around the par values (1 percent) within which exchange rates are allowed to fluctuate. Variations within 2 or 3 percent of parity would be helpful in making small adjustments in the trade balance, provided costs had not moved too far out of line. Such fluctuations would not give rise to stabilizing capital movements, regardless of commitments to maintain the parity, unless there were assurance that a country would take prompt action to restore the balance of payments. Nor is it true that a wider range of exchange rates would permit greater variability in short-term interest rates among countries. A range of 2 or 3 percent around parity, or even freely fluctuating exchange rates, would not prevent covered interest arbitrage. A country would still have to keep its money market rates at an appropriate level relative to those

in other countries unless it were prepared to finance an outflow of short-term funds.

“If it becomes clear that agreement on a satisfactory liquidity mechanism cannot be obtained, the United States must seek an alternative.” The best alternative, according to the Brookings report, “would be a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc. There would be relatively fixed rates within each bloc and flexible rates between them. Adoption of this system would imply cutting the tie between gold and the dollar.” The United States has been committed to a policy of a single trading system, with low tariffs, and international cooperation to maintain the gold value of all major currencies, including the dollar, since 1934. In the postwar period, the United States held to its objective of reducing tariffs, eliminating restrictions and discriminations, and restoring the convertibility of currencies. Is this policy of one Western World to be abandoned on the grounds that the United States cannot keep its balance of payments in order? The effects of such a decision, in the economic and political spheres, are too serious to regard such a policy as an acceptable alternative to the measures necessary to restore the balance of payments.

The recommendations of the authors of the Brookings report are in no way related to the statistical study they have made. They provide no practical basis for U.S. policy. There is no substitute for our own action in restoring the balance of payments. It is wishful thinking to believe that other countries will do it for us by their inflation, regardless of how our prices and costs behave. It is sheer fantasy to believe that international monetary reserves will be increased on a massive scale in order to enable the United States to avoid taking corrective measures to deal with the balance of payments. A comprehensive study is being undertaken, at the request of the International Monetary Fund, of various proposals to strengthen the international monetary system. We may be sure that the evolution of the international monetary system, within the framework of the International Monetary Fund, will not obviate the need to restore the U.S. balance of payments. And we may be sure that whatever changes are agreed will be more in accord with our own views if the United States shows a determination to eliminate the payments deficit and to maintain the present gold value of the dollar.

STATEMENT BY HARRY G. BRAINARD

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In the years between World War I and World War II the U.S. dollar became increasingly important as a medium of international payments and New York emerged as a financial center on a worldwide scale. Even so sterling continued as the leading international currency and London the principal money market. Following the Second World War a drastic change took place. The U.S. dollar was the only major currency fully convertible and was soon to become a key currency along with sterling. This situation was clearly recognized in financial and governmental circles but its full implications were either not understood or pushed aside in order to concentrate on aiding Europe in reconstructing its economy and to promote economic development in other areas of the world.

The emergence of sizable deficits in the U.S. balance of payments beginning in 1958 and continuing through the present and certainly into the future has come as a shock. Yet a careful study of international economic developments from 1946 to 1958 would have led to the conclusion that this Nation would sooner or later have to face up to two situations, both new in its experience. First, as reconstruction progressed the war-devastated nations of Europe would ultimately recover to the point where they could enter world markets again and begin to earn their own way. A consequence of this economic strength would be a determination to acquire international monetary reserves thereby allowing their currencies to become freely convertible. These reserves could come from but one source—the United States. A shift in international reserves could be accomplished only to the extent that European countries achieved surpluses in their balance of payments, thereby creating a deficit in our international accounts.

The second effect of the movement of monetary reserves out of the United States which should have been clearly anticipated was this Nation's loss of freedom in the use of monetary and fiscal controls to influence domestic economic activity. No longer could our Government take action designed to influence internal conditions without considering possible international repercussions.

As the full significance of these two situations has been realized in recent years, strenuous efforts have been made to develop policies and programs to meet this Nation's obligations in international affairs. The Brookings Institution study, "The United States Balance of Payments in 1968," is another in a list of investigations dealing with various aspects of U.S. trade and finance designed to give guidance to governmental officials responsible for developing appropriate policies.

"The United States Balance of Payments in 1968" must be appraised for what it is and not what one might wish it were. This study is directed to a single task, namely, the construction of a balance-of-payments statement as it may be expected to appear 5 years in the future.

The authors rightly emphasize that the value of their work lies in the processes and techniques employed and not their calculations which indicate a small surplus in 1968. In the pages that follow attention will be directed to four aspects of the study: scope, assumptions, methods, and findings.

SCOPE

In constructing a balance-of-payments statement for 1968 the authors of the Brookings study proceeded along well-accepted lines by making projections for each type of transaction that results in payments to or receipts from foreigners. By this means they were able to compute a net balance which would have to be financed by foreigners since a net surplus on U.S. account resulted from the calculations.

The authors have made this study within the narrow frame of reference inherent in an analysis of a balance of payments on an item-by-item basis. The temptation was very great indeed to expand the research into the monetary aspects of international commerce. To have done so would have extended greatly the scope of the project and contributed to its usefulness. Problems of international liquidity, key currencies, and gold flows have been thoroughly analyzed elsewhere, however, and can be more easily understood now as a result of the present study.

Limiting the analysis strictly to the construction of a balance-of-payments statement does not mean that the authors have been narrow in their treatment of the subject matter. On the contrary they investigated in depth all factors that might influence the projection of each item. The study, then, is in reality broad in scope. To give meaning to this statement one needs only to cite the chapters on agriculture, international investment, and foreign aid. In each the authors have shown great resourcefulness in developing data which are useful and essential in making the necessary projections for 1968. While one may not agree completely with all of the methods used or the results obtained, it must be conceded that every effort has been made to take into account as many of the variables as possible.

In the last two chapters the authors went beyond the limits inherent in their task by considering international monetary problems and making policy recommendations. These steps beyond the narrow confines imposed on the authors by the very nature of the study add balance to the project, broaden its scope, and give meaning to the findings. The analysis and comments contained in these chapters are significant and are derived naturally from the preceding sections of the study. They round out what would otherwise be too narrow a project.

ASSUMPTIONS

In order to make the projections of international transactions from 1961 to 1968 the Brookings study in effect, though not explicitly, sets up a model within which to work. This is good methodology where it is possible to make assumptions that are reasonably realistic. The authors were aware of this requirement and explained in detail the nature and meaning of their assumptions. Even so one finds it hard, in several instances, to agree completely with them in spite of the qualifications that may have been made. And in at least one instance this writer thinks additional assumptions should have been made.

With respect to the growth rates which were taken as a given and which served as the basis for projecting GNP in the United States and Western Europe, there is a strong inclination to be skeptical along with the authors. The degree of skepticism is indicated by the alternate and lower growth rates used. The rate of unemployment has declined only slightly in the United States and there is no strong evidence of improvement in the future. Unemployment here is largely secular in nature and will be slow in declining, especially as a greater share of the consumers' dollars is spent on services thereby limiting the market for commodities produced in automated plants. Moreover, the Congress is reluctant to pass legislation to implement fiscal measures that could be expected to encourage a higher level of economic activity. Monetary policies can be inaugurated generally without legislative action but such measures as might be used cannot be expected to promote any great expansion of the economy. Thus for economic and political reasons there is no great cause for optimism in the growth rate over the next few years. Indeed, there is a good chance that the lower rate assumed by the Brookings study will not be attained.

The projection of a growth rate for Western Europe is even more hazardous than for the United States. Western Europe is a composite of nations at different levels of industrialization which means that real income can be expected to increase in Italy while inflation is likely in West Germany. In other words, because of uneven growth rates in the various nations, it is almost impossible to derive a single rate having much validity. The educated guess contained in the study under review may be within the realm of reason, but it may not be. To the extent that growth rates differ from those assumed, the projections that have been made will be in error. This the authors recognize. This writer is even more skeptical of them than those who wrote the report.

In projecting the anticipated levels of demand, use is made of growth rates and expected prices. The procedure followed is all right in that it relates changes in demand to changes in price. In other words demand elasticity with respect to price is the basis for making demand projections. At various points in chapter II reference is made also to income changes but there the analysis stops. Yet it is well known that demand is directly influenced by changes in the level and distribution of income. One would have much more faith in the 1968 projection of demand, both domestic and foreign, if an effort had been made to consider income as well as price elasticities. Had this been done there is a good chance that the results would have been different, since there is reason to believe that the demand for luxuries in particular is more sensitive to changes in income than in price.

Two assumptions of considerable importance are made concerning trade between the United States and the European Economic Community. The first is that merchandise exports from this nation to the Common Market countries can be expected to expand substantially and the second is that sales of agricultural products may very well decline. Both of these predictions are probably true but the magnitude of the changes is open to serious question since heavy reliance for their validity is placed on successful negotiations under the Trade Expansion Act of 1962. Discussions in recent months preliminary to bargaining sessions in 1964 are not encouraging to say the least.

Moreover, efforts by our Government during the summer of 1963 to obtain a reduction of the Common Market tariff on chickens were unsuccessful and led to threats of retaliation. All of this is to suggest that unless the climate changes drastically by early 1964, there is not much hope that tariffs on commodities traded between the United States and Western Europe will be reduced significantly if at all. In this event the projections made for 1968 will have to be revised sharply downward.

The argument is made in the study that Japan can be expected to spend on imports practically all exchange earned through exports. On this assumption it is reasoned that Japan will not make foreign investments. There are indications now, 1963, that Japan will not follow this path since it is already investing in Far Eastern nations. If these investments remain small scale in nature, the Brookings study prediction will hold, but if Japanese foreign investments should expand appreciably as they might very well do, then its position in international trade cannot be considered neutral. Historically, Japanese industrialists and financiers made substantial investments abroad. As Japan's economy grows it seems more realistic to assume that its overseas investments will expand than that all foreign earnings will be spent on imports. Should this occur, imports from the United States would decline. It may be a mistake therefore to assume that Japan's foreign trade will not affect that of the United States.

There is another comment that needs to be made concerning international investment and it is this: Europeans traditionally invest in indentures and equities abroad while American businessmen tend to concentrate on direct investments. This distinction is made in chapter V but it is not given sufficient emphasis. Greater attention should be directed to the fact that portfolio investors are much more likely to repatriate their earnings than are firms with foreign branches or subsidiaries. In the latter case earnings can be and generally are used for further expansion of plant and equipment. Investors receiving interest and dividends on foreign securities do not have a readymade place to invest their earnings and must enter the market or transfer their funds home. What this means is that a smaller proportion of earnings on American foreign investments is likely to be repatriated than in the case of Europeans thereby constituting a drag on our balance of payments.

METHODOLOGY

The procedures and methods employed by the authors of the Brookings study are straightforward, traditional, and sound. It made good sense to set forth the basic assumptions for what in reality is a model and then to proceed to the construction of a balance of payments for 1968. The main weakness in this technique lies in the validity of the assumptions which, as has already been suggested, are by and large within the realm of reason. Changes in the magnitudes of the variables would affect the final result but not the procedure by which the 1968 figures were calculated. A prime virtue of the methods used is that they can be easily understood by anyone who might read the report.

The model developed by the authors is tightly constructed in two respects. First, as has been previously remarked, the study abstracts almost completely from the monetary aspects of international trade and thereby eliminates from the analysis the broad area of domestic

fiscal and monetary policies that might be expected to be used as inflation threatens certain European nations and as sluggishness in the American economy continues. To consider these factors would, of course, introduce additional variables of such an indeterminate nature as perhaps to make impossible the derivation of meaningful results. Nonetheless, a somewhat more extensive consideration of these and similar factors would have been desirable.

A second way in which the model is restricted is that the authors focus their attention on trade between the United States and Western Europe as the principal source from which surpluses or deficits will arise. And they go one step further by arguing that it is commerce in manufactures where one is most likely to find shifts as the economies expand. Such restrictions in the model facilitate making the necessary calculations but they also raise doubts as to the results since the coverage is confined so closely.

A variable considered by the authors but largely ignored is the influence of income changes on demand. Price elasticity functions were developed and used in making the 1968 projections of demand for exports and imports. It would not have been unduly difficult to arrive at income elasticity functions as well which could then have been joined with the price functions to determine demand for the period under consideration. Had this been done one could have greater confidence in the results.

In order to determine the likelihood of greater penetration of European markets by American exporters, predictions are made indicating that prices will tend to rise faster in the European Economic Community than in the United States. On this basis it is argued that exports from this country will compete strongly abroad. This line of reasoning is sound, but one wonders if there isn't another way to determine the competitive position of American exports which might be more meaningful.

A method that might have been used to assess the possibility of an improvement in the competitiveness of exports from the United States would have been to construct a terms of trade index. Movements in such an index could be interpreted as showing either a deterioration or strengthening of the American position vis-a-vis its foreign competitors. This is a technique that is normally employed and would have been useful in this study.

There is a hint in chapter III that the author considered the terms of trade index procedure only to reject it. His argument is that export price statistics are not available (p. 91) and hence, it is impossible to compute an index showing price movements. Yet in chapter II the writer estimates that export prices are likely to increase at a slower rate than prices in general. While the data employed for such an estimation may not be useful for terms of trade calculations, an effort should have been made nonetheless to use this method of analysis. Moreover, the terms of trade technique is more generally understood than the method employed. That the terms of trade procedure was not used does not impair the high quality of the study, but this writer feels that it should have been considered more fully before being rejected.

In chapter II the author makes a projection for 1968 of U.S. trade with Western Europe expressed in 1961 prices. He then suggests "that the primary consequences of the real income changes between 1961

and 1968 in Western Europe and the United States upon the U.S. current accounts will be unfavorable to the United States" (p. 58). He concludes "that a reduction in the U.S. basic deficit with Western Europe will have to come from other factors, such as favorable price developments, a rise in investment income, a significant change on capital account, or from Government transactions." There is no disposition to argue with these statements. When it comes to a discussion of these "other factors" in subsequent chapters, however, it is not at all clear whether the projections are comparable with those made in chapter II. This uncertainty arises out of the fact that when the final computations are made and presented in Appendix table 10 it is not stated explicitly whether all of the statistics have been corrected for price changes between 1961 and 1968 or whether the 1968 figures are at expected current prices. A clarification of this possible statistical discrepancy would contribute to the validity of the conclusions drawn from the projections.

FINDINGS

If one accepts the assumptions and the methods employed by the Brookings study, after allowing for possible statistical discrepancies, then there can be little argument with the conclusions reached. It is to be reemphasized, however, that this study is focused on a single and most important problem. Its findings are valuable to the extent that they add another dimension to the broader and more fundamental problem of international liquidity and the role of the U.S. dollar as a key currency.

To the extent that the assumptions and methods employed are not fully accepted, the findings made by the authors are open to question. There are, therefore, certain areas where this writer has reservations. The procedure adopted for projecting the 1968 demand for exports and imports is too narrow since only price elasticity functions are used. As indicated earlier consumer demand is influenced also by income changes. Since income changes were postulated, it seems only reasonable to argue that they should have been taken into account in making demand projections. Failure to do so leads to some doubt about the validity of the 1968 import and export figures.

In chapter III, which deals with the competitive position of U.S. products in foreign markets, attention is focused on prices of American exports in relation to those of manufacturers in other nations. By concentrating on price relationships almost entirely other factors having an influence of demand for exports from this country are not explored in any detail. It is recognized that a wide range of other factors could not be included but it would have been useful to investigate even briefly the relative position of European and American manufacturers with respect to research and technology. Research and technological innovations affect a firm's competitive position with respect both to quality and cost of production. The author considers costs but does not deal adequately with quality as a competitive factor. Manufacturers here and abroad have made significant improvements in machinery, aircraft, and chemicals in recent years because of technological advances coming from extensive research. Because of this situation it may be argued that American penetration of foreign markets will depend not only upon price advantage but upon ability to keep ahead of foreign procedures technologically. This may not be

easy to do since European aircraft manufacturers and steel producers, for example, have gained a strong position in American markets.

The discussion of U.S. trade with the European Economic Community in chapter IV is well done. With respect to agriculture, however, the statement that "the prospects for future U.S. agricultural exports to the EEC countries are not promising" (p. 110) is probably an understatement. Unless greater progress toward developing a rational farm policy is made by the Common Market countries than has so far been the case, the opportunities for American agricultural commodities are not promising at all. The estimated loss of \$350 million in this market is too conservative. The situation will be even worse in the event of British membership since agreement on agricultural policies will be more difficult. Because agricultural commodities account for a significant proportion of U.S. exports the loss of sales because of Common Market restrictions can have repercussions beyond those suggested by the dollar decline in exports.

In searching for a cause of U.S. balance-of-payments deficits, attention settles almost immediately on our foreign military and economic assistance programs as likely culprits. Both of these programs are analyzed carefully and adequately in the report. The trend of foreign economic assistance expenditures during the period is exceedingly difficult to project and will surely be influenced by forces not foreseen. Even though the cost of these programs is shown to have no great influence on the size of our balance-of-payments deficit, the fact remains that this point is not well understood. Unless Members of Congress come to understand better the impact of economic aid expenditures on the international accounts of this Nation, there will certainly be a concerted drive to reduce appropriations to the Agency for International Development (AID). In this event the upward trend of these expenditures forecast in "Chapter VI: Foreign Economic Assistance," simply will not take place. The temper of the Congress now in session is such that AID appropriations are almost certain to be held to current or lower levels.

A discussion of foreign aid limited to balance-of-payments considerations is too restricted as the authors of the report suggest. A more important relationship is that of the effect of assistance programs upon the economic and political stability of recipient nations and world peace. The prediction that U.S. aid will grow absolutely and relatively in the nations of Latin America gives weight to the observation made above. Here is a group of nations rich in natural and human resources but highly unstable economically and politically. It seems only reasonable to assume that aid from this country will make its greatest contribution to world peace in South America. Efforts must be made by all means possible, therefore, to direct the attention of the American people away from the balance-of-payments effects to the broader and more significant contribution that foreign economic assistance expenditures can make to the maintenance of peace in the world.

The final chapter, "Policy Recommendations," is the most important in the study because it focuses attention upon the central problem—international monetary liquidity. The question, therefore, becomes monetary with balance-of-payments considerations secondary. The policy recommendations point in the right direction and deserve serious study.

STATEMENT BY BENJAMIN J. COHEN

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"The United States Balance of Payments in 1968,"¹ by Walter Salant and his associates, is an outstanding public document. In my opinion, it warrants the widespread attention it has received—and will no doubt continue to receive. Mr. Salant and his coauthors have prevailed over an enormous econometric challenge, avoiding both the Scylla of broad oversimplification and the Charybdis of narrow professionalism. Their analysis is neither so implausible as to be disregarded by policymakers nor so unsophisticated as to be the object of upturned academic noses. Quite the opposite. It is a profound and relevant consideration of our balance-of-payments problem. Public officials should find the Brookings study useful for its systematic presentation of trends in, and interrelations among, the many categories of transactions in our international accounts. Scholars should find it interesting for the efficiency of its statistical procedures and estimating techniques. The study deserves to find its way onto many reading lists, in both universities and Government agencies.

However, the Brookings study is not without its flaws; no study of this scope could be. It also deserves, therefore, to come in for its share of criticism. It is to the credit of the authors that what defects there are do not invalidate the analysis. But some of the flaws are nevertheless quite serious. I am sure that they will all be discussed by one or another of the contributors to this collection. In order to avoid scattering my own shots, therefore, I shall concentrate on just the assumptions underlying the analysis. In concluding, I shall comment also on the general approach to balance-of-payments adjustment used by the authors.

1. THE ASSUMPTIONS UNDERLYING THE ANALYSIS

The Brookings study is supposed to represent an analysis of the future outlook for the U.S. balance of payments. But this is not a forecast. The principal findings are not estimates but projections, based on an extrapolation of certain trends and relationships observed in the past and the assumption of certain developments to which these relationships are applied. As the authors themselves warn, these are merely "estimates of what the assumptions imply, made without assessing the probability that these assumptions will be realized."²

The last clause is significant. The Brookings projections can be interpreted as forecasts only to the extent that the assumptions themselves are forecasts of what is likely to happen. On the authors' own admission, the assumptions are, for the most part, merely given. Yet

NOTE.—The opinions expressed are entirely personal and should not be interpreted as representing views of the Federal Reserve Bank of New York.

¹ Hereafter referred to as the Brookings study.

² *Ibid.*, p. 35.

too many interested parties, including not only the press but also people who should know better, have tended to interpret the projections as actual estimates of the U.S. basic balance of payments in 1968. Even the authors themselves seem to be guilty of this tendency, in their final chapter of policy recommendations. Such misinterpretation of the Brookings findings is unfortunate, but it was probably inevitable given the study's unusual circumstances and circulation. What is relevant here is that the authors should have anticipated this problem and forestalled it by making their balance-of-payments projections as nearly as possible balance-of-payments estimates. In short, they should have tried to make their assumptions as realistic as possible. They did not try. Consequently, many of the assumptions seem to be unrealistic, and, as I shall try to demonstrate, most of them tend overwhelmingly to be relatively favorable to the United States.

To begin with, the Brookings study deals specifically with the net balance of "basic transactions"—that is, with the part of the total of payments consisting of the net balance of goods and services, including investment income, and the net balance of aid and long-term capital flows. According to the authors, the "basic balance" is a much more satisfactory concept than the total net balance (as defined by the Department of Commerce) for the purpose of projecting the outlook over a number of years. In the first place, the basic balance concept is supposed to be a better indicator of the presence or absence of pressure on a currency, primarily because it excludes those transactions that are substantially influenced by transitory considerations (i.e., short-term capital and "errors and omissions"). Furthermore, unlike the total net balance, changes in the basic balance of the United States must be accompanied by opposite changes in the basic balance of other countries and international organizations.³ The basic balance, in other words, also has the advantage of symmetry.

By using the basic balance measure, rather than the total balance, the authors assume, in effect, that private short-term capital movements and unrecorded transactions in our international accounts are influenced only by transitory considerations and tend, over time, to net out to zero. The evidence does not confirm this tendency. In my own study, submitted in July by Secretary of the Treasury Dillon to the Joint Economic Committee,⁴ I demonstrated that a number of categories of short-term capital are related structurally to trends in categories comprising the basic balance. This is especially true of bank loans to "other" (nonofficial, nonbank) foreigners; bank collections outstanding, and "other" bank claims, all of which consist largely of credits extended to foreign importers in need of short-term commercial financing. Some of the dollar claims recorded by U.S. non-financial corporations also represent trade credit extended to foreign importers. Assuming, as do the Brookings group, that U.S. exports will continue to grow, there is no reason to doubt that these U.S. short-term claims on foreigners will grow, too.

Some other types of U.S. short-term claims may also have an upward growth trend over the next few years. The evidence cited in my earlier study indicates that the Euro-dollar market has been an increas-

³ Actually, this is true only apart from changes in the additions to free world holdings of monetary gold and in statistical discrepancies.

⁴ Benjamin J. Cohen, "A Survey of Capital Movements and Findings Regarding Their Interest Sensitivity," "United States Balance of Payments," hearings before the Joint Economic Committee, pt. I (Washington: 1963), pp. 192-208.

ingly effective magnet for U.S. corporate funds. Much of the outflow has been recorded in the increases of dollar claims of U.S. nonfinancial corporations; in addition, a large part has until now escaped our statistical nets, showing up in the now negative "errors and omissions" items in our international accounts. Whether recorded or not, these short-term outflows are apt to persist, at least so long as official policies here and in Europe remain roughly the same. The Euro-dollar market is only a few years old, and most U.S. corporate treasurers are only now beginning to learn how profitable—and how easy—it is to deposit idle dollar balances in Canadian or European banks; they will probably continue to place dollar deposits abroad, perhaps in increasing amounts, unless American and foreign authorities move to curb the growth of the Euro-dollar market itself.

U.S. foreign-currency claims are also apt to go on growing, as American banks and traders will probably require even larger working balances as world trade in goods, services, and securities expands.

Thus, it is hazardous of the Brookings group to assume that the items excluded from the basic balance will net out to zero between 1961 and 1968. The assumption is hazardous because many of these items are in fact influenced by the same basic economic forces affecting the other segments of our balance of payments. In the last few years they have, not surprisingly, appeared as net debit items in our international accounts. In the 3-year period 1960 to 1962 they added an annual average of \$2 billion to our basic deficit. This is almost as large as the entire improvement in the basic balance between 1961 and 1968 projected by the Brookings study on the basis of its more optimistic set of "initial" assumptions; it exceeds by far the improvement projected on the less sanguine set of "alternative" assumptions. By using the basic balance concept, therefore, the Brookings study seems to have introduced a bias favorable to the United States.

This bias could have been avoided, for the most part, had the authors used the "monetary balance" concept as defined by the International Monetary Fund, since this measure includes U.S. and foreign short-term capital flows "above the line." Since, moreover, a U.S. "monetary" deficit must be matched by comparable "monetary" surpluses elsewhere, the use of the International Monetary Fund concept would not have lost to the authors the advantage of symmetry claimed for the basic balance concept.

In making use of this advantage of symmetry, the authors introduce a second bias favorable to the United States. Noting that since 1950, substantial U.S. deficits had their major counterparts in Western European surpluses, the authors divide the world outside this country into two sectors: Western Europe and all other countries. Concerning the latter (Japan and Canada included), the authors make the important assumption that their aggregate foreign expenditures will, over the next 5 or 6 years, continue as in the past approximately to equal their foreign-exchange receipts. The assumption is extremely useful, since it means that only the changes in U.S. and Western European domestic economic variables need be considered as the major determinants of the changes in the U.S. basic balance. But the assumption is, perhaps, too much of a simplification. It is probably true that the reserves held by most of the countries outside of

Western Europe are not sufficient to permit them to run much of a deficit, and their development priorities will probably prevent them from running much of a surplus. But there are countries in this category whose incomes are rising sufficiently to permit them to increase their reserves. Indeed, in some (Japan in particular) investment in reserves is likely to have a high priority. The Brookings assumption, therefore, probably tends to overstate our chances for balance-of-payments improvement. This specific source of overstatement might have been avoided if Canada and Japan, two industrial countries, had been treated along with Western Europe rather than with the less developed nations.

Of all the assumptions in the Brookings study, the most important relate to the relative rates of inflation and real economic growth in the United States and Western Europe. On balance, these assumptions, too, seem favorable to the United States. The U.S. economy is assumed to grow at a rate of 4.5 or 4.8 percent a year, with unemployment falling to 4 percent of the labor force and domestic prices rising at a rate of 1.5 percent a year, which is no more rapid than in the recent past. This is a very favorable set of assumptions. In the first place, one may legitimately doubt whether the stipulated rates of growth and unemployment will be achieved. But even assuming they can be achieved, one may have even stronger doubts as to whether it will be possible to keep domestic prices within the bounds stipulated. The authors do not anticipate an excessive expansion of domestic demand in the United States, but this hardly seems realistic when they also project a doubling of the rate of real economic growth and a one-third cut in the rate of unemployment of a growing labor force. Throughout the postwar period, bursts of economic growth have had their counterparts in accelerated inflations. The authors do not adduce sufficient reasons for assuming that the pattern will be different in the next few years.

The authors also do not adduce sufficient reasons for assuming that export prices will rise at a rate of no more than one-half percent per annum. They merely assume that in the near future export prices will continue to rise as slowly as in the recent past. But in the period during which export prices behaved in this manner, American exporters were losing markets or meeting increased competition, both in Western Europe and in third countries. In the near future, by contrast, U.S. exporters are expected (by the authors themselves) to recover some of these markets, in which case they may be less reluctant to allow their prices to rise. Thus, even if domestic prices rise no more rapidly than 1.5 percent per year, export prices could rise more rapidly than anticipated in the Brookings study.

Conversely for Western Europe, where GNP is supposed to grow at an annual rate of 3.8 or 4.2 percent, domestic prices at a rate of 2 or 3 percent, and export prices at a rate of 1.0 or 1.5 percent. Assuming the stipulated rates of growth and unemployment can be achieved, one may legitimately doubt whether domestic and export prices will rise as rapidly as anticipated. There are no doubt strong inflationary pressures already at work in Western Europe. But there are also at work in Western Europe governments more experienced and better equipped than our own to deal with inflation. Consider the extraordinary range of selective budgetary instruments readily available to

the European national authorities to control the trend of prices.⁵ We can distinguish three broad categories of weapons in the arsenal. In no particular order, they are (a) public expenditures on goods and services; (b) taxes, subsidies, and government current transfers affecting mainly private disposable incomes; and (c) capital transfers and state lending aiming at influencing the investment activity of local authorities and the private sector.

Unlike our own Federal Government, the governments of Western Europe have been granted substantial discretionary powers to wield these weapons in the interest of price stability. In addition, they can resort as a matter of course to all manner of direct controls over construction, capital issues, wages, and prices which in this country would require congressional approval. Since all of these weapons can be used flexibly, and their impact can be made highly selective, the European governments can have a stronger influence on prices than we, with a smaller negative effect on the rate of overall economic activity. To take just one example, consider the French Government's reaction, announced in September, to growing inflationary pressures in that country. Prices on manufactured goods were frozen at the August 31 level, certain other prices were decreased, some taxes were raised, and projected public expenditures were reduced. In addition, installment buying was to be discouraged by an increase in the required downpayment and a decrease in the payment period, and saving was to be encouraged by a rise in interest rates on deposits. Finally, excess credit expansion was to be avoided by a long-term government bond issue and by new limits on authorized bank lending.

In addition to their impressive arsenal of policy weapons, the governments of Western Europe are armed with a very strong traditional distaste for currency depreciation. In other words, they have both the means and the will to resist inflation. It is rather doubtful, therefore, that they would tolerate the rates of increase in domestic and export prices anticipated in the Brookings study. If they do not do so, most of the projections of the U.S. basic balance can be seriously questioned.

These projections are extremely sensitive to the assumed changes in the U.S. competitive position (i.e., in relative export prices). By reducing the assumed annual rate of increase in European export prices from 1.5 percent to just 1 percent, the authors lopped \$3.1 billion off the projected improvement in the U.S. merchandise trade balance. (See their table III-8.) They readily admit, in fact, that almost all of the difference between \$2.7 billion net improvement in the basic balance projected under the initial assumptions and the \$200 million net improvement projected under the alternative assumptions is due to the smaller stipulated improvement in the U.S. competitive position.⁶ The authors are correct to emphasize how much our balance-of-payments problem is a matter of relative price levels. But they are, in my opinion, incorrect in assuming that Western Europe will solve our problem by inflating for us. Clearly, the Brookings group ought to have been more careful in their choice of assumptions regarding relative price changes—or at least ought to have tried harder to

⁵ Probably the only exception to the argument which follows this statement is Western Germany, where primary reliance has been placed on monetary instruments which work through the interest rate and the general availability of credit.

⁶ Brookings, p. 226.

justify their choices. As it is, their assumptions seem definitely to tip the scales in favor of the United States.

The Brookings group might also have been more careful in their choice of assumptions regarding interest rates. The authors assume that the general level of interest rates in the United States and Western Europe will not differ greatly from the present structure, but that the current spread may narrow somewhat since rates in Europe can be expected to decline. But at the same time, they make assumptions regarding price changes in Western Europe which imply that aggregate demand will rise more rapidly than output; savings, therefore, must be assumed to be declining considerably. Since the demand for investments is also assumed to rise faster than output, it follows that interest rates must rise unless the money supply in Europe is sufficiently expanded. Thus, to satisfy the Brookings assumptions regarding interest rates, the European governments would have to support, or at least acquiesce in, an expansion of the money supply more rapid than the expansion of output—in short, they would have to inflate. There is no need to repeat how unlikely this is.

Suppose, then, European governments do not prevent a rise in their interest rates. In that event, the profitability of portfolio investment in Western Europe may rise relative to that in the United States, or at least not decline as much as the Brookings study assumes. And, consequently, the net outflow of new investment funds across the Atlantic may not decline as much as the study assumes. In fact, the net outflow might not decline at all unless Western Europe finally undertakes the financial reforms necessary to channel a larger proportion of savings into long-term investment.⁷

On balance, it seems that many of the most crucial assumptions in the Brookings Report are implicitly weighted in our favor. By making only a few of them more "realistic," we could greatly reduce the net improvement in the U.S. basic balance projected on the basis of the initial set of assumptions, and would no doubt wipe out the improvement projected on the alternative assumptions. Therefore, there seems to be little reason for concluding, as the authors do, that "a significant basic surplus will develop"⁸ without the aid of any new deliberate policy correctives; there even seems sufficient reason for disagreeing with their "best guess" that the basic deficit will be eliminated. My own guess, as indicated in the foregoing comments, is that our outlook would be rather more grim were it not for the new measures announced by the President and the Federal Reserve Board of Governors in July (after the Brookings study was already written).

2. THE GENERAL APPROACH TO BALANCE-OF-PAYMENTS ADJUSTMENT

I do not intend to comment on the policy recommendations included in chapter IX of the Brookings study, but I do want to comment on one inference of those recommendations and of the analysis which precedes them. The process of balance-of-payments adjustment, it

⁷ A reallocation of European savings into long-term investment would probably help force up European short-term interest rates, implying some rise in the net outflow of short-term capital from the United States. The authors of the Brookings study ignore this possible implication because they deal with the basic balance, which excludes short-term capital movements. However, the net effect on our overall payments position of such a development would certainly be adverse.

⁸ Brookings, p. 230.

would seem, is a relatively straightforward matter: We just wait for it, meanwhile providing ample international liquidity to finance imbalances. The authors rule out all of the traditional adjustment mechanisms. Deflation is domestically impalatable, devaluation would destroy future confidence in the dollar, and direct controls of any sort would be inconsistent with our traditional policies favoring free markets. Yet they evince no concern for our balance of payments, because inflation in Europe can be expected eventually to improve our trade balance and reduce our long-term capital outflow. In short, the authors recommend that we simply finance our deficits while waiting—and hoping—for events abroad to reverse our position.

However, as I have tried to indicate, the probability that events abroad will reverse our position is rather less than the authors assume. Consequently, some corrective measures must be undertaken here. But the adjustment mechanisms used need not be of the traditional type. As Staffan B. Linder and I argue elsewhere,⁹ there are a number of additional means of adjustments available to the national authorities. Perhaps most important of these are policies designed to change foreign tastes, to stimulate domestic economic growth, and to develop new products. The United States Government is currently beginning to use all three types of measures. The authors of the Brookings study disapprove of some already being used, in particular the tying of foreign aid (which is meant, in effect, to alter foreign demand patterns in favor of American goods and services). No doubt some measures are less efficient than others. But if our payments position is to be improved, it will—by necessity—have to be through our own efforts.

As for the provision of more ample international liquidity, I think the authors are hasty. Their emphasis on liquidity follows directly from their general approach to balance-of-payments adjustment, which implies the financing of deficits rather than their correction. But the emphasis on liquidity is unfortunate, since it puts the cart before the horse. While the United States is the logical leader of any movement to reform the international monetary standard, we will not be followed if other countries suspect that our true goal is unlimited credit. Our primary problem is our balance of payments, and its solution is, ultimately, our own responsibility.

⁹ Staffan B. Linder and Benjamin J. Cohen, "Balance of Payments Adjustment in a Disequilibrium System," to be published in a forthcoming issue of *Kyklos*.

STATEMENT BY EMILIO G. COLLADO

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I appreciate the invitation to comment on the recent Brookings study of the U.S. balance of payments in 1968.

In my view the attempt to project our balance of payments in 1968 was a desirable undertaking, and I feel that the authors have taken a scholarly approach to the difficult task of making an estimate so far into the future. As I will indicate, I do question a few of their assumptions, but, more importantly, I fear that when they came to their current policy conclusions the authors were inclined to slight the pressing facts of our present situation and to place undue reliance on long-range projections which inevitably involve a large margin of probable error.

The "initial assumptions" used in the report were provided, in the main, by the Council of Economic Advisers. The results of using these assumptions may be of interest to indicate how the balance of payments might look if the Government's long-term growth objectives were achieved. I presume, however, that the authors' "alternative assumptions" may be taken to indicate their own expectations about the most probable future trend values. They expect a more rapid growth of real GNP in the United States than in Western Europe between now and 1968 and, quite logically, this implies for them a worsening of the U.S. merchandise trade balance. The effect of this deterioration in the merchandise trade balance is partly offset by the favorable effects of a pronounced improvement in the U.S. competitive position which they forecast. When other current account items are taken into account, a moderate (\$1.7 billion) gain in net exports of goods and services between 1961 and 1968 is shown. However, this expected gain in current account earnings is more than accounted for by a \$2.04 billion assumed increase in exports which the authors expect to be financed by an increase in U.S. foreign aid. When this projected rise in foreign aid is appropriately netted out, the report shows a modest (\$0.3 billion) deterioration in U.S. net commercial exports of goods and services from 1961 to 1968.

The various price forecasts contained in the report have a powerful restraining effect on the extent of the deterioration which the authors expect in net commercial earnings from exports. As the authors themselves state, however, these critically important price projections are highly intuitive and I believe they are somewhat optimistic from the point of view of their probable effects on our balance of payments. For example, the authors assume that Western Europe will be forced by economic circumstances to resign itself to a worsening of its international competitive position, but today several European governments are already demonstrating their determination not so to resign themselves. As another example, in their price assumptions applicable to exports, the authors project a very drastic reversal of past

trends which would be highly favorable to the United States. They project an increase in average U.S. export prices in 1961-68 only about one-half as great as the increase realized in 1953-60 (0.6 percent compared with 1.1 percent), while in Western Europe they project a future increase five times as great as the past increase (1 percent compared with 0.2 percent). In the circumstances it seems more likely to me that the study has underestimated, rather than overestimated, the magnitude of the deterioration in our current commercial account balance in 1968.

Whatever the size of this deterioration in our current commercial account balance, the expected small improvement in the basic balance (\$0.2 billion) is more than entirely accounted for by the projected \$0.6 billion decline in the net outflow of private long-term capital. I certainly agree with the authors of the report that we can expect a slackening in the balance-of-payments outflow of new direct investment funds to Western Europe—even though the gross investment expenditures by U.S. companies in the area will probably increase—but I believe the decline in the balance-of-payments flow to the rest of the world which they project (from \$874 million in 1961 to \$350 million in 1968) may imply too pessimistic a view of future investment opportunities in the developing nations of the world. When a projection of improvement in the balance of payments depends as completely as the Brookings study does upon an expected reduction in the outflow of private investment capital from the United States, it is important to consider whether adequate attention has been given to the role which we all hope the flow of private investment capital to play in tomorrow's world. The \$350 million outflow implied in the report for all areas outside Europe is only slightly above the \$300 million per annum for Latin America alone which has been assumed by the Alliance for Progress.

Nevertheless, the projected increase in the excess of the net flow of interest and dividends to the United States over the net flow of investment from the United States underscores the strength which long-term capital transactions contribute to our balance of payments. I was pleased to note that for direct investments the authors estimate that the cumulated income flows will match the original outflows in manufacturing in Europe within 5 to 6 years. This is considerably more realistic than the Treasury's estimate last year of from 10 to 15 years. However, I believe that even this estimate may be overly pessimistic as our own calculations would indicate that the average dollar of new investment returns within 2 to 5 years.

As indicated by the examples I have mentioned, I tend to feel that the Brookings projections may be based on unduly optimistic assumptions even when the authors' "alternative assumptions" are used. And even these "alternative assumptions" imply no significant change at all in the basic balance of payments between 1961 and 1968. Clearly, this analytical finding might have led the authors to conclude that their projections pointed to the urgent need to search for policies capable of establishing a definite and unmistakable improvement—and soon—in the basic balance of payments. Such an interpretation would have made a helpful contribution to a discussion of current policy problems; but, instead, the authors assumed away all present problems and devoted themselves to a solemn discussion of the presumed inadequacy

of international liquidity under hypothetical conditions in 1968. In the course of discussing problems which they believe we may face in 1968, moreover, they develop a "second best" proposal for a modified system of flexible exchange rates between a dollar-sterling bloc and a Common Market bloc. I must say that this proposal seems to me to be quite defeatist, because the introduction of such a system would disrupt established economic relations and at the same time deliver a serious blow to our prospects of creating a more productive North Atlantic economic community through reduction in trade barriers and through other measures of economic cooperation.

While I do not question the desirability of careful longrun economic projections as an aid to policy formulation, I do suggest that in the Brookings study such projections are used too exclusively by the authors in arriving at their conclusions. The authors point out several times, mostly in early sections of the study, that balance-of-payments projections are necessarily subject to a wide range of error, but they then seem to lose sight of this qualification when setting forth the conclusions to be drawn from their study. This means, in practice, that they have overlooked the serious problems we may have to face during the next few years if we do not achieve even the limited improvement which they foresee. In analyzing the problems which face us in 1963, I do not believe that we can afford to keep our eyes fastened solely on economic projections for the year 1968.

STATEMENT BY ARNOLD COLLERY

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Economics consists of a body of special knowledge; interesting and important propositions are discovered from its study. In addition its students are able to make a few predictions of some significance.

To some this may seem surprising, since they believe that economists disagree about everything. Economists, of course, do disagree and always will. But the extent of their disagreement is exaggerated. The many things on which there is no controversy naturally generate little discussion; it is disagreement that makes headlines. This in part explains the general misconception. In addition there is no clear criteria for deciding just who is an economist. Without such criteria there is bound to be disagreement. If superstitious old women were called doctors, doctors would disagree on the cause and cure of every human ailment.

Although economists are substantially agreed on many things and have some success in predicting, their knowledge and predictive ability are sadly less than complete. The distinction between what economists can do, may be able to do, and simply cannot do is not always clear even to them. Their success at doing one thing leads others, and sometimes themselves, to believe that they can do slightly related things. Consider an example from banking.

Much is now known about the nature of a fractional reserve banking system. Some propositions are now so clearly established that they seem perfectly obvious once learned. We know that a banking system with claims against cash that are greater than all cash in existence is liable to liquidity crises. Fear that banks cannot meet their obligations could lead to their collapse; the expectation of illiquidity producing illiquidity and insolvency. The knowledge and understanding of this weakness of a fractional reserve banking system has led to central banking and our own Federal Reserve System. Although we still have fractional reserves, we no longer need fear liquidity crises so long as the central bank is able and willing to create cash. The Federal Reserve System today maintains the liquidity of the banking system so well that few are even aware that it is serving this function. Here is then an example of something that economics clearly explains and where knowledge has led to the elimination of a social evil.

Not only have we learned much about our banking system, but, to a limited extent, prediction about the future state of bank reserves is possible. For example, a seasonal withdrawal of coin and currency from the banking system as the Christmas shopping season begins can now be anticipated.

Success in understanding the nature of our banking system and in reforming it so that it functions better and limited success at forecasting could conceivably deceive us into believing that we can do much more. There might be value in knowing the size of bank re-

serves in general or the size of reserves for one particular bank 5 years from now. It would not be surprising to discover that forecasts of just these things are actually made. But no economist in 1963 can tell a bank that in 1968 it is going to gain \$110 million worth of cash or tell the Federal Reserve authorities that if reserves are to grow at the rate of 3 percent over the next 5 years it must buy \$10 billion worth of Government securities. Anyone can guess at a number, but a guess based on 5 minutes thought would be as likely to be correct as one made after months of careful analysis. Contemporary economics has its limits, although the limits are not always clear. And to bring us to the Brookings report, it is just such a misunderstanding about the limits of economics that has produced this report.

The United States has been losing gold, and the administration has for some time been anxious about the strength of the dollar. Its concern is easily understood. The United States is on a gold standard. It is indirectly committed to convert into gold any asset in the world than can be sold for dollars by either Americans or others. An American could sell anything he owns and transfer the receipts from the sale to a foreign bank. The foreign bank could then transfer its new dollar claims to its central bank. Finally the central bank could withdraw in gold the value of the transaction. Similarly a foreigner could sell something for dollars and then the same consequences could follow. Thus the possible claims against our gold stock are enormously greater than the stock itself.

If our holdings of gold are rising, there is not likely to be much apprehension. But let our gold stock fall and then anxiety is almost immediate. For decreases in the gold stock may lead to undesirable speculation. If speculators suspect that the dollar may be in trouble and might be devalued, a flight of capital could occur and a serious international crisis follow.

Present anxiety over our ability to meet continually our commitment to pay out gold at a fixed price, and a mistaken belief that economists may be able to forecast the state of demands for gold in the future, undoubtedly explain why the administration requested the Brookings Foundation to forecast our balance of payments in 1968. But predicting in 1963 the state of the U.S. balance of payments in 1968 is a perfect example of something that economists cannot do. They may know a great deal about the balance of payments, but, even leaving numbers aside, they certainly do not know if it is probable that it will be in deficit or surplus 5 years from now.

Perhaps all economists would not share the view that prediction of our balance of payments is impossible. Certainly only a decade ago there were many who believed that they could see what the future development would be. It was fashionable to predict that the United States would have persistent surpluses, that the dollar shortage in the world would continue indefinitely. But what better evidence of the folly of making such forecasts can be offered than the present problem facing the United States only a few years after this prediction.

The authors of the Brookings report certainly share this skepticism about forecasting the balance of payments. Again and again they refer to rough estimates and guesses. We are told that " * * * the value of the projection lies less in its quantitative result than in the process of obtaining the result, for that process identified the kinds

and direction of influences that will determine the future development of the basic payments position of the United States."

Unfortunately the report at moments forgets its usual caution and gives an importance to its numbers that it has previously denied; for example, when it says that our exchange rate should not be devalued because the analysis has shown that the balance of payments will improve and be in surplus in 1968. If the Council of Economic Advisers or the Brookings group had only chosen a more pessimistic set of assumptions concerning future inflationary tendencies in the United States—a set of assumptions that would have predicted large deficits for the United States—they would have had to be more cautious in making readers aware that rather than actually predicting the balance of payments in 1968, they were only showing the factors that will determine its outcome and demonstrating the impossibility of actually making a meaningful prediction.

The impossibility of predicting what will happen to the present pressure on the dollar can be made clear by considering the problems of projecting imports and exports alone. If the latter is impossible, surely the former is all the more so. How can we forecast imports 5 years from now?

We do not know all the factors that determine imports, but we think we have a fair notion of some of the most important of them. National income and relative prices clearly are important. If we assume that they are the only determinants we obviously err, but since all factors can never be considered some such error is necessary if any analysis is to be conducted. Even if we could agree that relative prices and the national income were the most important variables and only a small error would occur if all others were ignored, as the Brookings report would suggest, we are a long way from being able to predict imports. We must know just what influence income and relative prices have on imports. Will a 10-percent increase in the national income mean a 5-percent, 10-percent, or 15-percent increase in imports. The standard procedure for answering this question entails gathering information about imports, prices, and the national income from the statistical records of the past, seeking a historical relationship between them, and assuming that any historical relationship that may have existed will continue to exist in the future. There are abundant difficulties. Even if the national income and prices are always the overriding determinants of imports, there is no reason to believe that their relative importance would be the same in 1968 as it was 10 or 20 years ago. This problem aside, we would have to decide what prices are the important ones. Even theoretically this is not clear. But if we knew what price indexes were required, we undoubtedly would discover, as the Brookings group discovered, that they are lacking and that the indexes of prices that do exist are not suitable for estimating the impact of prices on imports. In the end we would be forced to use the unsuitable information.

There is a difficulty of another nature. The separate influence of prices and national income can only be determined from historical data if changes in these variables are not closely correlated. If prices in the past have changed to just about the same degree and at the same time that national income has changed, there is no way of inferring how much a change in imports is due to a change in income

rather than to a change in prices. Unfortunately there is evidence that such correlation has existed.

And we are not through with difficulties. Only if the expected values of national income and prices lie within the range of the historical data is there any rationale for using the historically derived relationship for forecasts. But since the national income is growing, the forecasted value is sure to be outside the range of the historical data. Moreover, if a relationship is to be established between the variables it must be assumed to have some particular form. It is frequently assumed that the function is either linear or linear in logarithms. The choice, as usually made, is highly arbitrary. Polak and Rhomberg assumed that the relationships were linear. The Brookings group, although basically relying on their results, assumed that they were linear in logarithms. The choice makes a significant difference. But one is as defensible as another.

If you believe that these difficulties are not sufficient to prevent you from going on, you have a relationship between imports, prices, and the national income to use in predicting imports in the future. The relationship that Polak and Rhomberg found is far more controversial and surprising than the Brookings group indicates. The equation, as interpreted in terms of percentage changes by the Brookings group, states that a 1-percentage change in relative prices in any year will cause our imports to change by 4 percent in that same year; the full impact of price changes being felt in the year in which they occur. They do not indicate that many economists who are expert in this area would seriously question the assertion that a change in relative prices this year will have a major effect on imports in this year, eventually perhaps a great effect, but not this year. The Brookings group felt that the Polak and Rhomberg result exaggerates the effect of prices on imports, so they reduced the 4 to $2\frac{1}{2}$. Why to that number rather than some other number is not explained. All going to show how arbitrary the whole procedure is.

But so far only a relationship between imports, prices, and national income has been secured. In order to predict imports in 1968, it is necessary to project prices and national income in 1968. Perhaps a national income forecast may be worth something, although clearly the projection of the Council of Economic Advisers that was used by the Brookings group was a hope and not a prediction. But I know of no evidence that a forecast of U.S. prices relative to Western European prices can have any reliability.

A forecast of our exports involves exactly the same difficulties as a forecast of imports and a few others in addition. The amounts of foreign aid and foreign investment are likely to change. How will this affect exports? We can only guess. In addition countries that experience deficits may alter their trade policies or change their exchange rates so that any prediction that is based on unchanged exchange rates or trade policy, as the Brookings forecasts are, are likely to be wrong.

It is, of course, conceivable that all the difficulties might imply that the forecasts of imports and exports would be likely to be off by, say, \$4 billion, which perhaps would not be so much. But it is the excess of exports over imports that we seek; if each forecast can be wrong by \$4 billion the forecast of the balance of exports over imports can be

wrong by \$8 billion. No one could say that such a forecast has value.

These then are some of the difficulties of forecasting the future value of our trade balance—the excess of exports over imports. Forecasting the balance of payments or the degree of pressure on the dollar entails further problems and some of them are even more troublesome. The difficulties are so numerous and so serious that a snap judgment about the state of our balance of payments in 1968 could be as close to the truth as a forecast that has been offered after the most careful analysis. This means in effect that a meaningful forecast is not possible.

The Brookings report alerts us at least once to most of the difficulties that have been presented here. Anyone who takes their numbers seriously must mistake their intentions. The report will be an invaluable reference, nonetheless, for anyone who wishes to understand the complexity of the interrelationships between the components of our balance of payments and the pitfalls that await anyone who tries to see today what the payments situation will be tomorrow.

Although we may not be able to predict the future state of our balance of payments, one thing is clear. At the present time the United States has no satisfactory means of solving a fundamental disequilibrium in its balance of payments.

Without serious restrictions on the flow of trade there are three ways a deficit can be eliminated. A country experiencing chronic deficits can deflate—lower its prices relative to those of the rest of the world, can keep its economy operating at such a low level that imports will be checked, or finally can change its exchange rate—devalue its currency relative to that of other countries.

The United States cannot choose the first possibility without choosing the second. If wages and prices in our economy responded rapidly to changes in demand, a chronic deficit in the balance of payments could be cured by a dose of tight money. Tight money would reduce demand. The reduction in demand would lower wages and prices; output need not change at all. With a lower domestic price level, exports would tend to increase and imports to decrease, and the deficit would be eliminated. But wages and prices in our economy tend to be rigid, at least in the short run. Reductions in demand do not just lower the level of wages and prices, they lower output and raise unemployment. Since the price level tends to be rigid downward, a balance-of-payments disequilibrium cannot be corrected simply by changing the price level.

The second alternative, keeping output so low relative to its potential that imports are reduced below what they would be at full employment, may work all right, but at what cost. Some have estimated that close to \$40 billion worth of output annually is currently being lost because our economy is working at less than full employment. The authors of the Brookings report mention this. If indeed our failure to achieve full employment with this extra output is because of fear that prosperity will worsen the balance-of-payments deficit, much is being sacrificed for a small gain.

Since the first alternative is impossible and the second is unacceptable, we should choose the third alternative, devaluation, as the basic method of eliminating a fundamental deficit in our balance of payments. For many years it was thought by some that we had adopted this alternative. Under the agreement that established the Interna-

tional Monetary Fund, an agreement that we signed, it was understood that the members of the Fund would devalue rather than restrict trade or suffer unemployment when they were experiencing balance-of-payments difficulties. Every indication now shows, however, that we have no intention of correcting any balance-of-payments deficit that we have in this manner. Rather we will hope that others will inflate faster than we do or, when hope fails us, we will try through restrictions on trade and investments and by the maintenance of low levels of output and employment to protect our payments position.

It is indeed sad that we accept the unacceptable solution. Surely at the least a Government commission is required to see if there are any substantial objections to the abandonment of a rigid exchange rate in favor of a flexible one. But it is a good indication of the sad state we find ourselves in that at the present time many would object that the mere study of this important question by a Government commission might lead to a flight of capital and, therefore, must not be undertaken.

If we do experience substantial deficits in the future, I believe it is likely that we will solve the problem by slow growth and unemployment. In that case as the depression of the 1930's will surely be known in history as the great economic tragedy of the first half of the century, our enslavement to a rigid exchange rate may become to be known as the tragedy of the second.

STATEMENT BY GERHARD COLM

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I find the Brookings Institution's study, "The United States Balance of Payments in 1968," an imaginative analysis and quantification of various factors influencing the U.S. balance of payments and a straightforward presentation of the policy conclusions following from the assumption, the analysis, and the estimates.

I wholly agree with the basic attitude of the authors who seek a solution of the balance of payments problem that is compatible with the major objectives of domestic economic policy, namely to promote economic growth and to reduce chronic unemployment. I agree that in important respects a flourishing domestic economy facilitates the solution of the balance of payment problem. I agree with them that a policy of curtailing high priority international objectives or adapting a general policy of fiscal and monetary restraint for balance of payment reasons would be "unwise" and "perverse" (pp. 252, 262). I also agree that providing alternative sources of liquidity for international transactions would make more manageable the task of adjustments in the U.S. balance of payments without serious harm to other Western and the less developed countries.

However, instead of enumerating in detail the many aspects of agreement with the study I may be more helpful to the Joint Economic Committee by pointing to one aspect where I disagree and to one aspect which I believe has not found the necessary attention of the authors.

1. My first concern relates to the assumptions and estimates with respect to the rate of growth and price development in the United States and Western Europe. I regard the initial assumptions, given by the Council for the rate of growth in the United States and Western Europe as reasonable if it is understood that these are policy targets. The 1.5 percent price rise assumed for the United States (which in the light of the recognized bias in the indexes represents virtual price stability) also is certainly a desirable target. For Western Europe, however, no desirable target of price stability is given, but the authors make their own estimates, taking demand and cost influences into account, but not possible policies for maintaining price stability. Thus, I believe that the price projections for the United States and Western Europe are each of a different nature. In consequence, I question the validity of conclusions derived from these price comparisons for changes in the competitive position between the United States and Western Europe.

In the case of the alternative assumption, the authors use the same 1.5 percent price rise for the United States for the projected comparison. Here, the virtual price stability was not given to them but it presents their own estimate of what they believe is likely to happen.

They believe that, in this case, any pressure on prices "stemming from an excess of demand would be negligible" (p. 41). In contrast to their argument for Western Europe (see pp. 42, 218, 228), they do not mention the possibility of pressure on prices from the cost side. The annual influx into the labor market due to demographic reasons is relatively larger in the United States than in Western Europe. However, larger rates of unemployment in the United States are likely to induce more provisions for job security which slow down cost reductions from technological and managerial advances. Furthermore, governments in Western Europe are by tradition less hesitant than the U.S. Government to adopt an active policy of price and cost stabilization, and European business and labor are less unwilling and better organized to cooperate with the government in such efforts. I would therefore question the realism of the authors' projected improvements in the competitive conditions in the United States (as far as the price factor is concerned) unless one assumes a more effective policy of price and wage stabilization than is implied in the authors' reference to the traditional policy of persuasion (p. 254). This applies to both the initial and the alternative assumptions. I would not quarrel with these projections *per se* if the authors had made explicit the policy implications which in my opinion are involved.

2. At one point, the authors refer to the fact that advances in research and development "may materially influence the competitive position of the United States" and they observe in this connection that "expenditures for research and development in the United States remain far above those in Europe" (p. 93). This factor of technology deserves more than a brief paragraph under the heading of "Further Observations". Actually, I believe, technological and other nonprice factors may be of equal importance as price factors in determining the U.S. competitive position. The United States has obtained, and to some extent has maintained, a large share in the world market for some categories of manufactured products, in spite of a high cost and price level, because of the earlier development of domestic markets for technologically advanced products (e.g., agricultural and office machines in earlier periods; more recently electronic instruments and jets). The recent loss in competitive position is in part due to the fact that Western Europe and Japan also have made increasing strides in technology, backed by growing domestic markets. It is, in my opinion, an important fact that technological advances in one country are much sooner matched and sometimes surpassed in other countries than used to be the case in the past.

It is true that research and development expenditures are much larger in absolute and also relative terms in the United States than in Europe or Japan. However, the largest part of these expenditures is for defense and space research. The National Science Foundation cooperates with European countries and Japan in an attempt to obtain comparable figures. I do not believe that truly comparable figures of Government and private outlays for research and development in nondefense fields are already available. From some preliminary estimates I obtained the impression that such nondefense outlays—adjusted for differences in the relative costs of research—amount to very similar ratios of about 1½ percent of GNP in the United States, Western Europe, and Japan. There is in addition the

“spillover” effect of military and space research and development for which we have no quantification. In any case, I do not think it is justified to refer to all research and development, including military, as conclusive evidence of the competitive export superiority of the United States. There are great opportunities in the United States for technological developments which could have a favorable impact on the balance of trade and the balance of payments. However, not all current and foreseeable developments in this field are in favor of the United States.

Whether technology and other nonprice factors will influence the competitive position in the United States in a favorable or unfavorable way will depend on future developments in private enterprise and Government policies. In this letter I only wanted to express my view that these factors are of great importance for the competitive position, particularly of a high-wage country. Therefore, I wished the authors had given more attention to this aspect, both in analysis and policy recommendations.

These comments on the assumptions and analysis of the study obviously influence my reaction to the authors' conclusions. In general, I feel that the projected improvement in the U.S. competitive position follows in part from unequal assumptions made for Western Europe and the United States, and in part from an overly optimistic evaluation of market forces. Improvements in the competitive position of U.S. industry and in the balance of payment problem are certainly possible. However, I feel that this report, excellent as it is, understates the efforts needed to achieve this result.

I do agree that there is no present cause for alarm and that our gold stock is still ample, if used only as reserve for international transactions, and if measures are prepared, by one or the other method, to find ways of increasing world monetary reserves other than by continuing U.S. balance of payments deficits. I am intrigued and puzzled by the authors' bold statement “We do not recommend that the Government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves” (p. 253). I wonder if the authors really mean to exclude in principle consideration of all specific measures designed to promote exports or influence capital export. Unfortunately, I believe that, particularly for the short-term, measures must be considered which are not regarded as “desirable in themselves”. I agree with the authors that some of the most important policies which are “desirable in themselves” also will be an aid in the balance of payment problem. Such measures would include an expansion in the domestic economy which makes capital investment in the United States relatively more attractive. Also putting teeth into the jawbone approach toward price and cost stabilization and policies in support of technological and managerial advances are desirable for domestic policy objectives. It should be recognized, however, that policies which are desirable for reasons of domestic objectives may become imperative for reasons of international economic policy.

STATEMENT BY A. R. CONAN

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Any attempt to forecast future trends in the U.S. balance of payments will be examined with interest by observers in the United Kingdom. For 20 years the latter country has had to live with a balance of payments problem which on occasion has involved forecasting either to meet practical policy needs or as a basis for discussion. Viewed in retrospect the history of these forecasts has not been reassuring. After the war, for example, it was officially estimated that the deficit during the first postwar quinquennium would be about £1,250 million ("or even more"): In fact the cumulative total was very much smaller, less than £400 million. Again, at the end of the 1950's the Treasury was unduly optimistic, planning for the early 1960's on the assumption of a current surplus amounting to some £450 million per annum: So far, during the first 3 years of the decade, there has been a cumulative deficit of over £200 million, in lieu of the prospective surplus of nearly £1,500 million.

It is also unfortunately true that the attempts of British economists to forecast the future of the U.S. balance of payments have been equally unhappy. Keynes in a well-known article published just after the war¹ expressed the view that the U.S. trade balance would be likely to weaken as a result of inflationary trends and thought it probable that the invisible account would be in deficit; neither of these forecasts has been fulfilled. Ten years later MacDougall arrived at an opposite conclusion: His survey of the evidence² suggested that the nondollar world would continue to suffer from a shortage of dollars. This forecast also proved unreliable; the dollar shortage ended and it has not yet reappeared.

With this record in mind it seems unnecessary to stress the hazards of forecasting balance of payments trends. In the present context caution seems specially advisable since the structure of the U.S. economy and certain features of the balance of payments itself make such an exercise even more difficult than in the United Kingdom. The Brookings estimates, however, based on detailed study of the several factors which combine to make up the total balance, at least enable the different elements in the problem to be seen in perspective.

One feature of the U.S. balance of payments which intensifies the uncertainties necessarily attaching to forecasts is the dominating role of debits on Government account. The difficulty here lies not merely in the magnitude of expenditure on aid and defense but also in the fact that changes in these debits are in the main governed by noneconomic factors. Thus any economic or statistical analysis of the probable future trend is liable to be invalidated by the noncalculable impact of policy changes which have a direct and probably immediate effect on the Government account.

¹ *Economic Journal*, June 1946.

² "The World Dollar Problem," London 1957.

The special characteristics of this account would justify the segregation of its constituent items in order to permit separate treatment for transactions on private account and on such as basis it would perhaps be easier to focus the problem. In the present case an approach along these lines is ruled out because the classification adopted for the Brookings study includes defense expenditure with the current balance of goods and services while aid is brought in later with private capital. This arrangement, however, does not occasion any real inconvenience since only a relatively small change is expected for the defense item.

Accepting the defense estimate, the main factors for critical examination in the balance of goods and services are the trade balance and investment income. In the absence of detailed data it must be assumed that no very large changes are foreseen for other items.

Even a summary review shows that the trade balance and investment income are of crucial importance. On the initial assumptions the trade balance should rise from \$6 to \$8 billion and although on the alternative assumptions no increase in trade is provided for, receipts from investment income are in any event expected to yield an additional \$2 billion. With other invisible items (including defense) substantially unchanged, the balance for goods and services rises from \$5 to nearly \$7 billion on the less favorable assumptions and may be as much as \$9 billion on the more favorable. This should cover a \$2 billion increase for aid, especially if there is some reduction in private capital exports. Since these two latter categories are put at not much more than \$7 billion the basic deficit should on the more favorable assumptions be replaced by a surplus of almost \$2 billion while even if there is no increase in the trade surplus, the rise in investment income should bring a near-balance.

The computation starts with an actual surplus of over \$5 billion for visible trade in 1961. By historic standards this surplus is of course very substantial: During the 1930's the comparable figure was less than \$500 million (approximately \$1.5 billion at current prices) while during the early 1950's a surplus averaging no more than \$2 billion imposed a dollar shortage on the rest of the world.

The long-term trend evidenced by these figures hardly bears out the Keynesian theory that there are at work in the U.S. economy fundamental forces tending to restrict the development of any large surplus. In the article mentioned earlier Keynes stated his doctrine as follows:

There are in these matters deep undercurrents at work, natural forces, one can call them, or even the invisible hand, which are operating toward equilibrium. If it were not so, we could not have got on even so well as we have for many decades past. The United States is becoming a high-living, high-cost country beyond any previous experience.

The failure of the U.S. balance of payments to conform to this forecast did not pass unnoticed. Those who accepted the Keynesian analysis explained that it referred to longer term trends: In 1950 Harrod claimed³ that it could not be properly assessed on the basis of experience until 1960. The latter year has now come and gone yet so far there is no sign of the forecast being justified. On the contrary, the latest figures for the trade balance suggest that the doctrine as stated by Keynes is now untenable.

³ R. F. Harrod, "Life of J. M. Keynes," p. 621.

It is true that Keynes admitted the possibility of certain other factors such as tariffs and export subsidies, which might offset the fundamental forces: He did not foresee the introduction of large-scale aid to other countries (which, if tied, produces much the same effect as subsidies) or envisage heavy capital exports (which probably operate in the same way, if less powerfully). But whatever the value to be attached to such qualifications, the actual trend accords much more with the general conclusions of MacDougall in the work already mentioned: After detailed examination of the evidence, he concluded that over the next 20 years the U.S. balance of payments was more likely to improve than to worsen.

The Brookings projections bear out MacDougall more than Keynes. With a trade surplus which even on the less favorable assumptions may be \$5 billion and on the more favorable \$8 billion, the results hardly reflect the fundamental forces postulated by Keynes but strongly corroborate the evidence for a favorable trend noted by MacDougall.

In reaching these results the Brookings study lays emphasis on the balance with Western Europe as a determinant of the final outcome. The detailed estimates for this sector yield very different totals according to the assumptions adopted and from the point of view of practical policy therefore, there is the problem of deciding whether to proceed on the basis of the more or the less favorable conditions.

This problem hardly admits of any easy solution. It might be presumptuous for an observer in Europe to speculate or express an opinion on the probable future rate of growth in the U.S. economy and, although he may be better placed to evaluate trends in Europe, the recent change in the economic climate of the Common Market countries makes predictions unusually hazardous. The problem can, however, be simplified to some extent if (as shown on p. 90) different states of prosperity in the United States and Europe have, as between themselves, much the same effect on the trade balance. Accepting this result as reasonable, then the main factor to be evaluated as a determinant of the trade balance is the competitive potential of the United States as an exporter.

In assessing competitiveness the study has to take account of the recent decline in the U.S. share of world trade in manufacturers. Evidence is adduced which strongly supports the view that this does not reflect any general decline in the competitive position of the United States but was occasioned by special factors of a transient nature; moreover, no adequate support is found for the view that the trend of U.S. export prices, at least during the past few years, has seriously impaired competitiveness. On these grounds, and with the further assumption that U.S. export prices will now rise only slightly, the United States can look forward to earning much more from exports.

The case so far as it concerns past history seems fairly proved: There is, in fact, a close analogy with the United Kingdom whose reduced share in world markets would be attributed (by the present writer at least) to very similar factors and not to a general failure of competitiveness. So far as the future is concerned the case is perhaps more doubtful.

Again for practical purposes it is convenient to oversimplify by concentrating on the major element in the problem. The detailed estimates show that any large increase in exports should come from

trade with Europe: The prospective increase from this source is about three times as great as that from the rest of the world. The value of the estimates thus seems to depend primarily on the future level of exports to Europe.

On this basis the figures may be appraised in the light of two recent developments. First, there is now clear evidence of inflation in certain areas of the European economy; second, there is evidence of the strength of protectionism in the Common Market.

The first of these factors should tend to confirm the estimate that a considerable increase in U.S. exports to Europe is quite practicable. This estimate rests on the assumption that U.S. export prices over the period 1961 to 1968 will rise by no more than 0.5 percent per annum. Such a limited increase could perhaps be criticised as optimistic—U.S. steel prices, for example, have risen by nearly 4 percent so far in 1963 alone. If, however, inflation in European countries were to become much more pronounced than is allowed for in the estimates, there would be scope for a more rapid rise in U.S. prices and the attainment of the objective would be much more likely. Just recently there have been signs that such conditions may in fact appear. In 1962 Germany incurred a balance-of-payments deficit for the first time since 1950, while in France and Italy the progress of inflation has already been such that, in the autumn of 1963, both countries were forced to introduce special measures in an attempt to restrain the rise in prices. The problem facing the United States would be further eased if this trend were to extend to other parts of Europe or if, as seems quite probable, it were to be intensified. Certain basic conditions (e.g., the state of the European labor market now, in contrast to what it was a short time ago) suggest that the incipient inflation may be very hard to control and history does not record that European governments generally have been very successful in the attempt to do so.

The second factor mentioned above would, of course, if effectual, work against U.S. exports. The Brookings study takes account of the Common Market as an adverse factor, especially for agricultural products (over one-third of the total). The recent moves relating to the Common Market tariff on poultry corroborate this view and must raise doubts as to the future of trade with Europe, since, for agricultural products at least, the trade policy of the Common Market countries is likely to be strongly protectionist. Bearing in mind the protectionist tradition in both France and Germany, it would not be surprising if in due course a similar policy were applied to other categories also: the problem of low-priced steel imports, for example, is now under examination by the European Coal and Steel Community and French steelmakers have recently been given better protection against such imports. Naturally if, as seems likely, the United States takes countermeasures in the form of new restrictions on imports from Europe (or, in accord with the principle of nondiscrimination, from the rest of the world) the net effect on the trade balance may be slight.

With these two factors perhaps combining to exert a favorable effect there seems no good reason to modify the results shown in the detailed calculations. Some would look for a continuance or increase in the existing large trade surplus on the record for recent years, the unsoundness of the Keynesian view that the United States was in-

evitably heading for a deficit on trade account, and the absence of any adequate evidence that the outlook must now be regarded as unfavorable. In addition, there is the prospect of a further stimulus to exports through a large increase in aid; such an increase would, on the figures given, not only offset some reduction in oversea investment but would also probably have a more powerful impact on exports.

With the existing trade surplus, a failure to expand on the scale envisaged would not necessarily cause embarrassment if receipts from investment income develop satisfactorily. Here the Brookings estimates are of special interest in that they show within a brief period a 50-percent increase in the present enormous total; furthermore, this increase is expected on either the favorable or the unfavorable assumptions.

The trend for the category in recent years has transformed the balance-of-payments structure, and the transformation has been effected at extraordinary speed. At the end of the war the net credit was less than \$500 million; within 15 years it was almost \$4 billion. At this figure investment income contributes more toward balance than the trade surplus, at least if Government-financed exports be excluded. Now a further increase of \$2 billion is expected in less than 5 years.

Is such an increase likely to be realized? The Brookings calculations envisage the possibility of some reduction in direct investment and, after the completion of the report, measures were taken to limit foreign borrowing in the New York market; the increase in investment income may thus be slowed down especially if, as seems probable, profits are squeezed by adverse trends in the European economy. On the other hand these factors may be offset if highly protectionist policies in the Common Market countries were to stimulate U.S. investment in that area. Taking into account the dynamism of this category since the war, its self-generating character as a result of the process of reinvestment, and the likelihood that the exceptionally heavy investment of very recent years may not yet be yielding its full potential, there seems little reason to think that the prospective increase has been overestimated. One expert witness has in fact testified before the committee that in his opinion the Brookings projection for 1968 may be too low and has suggested that it may be exceeded by perhaps as much as \$1 billion.⁴ With that opinion the present writer would feel disposed to concur.

It is now possible to relate this tentative conclusion on the estimates for investment income to the earlier discussion of the trade balance. For both categories the outlook seems favorable. Without imputing an unwarranted degree of reliability to the estimates themselves, there is reason to think that the general picture they disclose is likely to be correct. With a visible trade surplus which might well be considerably larger than at present and investment income probably very much larger, the balance of goods and services should develop favorably; for the purposes of this conclusion it is assumed that defense expenditure will be reduced (a point on which no opinion is expressed here) and that there will be no change in the other items.

This is the core of the problem and the core seems sound. It is not of course the whole of the problem and there remain the two major categories of aid and private capital exports. As regards the latter

⁴ H. B. Lary (hearings, "The United States Balance of Payments, Pt. 2," p. 297).

it has been suggested above (p. 13) that the prospective reduction in exports of private capital may not be very great and in the circumstances the Brookings estimates seem reasonable. As regards aid an outsider may perhaps be excused from offering an opinion as to the future level of expenditure under this head. The Brookings figure is accepted for present purposes. With a favorable trend for the balance of goods and services there seems to be a good chance of a favorable outturn for the total balance: At worst no appreciable deficit and under better conditions quite an appreciable surplus.

This is a bullish view. In the opinion of the present writer the evidence justifies such a view for transactions on private account: how far the surplus on these categories will be absorbed by debits on Government account is another matter, on which individuals are hardly qualified to form an opinion.

STATEMENT BY RICHARD N. COOPER

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Walter Salant and his associates have performed a valuable service to the country by attempting to set down in quantitative terms the outlook for the U.S. balance of payments—a subject which many of us are willing to discuss perhaps too freely without undertaking the laborious task of specifying our assumptions and working out their implications. In this short paper on the Brookings report I will not discuss the validity of the analytical inferences made from the underlying assumptions. These will be amply scrutinized by others. Rather I will try to say something briefly about the assumptions themselves, and then concentrate on the role which projections of the type made by the Brookings group should play in choosing the proper approach, or strategy, for national policy measures to deal with the balance-of-payments problem. I will also suggest what I think is the relationship between the Brookings projections and the general character of the recommendations for policy found in the final chapter of the report, without commenting on the particular recommendations in detail.

At the outset, it should be emphasized that the Brookings report does not forecast the U.S. balance-of-payments position in 1968. If it had, it would have had to forecast business cycle developments in the United States and Europe, and it would have had to estimate short-term capital movements. Instead, the Brookings report abstracts from both of these factors; it focuses rather on the trends in basic international transactions of the United States on two sets of assumptions about economic growth and price movements in the United States and Europe. An initial set of assumptions was specified by the Council of Economic Advisers when it commissioned the balance-of-payments study in 1961; these assumptions called for a decline in the domestic unemployment rate to 4 percent before the end of 1963 and a 4.3-percent annual growth in real gross national product thereafter, implying an annual growth rate of 4.8 percent for the entire period 1960–68. This was not a forecast of economic developments in the United States; rather it represented at that time a feasible and desirable target, and the Government was rightly interested in the effects on the balance of payments of a rapid reduction in unemployment and a higher rate of economic growth than prevailed in the 1950's. It was assumed that real output in Western Europe would grow at 4.3 percent annually, a little faster than necessary to achieve the collective OECD growth target of 50 percent between 1960 and 1970.

As the study progressed the initial assumptions for the United States ceased even to be feasible—unemployment lingered around 5½ percent for nearly 2 years, well into 1963, instead of falling to the assumed 4 percent. The Brookings team therefore felt that the ini-

tial assumptions were "rather optimistic" and also projected basic transactions in the U.S. balance of payments on an alternative set of assumptions calling for slower growth both in the United States and in Europe. Note that the initial assumptions for the United States were "optimistic" from the viewpoint of U.S. employment and growth, not from the viewpoint of the U.S. balance of payments. In the Brookings report they imply a very sharp rise in imports—probably unrealistically sharp. The alternative assumptions, while less "optimistic," nonetheless imply a growth in real output in the United States of 4.5 percent a year from 1962 to 1968—still far higher than historical averages. Such a rate of growth is certainly possible for the United States, particularly in view of projected labor force increases at 1.6 percent a year; but it cannot be considered to fall at the low end of reasonable forecasts of U.S. growth.

The alternative assumptions for economic growth in Europe, by contrast, imply an annual increase in real output of only 3.7 percent, certainly far lower than recent experience would suggest. Even the "disappointing" growth in France for next year is expected to be 4.2 percent. The Brookings report's alternative growth assumptions would seem, therefore, to be designed to put an unfavorable, though possible, cast on the balance-of-payments projection—perhaps setting a lower bound on the improvement expected. Unfortunately, the report does not discuss in enough detail the reasons for selecting these particular alternative assumptions, and the view has become widespread that the Brookings authors regard these alternative assumptions as "realistic," in contrast to the initial set of assumptions which, at least for the United States, are clearly no longer likely to be realized. I would not consider the alternative assumptions the best forecast of European and American economic growth in the next 5 years; the rate for Europe is probably too low and that for the United States is, regrettably, perhaps too high.

FORECASTS AND POLICY FORMATION

What bearing should projections of the type made in the Brookings report, or of projections and forecasts in general, have on the decisions of those who frame U.S. policy? How should they affect the "strategy" which the United States adopts toward its payments deficit? Clearly, good forecasts and accurate projections should influence the measures which a government takes to achieve its objectives. Any program for action (or a decision not to act) is based on implicit or explicit assumptions about the future course of events. The more accurate those assumptions—i.e., the closer they are to the way things actually would turn out in the absence of action—the greater is the opportunity for selecting the course of action most suitable for achieving desired objectives. Since mistakes often involve very direct costs and even more often mean forgoing success in attaining aims, good forecasts of the future are valuable insofar as they help to reduce mistakes and increase the chances of attaining objectives at a minimum cost and effort.

An example from meteorology illustrates the advantage of reliable forecasts. Many truckers carry loads on open trucks which would be damaged—sometimes to the extent of thousands of dollars—by moderate rainfall. Full protection against rain would require all loads to be covered all of the time, yet it is costly both in time and money:

to cover them. Ideally, every trucker would cover his goods only before it was going to rain, never when it was not going to rain. One function of weather forecasts is to move toward this ideal, lowering the costs of unexpected precipitation.

If all weather forecasts were perfect, and if all those whose costs of operation depended on the weather acted on the information, the ideal of minimum cost due to rain damage would be achieved. Unfortunately weather forecasts, while improving, are still far from perfect. The vulnerable trucker must therefore decide the extent to which he should rely on the forecasts. He can cover his goods when rain is forecast and not cover them when the outlook is for clear skies, recognizing that sometimes he will have covered unnecessarily and sometimes he will suffer rain damage because he failed to cover. If the cost of rain damage to a particular load is very high compared with the cost of covering, however, he may decide that he cannot risk rain damage at all, so he must cover even when no rain is forecast if he cannot regard the forecast as certain.

This example from the inexact science of meteorology has two lessons for the even more inexact science of economics. The first, and more obvious, is that good forecasting can help reduce the costs—financial, political, and psychic—involved in achieving our objectives. The second, and far less obvious, is that a forecast alone never provides enough information for making final decisions about the course of action to be followed. It is necessary also to know something about (1) the costs involved in accepting the forecast and acting on it when in fact it turns out to have been wrong, and (2) the costs of acting on the assumption that the forecast is wrong when in fact it turns out to have been correct, and about (3) the probability that the forecast will be wrong (its reliability). A lot of information is required. Comments by others on the Brookings projections will be addressed to their reliability as forecasts of the U.S. balance of payments. The remainder of this paper will be addressed to the costs of (a) rejecting the Brookings projections as accurate forecasts when one of them actually turns out to have been correct (a type A error), and (b) accepting one of the Brookings projections as an accurate forecast when it turns out to have been wrong (a type B error).

The charge has been levied against the Brookings report that its policy recommendations do not follow from its projections—that they are merely obiter dicta by the authors. To the extent that the projections are in no way regarded as forecasts, this charge has merit; projections based on assumptions which are not regarded by the authors as reasonable do not lead to policy recommendations. Perhaps the principal recommendation of the Brookings report should have been for the Government to use its influence to assure that the initial assumptions of high rates of economic growth in the United States and in Europe be realized.

But if the projections are regarded as reasonable forecasts, or as setting limits to the range of reasonable forecasts, then recommendations are in order once an assessment of the costs of error is made.

NATIONAL OBJECTIVES

Any assessment of costs must depend, of course, on the Nation's objectives. A program of action is beneficial insofar as it furthers

attainment of the Nation's overall objectives, costly insofar as it retreats from or postpones the attainment of ends which are widely regarded as desirable. The Brookings report states clearly (p. 244) four objectives which the authors feel the United States should give high priority:

1. Achieving domestic economic stability and sustained growth at full employment.
2. Maintaining the military strength of the free world.
3. Promoting and supporting economic development of underdeveloped areas and avoiding injury to the continued growth of other countries.
4. Assuring the greatest possible freedom of economically productive international transactions in the free world.

Most Americans, I think, would agree on the importance of these objectives. Indeed, these objectives are virtually identical with those stated by the President in his balance-of-payments message of last July:

Although there is urgent need for further effort I want to make it clear that, in solving its international payments problem, this Nation will continue to adhere to its historic advocacy of freer trade and capital movements, and that it will continue to honor its obligations to carry a fair share of the defense and development of the free world. At the same time, we shall continue policies designed to reduce unemployment and stimulate growth here at home—for the well-being of all free people is inextricably entwined with the progress achieved by our own people. I want to make it equally clear that this Nation will maintain the dollar as good as gold, freely interchangeable with gold at \$35 an ounce, the foundation stone of the free world's trade and payments system.

The President's addition of a commitment to a fixed price of gold, omitted from the other list, will receive comment below.

A complete assessment of the costs of errors in judgment, involving as it does a wide range of contingencies, would be exceedingly difficult and well beyond the scope of this short paper. Quantitative measurement of the whole range of costs is of course quite impossible. Nonetheless, it is useful to suggest, even if only in a sketchy way, the possible costs of various measures applied severely enough to effect the balance of payments substantially, and to compare them with the costs of failing to act in time to avert a crisis.

COSTS OF TYPE "A" ERROR IN JUDGMENT

The disadvantages of taking drastic action now to reduce the payments deficit, particularly when such measures may not have been necessary, are perhaps clearer than those entailed by failing to act in time. They are discussed publicly as each particular measure is advanced. The costs of some measures can be quantified. Withdrawing Government expenditures from the same play of the free market which influences the direction of private expenditures, for example through aid tying and "buy American" requirements, has a direct cost in the Federal budget. The Defense Department has estimated that in the third quarter of 1962, after the new 50-percent price differential favoring U.S. goods was instated, oversea procurement returned to the United States for balance-of-payments reasons added an average of 36 percent to dollar costs. Raising all interest rates by half a percentage point to deter capital outflow would add over \$600 million to Federal expenditures on interest payments (and would add over \$100 million to our interest payments to foreigners).

Most costs are not so easily quantified, and some are quite intangible. A rise in long-term interest rates, not offset by an adequate fiscal stimulus, would slow U.S. economic growth and increase unemployment by discouraging investment. Some would add that it would also redistribute income undesirably from taxpayers to bondholders.

Direct controls on the movement of capital, an alternative method for limiting capital outflow, would perhaps slow economic growth in the rest of the world, including its underdeveloped regions, and would weaken the development of New York as the most efficient world capital market for both borrowers and lenders. It might also raise doubts about the continuing external convertibility of the dollar. The ability of foreigners to sell dollars for other currencies freely is a major element in their willingness to hold large assets in dollars, which in turn has facilitated the growth of world trade and payments.

Cutbacks in our oversea military expenditures to help the balance of payments may weaken significantly our military position. Perhaps even more important, redeployment of U.S. troops might loosen further the bonds of the Western Alliance by representing some disengagement from Europe by the United States. Reduced military expenditures in the developing regions of the world harm growing industries which depend on military custom.

Tying foreign aid to purchases of goods and services in the United States has reached its limits as a measure to improve the balance of payments. A drastic cut in foreign aid for balance-of-payments reasons, quite apart from reducing the deficit only fractionally, might jeopardize the program objectives—military security, political stability, and economic growth in the world's underdeveloped nations—of our foreign assistance effort.

Restrictive commercial policies such as reducing quotas or giving greater preference to American goods under "buy American" and other Government procurement provisions could well weaken the U.S. position in the forthcoming trade negotiations under the Trade Expansion Act, with their new emphasis on nontariff barriers to trade. The U.S. Government has made clear that tighter Government procurement practices are imposed for balance-of-payments reasons. But every low-cost foreign bid on a major contract which is turned down in favor of an American supplier is already frontpage news abroad, and the skeptical Europeans may doubt, for example, whether even a well-meaning administration would be able to lower a "buy American" preference of 50 percent once it were fully established. Extensive use of import quotas or higher tariffs would virtually preclude successful trade negotiations, already meeting a stiff reception in Europe, and would violate the letter or the spirit of the GATT and threaten the liberal trade environment which the United States has worked so painstakingly to establish in the two decades past. Moreover, the balance-of-payments gains from such measures might easily be nullified by retaliation abroad.

In addition to hampering the achievement of particular objectives, many of these measures also have indirect costs. Applied gradually, as they have been to date, no one additional measure seems substantial enough to be strongly objectionable, given the importance of reducing the U.S. payments deficit. But collectively such measures, even when taken in small doses, have a corrosive effect on the international posi-

tion of the United States as a great liberal trading nation, a position which has made possible substantial progress toward the major economic objective of U.S. foreign policy in the postwar period—low and nondiscriminatory barriers to the international movement of goods, services, and capital in a vigorous and growing free world economy. U.S. leadership is weakened as it begins to retreat from practices consistent with this goal under the pressure of balance-of-payments deficits.

COSTS OF TYPE "B" ERROR IN JUDGMENT

The costs or dangers of failure to take action to reduce the payments deficit when action is really needed are often alluded to but rarely spelled out. These costs are difficult to evaluate because it is usually assumed that a continuing payments deficit will result in some kind of crisis. Liberal U.S. policies could be continued for a time in the face of continuing deficits or of conversion of outstanding dollars to gold if the United States were willing to use its gold stock—and other means of credit available to it, such as its IMF quota—for the purpose. The U.S. gold stock is large and it would finance modest deficits for a long time. But the gold stock is limited and so, presumably, is U.S. credit with other countries. Eventually the United States would be compelled to retreat from the policies which it regards desirable—to retrench its oversea military and foreign aid commitments, to abandon its position favoring free capital movements, to reverse its encouragement of freer trade, or to suspend the gold convertibility of the dollar.

Moreover, continuing decline in the gold stock might itself aggravate the deficit and accelerate the outflow of gold. The domestic and foreign financial communities alike would harbor doubts about the U.S. ability to continue running deficits and would hedge their dollar holdings. Foreign monetary authorities might feel the need to convert their dollars to gold while gold was still available. The existence of the domestic gold reserve requirement exacerbates foreign fears that the dollar is on the brink of nonconvertibility, for the authority of the Federal Reserve Board to waive the domestic gold requirement is not widely understood.

If a speculative crisis were to develop, the overhang of \$20 billion in foreign dollar claims—and the ability of many Americans to send large sums abroad for speculative gain—could quickly raise the gold loss to a figure far greater than the losses generated by even the large payments deficits of the past 5 years. Under such circumstances the United States might not only have to drop (at least temporarily) pursuit of a number of its objectives, but it would probably have to negotiate support from other countries under unfavorable negotiating conditions. A high price for credit might be exacted in terms of foreign policy or in terms of domestic economic policy.

Even before a "crisis" developed, continuing payments deficits could weaken the U.S. position at the international conference table. As with military strength, economic strength affects the tone and self-confidence with which a country speaks and the attentiveness with which others listen. Chronic payments deficits introduce another consideration into a country's bargaining position, and limit its freedom of negotiation in seemingly unrelated areas.

The ultimate danger is that convertibility of the U.S. dollar into gold might have to be suspended. This eventuality would clearly be undesirable. But it is necessary to maintain some perspective; suspension of gold convertibility is not a contingency to be avoided at absolutely any cost. The purpose of the system of fixed exchange rates established at Bretton Woods, based on the convertibility of dollars into gold, is to promote the movement of goods and services among nations so that the world can maintain high levels of employment and still enjoy the benefits of an international division of labor. Instability of exchange rates is an obstacle to the international flow of goods, services, and capital. But since the purpose of exchange stability is to promote foreign trade (and, many would add, international capital movements), it hardly makes sense to restrict the movement of goods and capital for the purpose of maintaining exchange rate stability or gold convertibility. The gold convertibility of the dollar at a fixed price is an efficient means to serve our real ends; it is not an end in itself. This recognition that gold convertibility is a subsidiary, or derived objective and not a primary one explains its omission from the list of objectives in the Brookings report.

Suspension of gold convertibility of the dollar would not automatically entail a depreciation of the dollar and abandonment of the system of fixed exchange rates. The monetary authorities of other countries support their own exchange rates by intervening in the exchange markets to buy or sell dollars, as required. This is what maintains the stability in exchange rates among currencies. Suspension of gold convertibility would not prevent this practice from continuing. A devaluation of the dollar would be very distasteful to most Americans; but there is reason to believe that it would be distasteful to most Europeans too, and it is the European authorities who would be faced with the choice, if gold convertibility were suspended, of continuing to support the dollar in the exchange markets or of dropping that support and permitting the dollar to depreciate relative to their own currencies. In many ways the Europeans have as much or more to lose from a depreciation of the dollar and the resulting disruption of the international payments system than the United States does, and this fact should be considered in framing a program to deal with the U.S. payments deficit.

WEIGHING THE RISKS

So long as forecasting the future is uncertain, any course of action is a calculated risk. There is no escaping that. The United States could take drastic action to curb the payments deficit now, hoping that the unfavorable byproducts of such actions would be few. Or it could put off any drastic measures, concentrate on additional methods for financing the deficit, and hope that things work out in the end so that drastic action will not have been necessary.

There is a widespread tendency in thinking about an uncertain future to consider "prudent" action as that based on the more conservative, or pessimistic, assumptions about the future. This is mistaken. On this basis the trucker in our meteorological example would always cover his load on the assumption that it would always rain. The

“prudent” course of action really depends on the cost and probabilities of being wrong. If the overwhelming weight of evidence pointed to a continuation of large U.S. payments deficits, then the United States should consider really drastic measures to reduce them—including devaluation of the dollar against other currencies. If the evidence pointed overwhelmingly toward substantial improvement, then it would clearly be better to avoid undesirable measures and rely on our reserves and lines of credit for financing the deficit. If, as is at present the case, evidence on future developments in the U.S. payments position is very mixed, a careful weighing is required of the costs associated with alternative courses of action. The costs of action based on a pessimistic forecast may be very high relative to alternatives; if so, it would be “prudent” to gamble on an optimistic outcome and deal with adverse developments as they arise.

It is prudent to adopt all those remedial policies which are desirable on other grounds, which have a low cost, or which are easily reversible with no lasting damage. The present administration and its predecessor have taken or proposed a number of such measures. Other industrial countries have been urged through the Development Assistance Committee and other forums to increase their foreign aid to underdeveloped countries and to give this aid in a form not tied to purchases of goods and services in the aid-giving country. Military procurement in this country by several of our NATO allies has been increased with a view to strengthening conventional defenses in Western Europe. The administration proposed in 1961 to reduce inequitable differences in tax treatment of U.S. citizens living at home and abroad. Duty-free tourist allowances were reduced on a temporary basis, and greater travel by foreigners in the United States has been encouraged. The export drive, like encouragement of foreign travel here, involves some additional budgetary expenditures, but it does not run counter to other U.S. international economic objectives.

One has the clear impression that the easy measures for improving the balance of payments, the ones that could be adopted relatively painlessly and at relatively little cost, have largely been exhausted. To be sure, some of them have not yet had their full impact, and some could be pressed more vigorously. But additional measures to reduce the deficit have increasingly higher costs in terms of other U.S. objectives. We would rather avoid them if we can. But should we run the risk of courting a dollar crisis if we do not take the more costly measures?

The authors of the Brookings report seem to favor taking the calculated risk. The report (p. 253) does “not recommend that the Government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves. Action already taken, such as tying aid and restricting certain types of military expenditure abroad, should be regarded as temporary. Further restrictive measures of this type would be of negligible benefit, if not positively harmful. To cut aid or military expenditures for balance-of-payments reasons would be an unwise and unnecessary sacrifice of more important objectives.” Moreover, “measures which might endanger U.S. economic growth and the restoration of high employment levels should not be adopted for balance-of-payments reasons.” In particular, raising interest rates relative to those in Europe is “inadvisable.” Devaluation of the dollar is rejected.

However, the U.S. Government should make clear that it regards its vast reserves of gold, IMF drawing rights, and borrowing possibilities in Europe as means for buying time to permit balance-of-payments adjustment without sacrificing major policy objectives. To this end the report suggests that the Government might sell \$3 to \$5 billion of gold for foreign currencies to help finance the deficit over the next few years without further gold outflow, and that it make a drawing on the IMF in the near future, partly to help finance the deficit, partly to help establish the idea that use of the Fund's resources is not an act of last resort.

In addition, according to the report, the Government should step up its efforts to restrain wage and price increases during the course of domestic economic recovery to a high level of employment, and it should pursue vigorously trade liberalization under the Trade Expansion Act—though not at the price of excluding trade in temperate agricultural products and the export products of developing nations.

This set of recommendations has a common theme: it emphasizes measures to finance, or cover, the payments deficit rather than measures to reduce U.S. payments to foreigners. Measures which are desirable on other grounds and which have the incidental effect of reducing the payments deficit—troop redeployment corresponding to advances in military technology and capability might be an example—are of course welcome.

The Brookings report goes well beyond recommendations to deal directly with the payments deficit and urges immediate moves to improve both the stability of the international monetary system and its ability to generate additional liquidity as needed. The relationship of this recommendation to the projections is to be found in the study's statement (p. 225) that "even if the underlying forces are strong enough to produce a substantial surplus in conditions when their effects could be freely worked out, existing international monetary arrangements may not provide that freedom. Under existing monetary arrangements, the size of the actual U.S. surplus would be limited by policies in Western Europe designed to limit the deterioration in the balance of payments that a large shift in the basic balance would almost certainly imply." In other words, the authors feel that the strong economic forces favorable to an improvement in the U.S. balance of payments might be blocked by European policies designed to prevent a deterioration in European payments positions. An improvement in the monetary system is therefore a prerequisite for viewing any optimistic projection as a reasonable forecast. The Brookings group is apparently unwilling to take a calculated risk in this area; the costs of failure to improve the international monetary system must be considered very high relative to costs entailed in the process of improving it. One of those costs, in the judgment of the authors, is that a favorable turn in the U.S. payments position becomes all the more improbable.

CONCLUSIONS

In this note I have suggested that it is not sufficient, in choosing a program of action for dealing with the U.S. payments deficit, to assess the reliability of forward projections of the balance of pay-

ments. Some judgment about the future course of events is a necessary starting point, but one must also consider the costs of various strategies of action. With an uncertain future, we must choose between the dangers of two types of error in judgment. First, we can assume the worse and prepare for it, when in the event the heavy costs of such preparation might not have been necessary. Or, alternatively, we can hope for the best and avoid taking drastic measures to reduce the deficit now, thereby running the risk that we will find ourselves after several years still running a deficit but with much depleted reserves and lines of credit. The choice between these dangers depends on the priorities we attach to different national objectives. Various observers will, of course, give different weights or priorities to our several national objectives and will consequently recommend different strategies for dealing with the payments deficit. But in my view the costs of the second danger have generally been exaggerated and those of the first have been underrated. In reaching their recommendations for policy on the basis of their somewhat equivocal but moderately optimistic projections of the U.S. balance of payments, the authors of the Brookings report must have felt the same way.

STATEMENT BY JOSEPH D. COPPOCK

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I am very glad to have this opportunity to present my views on the U.S. balance of payments and related matters with particular reference to the 1963 Brookings Institution study, "The U.S. Balance of Payments in 1968," prepared by Walter S. Salant and his associates. I have been concerned, in and out of government, with this range of problems for many years.

Before entering upon the critical analysis of the study requested by the chairman of the Joint Economic Committee, I wish to state that the study contains many points of analysis and many policy judgments with which I fully agree. The assignment, however, is to criticize rather than to record agreement.

First, I consider it impossible for anybody to make a dependable estimate of the U.S. balance of payments for a period as far ahead as 1968. The net balance is a relatively small magnitude and it is the resultant of numerous influences, including deliberate policy changes, which are simply not predictable. The many numbers, though plausibly derived, give a false sense of certainty to the estimate. Their precision is factitious. The Brookings authors recognize this implicitly by their numerous hedges, qualifications, emphasis on assumptions, etc., but like the good soldiers they are they went through the drill. Even within their frame of reference, it can hardly be considered scientific or realistic, however, to omit estimates of short-term capital movements. These movements could easily swamp the net "basic" balance estimates.

Second, I wish to compliment the authors of the study for departing from a narrow concern with the balance-of-payments projection, especially in chapters I and IX, and for making what I consider to be a correct diagnosis of the international financial difficulties of the United States in recent years. "The elimination of the deficit [in the U.S. balance of payments] may not suffice to restore the dollar's strength because that alone might not increase the attractiveness of the dollar for foreign and domestic holders" (p. 1). "The present problem is not primarily a balance-of-payments problem. More fundamentally, the problem is the basic inadequacy of the international monetary mechanism in relation to the requirements of the free world" (pp. 242-243).

This point of view contrasts sharply with the U.S. official position on the balance of payments; namely, that reduction or elimination of the balance-of-payments deficit, as currently defined, would end the pressure on the dollar and the gold drain, and that nothing special need be done about the monetary mechanism. The private financial com-

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munity has voiced essentially the same view, with obiter dicta about "balance-of-payments discipline." Persons who have for some years seen the problem as primarily one of the monetary mechanism have not been able to obtain a modification of the standard line of the Treasury Department and the Federal Reserve. Since publication of the Brookings study by your committee, the executive branch has at long last expressed a willingness at least to consider the problem of the monetary mechanism. Both the Brookings Institution and this committee are to be congratulated for helping to bring this about.

Third, I wish to note, along with the Brookings authors, that recognition of the primacy of the problem of the international monetary mechanism does not necessarily mean that there is no U.S. balance-of-payments problem whatsoever. Before going into the monetary problem in some detail, I should like to state my views regarding the balance-of-payments problem of recent years. For one thing, the official concept of the balance-of-payments deficit is questionable in several respects, as the Brookings authors observe. The part of the concept I consider weakest is treating all net additions to foreign short-term dollar holdings as part of the deficit instead of as additions, at least in part, to foreign investment in the United States, undertaken for precautionary or transactions purposes. The deficits are much smaller when they are recalculated under this revised concept.

Next, I think the executive branch diagnosed the U.S. international financial situation incorrectly in 1960-61: The problem was one of short-term capital movements and temporary disequilibrium, not one of longrun fundamental disequilibrium in the "basic" balance of payments, calling for strong remedial action. In addition, even on its own diagnosis—of fundamental disequilibrium—the executive branch adopted poor remedies and rejected the remedy best calculated to correct the alleged fundamental disequilibrium. The poor remedies, which have now been applied for nearly 3 years without notable success, have been (a) the Government promotion of exports (which businessmen presumably have ample incentive to promote anyway), (b) the invocation of various restrictive measures on imports, capital exports, and Government expenditures abroad (particularly foreign aid and military outlays), and (c) the maintenance of higher interest rates and a tighter fiscal policy than the state of the domestic economy warranted. If the administration diagnosis had been correct, the best remedy would have been a reduction of the dollar exchange rate. The Brookings study gives an excellent discussion of the advantages of this method of dealing with a fundamental disequilibrium as compared with other methods.

Let me repeat that I think that the problem all along has been primarily one of handling or providing short-term capital movements, not one of fundamental disequilibrium. Therefore, depreciation of the exchange rate of the dollar has not been called for. In my opinion, the dollar crisis of 1960-61, and still dragging on, was a crisis of the international monetary system (of the gold exchange standard), similar to the monetary crises we had in the United States before the Federal Reserve System was established in 1913. It was not, I say again, a firm indication that the U.S. balance of payments was in such a state of deficit disequilibrium that drastic corrective action was called for. In retrospect, with full benefit of hindsight, of course, the

February 1961 "Message on Balance of Payments and Gold" of the President should have said:

(1) The dollar will remain convertible into other currencies at the going rate of exchange (which it did say, in essence);

(2) Measures to expand the domestic economy will be pushed hard, and the balance-of-payments consequences, if any, will be dealt with if and when they occur;

(3) No new restrictions on international trade or payments will be imposed and those which are in effect will be gradually reduced as a part of our effort to expand trade and capital movements among the countries of the free world;

(4) Congress will be asked to remove the 25-percent gold requirement for Federal Reserve notes and deposits, so that all monetary gold may be used if necessary to support the foreign exchange value of the dollar (the idea embodied in the Multer bill of May 1961 but not acted upon);

(5) The Secretary of the Treasury is instructed, under the provisions of the Gold Reserve Act of 1934, to pay out gold only at his discretion, not at the election of the foreign official holders of dollars, who have been the only parties able to obtain gold on demand under Treasury practice;

(6) Discussions will be initiated shortly with other principal trading countries, through the International Monetary Fund or otherwise, to strengthen the international monetary mechanism and reduce its dependence on gold, so that it can handle large shifts of funds from one currency to another and accommodate substantial temporary disequilibriums in balances of payments.

I think that these points are as relevant in the fall of 1963 as they were in the fall of 1960 or the spring of 1961.

The fourth and final section of my statement relates to the major problem in this sphere, namely, the inadequacy of the international monetary mechanism. I have three critical comments on the Brookings proposals: (1) Introduction of a new international currency unit needlessly further complicates an already complicated situation. Whatever can be accomplished by such a currency can be accomplished as well and more simply with existing national currencies, given the international cooperation required under either arrangement. It might be useful and feasible to have such an international unit at some time in the future, but national economies are too nationalistic now, with the possible exception of the members of the European Economic Community in their dealings with each other, to make an international unit feasible.

(2) The Brookings alternative proposal—for a system of freely fluctuating exchange rates between two free world currency blocs—is politically unattractive. It would foster economic separatism and hence increased political disunity among the North Atlantic countries.

(3) The place of gold in the preferred Brookings proposal—with pegged exchange rates, convertibility, and a new international currency—is not sufficiently discussed.

Let me now make my points about an improved international monetary system in a positive form. There is some repetition and some implied criticism of the Brookings proposals in what follows. I take it for granted that it is eminently desirable to have the U.S. dollar and

other principal currencies free of exchange controls except in extreme emergencies. Both international trade and investment are facilitated thereby. Pegged exchange rates for major currencies—with adjustable pegs to deal with fundamental balance-of-payments disequilibria—are preferable to freely flexible rates, for reasons stated very well in the Brookings study. There is much to be said in favor of freely fluctuating rates, however, when international monetary reserves are short and when countries trading heavily with each other have greatly varying rates of inflation or deflation. Among the major trading countries I anticipate large movements of funds, or at least attempted large movements, for a variety of reasons, just as there are large movements of funds from one place to another domestically. This means that the U.S. dollar will no longer be the overwhelmingly preferred form of liquid asset. In fact, this change in preferences has already occurred, at least in part. This is not something to be sad about; quite the contrary. It means that international monetary reserves can be held in a number of currencies instead of mainly in dollars. More generally, individuals, businesses, and governments can choose among a wider range of forms in which to hold their liquid assets. I anticipate larger disequilibria in balances of payments, partly because of the likely expansion of trade (in physical and monetary terms) associated with increased production, and partly because of the increasing freedom of trade and investment associated with convertibility, relaxation of some political tensions, and further negotiated trade barrier reductions. There is no reason to expect the multitude of individual international transactions to lead toward equilibrium in balances of payments under a system of fixed exchange rates and uncoordinated national monetary policies.

Therefore, to be very specific, the major countries are going to need dependable, expansible international monetary reserves to deal with unpredictable short-term capital movements and unpredictable imbalances in their "basic" international transactions. Stated another way, there has to be a highly expansible supply of scarce currencies, that is, those currencies for which from time to time the demand exceeds the available supply from normal business and financial sources within the par range of exchange values.

The central question, as I see it, is how this expansible supply is to be provided. Present arrangements, partly national and informal, and partly under the International Monetary Fund, have not been used as fully as they could have been and the arrangements themselves are inadequate to the needs. The IMF has been closefisted with its funds; it has been slow about soliciting expansion of its resources. The U.S. Government has let false pride keep it from drawing foreign currencies from the Fund, or borrowing them directly at an early stage of the dollar crisis. The U.S. Government has manifested primitive folk superstition in failing to sell gold readily, on its own initiative, to handle the outward movements of funds. If monetary reserves are not to be used when they are needed, what are they for? Of course, the U.S. Treasury lost command over its own reserves by standing ready to pay out gold on demand, a practice not followed by a single other country. It is perhaps not too farfetched to say that the Treasury has apparently been trying to follow a version of the 19th century gold standard—under the very different conditions of the present day.

There are several possible ways of reshaping the international monetary system so that it can handle shifts of funds and large temporary deficits beyond the capacity of the private foreign exchange market to handle. One way is for each country to hold large supplies of several other countries' currencies. This is cumbersome but it is certainly feasible. The supplies could be obtained by "swaps" if necessary. Another alternative is for each government to hold in reserve some commodities, such as gold, which other governments will always buy with their currencies (with or without pegged prices for the commodities). This arrangement is expensive, in real terms, since it keeps these commodities out of other uses, and involves storage, wastage, and interest costs even if transportation charges are avoided by earmarking arrangements. It is also dependent on the physical supply of the commodities and thus lacks the quality of elasticity that is essential. Another alternative is for each government to have borrowing arrangements with other governments, preferably set out well in advance of need, so that foreign currencies can be acquired when needed. The trouble with this arrangement, quite aside from its complexity, is that a potential lender might not want to lend the money when the borrower actually wants to borrow. The elaborate limitations placed on the intergovernmental credits which the French Government grudgingly agreed to in late 1961 illustrate the point.

The weaknesses of these three rather loose systems leads one toward the pooling of reserves, in traditional banking fashion. The establishment of an international pool of generally convertible currencies, large enough to meet any likely contingency, expandable as needs increase, and certainly available when needed, is clearly a systematic, economical and direct way to deal with the problem. This is the arrangement I advocate. No commodities are required; no supranational currency is required; no clearing mechanics are required.

The present International Monetary Fund is an overly complex version of this scheme. The IMF could conceivably be overhauled, but it would seem easier to set up a new organization among the dozen or so countries likely to qualify. The great majority of countries show no inclination to accumulate substantial monetary reserves and to maintain internal monetary-fiscal order. Given an adequate stock of currencies and provision for increases in the stock of currencies, the main question is the degree of automaticity of the drawing rights of the members. Unquestionably, a country should not have indefinitely large automatic drawing rights, since it could then acquire goods and services from other countries far beyond its capacity to repay. Hence, the method of decreasing automaticity as successive "tranches" (fractions of the total normal drawing rights of a country) are used is almost inevitable. Discretion rather than a rigid formula should govern the later tranches, but there should be a much higher degree of automaticity for the early tranches than has prevailed in the IMF.

It should be noted that the system I prefer explicitly leaves out gold and any other commodities. Clearly, if the scarce currencies are available through a proper international fund, gold is not needed as an intermediary in order to obtain them. Governments may wish to sell it, to stockpile it, or to operate price support or price control schemes for it. Such activities with respect to gold should have no connection with the international monetary mechanism, however. (Gold is already practically nonexistent in domestic monetary systems, of course.)

For the United States, I would recommend transferring the monetary gold to the strategic stockpile, to be added to or subtracted from as national needs require. Gold or other stockpiled commodities could be used to obtain foreign exchange in serious crises. I would not object to continuing to provide domestic gold producers with price support at \$35 an ounce for a few years, but I see no national advantage whatsoever in trying to maintain ceilings or floors for the world price of gold. People should be as free to trade in gold as in most other commodities. The final removal of gold from the monetary system would bring an end to such ridiculous spectacles as high Government officials, bankers, and editorial writers appraising the economic health of the country by reference to the size of the stock of monetary gold. More important, its elimination from the monetary system would enable the interested public and the Government to consider and pursue domestic and foreign policies without regard to such incidental matters as the supply and price of gold.

The announcement of this changed place of gold—if any announcement had to be made—might cause some shifts of funds from dollars into other currencies, at least temporarily. It would be a help in meeting these shifts to have in operation the monetary system I have outlined, but even without the new system the U.S. Government has large enough resources to meet such an outflow. Since the exchange rate would be maintained, the advantages of shifting funds to other currencies would be shortlived. There would almost certainly be a movement out of gold and into major currencies, including the dollar, as it became clear that the United States was not going to support the price of gold, that it might even deliberately dispose of some of its gold stock (amounting to about 40 percent of the world monetary gold stock despite the losses of recent years), and that the breaking of the price link between the dollar and gold was not a prelude to reduction of the dollar exchange rate.

I should like to summarize the main points of this statement.

1. The Brookings Institution study, published by this committee, rendered a great service in calling public attention to the need for an improved international monetary mechanism.

2. The Brookings estimate of the 1968 U.S. balance of payments, comforting though it is, should be taken with a grain of salt, since such a relatively small economic magnitude is simply not predictable that far in advance.

3. The Brookings proposal for a new international monetary arrangement among the principal trading countries is desirable in principle, but it is defective, in my opinion, in calling for a supranational currency and in failing to call for the removal of gold from the system.

4. The essential features of a better international monetary system are (1) fixed exchange rates (except for a moderate range around par and except for adjustments required by fundamental disequilibria in balances of payments), (2) convertibility of the principal currencies (for most purposes), and (3) a pool of currencies (held by an international organization) sufficiently large, expansible, and available to meet substantial "basic" temporary deficits and large transfers of funds between currencies. The International Monetary Fund could be reorganized, but I am inclined to think that it would be easier to set up a new organization alongside the Fund that would be composed of the leading trading countries likely to keep their currencies convertible

at fairly stable rates of exchange over fairly long periods, and able and willing to finance substantial monetary reserves.

5. Gold, or other commodities, should not be used in any way whatsoever in connection with the system. Gold is deficient as an international reserve currency because it is not plentiful relative to total money supply, the supply is inelastic, and in practice governments do not treat it as readily available to cover temporary deficits.

6. Substantial drawings of other currencies should be available to any member automatically; additional drawings, with no fixed ceiling, should be available in the discretion of the officers of the international organization.

7. The gain from such a system would be very great. International trade and investment would be encouraged. Restrictions on trade and investment could be eased without apprehensions about balance-of-payments effects. Domestic economic policies would be freed of international constraints within a considerable range. Government policies would not have to be inhibited by superstitions or outmoded institutional arrangements with respect to gold.

8. The specific things the U.S. Government should do in the near future are:

(1) Eliminate the 25-percent gold requirement for Federal Reserve notes and deposits.

(2) Cease paying out gold on demand.

(3) Continue the acquisition of "scarce" foreign currencies by sales of U.S. Government securities, "swaps," etc.

(4) Expand the lines of international credits available on a standby, reciprocal basis.

(5) Make occasional drawings from the International Monetary Fund, whether the foreign currencies are actually needed or not, in order to condition the public to such borrowings.

(6) Relax rapidly the protectionist measures which have been introduced to impede imports, capital outflows, use of aid funds, etc. Use the Trade Expansion Act of 1962 to bargain down other barriers.

(7) Use all resources available, if needed, to maintain the foreign exchange value of the dollar, unless it becomes apparent that the U.S. balance of payments is in fundamental deficit disequilibrium, in which case the remedy of depreciation of the exchange rate should be applied. The Brookings projection to 1968 should not be used as a basis for determining balance-of-payments policy. Continuing intensive, critical study is needed of both the concept of the deficit and the statistics.

(8) Proceed apace with the development of plans for a new international monetary organization along the lines indicated above.

(9) Finally, proceed with measures to raise the level of domestic economic activity. To paraphrase the words of your committee's report last spring on the Economic Report of the President, a balance-of-payments deficit of \$2 to \$3 billion a year is no excuse for economic slack costing the country \$30 to \$40 billion a year in foregone output of actual goods and services.

STATEMENT BY H. C. EASTMAN

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The chief value of the forecast of the U.S. balance of payments prepared by the Brookings Institution is to be found in its identification and discussion of the major factors determining the balance of payments rather than in the numerical value of the forecast itself. The precariousness of the forecast is chiefly owing to the impossibility of foreseeing changes in two factors which dominate the course of international transactions. The first is the introduction of new processes and products because of technical and scientific progress. The other is the relative course of prices in the United States and abroad. The Brookings study is able to provide no estimate of the possible importance of the first factor. It reveals the dominant importance of relative prices for the determination of the course of trade by its estimates of the consequences of a slight variation in assumptions about the future course of prices in Europe and in the United States. A rise in European export prices of 7 percent over the forecast period rather than of 11 percent was estimated to be the principal cause of a decline in the balance of merchandise trade of the United States of \$0.9 billion as against an improvement of \$1.8 billion. The change in the balance of trade is the dominant factor in the forecast changes of the entire basic balance of payments so that the actual future course of relative prices is of crucial importance. The rate at which European export prices may alter relative to U.S. prices is obviously wider than the range between the two examples in the study and it is also unpredictable in the present state of knowledge so that the numerical value of the forecast is of limited usefulness as a prediction.

In comparison to changes in assumptions about the basic conditions of international supply and demand and about the course of relative prices internationally, changes in other assumptions would have little effect on the forecast. Nevertheless, two points are made in this note: One on the appropriate assumption about possible changes in the foreign exchange reserves of Canada and of Western Europe, and another on the study's faulty view of the relative cost of changes in the rate of exchange and of changes in the rate of interest. Correction of the last point has no quantitative consequence since the factor in question was not assigned any specific importance in the forecast.

The study assumes that the level of reserves held by Canada, Japan, and all other countries than those of Western Europe will not alter because these countries change their policies respecting imports in accordance with changes in earnings of foreign exchange. In contrast, Western Europe is expected to be passive with respect to changes in its holdings of foreign exchange and gold. The assumption about Canadian behavior is not warranted, though the extent to which its correction would alter the forecast can only be vaguely guessed at. The assumption about the level of Canadian holdings of foreign exchange and gold was presumably based on a projection into the future

of Canadian behavior from 1953 to 1960 when the level of reserves was, in fact, almost completely steady, varying within a range of \$100 million to a total of \$1.9 billion. But this past experience is no guide to the future, because Canada had a flexible rate of exchange from 1953 to 1960 and the monetary authorities allowed the rate to find its own level virtually without interference. Changes in earnings of foreign exchange were reflected in changes in expenditures brought about automatically and smoothly by changes in the rate as is the case when the price system is allowed to work in a free market. The monetary authorities had decided on the appropriate level of reserves under existing conditions (including the system of exchange) and, having attained this level, maintained it with little variation. However, in 1961, the Canadian Government decided to intervene in the foreign exchange market and, since 1962, the rate of exchange has been pegged. The price system no longer operates in this sector of the Canadian economy and forecasts based on the previous period are consequently misleading. Indeed, by the end of May 1963 official holdings of gold and U.S. dollars net of borrowings from the International Monetary Fund were already roughly \$500 million above the level maintained in the period of a flexible rate. This accumulation of reserves took place for two reasons. The first is that the monetary authorities can no longer directly control the level of reserves, for they are committed to buy any excess supply of foreign exchange at a given price, and that they can affect the general conditions of demand and supply in the market in foreign exchange only indirectly, inexactly, and with a lag. The other reason, more important for the purpose of a forecast of a period of years, is that the monetary authorities have decided that more reserves are necessary with a pegged rate than was the case with a flexible one because their freedom of action is greatly reduced and because reserves should rise with an expected increasing value of foreign transactions under these circumstances. This view was expressed by the Governor of the Bank of Canada in his annual report to the Minister of Finance for 1962:

While there is no reliable formula for determining what level of reserves a country ought to aim at, I believe that the growth in our international trade and our international indebtedness and the increase in the size of movements in our reserves that must be expected in consequence of our return to a fixed exchange rate will make it desirable for Canada to aim at carrying higher reserves, on the average, than we did during the decade of the fluctuating rate.

This does not mean that Canadian reserves of foreign exchange can be expected to increase indefinitely. It does mean that their behavior will be similar to those of Western Europe, not to previous Canadian practice, and this is a new source of drain on U.S. net reserves of unpredictable size, though experience over the past year suggests that it will average more than \$100 million a year over the forecast period.

The assumption of unlimited Western European appetite for gold and foreign exchange also appears to be based on past European behavior. It should be borne in mind that most European accumulation took place when European reserves were below the level thought necessary and that the disappearance of this condition may lead to policies inhibiting further increase. The German and Dutch appreciations are examples of strong action in this respect and the early repayment of U.S. loans by Western Europe are indications of some

measure of willingness to remove pressure from the United States. If the main forecast is borne out that Europe will accumulate reserves at a decreasing rate even if Western European countries do nothing to affect their balance of payments and the United States takes no new steps, this assumption does not affect the outcome since it amounts to assuming that Western Europe will not resist declining increases to its reserves. However, if the forecast is too optimistic and Western Europe continues to accumulate reserves rapidly, it might come to resist increases to its reserves because of the decreasing usefulness of the further security provided by more reserves when compared to the net cost measured by the low return on such official lending to the United States relative to the alternative uses of the resources involved.

In the discussion of long-term capital outflow, the authors of the study appear to overestimate the importance of changes in rates of exchange relative to international differentials in rates of interest. They write (p. 133), referring to the Canadian experience:

The bargain of lower interest rates in the United States, therefore, turned out to be very expensive indeed. While current borrowings depend on the expectation of future exchange adjustments, and not on the adjustments of the past, the recent unhappy experience is likely to weigh on prospective borrowers as the exchange risk is recognized.

The second sentence quoted contradicts itself, but this is not an important point. A simple calculation reveals that, despite the depreciation of the Canadian dollar, few Canadian borrowers of U.S. dollars are today in a worse position for having borrowed in the United States than that in which they would be had they borrowed Canadian dollars. If we let R_1 be the rate of exchange when a sum is borrowed abroad and R_2 the depreciated rate prevailing immediately thereafter and for the life of the bond so that all interest payments and the repayment are made at the unfavorable rate R_2 , and if we let i_c be the rate of interest in Canada and i_a the rate abroad, then it will be profitable to sell a perpetual bond abroad as long as

$\frac{R_2}{R_1} < \frac{i_c}{i_a}$. Taking maturity dates into account necessitates somewhat

more elaborate calculation and the condition of profitability is

$\frac{R_2}{R_1} < \frac{i_c + i_c/(1+i_c)^n - 1}{i_a + i_c/(1+i_c)^n - 1}$. To give a numerical example: if the long-term

rate of interest is 6 percent in Canada and 5 percent in the United States and the initial rate of exchange R_1 is 1, borrowing in the United States is profitable on a perpetual basis as long as the immediately succeeding depreciation is to no higher a rate of exchange R_2 than 1.20. Profitable borrowing for 30 years would require a new rate no higher than 1.16, for 20 years, 1.13, and for 10 years, 1.08. The average rate for the 5 years 1956 to 1960 was approximately Canadian \$0.97 to the U.S. dollar and it is now Can\$1.08, so that borrowers of U.S. dollars on a long-term basis are mostly still better off than they would have been had they borrowed in Canada, despite the depreciation of the Canadian dollar.

These calculations show that the foreign borrowing of Canadians when the rate of exchange was low is not inconsistent with the successful minimization of the cost of borrowing despite the subsequent rise in the rate and that to refer to a "recent unhappy experience" is

unwarranted. It is certainly not the case that Canadian borrowers were unaware of an exchange risk in the 1950's and they must have added a premium for this risk to the rate of interest in the United States. At the margin the borrower's premium was presumably equal to the difference in rates of interest in Canada and the United States. This does not mean that borrowers may not be disappointed, but, if they are, the disappointment is with having borrowed at all, not with having borrowed in the United States.

STATEMENT BY OTTO ECKSTEIN

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These comments are submitted in response to the committee's request for an evaluation of the Brookings report's general methodology and findings.

The Brookings report is a skillful, technical exercise, working out the implications of a return to full employment for the balance of payments of the United States. It is a projection, and will, except through good luck, be in error to some extent. This is a fact of life for all projections. Nevertheless, this projection, like others, can serve a most useful function by directing the discussion of a crucial economic policy problem into more quantitative channels rather than leaving it a matter of casual opinion and prejudice. Those who disagree with the fundamental postulates of the Brookings report are free to make alternative assumptions, but it is incumbent upon them to seriously concern themselves with the quantitative implications of their views.

On the whole, the assumptions made for the study and the implications for our balance of payments from them are reasonable. While they are on the optimistic side, they are not extreme and there is a good chance that events will actually unfold about the way the report says. It is in this light that it should be interpreted. It is a scenario of plausible events—with a happy ending. It should not be taken as a single-point forecast, and possibly not even a forecast of the most probable outcome.

The report has one serious lack: It does not contain what has been called a sensitivity analysis. It does not show to what extent the final outcome for the balance of payments is affected by changes in the individual assumptions. Both the "initial" and the "alternative" assumptions for the movements of the economy as a whole are rather optimistic, and with regard to other matters, alternative assumptions are little employed. In principle, it is not difficult for other experts to make alternative assumptions and to utilize the apparatus of the Brookings report to work out the implications. But it would have been useful if the authors had conducted a sensitivity analysis themselves.

THE CENTRAL POINTS OF THE REPORT

The report is really built on a few points which I shall now take up individually.

Wage and price behavior

The substantial improvement in the balance of trade is partly to be attributed to an expected improvement in the relative cost position of the United States as compared to Western Europe. The report assumes that Western Europe will inflate considerably, the United States rather little.

Wages and prices in Europe.—As of this date (October 1963) two of the major European countries were indeed continuing to suffer from severe inflationary difficulties. (In Germany, the inflationary process had stopped.) Both France and Italy have been experiencing rises of consumer prices of over 6 percent a year, increases which inevitably influence wage increases, and through them, export prices. France has embarked on a major program of price stabilization, including selected price controls, long-term government financing and liberalization of some imports. The vigor of the measures certainly suggests that France is determined to stop the current inflation. But the very fact that the inflationary experiences of the 1950's could recur under De Gaulle, that the stabilization program begun in 1958 did not in fact retain its effectiveness in a period of rapid expansion, does give the observer reason to think that the inflationary bias remains in the French economy, perhaps reflecting certain institutional and political characteristics. In the case of Italy, the current political instability and the recent very high rates of wage increases make some continuance of inflation likely.

In this connection it should be recalled that the significance attached to the objective of price level stability in making the choices of economic policy depends very much upon the balance-of-payments condition. In the postwar period, governments have fought inflation resolutely when inflation was coupled with balance-of-payments weakness. At other times, marginal choices have often been resolved in favor of full employment and political convenience.¹ If this attitude persists, then one should not look for a real end to inflation in France and Italy until their balances of payments get into trouble. If the international payments system is adequate to current world levels of trade, then the reserve position of these two countries should not become weak until our own has become strong.

On the other side, it should be mentioned that European economic integration makes French and Italian inflation a Common Market-wide problem. France and Italy should develop trade deficits in relation to the other Common Market countries. While this will put some damper on their own inflations, it will spread the effects to Germany and Benelux. Given German determination not to have inflation, one can look forward to heavy German pressure on France and Italy to halt their inflationary processes.

Wages and prices in the United States.—The Brookings report performed a singular service in highlighting the effects of American wage and price behavior of the mid-1950's on our balance of payments. What had long been suspected is at least thoroughly documented in the Brookings report.² Relying partly on important studies conducted under the previous administration³ and summarizing later private and public research, the report concludes that the United States lost about \$2 billion of commodity exports over the period 1954-61; \$800 million of this loss is attributable to the relative decline of the market in which we sell, primarily Latin America as compared

¹ For a full discussion see E. Kirschen and others, "Economic Policy in Our Time," Amsterdam, North Holland Publishing Co., 1963, vol. I, pt. 3. Only in Belgium and Germany has the government, at times, made price level stability the paramount objective of policy for its own sake.

² See "Staff Report on Employment, Growth, and Price Levels," 1959, pp. 463-464, for a brief early statement.

³ See Brookings report, p. 66, for full references.

to Western Europe. Of the remaining \$1.2 billion of export losses, autos, steel, and machinery accounted for virtually all of it. The loss of the United States in the motor vehicle markets of the world alone account for \$610 million, and this makes no allowance for the almost equal loss to European imports inside the United States. The loss in iron and steel was \$260 million, the loss in industrial machinery another \$200 million. These losses in durable goods industries are in large part the result of the wage price spiral in this sector which was analyzed for this committee earlier.⁴ The decision of the automobile industry not to produce models suitable for sale abroad and to rely on their foreign subsidiaries to supply third markets also contributed to our loss of exports.

The wage-price spiral ceased in the durables sectors from 1958 to 1963 because of the diminished prosperity of the industries and the high rates of unemployment. I am not as sanguine as others about the continued price and labor cost stability. The steel industry has finally succeeded in raising prices once again this year. Important wage negotiations are coming up next summer. I think we must acknowledge that we have made little progress in devising measures to deal with wage-price problems. If the economy moves toward full employment—as the Brookings report assumes—then there is a serious hazard that the wage-price spiral will resume once more.

A large increase in investment income

The other major cause of optimism in the Brookings projections is a large increase in investment income. An extra \$2 billion is to be obtained from this source, part of which is to be offset by a decline in associated American exports. Given the heavy outflow of capital and its investment in high return uses abroad, one would indeed expect investment income to rise substantially. Nevertheless, a figure of \$2 billion seems to me a little large and seems to assume a higher payoff on investments than has accrued to the United States on previous investments.

Foreign exchange costs of foreign aid and military programs

In these sections, the Brookings report relies heavily on official material. It is difficult for the outsider to prepare independent estimates, and in the case of foreign aid it is virtually impossible to give a definitive foreign exchange cost because one cannot ascertain what the pattern of world trade would be without foreign aid.

I have no specific reason to disagree with the Brookings estimates. But if they are in error I would expect them to understate the foreign exchange costs of these programs.

The effects of the Common Market

The Brookings report estimates that the formation of the Common Market will cost the American balance of payments about three-quarters of a billion dollars. This chapter of the report is one of the most interesting, and represents a new realism in American thinking about the impact of the Common Market which is long overdue. Of this loss, \$200 million is estimated to accrue in manufactured products,

⁴ See the "Staff Report on Employment, Growth, and Price Levels," and study papers Nos. 2 and 3, "Steel and the Postwar Inflation," by Otto Eckstein and Gary Fromm, "An Analysis of the Inflation in Machinery Prices," by Thomas A. Wilson.

\$100 million in nonagricultural raw materials, and \$350 billion in agricultural products. In addition, the United States is estimated to lose \$100 million of exports to third countries associated with the Common Market.

The estimate is indeed a pessimistic one, but I believe it to be not far from the true mark. To some extent the final figure will depend on the outcome of the Kennedy round of GATT negotiations, and it is very much to be hoped that this round will move the world toward a pattern of multilateral rather than bloc trade.

Concluding comments

Having looked at the crucial assumptions, what conclusions follow for economic policy? While the Brookings assumptions are plausible and certainly well within the range of probable outcomes, the optimism on relative wage-price developments and on future investment income, as well as the rather favorable picture of the foreign exchange costs of our foreign aid and military programs do suggest that the Brookings projections are based on pretty optimistic assumptions. It would take very little to make the story come out much worse. The basic balance could get worse rather than better and it would be irresponsible indeed if balance-of-payments policy were predicated on the belief that the American balance of payments will cure itself with the passage of time. The possibility of real improvement is strong enough to keep us from taking panic measures. But the present deficit and the rate of improvement which can reasonably be expected are such that we had best take additional major measures to get our balance of payments out of its present perilous state.

STATEMENT BY PAUL EINZIG

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Before examining the materials contained in this report it is necessary to criticize two major errors of omission, each one of which is important enough to invalidate to a large extent the projections it contains.

(1) The experts of the Brookings Institution appear to have disregarded the Communist bloc in general and the U.S.S.R. in particular.

(2) They appear to have ignored the existence of the Euro-dollar market.

The impact of the production and foreign trade of Communist countries on the U.S. balance of payments might easily become a factor of considerable importance. Indeed, with little exaggeration we may contend that an attempt to project the balance of payments of the United States in 5 years' time without taking the possibility of that impact into account is like Hamlet without the prince and the gravedigger. Quite frankly, I am utterly perplexed by the complete absence of any reference to the U.S.S.R. and to the rest of the Communist bloc in a report which in most other respects makes a remarkable effort to cover very thoroughly the wide variety of aspects of the problems it deals with. The report divides the world into three sections— (1) the United States, (2) Western Europe (with Canada and Japan thrown in), and (3) the rest of the free world. As far as this report is concerned, the U.S.S.R. might well be on another planet. It is not even mentioned and no explanation or excuse is offered for ignoring it.

To my mind, the only conceivable explanation of this strange ostrich-like attitude is that, since trade between the United States and the Communist bloc has been virtually nonexistent for many years and is at present quite negligible, the experts do not feel the need for allowing for its future impact on the U.S. balance of payments. It is, however, to say the least, possible that, as a result of the relaxation of politico-military East-West tension, restrictions on American trade with the U.S.S.R. and with the European Communist countries might be materially relaxed. There is, of course, no means of knowing in what sense and to what extent such a change would affect American imports from and exports to the Communist countries concerned, and whether on balance a spectacular increase in their volume would result in an import surplus or an export surplus. But it is utterly unrealistic and grossly misleading to try to ignore out of existence this potentially important factor. Surely it would deserve a brief paragraph, or at least a footnote, in a report of 290 pages.

In any case, even in the complete absence of any change in the trade relationship with the Communist bloc, the development of the Soviet Union's economy is liable to affect the American balance of payments indirectly, through its impact on the foreign trade and national income of other countries of the free world. Judging by recent progress in the

industrialization of the U.S.S.R., it is possible and even probable that its exportable surpluses in many raw materials and manufactured goods will increase considerably during the next 5 years. In possession of such surpluses, the Soviet Union is liable to make itself felt in the world markets to a very considerable extent, and at times dramatically.

The development of comparative costs as between the United States and the U.S.S.R. are impossible to foresee, but in any case costs play a subordinate part in the export policy of the Soviet Government. When they deem it essential to secure foreign exchange they might be prepared to export vast quantities of their products at heavily reduced prices at a bookkeeping loss. Even if we ruled out the possibility of the cold war being pursued in the sphere of foreign trade, the possibility of large-scale dumping for purely economic reasons must be envisaged, because it is inherent in totalitarian economies.

The reason why economic planning in the Soviet Union has been tolerably successful until now is that, throughout the existence of the present regime since 1917, Russia has been entirely a sellers' market. Consumer goods have been all the time in short supply, so that those in charge of planning production could safely rely on selling to the public anything they chose to produce. With the increase in the volume of consumer goods that is likely to take place during the next 5 years, the masses of consumers will gradually be placed in a position to exercise a growing extent of choice, which necessarily means that their changes in taste and preferences will be increasingly liable to be miscalculated by the planners. Consequently, large quantities of goods are bound to remain unsold from time to time. In the absence of a price mechanism there can be no automatic adjustment of supplies to changing demand. In possession of vast quantities of unsold and unsalable goods, the Soviet authorities are likely to be strongly tempted to resort to dumping such goods on foreign markets, regardless of the loss incurred.

Even if the U.S. markets can be safeguarded against such dumping, it is liable to spoil markets for American exporters. Admittedly, as things are at present, such effects appear to be likely to remain confined to raw materials and manufactures of low quality. But, judging by the fact that during recent years Japan and other newly industrialized countries have appeared unexpectedly as fierce competitors in the sphere of very high grade industrial products, such as precision instruments, it would be imprudent to rule out the possibility that in 5 years Soviet dumping may come to be practiced in a wide range of advanced manufactures.

In addition to the direct effect of such development on American exports, its effect on the exports, production, and prices in other industrial countries might also react on the U.S. balance of payments. All the elaborate forecastings on which the report's projection are based are liable to be gravely vitiated if, as a result of large-scale Soviet dumping, there should be heavy economic setbacks abroad, and if the industries in the countries concerned sought to hold their own by means of drastic price cutting, or if their Governments felt impelled to resort to drastic deflation.

Apart altogether from the perturbing possibilities indicated above, the possession of a very large gold reserve by the Soviet Government introduces an important element of uncertainty which is entirely

ignored by the experts. Throughout the report they assume that the Western European countries, Japan, and possibly Canada, are the only countries whose attitude toward accumulating or releasing large gold reserves is liable to produce incalculable net export surpluses or import surpluses on their trade with the United States and with the rest of the world. But surely they must be aware that the U.S.S.R. is generally assumed to possess by far the largest net gold reserves, allowing for external short-term indebtedness that has to be deducted from gold reserves. Its current output of gold, too, is believed to be second only to that of South Africa. Policy decisions in Moscow whether and to what extent to draw upon this gold reserve are bound to be a factor of major importance either favorable or unfavorable in determining net trade balances of the free world, and they are bound to react on the U.S. balance of payments.

For instance, in 1963 there has been until August much less selling of Soviet gold than in previous years. Knowing as we do that the U.S.S.R. increased its adverse balance of payments, the absence of gold sales until August and September was probably due to a policy decision to cover the deficit by means of borrowing abroad. In fact, during 1962-63 the U.S.S.R. and other Communist countries have greatly increased the amount of their net borrowing of Euro-dollars and other Euro-currencies. When, in addition to this, large amounts of Soviet gold came to be exported, it tended to react favorably on the balance of payments of the free world. Decisions in the opposite sense—to stop gold sales and repay Euro-dollars debts—are liable to produce the opposite effect.

This brings me to the second major omission of the report. It makes no mention of the far-reaching change in the system of international finance brought about by the development and expansion of the Euro-dollar system. The increasing volume of Euro-currency deposits provided to a large extent additional means of borrowing by countries with an adverse balance of payments. It may be argued that this institutional change is now more or less complete, so that no further spectacular increase in the volume of Euro-dollars is liable to affect balance of payments. The answer to this argument is that we are by no means certain whether that total will not increase further, and that in any case even its sudden contraction that might occur for a variety of reasons is liable to affect the balance of payments to the extent of billions of dollars. Besides, even changes in the ways in which an unchanged volume of Euro-dollar deposits is actually employed are liable to affect the U.S. balance of payments.

There is no short answer to the question in what way and to what extent the operation of the system is liable to affect American imports and exports and movements of short-term capital into and out of the United States. This is a highly technical and involved subject, for the detailed discussion of which I must refer to my forthcoming book, "The Euro-dollar System—Practice and Theory of International Interest Rates." But, to illustrate the potential effect by one realistic instance, I mentioned above the possibility that during the first 7 months of 1963 the Soviet Union financed its adverse balance of payments by means of large-scale borrowing of Euro-dollars instead of by means of selling gold. This reminds us that the operation of the system has provided the Soviet Union with an important additional means by which to bring about noteworthy changes in the

pattern of international trade. Possibly the Communist borrowers may have exhausted by now their credit limits for the time being. But by scrupulously meeting their liabilities they might create a goodwill which would enable them to borrow more later, whether in the form of Euro-currencies or in other forms. In any case, as I said above, a decision to repay the Euro-dollar deposits might also react on the balance of payments of the United States.

The instances of the two major omissions from the report dealt with above illustrate the impossibility of making an even approximately reliable balance-of-payments forecast. I happen to have spotted these two omissions merely because I happen to have taken special interest in their subjects, but for all I know there may be scores of other equally important omissions. The report of the Brookings Institution can hardly be blamed for its inability to cover all the immense variety of influences and of the wide possibilities of the changes in their absolute or relative importance from the point of view of their effect on the U.S. balance of payments in 1968. Within the limitations inherent in their task, the experts have done admirable work by analyzing influences behind balances of payments in general and that of the United States in particular, by tracing influences behind those influences, examining flexibilities, automatic adjustments, feedback processes, vicious circles, self-aggravating and self-canceling influences. In my opinion the report constitutes the most important contribution to the theory of the balances of payments for all time. Its value as a practical forecast for 1968 is, however, highly problematic.

The experts themselves repeatedly indicated in their report their awareness of skating on extremely thin ice when trying to express their very sensible findings and conclusions in terms of actual figures. They had to base their projections on forecasts which they had known to be undependable. And, as they rightly remarked, even if the forecasts were absolutely correct it would not preclude the possibility of major errors in their projection based on them.

Even in respect of completed past periods it is, for instance, impossible to ascertain causal relationship between changes in GNP and changes in balance of payments. Yet the forecasts that were provided to the experts were largely based on the assumptions that there is ascertainable causal relationship between these two magnitudes. It is easy to imagine the difficulty of making a prognosis on the basis of such a dubious diagnosis.

When it comes to assumptions that trends which happen to operate at present—or, to be correct, which are supposed to be indicated by statistical averages over an arbitrarily chosen number of recent years—would continue during the next 5 years, we find ourselves entirely in the realm of irresponsible conjecture. Considering that within the last 12 months the statisticians forecasting the current balance of payments of the United States for the immediate future proved to be wrong on a gigantic scale; it takes courage bordering on foolhardiness to try to predict what the exact or even approximate amount of the U.S. balance of payments will be 5 years hence. Even if we knew how the GNP will develop it would be utterly futile to try to establish arithmetical relationship between changes in the GNP and in the balance of payments.

Whether Americans will spend their additional incomes on American goods or on imported goods does of course depend to a large extent on comparative costs. There are, however, many other considerations that are liable to affect the balance of visible trade, and only a few of these are touched upon by the report. The authors ought to have paid more attention to the disturbing findings contained in "The Dollar in Crisis" (editor, Seymour E. Harris), which seeks to indicate some major institutional or structural changes that have little or nothing to do with comparative costs. For instance, the spread in Western Europe and elsewhere of the industrial know-how that was until recently virtually an American monopoly is a fact that ought to have been taken into full account.

The experts are probably right in viewing with optimism (from an American point of view) the probable adverse developments in Western European economies during the next few years. As far as Great Britain is concerned, they are, I believe, right in predicting an increase in manufacturing costs per unit through wage increases which the Government, for fear of causing an increase in unemployment, is not likely to prevent by the application of disinflationary policies. But one is permitted to wonder whether the predictions that increases in American costs in general, and of exportable manufactures in particular, would lag so conveniently behind corresponding increases in Europe will prove to be correct. Hard as I have tried to follow developments in the United States, I have failed to discover any fundamental improvement in the attitude of American trade unions that would justify such optimistic predictions. It is true, at this time of writing, wages in Western Europe are rising faster than in the United States. But this relative trend is liable to change more than once in 5 years.

It is true the extent of unemployment is much higher in the United States than in Britain and in Western Europe. Logically the experts are right in suggesting that it will be therefore easier for American industries than for their European competitors to keep down the increase of their costs. But on the basis of that self-same logic it is impossible to explain how the United States has come to drift at all into its balance-of-payments difficulties. In spite of the availability of unemployed labor in the United States throughout the fifties and the sixties, American costs have not become sufficiently competitive. I am utterly perplexed why this should be so, and nothing contained in the report has persuaded me that within the next 5 years unemployment in the United States would at long last produce its natural effect. In postwar America relatively large-scale unemployment seems to be utterly incapable of generating its automatic corrective. It seems that, notwithstanding higher unemployment, the bargaining power of American organized labor is for some obscure reason high enough to enforce wage increases unearned by an adequate increase of productivity. In the United States, as in Britain, the trade unions seem to be utterly antisocial in their attitude toward the community and refuse to recognize that they have to make a contribution toward solving the chronic balance-of-payments problem. The report indicates no convincing reason to justify hopes that this attitude might change.

Another reason why I think that, notwithstanding the intimidating array of skillfully marshalled figures, the conclusions derived from

them, even on the basis of the experts' own less optimistic alternative assumptions, are much too optimistic, lies in the absence of any indication of a change in the basic American attitude toward consumption. Its most characteristic but by no means only manifestation is in the staggering degree of waste of manpower, materials, and industrial capacity resulting from the habit of wanting to possess the latest model in automobiles and other consumer durables. I am convinced that it is because such wasteful consumption absorbs a far too high proportion of American productive resources, and because it provides producers with a highly dependable vast domestic market, that American industries do not concentrate on exporting on a sufficient scale. Beyond doubt, large domestic markets have considerable advantages from the point of view of reducing the cost per unit. At the same time, however, they reduce the incentive to export. The experts duly realize this when dealing with export prospects of the European Economic Community. They do not appear to be sufficiently aware of it when dealing with the American economy. In respect of the latter they assume that American exports would expand with the expansion of the GNP. This is not likely to be so unless the American public can be induced to abandon the habit of throwing consumer durables on the scrap heap simply for the sake of acquiring the latest models.

The report does not seem to indicate that the experts are aware of the extent to which the deterioration of the U.S. balance of payments in the late fifties was due to the inexplicable miscalculation of most American automobile designers in producing unnecessarily large automobiles which, however impressive they were to the eye, were utterly inconvenient amidst prevailing conditions of crowded roads. Is there any reason to hope that similar gigantic miscalculations would not occur during the next 5 years?

The experts make commendable efforts to emphasize that, for a wide variety of reasons, the figures they have produced cannot be relied upon absolutely. But even so they fail to indicate the full extent to which their econometrical findings must be regarded as undependable. The margin between the figures based on forecasts supplied to them and those of the alternative forecasts they themselves elaborated seems to be much too narrow. The least undependable section is the one dealing with future capital exports from the United States. Even in that respect many basic assumptions are very bold. But on the whole the experts are probably right in predicting a decline in direct investment of American capital in Europe. When it comes to their prediction of the trend of American investment in foreign securities, surely that largely depends on relative stock exchange trends which are entirely unpredictable for a period of 5 years.

The most undependable section is the one dealing with American military expenditure abroad. Of course the experts can hardly be blamed for having been unable, at the time of writing (which was before the conclusion of the nuclear test ban agreement), to foresee the possibility that within the next 5 years there might be a relaxation of East-West tension that would enable the United States to withdraw its troops from Europe, nor could they be expected to foresee whether an aggravation of a threat of war, possibly with China, would necessitate heavy additional expenditure.

A major element of uncertainty which could not be expected to be allowed for is the possibility of devaluations or revaluations of

major currencies. Even though at the time of writing they do not appear likely, they cannot be ruled out. Nor can we exclude the possibility of relapse into controls and bilateralism in a number of countries unable to balance their accounts. Either of these changes would affect the U.S. balance of payments considerably.

Impossibility to foresee the degree of priority that the U.S. Government will give to balance of payments among the ends of its monetary policy in 1968 is probably the most important unknown factor for which the report could not be expected to allow. It is even difficult to foresee whether in 6 months' time increased employment will come to be considered more important than stability of prices or a favorable balance of payments. Between now and 1968 the U.S. Government is liable to change its policy more than once in that respect.

In a great many respects the report serves a very useful and essentially constructive purpose. On the other hand, by breeding complacency, it is liable to produce a highly damaging effect. In all fairness to its authors, they went out of their way on a large number of occasions to make reservations that are calculated to warn readers of this report not to take the figures it contains at their face value. Unfortunately, it is not the obscure passages inserted to that effect that determine the general impression the report is liable to convey to Congress, to public opinion, and even to expert opinion. Even many experts who ought to know better are apt to become hypnotized by impressive tables of figures—not round amounts that would convey their very tentative and approximate character but precise figures with decimals which convey the impression that the scientific calculations on which they are based must have been painstakingly thorough and accurate. The fact that all press summaries of the report which I have come across stressed the broad findings illustrated by quoting figures, without mentioning the reservations, speaks for itself. This criticism is directed against the econometric methods in general rather than against their specific application in this report, though I do feel strongly that its authors might have gone much further than they did in laying stress on their reservations.

It would be deplorable if the general impression conveyed by the report, that by 1968 all will be more or less well, were to weaken the determination of American political opinion to treat the problem of balance-of-payments default as one of the utmost importance and urgency. For one thing, if the predicted decline of the deficit were to spread over 5 years, long before equilibrium is reached the gold reserve might decline below danger point. Admittedly, in their policy recommendations the authors stress the need for a variety of steps. Even so, the optimistic overall impression conveyed by their report is liable to weaken their call for action.

Over and above all, the report fails to convey the full extent of the disastrous consequences of a failure to solve the problem through dealing urgently with basic causes rather than symptoms. Its main recommendations aim at juggling with international liquidity and administering a "shot in the arm" in the form of dollar depreciation under the excuse of flexibility. Such solutions were rightly denounced by some of the contributions in "The Dollar in Crisis."

What I feel is needed is a widespread realization of the full extent of the danger to American prosperity and security and to the free world as a whole, and of the fact that fundamental causes of this danger lie in the antisocial attitude of organized labor, the recklessly wasteful system of consumption, and the failure to keep adequate lead over other industrial countries in respect of technological progress. None of these defects are irreparable. But the conveying of unwarranted optimism and the recommendation of palliatives which leave the basic causes untouched is likely to make it more difficult to repair them.

STATEMENT BY STEPHEN ENKE

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NOTE.—The author's views were solicited by the committee in his capacity as a professor of economics at Duke University; hence they do not necessarily reflect the position of any Government agency or contractor with which he has been or is now associated, none of which have reviewed or approved this paper.

INTRODUCTION

The Brookings Institution, and especially Dr. Walter A. Salant and his immediate associates, are to be commended for this study of the U.S. balance of payments.¹ Their estimates of the U.S. net basic balance for 1968 are of technical interest. And the separate conclusions in the final chapters in the final chapter will long stimulate discussion. Moreover, the authors have throughout been honest and impartial in their approach, stressing doubtful assumptions and admitting hazards of attempting balance-of-payments projections. They have earned the thanks and esteem of their profession.

Nevertheless, all studies have omissions, as does this one. Accordingly, in sections below, this reviewer advances some major neglected considerations. First, there is no explicit recognition that the U.S. balance-of-payments difficulties may be an outcome of its Government's attempting too much militarily and economically abroad, given present currency exchange rates and the competitiveness of the national economy. Second, there is no examination of the extent to which a single currency devaluation might serve to increase domestic employment and strategic activities abroad. Third, there seems little realization that current DOD offshore procurement regulations constitute a selective depreciation of the dollar, and that such practices could be extended to other U.S. agencies and simplified through such a blocked account system as is later described here. Fourth, the Brookings study treats the U.S. current account too often as an aggregate, although more detailed analyses of classes of exports and imports might have suggested ways in which the trade balance could be improved through this Nation exploiting its existing comparative advantages in production. Fifth, the possible balance-of-payments impacts of a limited war occurring between now and 1968 are ignored, considerable though these impacts may be. In many instances these omissions are attributable to the limited terms of reference accorded the Institute, and hence are no reflection on the study's authors, but they remain part of the balance-of-payments problem nonetheless.

The final chapter of policy recommendations is essentially a separate document. The logical relations between these recommendations and the preceding analyses and estimates are in many instances not apparent. Fortunately, this lack of connection makes them no less significant or deserving of attention, and some of them (e.g., removing the

¹ "The U.S. Balance of Payments in 1968," materials presented by the Brookings Institution to the Joint Economic Committee, Congress of the United States, for consideration in connection with its study of the U.S. balance of payment: GPO, Washington, 1963.

25-percent gold backing of Federal Reserve notes) reflect the majority view of economists today. Certain other recommendations, as for instance the proposed fixed dollar-sterling rate and the flexible exchange rates between the dollar and European Common Market currencies, carry long-term implications regarding our international relations that may subordinate purely monetary issues. Also the possibly dangerous consequences for the United States of establishing what would in effect be an international central bank—which seems to be the first choice of the study's authors—are not examined.

The study's authors tend, especially in chapter IX, to overstate the interaction between the U.S. present balance-of-payments problem and existing international payments mechanisms. Certainly, because the dollar is a key currency, a prolonged "unfavorable" basic balance very seriously increases the danger that foreign central banks might eventually try to cash most of their dollar exchange reserves for U.S. gold. But no acceptable scheme for promoting international payments could or should be so "liquid" as indefinitely to finance nations that cannot or will not earn their way in the world. Ignoring rare charity, over the years each nation must limit its imports and lending to what it can buy with exports, or borrow, for otherwise it must accept a worsening in its terms of trade through devaluation. Even the United States is no exception. So far this Nation's balance-of-payments problem stems essentially from international overspending and underearning and not from the current system of clearing international payments. There are no simple and obvious ways to change the rules of the international payments game that will enable us to win in the end without playing harder.

SOME MAJOR OMISSIONS

The Brookings study underlines several world developments during the past 5 to 8 years that are generally considered major causes of the United States concurrently unfavorable basic balance. These causes include (1) the restored productive facilities and trade competition of Western Europe and Japan; (2) the new preference of many U.S. savers for investments in Canada and Western Europe; and (3) a decreased fear in Western Europe of Soviet subversion or invasion, coupled with a realization that it is hereafter the United States that may suffer massive human and capital losses in a future nuclear war. However, in this analysis, the study omits several other important aspects of the balance-of-payments problems that are accordingly emphasized here.²

Government programs and exchange losses

The U.S. Government, to enhance the power and goals of the Nation abroad, finances a variety of mutual defense and economic assistance programs that occasion very considerable gross transfers of dollars—roughly, \$5 billion a year—to foreign governments and nonresidents. These gross exchange losses are in addition to private purchases of imports and lending to foreigners by domestic residents. All gross exchange debits cause some gross exchange credits from extra exports

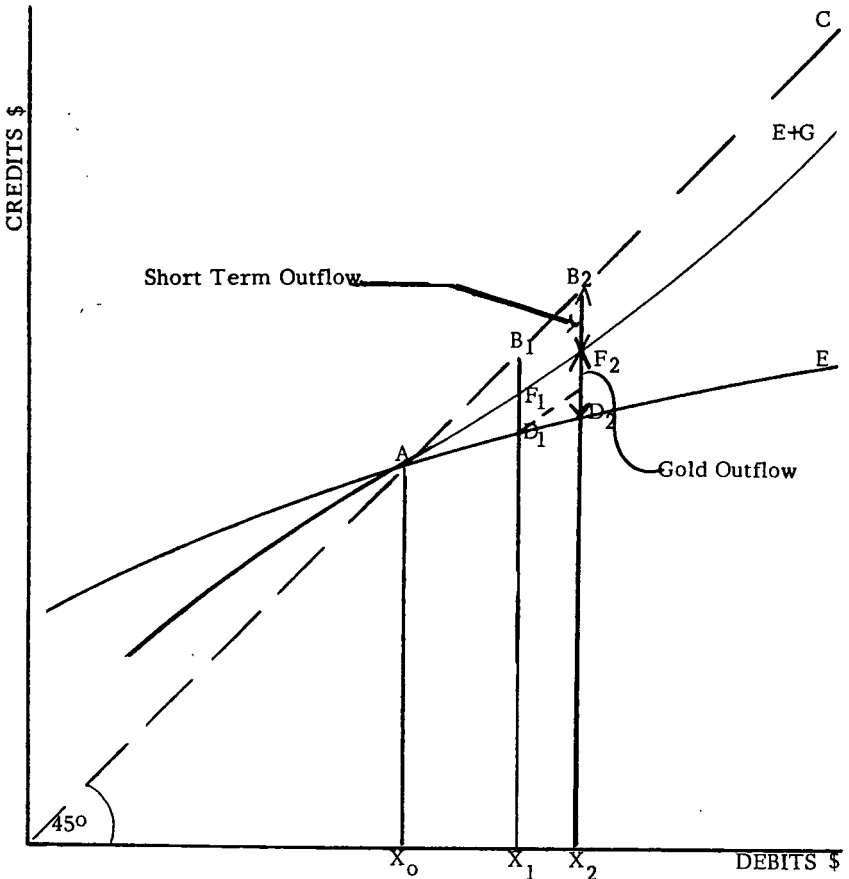
² The Brookings study might well have given more consideration to international capital inflows than it does. The role of interest rates in influencing short-term capital movements has a tradition that should not be ignored. Moreover, there are means whereby short-term interest rates can be raised without inhibiting long-term domestic investment significantly. Present circumstances suggest too that some European nations should be put under pressure to open their capital markets once more to private and public long-term borrowers in the United States.

of course. Unfortunately, the greater the level of these publicly and privately caused international debits in any year, the smaller will be the incremental export credits occasioned by any increment in these debits. Moreover, the greater the holding of dollars by foreign governments and central banks at any time, the greater the reluctance of nonresidents to accept more dollars rather than gold in payment of those U.S. debits not financed by U.S. export credits. At each level

FIGURE 1

FINANCING PAYMENTS IMBALANCES

(Imports + Net LT Lending = Exports + ST Inflows + Gold Losses)



of aggregate U.S. spending and lending abroad, given effective market demands, relative national price levels, currency exchange rates, and foreign holdings of dollars and gold, there is conceptually some specific combination of exactly offsetting exports and dollar and gold outflows for the United States.

Schematically, these relations are illustrated in figure 1, where the horizontal axis gives in dollars the total debits in some year arising

from public and private purchases of goods and services from foreigners, plus all net long-term lending by residents, plus U.S. grants-in-aid. The vertical axis represents in dollar values how these total expenditures abroad by the U.S. economy are financed with exports of goods and services (including net interest), augmented net dollar balances held by nonresidents, and gold drains. Thus, if aggregate U.S. international debits are X_0 , the diagram shows that AX_0 exports will be sold to nonresidents (because A is located on the export curve E). This point is also on the broken credits line C , constructed 45° from the horizontal, so OX_0 and AX_0 represent equal dollar values. In other words, the net basic balance is zero, and no adjusting movements of foreign exchange and/or gold are needed.

Suppose instead that total U.S. debits are OX_1 . At this horizontal value the export curve E lies below the broken credits line C , which indicates the total offsets, "receipts," or international accounting credits that must be somehow accumulated. B_1D_1 is the negative (unfavorable) net basic balance. To some extent, B_1F_1 , this gap can be financed by nonresidents accepting more dollar balances during this annual period. The balance of F_1D_1 must be financed with gold outflows from the United States. (The point F_1 is on the exports plus gold curve, labeled " $E + G$.")

The position of the exports plus gold curve depends on the stocks of dollars already held by foreign central banks. As these stocks increase, the $E + G$ curve will shift upward, indicating that ordinarily the gap between total international debits and export-occasioned credits must be increasingly met by exports plus gold rather than exports plus dollars. Moreover, in figure 1, the $E + G$ curve becomes almost vertically parallel with the broken credits line for very large annual debits.

There would never be an international payments problem for the United States—ignoring all capital movements—if foreign governments and nonresidents always wanted to buy from the United States the value of goods that the United States wanted to buy from the rest of the world. In this happy but unlikely instance the E curve in figure 1 would be coincident with the broken credits line C . Unfortunately, merely because the U.S. Government desires to finance additional activities abroad on behalf of its assessed national interests, foreigners in practice do not increase their desire to purchase U.S. goods and services by an exactly offsetting amount at exactly the same time.

Logically, assuming private spending and lending abroad by U.S. residents to be constant, the U.S. Government in the long run can only increase and finance oversea activities, such as deploying more armed forces outside its territories, financing more military and economic infrastructure in Allied Nations, and granting more economic assistance to so-called neutral countries, to the extent that nonresidents decide to purchase more U.S. goods and services or invest more in the U.S. economy. This is the significant and final constraint on the United States because its gold stocks, and the willingness of foreigners to hold dollars, will otherwise become exhausted in the end. Basically, in the absence of U.S. exchange controls, and given existing currency exchange rates, the degree to which the U.S. Government can finance oversea activities depends on the competitiveness of the U.S. economy's private firms, the productivity of its labor, the value of its ex-

portable natural resources, plus the willingness and ability of foreign buyers to purchase its output, and of foreign investors to lend to U.S. borrowers.

For example, suppose the U.S. Government decided that the international situation required it to grant more foreign military and economic assistance, increasing gross international debits a year to OX_2 from OX_1 . (See fig. 1.) The E curve indicates that this will induce only a small increase in exports. Foreign central banks will absorb part of these extra U.S. debits as extra holdings of dollars in their exchange reserves; B_2F_2 is a little larger than B_1F_1 . The rest of the gap will have to be financed by extra gold outflows; F_2D_2 is greater than F_1D_1 .

Usually, if the U.S. Government bargains forcefully enough, it can "tie" some of the increment in Government oversea spending of X_1X_2 so that foreign recipients of assistance—whether as grants, soft loans, etc.—increase their purchase of U.S. goods explicitly. The effect of tying is illustrated schematically by the short broken line originating at point D_1 . However, for many reasons detailed below, "tying" hardly ever provides a complete offset.

The ultimate recourses of a government that feels compelled to spend overseas beyond the present export capabilities of its domestic economy, other things equal, are either exchange control or exchange devaluation.

Exchange control can of course be used to limit purchases of U.S. residents and tourists abroad, or to reduce oversea lending by U.S. investors, so that more export proceeds are available for external Government spending. One difficulty is that the United States cannot restrict private imports without altering the character and aggregate demand for its exports. Protective exchange control would violate all the international trading virtues that the United States has been preaching since World War II.

The alternative of exchange devaluation would schematically raise the E curve, by roughly the same proportion throughout its length, so that it would appear steeper in the diagram. This is because domestic producers receive higher prices in dollars on exports after devaluation and foreign purchasers tend to import larger quantities at prices that appear somewhat lower in their currencies. And, of course, U.S. importers may purchase rather smaller quantities at prices that appear higher in dollars after devaluation. However, if rival trading nations do not devalue competitively, exchange devaluation by the United States would worsen its "terms of trade." The United States would physically be exporting a larger quantity of goods than hitherto in exchange for a smaller quantity of imports than before.³

Fundamentally, at any given set of exchange rates and interest rates, there is eventually a limit to the oversea activities that even the Government of the world's most powerful nation can finance abroad, unless the domestic economy is becoming more productive and competitive relative to those of other major trading nations. Unfortunately, the United States has become less rather than more competitive relative to Western Europe and Japan during the past 10 years, and

³ However, as discussed below, a single and unlimited act of devaluation would presumably increase domestic employment and output; thus domestic availabilities of goods and services are not necessarily lessened, and they may be increased despite a worsening in the so-called barter terms of trade.

this during a period when the United States has assumed increasing responsibilities for the defense or development of approximately a hundred countries. More foreign economic assistance, increased over-sea military support of allies, continued freedom of residents to spend and lend abroad, low domestic interest rates, plus maintenance of present exchange rates with the dollar, are simply incompatible Government policies.⁴

Costs of depreciation versus costs of unemployment

There is a widely recognized relation between domestic employment levels and the foreign value of a nation's currency. But the direction of causation can be from reduced unemployment to currency depreciation or from currency depreciation to increased employment. Estimation of "equal cost" combinations of reemployment and depreciation were unfortunately outside the terms of reference of the study by Brookings.

Most people assume that reducing unemployment is worth so much in extra GNP that balance-of-payments effects should never inhibit the kind of deficit financing that is supposed to increase employment. The usual argument is that the cost of having the dollar worth less externally is trivial in comparison. Or it is sometimes argued that a more "liquid" system of international payments would permit higher domestic prices—resulting from internal credit inflation—without imminent external depreciation of the dollar.

However, a 1-percent reduction in unemployment does not necessarily yield the kind of GNP increases that are often mentioned.⁵ If one assumes that there is excess capital capacity waiting for the extra employed, having 1 percent more of the supposed labor force working might increase GNP by 1 percent, or roughly by \$5.8 billion. Or if one supposes that there is no excess capacity available, but labor output and income vary proportionately with total employment, a 1-percent increase in employment would increase GNP by about \$4.1 billion. This latter estimate is only 0.7 as large as the former estimate because labor's contribution and reward, among all factors of production, is roughly 0.7 of GNP. But these may be overestimates, because the marginally unemployed disproportionately comprise women, youngsters only recently on the labor market, and the less technically trained. Thus a single percentile point change in employment of the labor force may realistically be around \$5 billion in extra output in the long run.⁶

The cost of depreciation can be estimated roughly by calculating the extra dollars required after depreciation to buy the same imports

⁴ It is so easy to underestimate the economic, financial, and political consequences abroad of U.S. devaluation that the above analysis should not be construed as a recommendation to raise the U.S. dollar price of gold. Competitive devaluations could not be prevented perhaps. The United States would be under at least a moral obligation to compensate in gold those foreign central banks now holding dollar claims on the assurance that the United States will not devalue. All these difficulties should focus attention on the advantages of making more flexible use of short-term interest rates before more drastic remedies such as devaluation have to be examined seriously.

⁵ The Brookings study (p. 244) states that a fall in unemployment from 6 to 4 percent of the labor force is worth about \$30 to \$40 billion in national output. This estimate is not explained. It probably is based on some studies undertaken for the Council of Economic Advisers which observed a historical relation between extra GNP and extra percentages of labor force employed during past upswings. But incremental percentage labor to output ratios fail to give credit to the contributions of capital and improved technology to national output. Hence they are very treacherous instruments—as are incremental capital to output ratios—if a causal relation is assumed when making future projections.

⁶ This ignores the influence of variable proportions between capital and labor—permissible perhaps when considering changes in one factor of only 0.01.

and make the same gross foreign investments abroad as before depreciation. Purchases and investments abroad by the United States are currently around \$28 billion. Thus a 1-percent depreciation of the dollar occasions a loss of approximately \$0.28 billion.⁷

Depreciation by the United States—assuming no other nations depreciate—would physically increase exports and reduce imports. This worsening of the terms of trade ordinarily means more domestic employment. How much depreciation means how much reemployment is uncertain though. The crude estimates above indicate that there is a net gain for the United States *if* each 10 percent of dollar depreciation means more than 0.56 percent increment in employment.⁸

Should investigation suggest that such a net gain might in fact result, the possibility of devaluing the dollar becomes yet more deserving of study as an ultimate "solution," for the extra output from the extra employment would help to finance U.S. economic and military assistance abroad. Meanwhile, higher short-term interest rates may be the answer, providing the extra time for adjustments is used. Otherwise fears for the Nation's gold stock will continue to inhibit pursuance of national objectives overseas.

Reducing future drains from external Government payments

The Brookings study notes that DOD procurement regulations now provide that goods and services used overseas by the U.S. military and available through local purchase shall instead be placed with U.S. suppliers unless the extra cost—including all transportation and handling—exceeds the foreign price by over 50 percent.

The study also notes that AID loans for commodity purchases must be spent in the United States; that AID grants cannot ordinarily be spent in Western Europe, the "white" British Commonwealth, or Japan; and that AID cash grants are now tied to U.S. procurement through an irrevocable letter of credit scheme instituted in 1963. But the study did not consider either the economic incidence of these DOD procurements nor the possibility of completely blocking both DOD and AID "expenditures" abroad.

It needs to be understood that present DOD procurement regulations constitute a considerable and arbitrary depreciation of the dollar. Suppose a good or service is obtained in the United States at a cost of \$145, when it could have been obtained say in Germany at a dollar equivalent cost of \$100. The United States has then spent \$45 more dollars worth of resources in this country in order potentially to save \$100 of foreign exchange. Such exchange might have been earned through exports using only \$100 worth of domestic resources. Essentially, the dollar has been depreciated 45 percent in this single instance, and any cost effectiveness analysis of such practices might find them unjustified.

General devaluation of the U.S. dollar is resisted by many, including administration officials, for reasons of national prestige, psychological confidence, political consequences, and other valid considerations. But economically it is anomalous to depreciate certain DOD dollars, through procurement regulations as described above, and not devalue AID dollars, tourists' dollars, private importers' dollars, and

⁷ Assuming no changes in domestic price levels.

⁸ Because 0.56 of \$5 billion equals 10 times \$0.28 billion.

so on. The explanation of this anomaly, which in the end could increase DOD appropriations by some magnitude approaching 50 percent of foreign exchange savings thereby affected, is presumably that DOD external payments are both considerable and administratively simpler to rechannel than private expenditures abroad. However, if only certain dollars that might have been spent abroad are depreciated, these dollars must be depreciated very drastically indeed to achieve any substantial effect, and so the alternative of less severely depreciating more kinds of Government dollars spent abroad should be considered.

One wonders whether all procurement abroad by DOD and AID, plus perhaps other classes of external payments by these and other Government agencies, might take the form of claims against a special blocked account in the Treasury. These claims could only be exercised for the purchase of goods and services from U.S. sources. How negotiable or fungible these claims should be needs careful analysis. For instance, the direct recipient of such a conditional claim might be allowed to sell it to a third party (other than U.S. residents), but the kinds of goods and services that these claims could purchase in the United States might be restricted.

These decisions involve several trade-offs. If the scheduled goods are of a kind that foreign recipients of DOD and AID blocked dollars do not want, these recipients will demand more blocked dollars, especially if they are not allowed to transfer these claims through sale to third parties. Alternatively, if these scheduled goods are of a kind that nonresident DOD and AID dollar recipients urgently want from the United States anyway, there is no object in creating special claims against a blocked account. U.S. schemes of blocking and tying can be most effective in increasing U.S. exports when (1) blocked account claims can be used to buy goods that are currently submarginal demands of potential foreign public or private buyers somewhere, (2) these goods are currently obtained by such buyers from foreign sources because of price and cost differentials, or because they are a class of goods that they cannot quite afford yet, and (3) these blocked dollars can be freely bought and sold abroad so that a market in them develops. Under these conditions blocking should be administratively simpler and more effective economically than tying.

Blocked dollars would naturally trade in such a market at a discount compared with the foreign exchange value of the dollar itself. And this discount, or selective depreciation of the dollar, would tend to stimulate exports of the scheduled goods and services. Nor would this partial currency depreciation seem to violate GATT agreements or cause many of the other adverse consequences of outright devaluation of the dollar.⁹

Unfortunately for administrators, there always seems to be more avoidance of such schemes through substitution than is anticipated, so that the net effect may in the end be slight despite ever more numerous and annoying restrictions. For instance, foreign governments and nonresidents may be compelled to purchase certain U.S. exports that they otherwise would not, but they may reduce their purchases of other U.S. goods. However, now that the United States is increas-

⁹ IMF rules prohibit blocking of current accounts without creditor consent, but in these cases the United States often has considerable bargaining power that can be used to obtain such approval.

ingly having recourse to discriminatory procurement and tied expenditures, alternative schemes of more embracing scope deserve close scrutiny.

Future changes in demands and supplies of specific goods

Throughout several chapters of the Brookings study—and especially in chapter III—estimates are made of U.S. imports and exports in 1968. These projections treat the trade balance in very aggregate terms, the estimates depending mostly upon GNP and export price level projections for Western Europe and the United States. Except for several references to agriculture, and possible changes in consumer demands with the European market, there is little mention in the study of major component shifts that seem to be occurring within the demands and supplies of important trading nations. Perhaps such a discussion was considered too speculative. Exporters and importers do not buy and sell current account aggregates, however, but specific goods and services, so at least a qualitative discussion of the probable future for important subaggregates would have been in order. The trouble with models is that they exclude anything weighty if it cannot be weighed.

An obvious and important trend is that the United States is becoming a have-not nation as regards many raw materials. Thus iron ore from Labrador and Liberia comes partially to replace Mesabi ore, Venezuelan oil threatens to replace some domestic production, and Canadian lumber makes inroads upon west coast markets. Moreover, while U.S. natural resources become more depleted, economic development of backward countries is discovering and exploiting new alternative sources overseas. Even by 1968, and despite a countertendency for domestic synthetics to substitute for some tropical products like rubber and silk, the GNP-induced import coefficients of the model used by Brookings may serve to understate actual commodity imports.

The study mentions that rising consumer incomes in Europe will expand the market for durable consumer goods of a kind that have long been produced in the United States. And there is an implication, despite a reference to mass production economies made possible by the European Common Market (p. 54) that this trend will benefit the United States. But the context in which consumer goods are used can be very different in Europe from the United States. Thus motor cars in Europe tend to operate on narrower streets, and gasoline is more expensive, so that the marginal motorists can only afford really small and lightweight automobiles. For most durable consumer goods there is more European consumer emphasis on ease of maintenance, small space requirements, and functional design in contrast to style obsolescence than over here. Also, for many U.S. firms, the European market, with its special tastes and requirements, is too unimportant compared to the U.S. market to justify special export models to suit its tastes.¹⁰ And in those exceptional cases where the European demand is sufficient to support an American branch factory there, the U.S. balance of payments immediately benefits less from export credits than it suffers from substantial long-term investment debits.

Politically realistic perhaps, the Brookings study makes little of the possible contribution of agriculture to reducing the U.S. balance-

¹⁰ Japan has been remarkably successful in designing its durable consumer and other exports to foreign tastes and needs, but this may partly be because its domestic market is relatively less important than foreign markets as compared with the United States.

of-payments problem, despite a long analysis of the Public Law 480 program (pp. 175-182). But the United States possesses a significant comparative advantage in food grains and other agricultural lines. Unfortunately, the domestic production of several major crops is still restricted, there are few incentives to export them, and immense carryovers have accumulated that occasion annual holding costs. Despite international protests from other exporting countries, and perhaps instead of Public Law 480 shipments, the possibility of selling agricultural goods abroad at lower world prices needs more examination. Such a policy change would have to be associated sooner or later with a drastic reduction in support prices and production controls. Although farmland values might fall, farm wages and employment should rise, and the Nation's balance of payments could well be strengthened by unleashing agriculture. A free agriculture might somewhat slow future U.S. cost-of-living increases, and hence retard money but not real wage gains, thereby enhancing the international competitiveness of the Nation's economy during the years ahead.¹¹

Payments impact of contingent wars

Between now and through 1968, there is a distinct possibility of a "Korea-type" war erupting in southeast Asia or elsewhere. Even such a limited war can have a considerable impact on the U.S. balance of payments. Thus the onset of the Korean war in 1950 had an adverse effect of roughly \$3 billion in that year. Conversely, the international payments benefit in the United States in 1956-57, following the unsuccessful Anglo-French attack on Suez and its closure, were probably around \$2 billion.

The international payments impact of a limited peripheral war involving the United States is far more than the direct foreign spending of the DOD. Its increased domestic procurement induces imports and diverts exports. Reduced availability of domestically produced goods for civilians—particularly for goods requiring rationed materials—can result in more private imports.

The overall balance-of-payments impact of an unpredictable limited war would depend of course upon its nature and duration, the contributions if any of allies, and the extent to which the Government from the outset could be sure of ending the struggle with forces and weapons in being. Experience suggests though that there are possible wars during this period that could readily occasion a net international cost for the U.S. Government and economy of from \$3 to \$5 billion. And this contingency, ignored by the Brookings study, carries a probability exceeding zero.¹²

BRIEF COMMENTS ON POLICY RECOMMENDATIONS

The Brookings recommendations are designed to resolve several problems. Its authors, as almost everyone, are anxious to revise the international monetary system so that key currencies such as the

¹¹ Recent Soviet purchases of food grains in world markets only serve to underline these possibilities. Soviet food grain shortages may well recur in most future years. Provided the Soviets do not release agricultural labor to armament production as a consequence, and can pay with goods (including gold) that the United States wants, domestic agricultural programs should be reviewed in their relation to the U.S. balance of payments. It is important though that the United States act in concert with Canada and perhaps adopt different policies on food grain sales to China than to Russia.

¹² It is important to recognize, under present circumstances, that the United States might not be able to undertake such a limited war without the support of several foreign central banks and hence the approval of their governments.

dollar and pound will be less vulnerable to "runs." They also desire to increase the international liquidity of nations, partly because world trade is expanding proportionately more rapidly than monetary gold stocks, but primarily so that each national economy will have more time to make "structural" adjustments. They do not seem to believe that the United States is attempting too much overseas, given the competitiveness of the domestic economy in the near future, and a revision of interest rates and exchange rates is not examined seriously.

As the study's authors stress, the dollar is now only one of several strong currencies. Hence, were it not for voluntary but binding agreements among the major central banks to hold each other's currencies, it would be extremely vulnerable to continuous adverse balances in the current plus long-term investments accounts of the United States. This is especially true at a time when net short-term claims against this country exceed its gold stocks. Should resident corporations and individuals begin to leave the dollar, exchange control would have to be imposed promptly, and the resultant damage to the Nation's prestige would be far greater than from that of a deliberate and unrepeatable devaluation.

The exchange reserve system is inherently unstable because any key currency that weakens may be collectively abandoned by foreign central banks, and by private holders of short-term dollar claims, in favor of a strengthening one. To avoid such "runs," the major free world countries "will have to relinquish part of their freedom to choose the form in which their international reserves are held" (p. 256), as in fact the United States, United Kingdom, and France, etc. have already done through special central bank agreements. Whether this freedom of choice among forms of reserves should be more drastically and irrevocably limited is currently a subject of intense debate.

International bank and payments union

The most avant garde proposal so far made—which the Brookings study hints at being its first choice (p. 257)—is to establish an international payments union that would evolve into an international central bank.

One variant of this idea is to limit central banks to holding gold and IMF balances as reserves. They would not be permitted to hold foreign balances as reserves. Their present reserve accumulations of dollars, sterling, etc. would be sold to the IMF in return for credits to central bank accounts with it. Over 10 years or more, the United States and United Kingdom would redeem from the IMF the large dollar and sterling balances it would be holding as assets, thereby canceling the interest-free and unofficial "loans" they have been enjoying from the rest of the world economy because their monetary obligations have been used by others as international key currencies. However, so that international means of payment would be expanding with the volume of world trade (rather than contracting), the "reformed" IMF would presumably be increasing loans to governments and international lending agencies.

Such "loans"—or effectively grants in some cases—would nominally increase the IMF's assets and also its liabilities. These liabilities would be the deposits central banks, and perhaps certain international agencies, would have with the new IMF. They would be international money, transferable to other deposit accounts with the Fund, and

hence would be the equivalent of gold. Also, private dollar and sterling claims by nonresidents of the United States and United Kingdom, respectively, might be sold through the owners' central banks to a modified IMF.

There would obviously be inflation under such a scheme unless the new IMF exercised restrictions that would in the end reestablish the sort of "insolvency-fear-discipline" that is so unpopular in some quarters today. Suppose Tetzeland, anxious to "develop," inflates its domestic currency (denominated in "tetzes"). "Tetzes" will be negotiable everywhere if major central banks are able to sell them in turn to the new IMF and have their balances with it credited accordingly. Under these circumstances each and every nation—poor and rich alike—would actively cooperate in this "solution" of alleged international illiquidity.

The new IMF, to prevent accelerating world price inflation, would have to limit the value (at par) of the obligations of each government that it would acquire and hold as assets. Then if Tetzeland continued to create local currency, its IMF quota limit would soon become replete, after which there would be no external market for tetzes except at an enormous discount. Governments issuing weak currencies would tend to fill their IMF quotas (but have small IMF balances and no gold) whereas governments with strong currencies would tend to have unused quotas (but possess large IMF balances and considerable gold).

Given international pressures, it is inevitable that the relative quota sizes of participating nations would be more equal than the present use of their currencies as exchange reserves. The net effect would initially be a substantial transfer of purchasing power from strong to weak currency nations. Eventually, unless quotas were continually revised in their favor, the less disciplined countries would soon find themselves insolvent again.

Determining national quotas would hence become extraordinarily important. Conceivably, their relative sizes could be negotiated once for all at an international conference, such as presaged the present IMF at Bretton Woods. But conditions change, and the need for flexibility is always argued vehemently by those doubtful of their solvency, so that a majority of national governments would demand that quotas be subject to adjustment by the management of the IMF.

An international bank, if able to adjust quotas, would have truly enormous power. It would be as though it could expand or contract the world's stock of gold at will and determine initially what government should receive any increment or lose any decrement. The influence that the United States now exercises in the world, through the strength of its economy, would almost certainly be transferred in part to smaller, weaker, and poorer nations, some of them less responsible, through the establishment of an international bank with such unprecedented authority.¹³ The vital question, when considering a real international bank is, Who will manage it? Can one assume that the philosophy of the present IMF management would be continued if this institution were "reformed"?

¹³ These are essentially the same reasons that presumably led the United States to reject the Clearing Union proposed by Lord Keynes at the Bretton Woods Conference toward the end of World War II.

Mutual key currency support arrangements

The Brookings study's "second best" recommendation—which this writer would consider better for the United States than its first choice—is for the monetary authorities of the United States, United Kingdom, and leading West European nations to support one another's currencies. Thus, if one participant's currency weakens, the other members of the group will purchase it with their currencies. Alternatively, as the Treasury has already arranged, *ex ante* currency swaps can be negotiated among leading central banks. Support is then more certain, for it can be initiated by the weakening currency nation without delay. A further extension of the same Treasury theme is for central banks to give each other a line of credit in anticipation of short-term difficulties.

One feature of Brookings' "second best" proposal, which sharply distinguishes it from current practice, is the apparent recommendation that gold no longer be sold by the United States for dollars at a fixed price on the demand of selected central banks. The United Kingdom and certain other nations' central banks should inferentially sever this last formal link between their currencies and gold. However, gold would presumably be used on occasion to support a currency, and its currency price might slowly rise over time.

Another feature of the Brookings recommendations is the proposal that (1) the dollar-sterling rate should be fixed and (2) the rate between these two currencies and the leading moneys of the ECM should be permitted to vary within narrow limits. Perhaps the study's authors can foresee fewer variations in the flow of payments between the dollar and sterling areas than between this bloc and the ECM bloc, but one wonders whether the much closer cooperation that this would require among the American and British "Anglo-Saxons" might not exacerbate the split between the vestigial Paris-Bonn axis and the London-Washington one. Another effect might be economically and politically to gather members of the British Commonwealth closer around the United States. These matters may seem mere issues of monetary technique, but they involve far more fundamental questions for the United States, and these last should not be answered incidentally.

Fixed proportion reserves

Another logical agreement among major nations' central banks, and one that would help to prevent a run on any key currency, would be for each participating central bank to hold the various currencies of the others in fixed proportions over time. These proportions might well be in uniform among all central banks participating in the system. Thus each central bank would have reserves comprising (1) certain other currencies in agreed proportions, (2) gold, and (3) IMF credits. Any participant could increase its foreign currency reserves—so long as it purchased them in the authorized proportions—by selling gold or IMF credits.¹⁴

To be effective, any such scheme would have to include, in addition to the United States and United Kingdom, all the more important

¹⁴ Hence this proposal, evolved quite independently, is in several respects quite distinct from that of S. Posthuma ("The International Monetary System," *Banca Nazionale del Lavoro*, No. 66, September 1963). He has recommended fixed proportions between gold and the dollar, plus several other key currencies perhaps. Fixed proportions among a larger number of currencies used as reserves, but with varying ratios between all currency reserves and gold, is something else again.

trading nations that ordinarily hold public and private balances in key currencies. Thus, all the West European nations, the "white" British Commonwealth members, and Japan should be included. (Moreover, a fixed proportion reserve scheme will operate better if private non-resident claims to key currencies can be converted into nonresident central bank claims, so that more short-term international claims must be in fixed proportions.) The object is to make a number of currencies, and not simply dollars and sterling, full key currencies. The new key currency nations gain unrequited loans as a consequence. And in return each abdicates the right to liquidate any one key currency in its reserves. The effect is to create an international banking system informally governed by the central banks of the important trading nations.

However, for illustrative purposes only, suppose the United States, the United Kingdom, France, and Germany alone wish to form such a fixed proportion reserve system. Table 1—the data of which are entirely hypothetical—explains the various steps. There must first be a determination of the proportions in which the four central banks collectively hold each other's currencies as reserves. This is given in the center of the table, calculated from presystem conditions given on the left, and it is seen that dollars constitute 45 percent of aggregate system currency reserves, pounds sterling account for another 35 percent, and so on. (The United States has relatively small foreign exchange reserves because others have been holding its currency, and not conversely.)

The next step is to reconstitute the foreign currency reserves of each participating central bank so that they all hold such foreign exchange in the same proportions. Thus the United States should hold pounds sterling, French francs, and deutsche marks in the ratios of 0.350, 0.145, and 0.055 to 0.550 respectively. And the United Kingdom will hold U.S. dollars, French francs, and deutsche marks in the ratios of 0.450, 0.145, and 0.055 to 0.650 respectively. This outcome can be affected by currency exchanges of equal value among the system's central banks. For example, afterward the United States will hold French francs worth \$106 million, because this is $0.145/0.550$ of \$400 million. The right side of the table gives the situation after the exchanges needed to establish the system before operations can begin.

Subsequently, were the United States to overspend internationally, foreign exporters and borrowers would be presenting dollars on balance to their commercial banks, which would sell them to their central banks. But the Bank of England, say, cannot hold more dollars unless it also holds more French francs and deutsche marks in the agreed proportions. For instance, if it received \$100 million in extra dollars it could sell \$55 million worth to the U.S. central bank in exchange for \$35 million worth of pounds sterling, \$14.5 million worth of French francs, and \$5.5 million worth of deutsche marks. (The dollars thus received by the U.S. central bank would not be counted part of its official reserves of course.)¹⁵

¹⁵ The foreign currencies the U.S. central bank (loses) from its official reserves, and which financed an adverse net basic balance of \$100 million in U.S. payments, can be replaced by selling \$55 million worth of gold, or drawing \$55 million on the IMF. This is because \$45 million of the negative basic balances went into official reserves in the Bank of England. And, under the fixed-ratio agreement, the Bank of England cannot sell these dollars unless it also sells French francs and deutsche marks in the agreed proportions.

Clearly, each participating country has a ratio of negative balance to gold-IMF losses that exceeds unity, this ratio being smaller to the extent that participating central banks hold its currency in small proportions. Thus the international "spending to gold-loss ratio" for the United States is $1.00/(1.00-0.45)$ because dollars comprise 45 percent of the system's foreign currency reserves. While the U.S. ratio is 1.82, France's is only 1.17, and Germany's is 1.06 in the hypothetical example of table 1.

TABLE 1.—*Establishing reserves by countries in fixed proportions: A hypothetical example*

[Dollars in billions]

Before variable proportion reserves				Total			After fixed proportion reserves			
United States	United Kingdom	France	Germany	Currency	Value	Percent	United States	United Kingdom	France	Germany
0.30	0.70	1.20	1.70	U.S. dollars.....	3.60	45.0	0.254	0.620	1.476	1.856
.06	.10	1.30	1.20	Pounds sterling.....	2.80	35.0	.106	.202	1.144	1.446
.04	.10	.30	1.00	French francs.....	1.16	14.5	.040	.076	.180	.598
				Deutsche marks.....	.44	5.5				
.40	.90	2.80	3.90	Sum, in U.S. dollars.....	8.00	100.0	.400	.900	2.800	3.900
5	11	35	49	Percent.....			5	11	35	49

Operation of the fixed proportion reserve system can result in overspending countries receiving unrequited loans from other participating nations. Thus, in the example above, \$100 million of overspending by the United States had the effect of the United States receiving an unrequited and interest-free loan of \$45 million from the United Kingdom. This does not follow inevitably though, for the Bank of England might sell its \$100 million worth of extra foreign exchange to the IMF and the IMF might require the United States to buy the Fund's extra holding of \$45 million in dollars with IMF balances or gold. Thus fixed proportion reserves do not necessarily relieve an overspending nation of IMF balance and gold discipline. Rather they serve to protect a key currency nation from an international run on its money alone.

Nevertheless, because a participating country may be able to overspend more readily if its currency is held by others as a large proportion of their foreign currency reserves, the establishment of a fixed proportion reserve system would be preceded by very active negotiations. The European participants might well demand that the United States repurchase some of their dollar holdings with gold and/or purchase some of their currencies in the same way. Taking the situation in table 1 for instance, each of the four currencies could be held in equal proportions of 0.25 if the United States were to buy (with gold) \$800 million worth of sterling, \$2,440 million worth of French francs, and \$3,160 million worth of deutsche marks.

Such equality of proportions is not necessarily desirable. A strong argument could be made for making the official currency reserve proportions roughly the same as the proportions in which public and private nonresidents hold short-term claims and balances in each par-

ticipating nation's currencies. This would give the United States, and next the United Kingdom, the largest proportions.

Fixed proportion reserves do not theoretically require fixed exchange rates. Thus, when the Bank of England presented the U.S. authorities with \$55 million of dollars in the previous example, the latter might have supported the dollar at a lower price than "normal." Ordinarily, this should have the effect of increasing U.S. exports and decreasing its imports in value terms, thus strengthening the current account. But exchange rate flexibility would practically have to be confined to very narrow and agreed limits. Any explicit devaluation would have to include compensation to member central banks holding the depreciated currency.¹⁶

The total reserves of the participating central banks can always be increased by having each central bank contribute its currency to the others in exchange perhaps for a long-term note. Suppose the object were to increase total reserves by \$4 billion without altering the original reserve proportions. Then, see table 1, the United States would contribute 11 percent of \$1.8 billion to the United Kingdom, the United Kingdom would contribute 35 percent of pounds sterling worth \$1.4 billion to France, and so on.

The relation of the system nations to outside countries needs mentioning. The system countries as a group can overspend with non-system countries if the nonsystem countries are willing to hold their reserves in system country claims and currencies. So long as the non-system countries do not or cannot demand gold from system countries in exchange for their currencies, the system countries can obtain unrequited and interest-free loans from the others by overspending with them if there is no IMF clearing.

The above description of a fixed proportion reserve system has been in terms of rigid proportions for simplicity's sake. Practically, it might be better to permit each participating central bank to vary its reserve proportions, among different currencies, by some small percentage from normal. And, as almost any system can operate if only major central banks cooperate, one would hope that these variations would be used to assist a country struggling to correct a negative net basic balance.

Fixed proportionate reserves of key currencies, held by the central banks of their nations, might have several advantages in summary. First, there can be no major central bank run on the dollar, or against any other key currency in isolation. Second, international liquidity can be increased proportionately more rapidly than the free world's monetary stock of gold. Third, gold and IMF credits continue to give some time for structural adjustments. Fourth, the United States continues to benefit from unrequited loans as a reward for providing a key currency, but to a lesser extent than now. Fifth, the management of this international payments system would not fall into the hands of backward and financially irresponsible nations having a vested interest in worldwide inflation.

¹⁶ It is always hard to know whether currency depreciation and international liquidity are substitutes or complements. Liquidity gives time for structural adjustments to occur, but it does nothing to bring them about, whereas currency depreciation helps to rechannel trade. For a country in which nonresidents do not hold large short-term or demand claims, depreciation and liquidity are probably substitutes, for depreciation shortens the necessary time for structural adjustments that liquidity can buy. But a key currency country, if it has many short-term private credits abroad, may find gradual depreciation (as distinct from a single devaluation) increases enormously the need for liquidity because of speculative withdrawals.

THE NET BASIC BALANCE ESTIMATES FOR 1968

The Brookings study courageously makes estimates of the 1968 U.S. balance of payments, and concludes that the net basic balance will then either be +\$1.9 billion or -\$0.6 billion, depending upon whether it made assumptions regarding GNP and export price levels for the United States and leading trade rivals as suggested respectively by the Council of Economic Advisers or its own reflections.

A great deal could be argued about the econometric model employed, some of the parameter values, and the assumed magnitudes of crucial independent variables. The simple truth, as anyone who has constructed and operated macroeconomic prediction models knows full well, is that they can yield a wide range of estimates of almost equally undemonstrable validity. The very fact that the alternative projections for 1968 vary by \$2.5 billion using the same model, by either the Council's or Brookings's inputs, illustrates this point. And many experts will undoubtedly disagree with both sets of assumptions. This reviewer would doubt for example that the United States will prove so successful in restraining export prices, and Western Europe so unsuccessful, as the study's authors suppose.

There can also be disagreement about the model's structure. For instance, a relation that seems not to have been included is investment in the United States by nonresidents as a function of this country's growing GNP, perhaps because so little is known about the causes of international long-term capital movements. Should in fact there be little debate regarding the model itself, this may be because any description of it is necessarily hard to follow, and probably only a few people among the many who have a voice in shaping the foreign economic policy of the United States will really understand it.

Fortunately, the model's 1968 projections for the U.S. balance of payments need not be the basis of important policy decisions, if only because the credibility of any such estimates must remain slight until the art of econometrics improves. Moreover, who can now predict whether there will in fact be an expansion of AID loans and grants to Latin America, no Korea-like war, and no international run on the dollar by U.S. residents by 1968? The moral of the Brookings exercise in prediction is surely that major balance-of-payments determinants remain disturbingly unpredictable.

Hence the essence of economic statesmanship is rather to establish institutions and practices that can adjust to unpredictable payments disturbances if and when they do occur. It is to these more significant matters that the last chapter of the Brookings study addresses itself. The real question for the United States and for the Joint Economic Committee is to choose, from among all those alternative institutions and practices that can lessen the chances of a "run" on any key currency, an international payments mechanism in accord with the proper self-interests of this Nation.

STATEMENT BY THEODORE GEIGER AND JOEL DARMSTADTER

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The major portion of the Brookings study consists of working out the implications of certain specified assumptions for the detailed components and the aggregate of the U.S. balance of payments in 1968. Two models were constructed. An initial one—built on assumptions furnished by the Council of Economic Advisers—postulated for the United States a rapid return to full employment, rapid output growth (a GNP growth rate of 4.8 percent annually between 1960 and 1968), accelerated labor productivity, relative price stability, and considerably improved U.S. competitiveness in foreign trade; and for Western Europe, a continued high rate of economic growth (GNP rate of 4.3 percent), accompanied by relatively sharp upward wage and price pressures, and a substantial worsening in its competitive position. An alternative model introduced certain modifications in these initial specifications: For the United States, lower GNP growth (4.2 percent yearly between 1960 and 1968) and lower man-hour productivity improvement, without, however, sacrificing the full-employment assumption for 1968; for Western Europe, reduced GNP growth (3.8 percent), more effective suppression of inflationary pressures, and a less serious deterioration in competitiveness than under the initial assumption. In the first model, a marked improvement in the U.S. basic balance is achieved for 1968, a surplus of \$1.9 billion; in the second model, a moderate deficit of \$0.6 billion remains.

This analysis is correctly described by the authors as a projection rather than a forecast. That is, the quantitative implications of the specified assumptions are worked out, and little judgment is expressed about what is actually probable. The report also does not touch upon the means of attaining the major projected magnitudes. For example, the Chairman of the Council of Economic Advisers, in a letter to Senator Miller of the Joint Economic Committee (hearings, "The United States Balance of Payments," pp. 334-335), points out that " * * * barring major changes in economic conditions, we would regard 4-percent unemployment in 1968 as most unlikely without a tax cut."

However, since the quantitative analysis—even though it constitutes the major portion of the Brookings effort—serves primarily as a framework for the policy recommendations which cap the entire study, it is reasonable to ask whether the two Brookings models provide a sufficient basis for a full and realistic understanding of balance-of-payments policy implications.

We believe that a course of development for the U.S. economy insuring full employment (as defined by the 4-percent unemployment rate used in the two Brookings projections) in 1968, and GNP growth close to the initial Brookings model is most urgent, but depends upon

the adoption and vigorous execution of strengthened governmental fiscal and manpower policies. Such policies—and the stimulating responses they would elicit in the investment and household sectors of the economy—are, in our judgment, entirely feasible. However, the Brookings report has been criticized for assuming high rates of growth in its projections. It is alleged that such growth rates are unrealistic and cannot be attained. Moreover, it is argued that high growth rates would be undesirable since, following the classical deflationary prescription, they would adversely affect achievement of balance-of-payments equilibrium. We have already indicated our disagreement with the first criticism, and our concern in this statement is to ascertain what validity the second criticism may have as applied to the outlook for the U.S. balance of payments over the period covered in the Brookings report.

Specifically, it appears to us worth while to ask: What would be the balance of payments implications given an economic model predicated upon considerably lower growth assumptions than are contained even in the Brookings alternative projection? Our purpose in doing so is to ascertain whether a less expansionary course of development of the U.S. economy would produce by 1968 a significantly better improvement in the U.S. balance of payments than that envisaged in the alternative Brookings model.

An additional low-growth projection

Accordingly, we offer here the principal outlines of such an additional low-growth projection. For the United States, the figures depict what might be called a current-policy model, since they appear to us to be the likely consequences if existing policies remain unchanged. For Western Europe, the assumptions probably rest on a greater degree of pessimism than current evidence suggests. Although this additional model should ideally be subjected to much more rigorous quantitative analysis than is provided here, the calculation—though highly aggregative—may still be instructive.

In terms of average annual percentage growth rates for the period 1960–68, the following developments are assumed:

[In percent]

	Brookings alternative projection		Additional low-growth projection	
	United States	Western Europe ¹	United States	Western Europe ¹
Gross national product.....	4.2	3.8	3.1	3.6
Gross national product, man-hours.....	2.3	4.2	2.5	4.0
General price level.....	1.5	1.75	1.4	1.6
Unit labor costs.....	1.5	2.5	1.5	2.3
Labor costs, man-hours.....	3.8	6.8	4.0	6.4

¹ Comprising, as in the Brookings report, France, West Germany, Italy, and Great Britain.

It is worth pointing out that the Brookings initial projection (not shown above) assumes man-hour productivity improvements in the United States of 2.9 percent annually, compared to an assumed rate of 2.3 percent in the alternative projection. Yet, in both cases, full employment labor force growth and a 4 percent unemployment rate in 1968 are assumed to prevail. It appears extremely unlikely that,

for the relatively brief period here considered, a rate of man-hour productivity advance as low as 2.3 percent would be associated with full-employment growth. Developments that would deliberately inhibit technological advance and thereby limit unemployment can be ruled out as unrealistic. It is much more likely that low productivity would be the consequence of low investment—in turn the consequence of low growth and discouraging market prospects—and would, therefore, be associated with high unemployment.

In our additional model, the unemployment rate for 1968, at best, implies no improvement over the present 5.5 percent rate and, more likely, would mean a marked increase in the rate. Moreover, under these circumstances there are bound to be additional "disguised unemployment" effects not reflected in this statistical measure of unemployment. Thus, our additional low-growth projection assumes that a scarcity of job opportunities would both (a) discourage potential jobseekers from entering the labor force and (b) cause pressures for a reduction in working hours below the level consistent with high-employment conditions.

Accompanying the assumptions tabulated in our additional low-growth projection above, we postulate the following further conditions:

1. The ratio of European to U.S. export prices during 1961–68 will rise only 1 percent compared to 7 percent under the initial Brookings assumption, and 3 percent under the alternative.

2. U.S. Government net foreign assistance will continue at a level of \$4 billion until 1968 instead of rising to \$5.8 billion as assumed in both Brookings projections.

3. U.S. military expenditures will decline to \$2 billion instead of \$2.6 and \$2.4 billion in the initial and alternative Brookings projections respectively.

4. The somewhat reduced earning potentials of U.S. foreign investments, under assumed conditions of slower European growth, will reduce U.S. private investment income from \$5.45 billion, under the two Brookings assumptions, to about \$5.2 billion.

5. Net U.S. private long-term capital exports will amount to \$1.7 billion compared to \$1.5 billion in the two Brookings models in consequence of lower growth and less attractive investment opportunities in the United States.

Tracing through the quantitative implications of these assumptions requires detailed study of the functional interrelationships among balance-of-payments components—a task performed in exemplary fashion in the Brookings study. We confined ourselves to summary calculations. Needless to say, the implications of our assumptions have both positive and negative effects on the U.S. basic balance. Thus, our GNP assumption would reduce U.S. real income and thereby imports; our relative price assumption—given the sharp sensitivity of relative competitiveness to relative price change—would more seriously curtail exports. Illustrative of further—and more indirect—feedbacks, the assumed pursuit of vigorous European antiinflationary policies might prompt more liberal European trade policies and thus spur U.S. agricultural exports above otherwise prevailing levels. However, this latter possibility is not reflected in our calculations.

A rough estimate of the total impact of our real income, relative price, and competitiveness assumptions upon the U.S. basic balance

in 1968 is a reduction (from the Brookings alternative projection) of about \$0.2 billion. A net reduction of approximately \$0.3 billion is assumed to be the combined result of the reduced earnings rate on U.S. investments, and somewhat higher capital outflows—the latter offset slightly by higher exports. The net improvement in the basic balance stemming from the \$1.8 billion reduction in U.S. foreign aid below the Brookings aid projection comes to about \$0.4 billion. Lower military spending likewise adds an improvement of \$0.4 billion. The total improvement in the U.S. basic balance under our low-growth model thus amounts to \$0.3 billion. As compared to a surplus in the basic balance of \$1.9 billion under the Brookings initial projection, and a deficit of \$0.6 billion under the alternative Brookings projection, our additional growth model suggests a slight improvement over the latter, resulting in a deficit in the basic balance of \$0.3 billion.

Implications

Granted the limitations and uncertainties implicit in economic projections of this type, it is clear that a continuation of existing policies until 1968 will not produce a significantly greater improvement in the U.S. balance of payments than would result from the adoption and implementation of policies designed to achieve a higher rate of growth in the U.S. economy and full employment, as envisaged in the two Brookings models. Restraint of domestic demand and reduction in foreign aid—both frequently urged as essential to the elimination of payments problems—are likely to be negligible sources of improvement in the U.S. payments position. In contrast, policies designed to absorb unused resources and to promote expansion in line with the full-employment potential of the U.S. economy—as depicted in the Brookings initial model—offer the best hope for achieving a substantial surplus in the U.S. balance of payments by 1968. The caveat that must be added is one recognizing the possibility of expansionary actions here whose effects would be negated by deflationary policies in Western Europe. However, such a combination of offsetting developments may be regarded as unlikely in view of the presumed “demonstration” effect of the benefits of full-employment growth among countries having little to gain and much to lose from frustrating their mutual interest in avoiding inconsistent economic policies.

In conclusion, our additional low-growth projection indicates that balance-of-payments considerations need not be permitted to frustrate the achievement of such major domestic and foreign policy goals as full-employment growth in the U.S. economy and a reasonable level of U.S. external aid to the development and protection of our allies and friends throughout the world. Continuation of present policies would not significantly contribute to balance-of-payments equilibrium while adversely affecting the unemployment situation and jeopardizing U.S. ability to carry out its international responsibilities.

STATEMENT BY HERBERT G. GRUBEL

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I. INTRODUCTION AND SUMMARY

“Projections of net balances in international payments, even of net balances basic transactions, are still more speculative than most economic projections * * * quantitative projections of the competitive position of the United States can be little more than informed guesses * * *” These statements can be found in the report (p. 211 and p. 91). They are a sufficient warning about the reliability of the authors’ best guess “that the basic deficit [of the United States] will be eliminated [by 1968]” (p. 230).

The report’s merit lies, therefore, less in the comfort that this prediction brings but in the method of analysis and approach to the problem of making a projection which it has employed. The report has succeeded in focusing the attention on the key variables which influence the balance of payments directly and on the various factors that in turn are crucial in determining which values these key variables are likely to take on. The insights and information made available as a result of this effort should be very useful to the Washington policymakers concerned with taking steps aimed at bringing about an improvement in the U.S. balance of payments.

In the main part of this paper I shall comment on the following points:

(1) The report has overlooked the possibility that there could occur an improvement in the U.S. basic balance of payments not accompanied by a simultaneous deterioration in that of Western Europe. Such a development could be caused by a more liberal lending policy of the IMF leading to an increase of the average indebtedness of underdeveloped countries to the Fund.

(2) The report may have been too optimistic in its estimate of the favorable impact on the U.S. balance of payments expected to be brought about by increases in European export prices and a slowdown in U.S. foreign investment. The projected price increases may appear to be excessive in the light of the recent historic record of the European countries examined individually. A new survey of oversea investment plans of U.S. corporations suggests that foreign investments will again increase next year and that they can be expected to continue at a high level in the more distant future.

(3) On the technical side, the report’s choice of a price elasticity coefficient is criticized on the basis that its crucial role in the computations deserves greater care in its derivation. A breakdown of estimated demand and price changes by products or product classes is suggested as a way of giving greater precision to forecasts of this nature.

(4) The cause of the reform of the international monetary system may have been hurt by receiving such a heavy emphasis in the policy

recommendations of the report. The impression can be gained that the United States is interested in world monetary reform in order to solve her balance-of-payments problem.

(5) In conclusion it is suggested that U.S. policymakers cannot derive much comfort from the report's predicted improvement in the balance of payments in 1968 for two reasons. One is the unreliability of the projection itself. The second is that even if the basic balance should be balanced by 1968 the financing of the deficits in the intervening years may be accompanied by serious difficulties.

II. MAIN PART

1. *Improvement of basic balance through IMF policies.*—The report assumes that the U.S. net basic balance of payments can improve only if there occurs a reduction in the net basic balance of payments of Western Europe since the underdeveloped countries and Japan are not likely to either accumulate or decumulate foreign exchange reserves within the period covered by the forecast. This is, in general, a valid and reasonable assumption to make but it neglects to consider a possible development which could make it invalid.

A former official of the IMF, E. M. Bernstein, has suggested that the IMF be adapted to meet future shortages of world liquidity. The process which he has proposed consists of regular increases in countries' drawing rights (quotas) on the Fund. Accompanying the increases in the quotas would be a change in IMF policy regarding the ease with which countries could avail themselves of these drawing rights. A campaign urging countries to include these IMF quotas in the computations of their international reserve position has actually been underway for some time.

The process whereby the IMF could increase the world's stock of active international reserves would be to make these funds within the quota available freely and by increasing the length of time over which repayment has to be made. Technically there are no obstacles which could prevent such a change of policy within the present IMF statutes. The country availing itself of its drawing rights would purchase dollars or any other currencies convenient for its purposes by surrendering its own currency to the Fund. Repurchase of its own currency could occur in any of a number of currencies and within a period of time specified by the Fund. Efforts should be made to convince countries, as is suggested as part of Bernstein's proposals, to borrow from a wide range of currencies and to use not only strong currencies with an overall world balance-of-payments surplus. If this effort were successful, the Fund's stock of lendable currencies would be quite large and could be increased by occasional increases in quotas or special arrangements with strong creditor countries as had been done within the European Payments Union.

It is thus even at the moment within the power of the IMF to increase the average indebtedness of countries by several billion dollars if it so cared to do. Such an increase in the average net indebtedness of the world to the Fund during a given period of time would mean that some countries could have an improvement in their net basic balance unaccompanied by a deterioration in the net basic balance of any other countries. The idea of providing the reserve-hungry nations of the world in this fashion with what they want is in my interpretation

the essence and real merit of the plans for international monetary reform proposed by Triffin and Stamp. That the Bernstein proposals are analogous to the Triffin proposals in this respect came out very well when Bernstein was questioned by H. G. Johnson and F. Machlup during a hearing before the Joint Economic Committee. ("Outlook for U.S. Balance of Payments," hearings, Washington, D.C., 1963; reprinted as selection 22 in a collection of essays, "World Monetary Reform, Plans, and Issues," which I have edited and which the Stanford Press will publish in the fall of 1963.) While the Triffin-Stamp proposals would solve the problem of longrun growth in reserves in a much more elegant and rational fashion the Bernstein proposals have been discussed here because they may at the moment have the greater chance of becoming translated into action.

With respect to the U.S. balance of payments the result of these changes in IMF policies depends primarily upon whether the average net indebtedness of underdeveloped countries would be allowed to rise. For if these countries will find their reserves increased in this fashion it is likely, as the report has argued, that they will spend the increased resources at their disposal. A substantial part of these expenditures would be expected to occur in the United States and would lead to an improvement of the balance of payments.

This method of helping the U.S. balance of payments has much to recommend for itself. It would help the underdeveloped countries by allowing them to gain greater command over real resources which it appears the United States is willing to supply but cannot do because of the transfer problem. This foreign aid would be anonymous as far as the underdeveloped countries are concerned and would not require the congressional approval present U.S. aid requires. Western Europe which has shown and continues to show a high propensity to hoard foreign exchange could continue to do so and would not have to part with any of their precious reserves. European countries' cooperation in the making of this scheme would be required insofar as they would have to permit a reduction in the Fund's holding of their own currencies. This amounts essentially to giving up the right to demand gold from the Fund in return for their own currency in quantities sufficient to restore the 75-25 currency-gold ratio of their quota.

Whether countries which by virtue of this process of reserve- and demand-creation in the world would be called upon to provide the real resources are willing to do so or not depends upon the condition of their own economies. During periods of full employment some countries might fear inflationary pressures from excess demand. But it appears to me that this is a much less serious evil and one that monetary and fiscal policies in each full-employment country can cope with much more easily than are the deflationary pressures, slow growth and external deficits currently plaguing the United States and some other countries.

2. *Overestimation of favorable developments.*—(a) *Price stability and growth in the United States and Europe.*

The report makes specific assumptions about rates of growth in GNP and prices both in the United States and Western Europe which imply a rather strange mixture of disbelieving the announced policy goals of European countries and believing those of the United States. Both the United States and West European governments are com-

mitted to and have announced plans for the achievement (or maintenance) of full employment, rapid growth and price stability.

With respect to the United States the authors of the report were directed by the Council of Economic Advisers to assume that the United States would grow rapidly and would maintain price stability. While economists have long argued that these two goals are compatible given the proper mixture of monetary ease and fiscal restraint it has in recent years in practice been impossible to achieve such a mixture of policies. Aside from political obstacles it has been exactly the balance-of-payments deficit and the fear of capital outflows which have prevented the United States from pursuing an easy-money, low-interest-rate policy designed to spur investment. At the same time the need to restrain consumption expenditures through a budget surplus did not arise because full employment has not been reached. It does not appear to be very reasonable to assume that this basic pattern, especially the capital outflow constraint, will change within the next few years. Thus it is not likely that the U.S. policy goal of a higher growth rate can be reached.

What appears to be much more likely is that the United States will continue to fear the balance-of-payments implications of monetary ease. To what extent the enacted investment credit plan will speed up investment and growth will have to be seen. But there remains the problem of achieving full employment. The administration's tax-cut proposal points the way in which it is to be achieved, namely, through fiscal ease and an increase in consumption expenditure.

The reasoning that the U.S. growth target will not be achieved implies, *ceteris paribus*, a slower growth in the demand for imports and therefore an improvement in the projected U.S. balance of payments in 1968 which was based on the assumption of a much higher rate of growth. However, as will be argued below, the report may also have assumed too high a rate of growth for Western Europe. On balance the effect of slower rates of growth both in the United States and Europe would tend to offset each other, and if both of the alternative predictions made here are corrected they would be likely to have no direct influence on the 1968 U.S. balance of payments projected by the report.

But there remains the problem of price developments as the U.S. economy moves toward full employment. Here the report's assumption appears to be reasonable. The record of U.S. price increases since 1953 shows a concentration of price rises in certain products critical for the balance of payments (pp. 63-70). It is unlikely that such a record will be repeated precisely because of the inroads which foreign competition has made on the U.S. foreign and domestic markets of these products. Instead price pressures are more likely to continue another 1953-63 characteristic and push up GNP and consumer prices because of continued rises in the cost of services where productivity changes will continue to lag behind those in the manufacturing and agricultural sectors. But since most of these services do not directly enter the cost of exportable products their higher prices will not significantly reduce the U.S. competitive position in the world's export markets.

While it thus appears to me to be reasonable to believe, as the report does, in the attainment of the U.S. policy goal of stable export prices and a perhaps somewhat increased rate of growth accompanying the

move toward full employment I am not convinced of the appropriateness of the report's disbelief in the ability of Western Europe to achieve its own policy goal of stable prices, especially export prices.

The model underlying the computations made in the report is based on historical evidence. It gives great weight to the price changes and "the total net difference in trade effects is dominated by the relative price component" (p. 91). This indicates the crucial role which the projection in export prices plays on the final projected balance of payments in 1968. The possibility of price developments different from these projected should therefore be given great weight in the interpretation of the report's projection.

The report's optimistic conclusion about the U.S. net basic balance-of-payments position in 1968 depends crucially upon an improvement in the U.S. competitive position through stable U.S. export prices and a rise in European export prices. The rise in European export prices is inferred in an ingenious way by showing that under a set of plausible assumptions the rate of real GNP growth projected by European countries will lead to excessive cost pressures and a rise in product prices.

The entire analysis loses its validity if these growth targets are revised downward. While the report has made alternative computations involving lower growth targets I feel it has not gone far enough either in reducing the projected growth rate or in admitting to the possibility that an appropriate fiscal-monetary policy mixture could be found to insure rapid growth with price stability. The basic premise on which I disagree with the report is that European countries will allow a deterioration of their competitive position within the next 5 years significant enough to bring about a favorable U.S. balance-of-payments position.

My belief in the validity of this assertion is based on the interpretation of recent history and the sentiments of people in Western Europe. In analyzing the probable future development on the Continent the report has failed to distinguish sufficiently the reactions which we can expect to get from the individual countries making up the EEC.

Benelux

The Benelux countries depend more than the other members of EEC on export earnings in order to pay for vital imports. They have in the past succeeded in maintaining their competitive position, perhaps mainly because of their population's awareness of the need to remain competitive. I see no reason to believe that any basic change has taken place either in the willingness or the ability of the Benelux countries to keep their basic balance in order.

Germany

West Germany seems to be still in a "beneficial cycle" brought about by export sales of large amounts of capital goods. The production of these goods leads to possibly substantial economies of scale. These scale effects in turn would tend to increase the productivity that given resources devoted to investment bring about in the domestic as well as export producing sectors of the economy. The "cycle" is complete when these productivity changes as well as the economies of scale in turn increase the competitiveness of Germany's capital goods industry in world markets.

Price pressures in Germany were strong in 1961-62. But recently they seem to have come under control. Automobiles, one of the main commodities in German exports carried constant and in some cases lower prices when the new, often technically improved, models were revealed at the International Automobile Exhibition in Frankfurt this fall. The price index on basic materials and producers' goods has shown a steady decline since its high in May 1962 of 99.7 to a level of 98.6 in June of this year. Similarly the price index for capital goods has arrested its rise and moved from a high of 107.5 in October 1962 to a level of 107.2 in June of this year.¹ Accompanying this leveling or decline in prices has been a renewed surplus of the German balance on goods and services account after a period of deficits following the upward valuation of the deutsche mark in March 1961.

Underlying Germany's apparent ability to deal with inflationary pressures may be the following. The German population has a great fear of price inflations having experienced the effects of a runaway inflation twice within a generation. Furthermore, German manufacturers and laborers have not yet forgotten the arguments about the need for Germany to build up her exports if she wanted to rise from the ruins of World War II. In many branches of German manufacturing the share of exports in output is considered to be as critical a value as is the market share for American businessmen.

I am not trying to suggest that German consumer prices will remain constant. It will be as difficult for Germany to prevent increases in the cost of services, rent, et cetera, or find products with offsetting declines in prices as it has been for the United States. But changes in the Consumer Price Index or even GNP index must not necessarily be reflected in changes in the crucial prices of exportable commodities, as the report has argued.

These considerations and the evidence of the most recent period make me believe that the United States cannot expect to derive a significant improvement in a competitive position as a result of increases in German export prices in the next few years.

France

The country that has shown the least ability to cope with inflationary pressures since 1950 is France. If it should be true that no change has taken place in this characteristic of the French economy I do not believe that one can derive much comfort from this. For the historic record shows also that France had found an excellent way of dealing with the negative effects which inflation had on her balance of payments. In contrast with the United States and the United Kingdom, France showed no great reluctance to change the external value of the franc and I believe that we should not rule out the possibility that she will devalue again should this be expedient or necessary because of persistent balance-of-payments deficits.

If on the other hand one believes that De Gaulle's new spirit has made a devaluation impossible it appears to me to be logical and consistent to believe also that this same De Gaullist spirit will not allow either a persistent inflation or a persistent deficit.

¹ Monthly report of the Deutsche Bundesbank, July 1963 (1958=100).

Italy

Italy is the one country of EEC which does not face a present or pending labor shortage. The reserve of unemployed or underemployed workers in the South is large enough to prevent the advent of an excessively tight labor market in the near future so that Italy might be in the position to achieve a high rate of growth in GNP without experiencing substantial cost pressures. In spite of this, however, I consider Italy to be the best candidate among the countries from the deterioration of whose balance of payments the United States can expect an improvement.

United Kingdom

A look at the only other major country outside the EEC shows that the United Kingdom in the past decade has been willing (perhaps from necessity) to accept unemployment and slow growth for the sake of external balance. Little change in this ordering of the policy goals seems to be in prospect, essentially because Britain's present reserve position does not permit a significant loss of reserves. The United States should therefore not expect an improvement in her balance of payments because of a persistent deterioration in the United Kingdom's competitive position.

What these comments about the major European countries imply is that the increases in European export prices projected by the report may have been too high. Certainly the basic forecast of an 11-percent increase in export prices for the entire area between 1961-68 (p. 83) appears to be excessive. But even the alternative projection of a 7-percent rise (p. 88) may be erring on the high side.

It is difficult to say exactly by how much the report may have overestimated the increase in European export prices. But the significance of any overestimation for the balance of payments may be seen by the report's computations under alternative assumptions. Given U.S. price changes of 4 percent from 1961 to 1968 an increase of European prices of 11 percent between 1961-68 would have a net effect on the U.S. net trade balance of plus \$4.8 billion. Given the same U.S. price changes but a 4-percent slower increase in European prices (that is, 7 percent between 1961-68) would have a net effect of only plus \$1.5 billion so that a 4-percent difference in the divergence of prices accounts for a \$3.5 billion change in the U.S. balance of trade in the year 1968.

2. (b) Capital movements and EEC

The chapters of the report devoted to analyzing the impact of the EEC and capital movements on the projected balance of payments serve more than any other part of the report to point out fruitful areas for official efforts aimed at influencing the course of events to come. The current U.S. balance-of-payments difficulties could in fact be a very useful basis from which to negotiate for more liberal trade policies on the side of the EEC not only because it would help the U.S. balance-of-payments position but also because Europe can afford to liberalize. In addition, trade liberalization could be a valuable aid to European governments in their efforts to check inflation.

Since the writing of the report some evidence has appeared which has a bearing on the projected improvement of the balance of payments caused by capital and dividend flows. The Fifth Annual McGraw-Hill Survey of Overseas Operations of U.S. Companies reported in the September 7, 1963, issue of Business Week found "the

push overseas going strong." Foreign capital expenditure plans by U.S. corporations for the next year are up 8 percent over the previous year, direct investment in manufacturing leading the way. For the "longer run" the survey indicates that spending will continue at a high level. The findings of this survey modify the findings of an earlier Department of Commerce survey of expected future expenditures, which suggested that a decline in the aggregate flow of new direct investment from the average level of the last few years was in prospect. This Department of Commerce survey was the basis of the report's projected flow of investment funds. The report gave a further reason why it found the acceptance of this survey's findings appropriate. Given the report's assumptions about economic growth and prices in Europe and the United States, investment in the United States would become relatively more attractive than investment in Europe. The possible inappropriateness of these basic assumptions has been discussed in section 2(a) above.

Thus the projected improvement of the U.S. balance of payments expected to result from changed investment behavior may be smaller both because plans of businessmen have changed, and because profits in Europe may not be squeezed as much and business conditions in the United States may not improve as much as the report assumed.

The McGraw-Hill findings show that perhaps more weight should be given to a point made by the report; namely, that capital exports may be determined by the notion that "investment abroad has become the thing to do" (p. 123). The Business Week article quotes what are presumably typical sentiments of the businessmen interviewed: "The company does not earn abroad at a rate as high as it does at home but we have to increase sales abroad." The notion that firms may be interested in expanding sales volume rather than profits is in conformity with some recent work on the theory of the firm. It is best summarized by the following passage from Business Week: "If you compare our company's sales as a percentage of gross national product in overseas markets with the U.S. level you can see we still have plenty of growth ahead."

The implication of these findings is that it may be necessary to not only revise upward the estimates of foreign direct investments but also to possibly revise downward the earnings which can be expected from these investments, because concern with market shares may lead to capital expenditure greater than expected from profitability and opportunity cost considerations.

3. *The choice of elasticity coefficient.*—The report states that "the projection of changes in the net balance of goods and services is very sensitive both to the assumption about the size of relative price changes and to the assumptions about the response of trade to given changes in relative prices" (p. 89, italic mine). Yet, in spite of the importance which the authors attach to this assumption about the price elasticities of foreign trade, they provide little justification for the choice of the specific value used in their computations. The empirical model on which most of the computations in the report are based yielded an elasticity coefficient estimate of more than 4. While heavy reliance was placed on the other estimates of the model with respect to this estimate it was not considered appropriate. "Since this value seems too high to be plausible, we apply an elasticity coefficient of 2.5" (p. 82). The only justification for the choice of this

specific value given is that it "results in a lower estimate of the improvement in U.S. exports" (p. 82) than the higher coefficient of 4 would have brought about.

While one can sympathize with the difficulties associated with finding a plausible value for this crucial variable and one can agree with the desirability of underestimating rather than overestimating the improvement in the U.S. balance of payments, it would have been much better if more reasons had been given why a value of 2.5 had been chosen rather than one of 1.5, 3.5, or any other.

The need to pick one single coefficient could have been avoided if estimates for expected changes in trade of some important commodities or broader categories of products had been made. Not only are estimates for coefficients of such products or groups of products available,² but also greater precision could be expected from forecasts which take account of the fact that rather substantial differences exist in the price elasticities of different products, as one would expect on the basis of theoretical considerations as well as empirical evidence.

The reason why no attempt was made at greater precision of the estimates along these lines may have been due to the lack of time and the prior commitments of the authors, mentioned in the introduction of the report. The fact that such a breakdown would have been desirable remains and should be considered in any future attempt at making a balance-of-payments projection. Without actually carrying out the computations of such a nature it is difficult to correct the report's estimates but their reliability is reduced further.

4. *U.S. balance of payments and monetary reform.*—As a last point I should like to comment on the inappropriateness of including a chapter on world monetary reform in a volume devoted to projecting U.S. balance-of-payments developments. While it is true that the solution of the U.S. balance-of-payments problem will dry up an important source of international liquidity and may thus present new problems to the world community, the solution of this problem may actually be made more difficult if the world gets the impression that the United States is pushing for a new world monetary order because it would help her balance-of-payments problem. Careful reading of the section of the report devoted to the analysis of the defects of the world monetary system shows that the authors are fully aware of the need to distinguish between these two problems. But it appears to me, nevertheless, that the cause of international monetary reform would have been served better if this section of the report had been omitted and the thoughts and recommendations contained in it published as a separate paper.

III. CONCLUSIONS

U.S. policymakers should not place too much comfort in the projection that the U.S. balance of payments will show a surplus in 1968. The prediction may be too optimistic as the above considerations suggest. But even if a balance were to occur by 1968 the deficits of the years 1963, 1964, 1965, 1966, and 1967 piled on top of the already outstanding U.S. obligations may lead to a major convertibility crisis long before then.

² See R. J. Ball and K. Marwah, "The U.S. Demand for Imports, 1948-58," *Review of Economics and Statistics* (November 1962); A. C. Harberger, "Some Evidence on the International Price Mechanism," *Journal of Political Economy* (December 1957).

The danger facing the world today is that the United States will continue to seek improvement in her balance of payments by official halfway measures which amount to an interference with the allocative efficiency of the market. This is especially tragic and a bit ironic since U.S. policy from the end of the war had been directed at deploring and fighting the existence of exactly such measures in the rest of the world. Discriminatory taxes on some types of capital movements, the shipment of beer from the United States to troops in Germany, limitations on U.S. tourist expenditures, export subsidies to producers are examples of interference with the functioning of free trade which are likely to remain long after the current balance-of-payments crisis will have disappeared. The Brookings report's findings are dangerous in that they imply that the United States can continue to go on with these halfway measures and that in the end all will be well.

It may not be in the best tradition of American policy to face up to realities very rapidly. But one wonders how long the textbook case of an overvalued currency—continued deficits and unemployment—must persist before the basic remedy is undertaken and the dollar is devalued.

Devaluation is a policy which the present administration has chosen to exclude completely as one of the methods whereby the present balance-of-payments problems can be solved. In fact, it is excluded to the extent that all open official discussion about the effects of such a policy has ceased and only a few economists propose it while the majority of their colleagues search for second-best solutions.

This is a very unfortunate situation. For, as a result, there has been very little discussion of what the disadvantages of devaluation would be and how these could be handled. It would, in my opinion, be a much better allocation of resources if more efforts were devoted to finding remedies for the undesirable consequences of devaluation and fewer to thinking on how to prevent market forces from working in internationally least objectionable ways. I am sure that economists could easily come up with an equitable scheme aimed at compensating dollar holders for their devaluation losses, should the United States feel an obligation to do so. Similarly politicians and the American public should not be too difficult to convince that a devaluation not only fails to hurt U.S. prestige abroad because America's H-bombs, factories, and skills will still make her the most powerful and wealthiest nation in the world but that, to the contrary, these positions might even be strengthened because the balance-of-payments restraint on desirable military and economic policies has been removed. It should equally be possible to convince Europeans that such a devaluation would be in the interest of a healthy Western economy and therefore in their own interest as well. A reform of the international monetary system which appears to be necessary whether the United States improves her external balance through series of halfway measures and market interferences or through a devaluation might actually be brought closer to realization as a result of the shock effect of such a dollar revaluation.

STATEMENT BY JOHN M. GUNN, JR.

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To forecast a nation's balance of international payments is among the most difficult of all economic forecasting. This is true because it requires first of all that comprehensive forecasts be made of the economic development of one nation and all others related with it in multilateral economic transactions, then that the interaction of these projected national economies with each other be predicted, and after these hazardous projections are completed, it depends upon the difference between two similar magnitudes, minor inaccuracies in either one of which could cause the desired forecast to do flip-flops.

It would seem foolhardy to undertake such "forecasting." Yet, the deterioration of the U.S. international reserves, which has persisted, with two minor interruptions, since the major currency devaluations of 1949 and which has been acute from 1958 to the present, requires investigation of the adequacy of international financial machinery to maintain international balance in the years ahead. Therefore we may judge courageous Walter S. Salant and his associates in the Brookings Institution for the study they have presented to the Joint Economic Committee under the title, "The United States Balance of Payments in 1968."

It seems ungracious to criticize sharply a piece of work which is done so comprehensively, so carefully, and with such meticulous specifications of its own limitations. Yet, there are criticisms I believe should be made. In my analysis of this study, I shall develop the following major points:

1. This report is richly instructive in understanding of the U.S. international balance, both with respect to the complexities of its interaction with the Nation's economic system and the economies of other nations and with respect to its significance for high policymaking for the domestic and international welfare.

2. The specific "forecasts" of the study involve such probable degrees of error, especially in their quantitative aspects, as to make them of limited usefulness in long-range policy planning. Most emphatically, *no policy should be undertaken* which depends upon even moderate accuracy of forecasts. Indeed, the projections, themselves, are massively dependent upon assumed policy decisions by the United States and other nations. (The authors give multiple warnings of the uncertainty of their projections; the danger is that others may seize upon the projections without their accompanying caveats.)

3. Aside from the general uncertainty, some of the projections may be unduly optimistic, notably (1) the anticipation of sharp increase in European prices relative to those in the United States, and (2) assumed passiveness of European governments if their balances of international payments began deteriorating as counterpart to improvement in the U.S. balance. The projected decline in American prices

relative to European prices, for example, could be dissipated in an instant if several European currencies were devalued, even if domestic price movements in each country were precisely as projected.

4. A more fundamental conclusion to be drawn from the study is that the United States must be prepared to accomplish large balance-of-payments adjustments in the years ahead, details of which cannot be forecast with even approximate precision. The authors point to several possible sources of difficulty; others can be cited readily.

5. The report is doubtless correct in warning of necessity to increase international liquidity in the coming years. However, the projection of the magnitude of international reserves that will be needed is open to question. Among other things, the amount of international reserves required for smooth functioning of the international economy depends upon the adequacy of the fundamental balancing mechanism, and this is a point the authors all but ignored.

The Brookings group here followed a fashion current among officials of the U.S. Government, other national governments, and the International Monetary Fund, in treating the need for reform of the international payments-and-balancing mechanism primarily in terms of needed increase in liquidity. I believe the greater need is to improve the fundamental balancing mechanism. Where there are many sources of divergent economic developments between nations, it is quite impossible to have international balance unless there are some balancing devices stronger than faith, hope and "time."

THE INSTRUCTIVE VALUE OF THE REPORT

The initial presentation of Mr. Salant and his associates is admirable. Their argument is that the United States faces more than a balance-of-payments problem. Throughout the study they maintain this problem in perspective of a nation committed to high purpose for the welfare of its people and other peoples of the world. Approaches to the solution of balance-of-payments difficulties are kept always within the context that they must be overcome by means that will permit the American nation to pursue its domestic economic goals and will avoid their transfer to other nations, while serving also to expand opportunities for beneficial world trade and investment, to stabilize international trade and payments in the short run, to increase the security of the free world, and to assist in the economic development of poor nations. Balance in international payments is correctly posed, not as a goal to be sought for itself, but as a limiting condition within which proper national goals must be sought.

The plan of the work is also admirable, as it proceeds from forecasts of growth in production to consideration of probable price developments and the effects of these on foreign trade, thence to projections of foreign investment, foreign aid, foreign expenditures for defense purposes, and anticipated effects of increasing unification of the European Economic Community. In executing this plan, the authors have considered an astonishing number of variables, assembled much historical data, analysed their data perceptively, and when they felt unable to account for relevant variables they have been careful at least to call attention to factors whose possible influence was being omitted from consideration.

The comprehensiveness of approach to the interactions of the economy of one nation with others is a model for such studies, and the complexities of these interactions are made both lucid and vivid; the analysis of "feedbacks," both positive and negative, in various components of the balance of payments is uncommonly good. Lawrence Krause's chapter on the European Economic Community merits particular citation, and it also merits particular attention to its tentative conclusions about restrictiveness in the Community's external trade.

UNCERTAINTY OF THE SPECIFIC FORECASTS

Despite the admirable context, the proper plan, and the comprehensiveness of execution of this study, its specific projections are speculative to a very high degree. The most that can be said for them is that they are within a range that is within the limits of plausibility. The final projections of the balance of payments are derived from a chain of subsidiary forecasts, each step of which involves large uncertainties, from which many changes that are both possible and important have been excluded, and including many elements that depend upon discretionary governmental policies, some of which will be determined in part by the state of the international balance at the time they are made. Moreover the development of the final projection is such that uncertainties within the chain may compound from step to step. The authors' own citations of these uncertainties are commendable, but they do not deter the authors' movement to a conclusion which, though qualified by surrounding statements, is quite specific.

To appreciate the effect of compounding uncertainties, it is helpful to review some of the steps in the projections, together with some of the authors' own comments on their assumptions. (In doing this, I have no wish to deprecate what is, in fact, an impressive exercise in economic analysis; however, I believe it is important to demonstrate the extent to which it is an exercise in reasoning from possible assumptions and not a forecast.) In the chain of development of these projections are the following possible sources of uncertainty or error:

1. The projections for growth in real production for the United States were given to the Brookings study group by the Council of Economic Advisers. They involved an annual growth rate of 4.8 percent a year, reduction of unemployment to 4 percent of the labor force, and no increase in the rate of inflation—admirable goals, to be sure, but conditions whose mutual compatibility is not demonstrated by recent U.S. history, given the extent of restriction in both product and factor markets. The growth rate projected is much faster than recent American experience indicates would be attainable, and the unemployment rate in this country has not touched 4 percent since April 1957. The Brookings group implied they thought these projections overly optimistic, by offering a set of "alternative assumptions," but these were little reduced from the Council's figures.

2. By a series of assumptions, each reasonable enough in itself, the "rest of the world" was reduced to Western Europe (Canada disappearing in a footnote at p. 34), and part of the computations for Western Europe was derived from data for just four countries "to minimize computations" (p. 38n).

3. The projections for growth of production in Western Europe were drawn from "plan targets" submitted by the respective coun-

tries to the OECD. Like the Council of Economic Advisers' projections for the United States, these targets were optimistic. The Brookings group, too, thought these targets "may be unrealistically high," and "alternative assumptions" reduced these projections, but again, the alternative set of data were changed only slightly, in this case by 10 percent.

4. At one point in calculating the investment requirements for the "plan target" growth rates in Western Europe, the authors of the study wrote, "It is clear that such a procedure is subject to severe limitations, as the OECD group stresses itself, and can yield only very crude estimates." (App. to ch. II, p. 264.)

5. In projecting labor costs in Western Europe, the authors acknowledged, "our assumptions are very rough" (p. 47).

6. Elsewhere, the report states, "our assumption regarding the rise of U.S. export prices is largely a guess" (p. 229). It continues, "Although it reflects a judgment about how substantial price relationships between export and other prices are, this judgment is mainly intuitive. Because of the lack of reliable data even for past export prices, it could hardly have been anything else."

7. In projecting the effects of income changes on international trade, the authors said, "Although we cannot have much confidence that the relationships derived from econometric studies of the postwar period will hold in the future, we have nonetheless used elements of [such relationships] * * * suitably modified for our use, to establish a starting point" (p. 56). And after completing this particular projection, they wrote, "Admittedly, it is difficult to feel much confidence in these figures" (p. 58).

8. In estimating the effects of price changes of internationally traded goods on the volume of their trade, at one point where the authors needed a measure of elasticity of demand they had an estimate with a value of 2.6, found reasons to believe that too high, and adjusted it to 2, a value which they said "seems a reasonable guess" (p. 86). It should be noted also that of various efforts that have been undertaken to measure price elasticities in international trade, there is a marked lack of consistency in results.

9. "The projection of changes in the net balance of goods and services is very sensitive both to the assumptions about the size of relative price changes and to the assumptions about the response of trade to given changes in relative prices" (p. 89). Later, in the same section, "Until the price data are improved, quantitative projections of the competitive position of the United States can be little more than informed guesses—and this warning applies to our projections" (p. 91). Moreover, the section from which these quotations come did not even mention the possibility that the relative prices of which it was speaking could be altered drastically by devaluation of one or more European currencies.

10. "The discussion of the prospects of the U.S. balance of payments on goods and services in this and the next chapter will take no account of institutional developments—such as the effects of trade discrimination by the European Economic Community (EEC)—which might modify the results" (pp. 36–37).

11. "It is clear that the net balance of goods and services is influenced to an important extent by factors which we do not take into account * * * because there is no way of projecting them or of making quan-

titative estimates of their effects on trade" (p. 228; for the authors' own discussion of some of the omitted factors, see pp. 227 ff.).

It is to be emphasized again that all of the foregoing references come from a chain of projections, each step of which depended on previous steps, so that uncertainties may be compounded as the chain proceeds to its conclusion. These references are drawn entirely from the projection of commodity trade. Comparable uncertainties exist in projection of foreign investment, foreign aid, foreign-exchange expenditures for national defense, and the effects on trade of developments in the European community, though the nature of the projections for these elements does not involve as much possible compounding of uncertainty.

Tarshis wrote, in introducing the projections of real income in chapter II, "The projections made in this report are not unconditional forecasts. They are estimates of what the assumptions imply, made without assessing the probability that these assumptions will be realized" (p. 35). And Walter Salant wrote in the introductory chapter that "the value of the projection lies less in its quantitative result than in the process of obtaining the result, for that process identified the kinds and directions of influences that will determine the future development of the basic payments position of the United States" (p. 31).

On the basis of "what the assumptions imply" the authors reached the conclusion that "our best guess is that the basic deficit will be eliminated" (p. 230). That is surely the strongest sensible statement they could have made. But even that mild forecast must be regarded as very uncertain, when one considers that the small changes involved in the "alternative assumptions" converted a projection of a \$1.9 billion surplus in 1968 to a \$0.6 billion deficit.

OPTIMISM ON RELATIVE PRICE MOVEMENTS

After due allowance for the range of uncertainty involved in these projections, further qualification must be made for what I believe to be too optimistic a view of the critical matter of relative price changes. Some testimony was given in hearings before the Joint Economic Committee on July 30, 1963, that European price increases might be more moderate than the authors of the Brookings study anticipate.

On the other hand, I am less confident than the Brookings group about the probability of nearly stable prices in the United States. Unemployment in this country has persisted above almost anyone's definition of the "normal" range for more than 6 years. The President has repeatedly avowed his intention to get the unemployment rate down. He has also expressed dissatisfaction with the Nation's rate of economic growth. The projections of the U.S. economy in 1968 furnished the Brookings study group by the Council of Economic Advisers reflect both these concerns. The present administration, as well as that of President Eisenhower during its latter months, has been inhibited in seeking higher levels of domestic economic activity by recognition of the balance-of-payments deficit.

The nations of the world rejected the former international gold standard because it required domestic restriction to rectify a deficit in international payments. It is doubtful that the American Nation indefinitely will tolerate a lagging economy in order to improve an

international balance of payments, which shows little sign of improvement. If vigorous efforts were made to stimulate domestic employment and investment, accelerated price increases almost certainly would follow, with harmful effects on the balance of payments.

However, even if internal prices in Europe rose significantly relative to the prices of U.S. goods, a relative shift in international prices in our favor might not occur. The Brookings study concluded early that improvement of the American balance of payments would occur at the expense of Europe. Are we to expect that European governments would take no action to check their loss of reserves if the balance turned in favor of the United States?

It is at this point, especially, that the authors' assumption of fixed rates of international exchange is dangerous. President Kennedy's determination to maintain the gold price of the dollar constant cannot bind other countries to similar policies for their currencies. If inflation in Europe resulted in increased imports and loss of export markets, devaluation of the inflated currencies would be a marked probability, and with such devaluation the relative international price shift in favor of the United States would disappear. This would be a crippling development for the Brookings projections, for decline in American prices relative to those in Europe is one of the two developments upon which depends their conclusion that the U.S. deficit in international payments will be overcome by 1968.

THE MORE FUNDAMENTAL CONCLUSION

More important for policymaking than any particular projection of the U.S. balance of international payments is the conclusion inherent in the Brookings study that the United States must be prepared to accomplish large balance-of-payments adjustments in the years ahead. There is hardly any economic change and hardly any decision of government that does not have interaction with the balance of international payments. The authors of the study here under review cited a number of possible causes of disturbance in the U.S. international balance. In addition to those, there are many other possible international developments which could require major adjustment by the United States.

Though it now seems unlikely, Great Britain might yet enter the European Community under terms that would involve dismantling the Commonwealth preference system. Regional trading blocs may develop further and might turn to regional autarky that would squeeze United Kingdom exports out of many current markets. Contrary to the study's expectations, Japan might begin to build international reserves.

The United States faces an increasing demand for imported raw materials, which in time will surely lead to necessity of increasing foreign exchange earnings in order to pay for them. Commercial policies associated with agricultural subsidies in many nations, especially in the European Community (as discussed by Lawrence Krause in the Brookings study) could disrupt international trade badly. Shifting conditions in the relations between the free world and the Communist bloc, or within the Communist bloc, could lead to sharp changes in free world trade, which would affect the United States at least indirectly through third countries if not involving

American trade directly. A new Berlin blockade, or major political disturbance in the Middle East would cause major strains in the U.S. balance of payments.

Though neither the magnitude nor the direction of future balance-of-payments adjustments can be forecast with confidence, it is apparent that only the most fortuitous of circumstances would avoid the necessity of major adjustment from time to time. Thus the major conclusion to be drawn from the Brookings study and from other evidence is that prospects are high for continued disturbances in U.S. international payments; the international monetary mechanism requires major revision.

INTERNATIONAL BALANCING AND INTERNATIONAL RESERVES

There are two distinct problems in construction of an international payments-and-balancing mechanism, though the problems are mutually dependent. Some set of forces must be provided to rectify fundamental imbalance in international economic transactions, and international reserves must be large enough to accommodate seasonal and cyclical variations in international payments and to maintain temporary balance while structural changes in demand and supply are being adjusted to overcome fundamental disequilibrium. It is obvious that the required level of international liquidity depends upon the effectiveness and speed of the long-term balancing machinery.

There is widespread belief that the international monetary system needs major overhaul in the 1960's, but there is also a great propensity in the United States and elsewhere to regard this need primarily in terms of the adequacy of international reserves. Mr. Salant and his associates in the Brookings study partake of this inclination. There is doubtless a need to increase international liquidity. I join the Brookings group and all the others who recommend abolition of the gold reserve requirement for Federal Reserve Bank liabilities as one way to meet this need, and a way that would be particularly advantageous to the United States in the present circumstances. However, the amount of international reserves needed for smooth functioning of the international economy cannot be estimated without first specifying the nature of the fundamental balancing system.

Equilibrium in international payments can be summarized more accurately than it can be stated in detail. Its summary statement is that exchange rates between the currencies of the nations of the world must be such that their reciprocal demands and supplies for each others' goods and services (with adjustment for capital movements and international donations) result in each nation's foreign receipts being equal to its foreign payments, given the price and income structures of the respective nations. When equilibrium does not exist, the underlying forces of demand and supply must be altered to restore it, and resources shifted to support a changed structure of production. Such adjustments will never be painless; some persons must move, both geographically and industrially, and there will always be some relative redistribution of income, which must be unfavorable to some people. Its painfulness, however, cannot remove the necessity for such adjustment to take place.

In order to induce such adjustment, it is necessary to alter either the terms of trade (relative prices of exports and imports) of a nation.

with other nations, or to alter their relative incomes, or typically, to alter both. There are many types of policies for making these fundamental alterations, some of them highly automatic, some of them requiring deliberate action by government. The international gold standard, prevalent in the 19th century, accomplished international balance quite automatically by depressing domestic incomes and prices to overcome an international deficit, or causing domestic inflation to rectify a surplus in international payments; these were accomplished while maintaining rates of exchange between currencies permanently fixed. Much simpler adjustment could be accomplished by varying the exchange rates, provided means could be found to do that without sharp day-to-day fluctuations, though with some cost in inconvenience and risk to international traders and investors. Various restrictions by government can also be used to rectify international disequilibrium; these are undesirable, however, for they violate the principle that the more international price comparisons serve as guides to all international economic transactions, the greater will be the efficiency of resource use by each nation.

As a corollary for the world's current emphasis on international liquidity as the primary source of difficulty in the international payments-and-balancing system, there is a curious but widespread preference for fixed rates of international exchange but an unwillingness for nations to undergo the internal recession and inflation which are part of the balancing machinery with such an exchange-rate system. The authors of the Brookings study partake also of this curious preference, and the futility of their arguments in its favor is typical of those who try to support this impossible system, or rather this nonsystem.

The Brookings group's recommendations for an international monetary system are very nearly in contradiction with themselves. The adjustment devices they recommend are analogous to an automobile with twin driveshafts and two sets of gears, installed in such a manner that one-gear-train could be set in forward position and one in reverse. The specific policies they recommend—subsidy to investment in international goods industries ("policies to stimulate," in their words, p. 248) and shift in procurement policies of the government—are in direct opposition to maximum use of price comparisons to allocate resources internationally, of which they have expressed approval elsewhere in the study. Their recommendation for restraint of wage increases is doubletalk if they mean what they say about keeping the government free to implement policies that will maintain full employment and keep the economy growing at a fast rate. Use of large international liquidity to gain "time" can be part of fundamental adjustment only if one has great confidence in fortuitous, autonomous new disturbances offsetting to the existing ones. (The study cites certain reactions that would operate in this direction. See p. 247.)

The authors of this study need not blush. They are among distinguished company: the President of the United States, every member of his administration who has spoken publicly on the matter, officials of the International Monetary Fund and of the nations of Western Europe. They all seek international balance, with fixed exchange rates but without any effective balancing machinery. If the major trading nations of the world follow parallel economic policies (and, in fact, all are heavily committed to maintaining "full employment,"

though with variant understanding of what that means and varying willingness to sacrifice other goals to attain this one), an international payments system might be able to limp along pretty well with fixed exchange rates and a tolerable level of disturbance to domestic economies, provided it began from a position of near equilibrium. Given the disequilibrium in the world today, however, and given the economic stresses associated with East-West conflict, in all its manifestations, and given other possible sources of disturbance cited earlier in this essay and in the Brookings study, unless the nations of the world are willing to undergo significant internal disequilibrium in order to keep international accounts balanced, they must permit variation in rates of international exchange.

It is unfortunate from the point of view of the United States that the need for exchange rate variation has become acute at a time when circumstances would call for depreciation of the dollar in terms of other currencies. It is also unfortunate that devaluation is regarded widely as a sign of "weakness" in a currency. This would not be the fact in case of devaluation of the dollar; it is under pressure in the markets for international exchange not because the U.S. economy is weak, but because it is very strong—strong enough to invest internationally at a rate of \$2 to \$3 billion a year; strong enough to carry a major share of the burden of defending the free world, including external expenditures of \$3 billion annually for this purpose; and strong enough to support economic assistance to the less strong at a comparable level. It should not be forgotten, too, that the U.S. deficits began immediately after many other currencies were devalued in 1949. This fact might suggest the devaluations of 1949 were of "too great" a magnitude, though the level of foreign defense spending and foreign aid by the United States that has prevailed since the early 1950's could not have been anticipated at that time.

Depreciation of a nation's currency, of course, causes adverse change in the terms of trade. This change, however, is a necessary step in rectifying a deficit in international payments. Moreover, fixed exchange rates do not avoid the necessity of an unfavorable shift in a deficit nation's terms of trade; they just accomplish it through a more painful device; namely, domestic recession.

What is required in remodeling the international payments-and-balancing system is more flexibility in exchange rates—not less flexibility, as advocated by the U.S. administration, as the major studies being undertaken by the International Monetary Fund and the "Paris Club" of 10 nations seem predisposed to seek, and as recommended by the Brookings group. The well-told advantages of permanently fixed exchange rates are undoubted, but they also have a disadvantage—they can't do the job that must be done.

On the other hand, the variety of possible choice is much greater than the Brookings study would indicate. Chart I gives classification of international payments-and-balancing mechanisms, with a large variety of elements from which a variety of systems could be put together. The task for those who would improve the international monetary mechanism is first to seek that combination of exchange rate freedom and discretionary adjustments of national economic policy that would involve the least friction possible in required internal adjustment and avoid putting unjust share of adjustment on other

CHART I

The Balancing Mechanism
In a Variety of Systems of International Payments-and-Balance

Temporary Balancing Devices	Shifts in Ownership of International Reserves: International Flows of Gold, IMF Credit, Official Holdings of Foreign Exchange, and/or Private Short-term Credit (Employed with all Systems, with varying Contributions to Balance)		
The Balancing Mechanism	I. Fully Automatic Systems	A. Independent National Monetary Systems with Freely Fluctuating International Exchange Rates	B. International Gold Standard (Permanently Fixed Rates of Exchange)
	II. Semi- Automatic Systems	Near-Independent National Monetary Systems with Exchanges Fixed within Moving Ranges related to their own recent values. Such a system could be managed in the short run but would be open to long-run automaticity.	
	III. Managed Systems ↓ (Increasing State Control) ↓ (Approaching Maximum Control)	<p>Managed Systems of International Payments and Balancing include any policy altered from what it would be if there were no concern for the state of the international balance and surely will include some combination of the following:</p> <p>(Heavy reliance on International Reserves--"Temporary" Devices)</p> <p>A. Exchange-Rate Policies. Exchange Rates subject to control but with great variety possible in degree of freedom. Even hourly fluctuations possible, with official trading to affect trend; at opposite extreme, permanent fixity is possible by massive resort to policies in Class B and/or Class C.</p> <p>B. Policies affecting primarily the Levels of Domestic Production (Employment & Income) and Prices</p> <ol style="list-style-type: none"> 1. Fiscal and Monetary Policies chiefly for short-run effect. 2. Rationing, Price Controls, & other devices to alter demand and availability of current goods & services. 3. Depreciation and Tax Policies, Credit Policies, Resource Allocation, etc., to affect long-term rate of growth. <p>C. Policies of Market Intervention that Discriminate between Domestic and International Trade</p> <ol style="list-style-type: none"> 1. Official, long-term international borrowing and/or grant aid. 2. Shifts of governmental spending, especially spending for defense and for foreign aid. 3. Suasion: promotion or curtailment of export, import, foreign travel, foreign investment, etc. 4. Subsidy, Resource Allocation, etc. to affect capacity of international-goods industries. 5. Manipulation of Commercial Policies and Regulations on International Investment (either restriction or subsidy). 6. Exchange Controls. 7. State-Trading Monopolies. <p>(Since the international balance depends upon policies of a nation's trading partners as well as upon its own, interna- tional consultation & diplomacy may be balancing techniques.)</p>	
Sub-Monetary Transactions	Barter		

Classification and Diagram by John M. Gunn, Jr., Washington and Lee University

NOTES TO CHART I

1. The essential adjustment to rectify imbalance in international payments is that a deficit nation's aggregate private and public spending declines relative to its production, or that a surplus nation's aggregate private and public spending increases relative to its production. These necessary adjustments may be accomplished by a variety of techniques. The essence of international balancing, however, is alteration of the terms of trade (against the deficit nation) or change in relative national money incomes (relative decline for deficit nation) or, typically, both these changes. Imbalance may be suppressed, and an artificial "balance" attained, by restricting international trade and payments.

2. The balancing mechanism may operate through either of two major techniques: (a) variation in rates of international exchange (depreciation for a deficit nation), and (b) alteration of national money incomes (depression for a deficit nation; this was the technique of the old international gold standard). The needed adjustments may be postponed, or even avoided, by a third technique, less (c) restriction of foreign trade and investment. Such restriction ignores the lesson of the doctrine of comparative advantage: The more international price comparisons guide international specialization of production and trade, the more efficient will be every nation's use of resources. Moreover, restrictions imposed for this purpose must be maintained indefinitely to prevent recurrence of international imbalance.

3. The fully automatic systems (I-A and I-B) probably could exist only as conceptual models, although the international gold standard operated during much of the 19th century and until World War I with relatively little intervention. After the war tampering

nations; at the same time, it should be recognized that the optimum combination will not be the same for all types of disturbances to the international balance.

If the international balancing mechanism were improved, then the requirements for international liquidity would be much reduced. Moreover private, short-term credit movements probably would contribute more to international liquidity than they now do. This is not to say, however, that there will be no need for increased international reserves.

Whatever views I may hold different from the authors of the Brookings study, about the wiser choice among possible international payments-and-balancing systems, I endorse as vigorously as possible their fundamental proposition: that the international monetary mechanism must be improved, in order that disturbances to international equilibrium may be adjusted without major compromise of the Nation's domestic economic objectives, or abrogation of its international responsibilities.

with the system became continuous, and during the great depression all pretense of an international gold standard was dropped.

In the absence of automaticity, when large use is made of fiscal and monetary policies (systems III-B-1) to achieve international balance, the balancing mechanism operates quite like the international gold standard, and a heavy price in domestic instability must be paid to gain international equilibrium. When large use is made of restrictions on international trade and payments to achieve international balance, international price comparisons are substantially destroyed as guides to efficient specialization of production and trade, hence, as guides to efficient resource use. Exchange-rate variation of some variety (systems I-A, II, or one of the myriad forms of III-A) is the only fundamental balancing technique that avoids both disturbance to domestic income and price levels and the harmful effects of trade restrictions.

4. It is to be emphasized that international balance depends upon all the economic developments of a nation and of all other nations related with it through international economic transactions, directly or multilaterally. Particularly to be emphasized are many "feedbacks" in the balance of international payments. For example, a decrease in imports from the underdeveloped countries will cut exports by a major fraction of the same amount, since those countries typically import up to the limits of their earnings in foreign exchange; decrease in foreign aid or in foreign investment will diminish commodity exports by comparable magnitudes. It is also to be noted that some devices that improve the current balance will worsen international balances in the future; for example, here international borrowing will require both payment of interest in future years and ultimate repayment of the loan.

5. Most of the free world has operated since World War II, under the articles of agreement of the International Monetary Fund, with international payments and balancing systems of class III. Exchange rates are subject to intermittent, official variation (a system of "movable pegs") but revaluations of currencies have been infrequent; credit is provided by the IMF for nations with "temporary" deficits in international payments; and restriction of foreign payments to maintain international balance is prohibited, though in fact it has been common, especially during the earlier postwar years. The present U.S. administration, and that immediately preceding, have emphasized policies of class C, Nos. 1, 2, and 3, with significant reliance in fact, though with reluctant acknowledgment, on policies B-1 and C-5; at the same time there has been strong prepossession against altering the dollar's value in gold and/or foreign exchange, though such variation would be permitted under existing arrangements with the International Monetary Fund.

6. The greater international liquidity (international reserves), the wider the swings that can be accommodated in the international balance because of seasonal, cyclical, or random disturbances, and the longer balancing adjustments can be postponed. However, large international liquidity can only postpone necessary adjustments in the underlying forces of reciprocal demand and supply and in investment decisions; it cannot avoid fundamental adjustment, unless fortuitous, autonomous disturbances occur that are offsetting to existing ones.

7. Adjustment of the balance of international payments can never be painless. Indeed, it could hardly be expected to be easy, since a deficit in international payments means essentially that a nation—public and government combined—is overspending its income. In the necessary adjustments to overcome imbalance in international accounts, some changes in both geographical and industrial location of both labor and capital normally will be required, and there will be some redistribution of income as between persons and sectors of the population. Alternative balancing systems will affect different sectors of the population in different ways, and particularly they will concentrate the burdens of adjustment on different groups.

It is therefore to be expected that political factors will weigh heavily in determining a nation's choices among possible balancing systems, and contending groups may inhibit any clear-cut choice whatever. Given the inconvenience of fundamental adjustment and the fact that for some persons it may involve permanently diminished income, pressures will be great in the face of any deficit to try to ride it out by reliance on international reserves; and whenever that appears impossible, pressures will mount for import restriction, with even many of those nominally committed to nonintervention by government in international trade, and investment finding excuses to support state control of trade and payments.

STATEMENT BY SEYMOUR E. HARRIS

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1. PRELIMINARY

In general this is an excellent report. Brookings reflected a high level of civil responsibility to undertake a task of such difficulty, and an unusual administrative capacity in bringing together six unusually able young and middle-aged economists to produce the report now under consideration. No economist operating alone could have turned out such a product, and in view of the great difficulties of getting this report out in a short period, with the participants in different parts of the country and with the situation changing from day to day, the authors deserve the highest praise. With more time available they would have carried their fact gathering and analysis much further.

Both the authors and The Brookings Institution are to be congratulated. That does not mean that I do not have serious criticisms and I am sure there will be many others. But who could have written this report and been confronted with less criticism? The authors themselves are very much aware of the limitations of their study, the difficulty of getting adequate estimates, and the impossibility of taking into account all the relevant issues. For example, in trying to relate GNP to the balance of international trade and services the authors have depended upon a regression equation based on the experiences of the period 1948 to 1960. Unfortunately, many important causal factors operating during the past, and likely to prevail in the future, cannot be taken into account in the regression equations. Moreover, the 1950's were a hectic period and one in which the changover from dollar shortage to dollar saturation necessarily made that period less than ideal for a base.

2. GROSS NATIONAL PRODUCT AND THE BALANCE OF PAYMENTS

A theory attracting increasing approval in the last few years in Washington is that the way to improve the balance of payments is to achieve full employment and accelerate the rise of GNP through the route of full employment and rising productivity. This is a theory that is contrary to what has been taught in the colleges and universities for a great many years. For the general view has been that a country that increases its GNP more rapidly than other countries is likely to suffer from an adverse balance of payments. Its prices and income will rise relatively, and it will, therefore, tend to import more and export less. I should add, however, that the classical theory concentrates on the current balance. But many in Washington adhere to the view in recent years, and particularly since 1960, that since the rise in GNP at a rapid rate would bring and respond to increased investment, and, therefore, induce declining costs per unit of output; and since another result would be a more favorable investment

milieu with profits rising and, therefore, less capital going out of the country and more coming in; and since a feedback would follow—that is, any rise of imports would be offset by countries from which the United States buys in turn increasing their purchases from the United States—for all these reasons it has been held that a more favorable economic situation would improve the balance of payments.

I have serious doubts about this. I may add that the Brookings authors do not take this position. In fact, when they consider the more rapid expected rise of GNP in the United States than in Western Europe, they draw the conclusion that so far as the trends in GNP are concerned, they anticipate a less favorable balance of payments for the United States. Nevertheless, throughout their presentation they do develop a feedback theory which is largely based on the general idea that although the initial effects may be adverse of a great relative growth of GNP, there are compensating factors.

In the Brookings report (p. 217), it is revealed that according to the initial assumptions¹ there should be a rise of merchandise exports of \$11.2 billion from 1961 to 1968. Of the \$11.2 billion, an increase in United States' and Western Europe's real income would account for \$5.5 billion; an improvement in U.S. competitive position, \$4.8 billion; and an increase in U.S. foreign aid, for \$2.04 billion. (Smaller items, both plus and minus, are omitted.)

But under the alternative assumptions the rise of merchandise exports would only be \$7.6 billion, and the amounts related to the increase in United States' and Western Europe's real income would be only \$4.6 billion rather than \$5.5 billion. Improvement in the U.S. competitive position would now account for only \$2 billion as against \$4.8 billion on the initial assumptions.

Under the alternative assumption instead of Europe's GNP in real terms rising at 4.2 percent per year from 1961–68, it would rise only by 3.8 percent, or 10 percent less than the original assumptions would suggest. For the United States the original assumption was a 4.8 percent rise in GNP from 1961–68 and the alternatives 4.5, or a decline of 6 percent. A smaller increase of U.S. exports under the alternative assumption related to the changes in the United States' and Western Europe's real income could be expected under classical economics. The point is that, with Europe's real income rising somewhat less rapidly relative to the U.S. rise of real income in relation to the initial assumptions, the result of this would be a less favorable effect upon the U.S. exports.

There is no doubt that the alternative assumptions are closer to reality than the initial assumptions which were given to Brookings by the Council of Economic Advisers. The alternative assumptions seem more likely for both Europe and the United States, particularly on the basis of what has happened in the last few years.

3. COMPETITIVE POSITION

Under the initial assumptions of the \$11.2 billion increase in merchandise exports, improvement of the U.S. competitive position would account for \$4.8 billion, or more than 40 percent; under the less favorable assumptions, \$2 billion out of the \$7.6 billion rise in mer-

¹ GNP of \$743 billion in the United States of America for 1968 (1961 prices).

chandise exports, or roughly 30 percent. Improvement in the U.S. competitive position is largely based on the assumption that Western Europe will have increasing difficulty in obtaining necessary supplies and labor, and their productivity will not rise as it has in the past. The report is convincing on the likelihood of substantially higher cost and price rises in Europe from 1961 to 1968. For the United States the crucial item is that export industries, particularly important export industries, are confronted with excess capacity, large amounts of unemployment, and, therefore, the trend toward modest increases in wages, and, therefore, in labor costs. Moreover, with the rise of investment, it is assumed that productivity will increase greatly in the United States. The authors of the Brookings report are frank to admit that their conclusion on the change in competitive prices is largely guesswork. It cannot be anything else. Yet their presentation has a ring of conviction. What is not too clear is whether Western Europe will accept inflation. The authors seem to think that they will not jeopardize their high level employment by introducing anti-inflationary policies. As I write these lines the French government, disturbed by the 6-percent increase in the cost of living in the last year (1½ percent in the United States), announced an anti-inflationary policy (New York Times, Sept. 11, 1963).

Although the United States has had a relatively stable price level in the last few years, it is too much to assume that this will continue until 1968. Indeed, increased investment may contribute toward declining real costs. But it is unlikely that the pressure for higher wages will be delayed much longer, and especially if the rise in investment, as the Brookings report expects, is forthcoming. For this will increase profits greatly and increase the pressure for rising wages. Moreover, the Brookings report seems to expect too large a relative rise in domestic and export prices in Western Europe vis-a-vis the United States.

For several years Western Europe has profited from large expansion of capital resources, increased scale of output, and hence declining unit costs, movements into more productive industry—all these factors tending to reduce unit costs. Despite very large increases in wages, Western Europe seems to have been able to keep their export prices relatively low. Rising productivity has been a substantial factor here. From 1953 to 1960, hourly earnings rose by 49 percent in the basic metal industries in France, Germany, Italy, and Japan (average) and 37 percent in the United States; the labor costs rose by 20 percent in the United States and declined by 10 percent in the four competitive markets. The gains in productivity were much greater in the four other countries. It may well be, as the Brookings report suggests, that this trend will not continue. But one cannot be sure, particularly in view of the large inflow of capital that continues into Western Europe, and in view of the fact that the exploitation of the large new plant and the Common Market has just begun.

In this connection, it is well to note the fact that despite the large relative increase in wages in Western Europe in the last few years compared to the United States, nevertheless in 1961 and 1962 the U.S. share of exports of manufactured goods among industrialized countries had declined further and at a more rapid rate than in the preceding years. Moreover, her share of total export trade continued

to decline. This unexpected result may be explained by deficiencies in the statistics of prices or by certain nonprice advantages that Western Europe has over the United States, for example, better selling methods, better adaptation of commodities and services to what the customers want and perhaps also, a more flexible export pricing policy as compared to that of U.S. sellers.

As I said above, I also think that Brookings tends to underestimate the possibility of emerging bottlenecks; and continued advances in the American economy year after year are not likely to be accompanied by stable wage rates or relatively stable wage rates. Since the authors have all been trained in Keynesian economics, I am a little surprised that they are not adequately aware of these sequences. Unit costs are likely to rise more than the Brookings study allowed. Thus Keynes, in his "General Theory of Employment," page 296, states as follows:

Having, however, satisfied tradition by introducing a self-sufficient number of simplifying assumptions to enable us to enunciate a quantity theory of money, let us now consider the possible complications which will in fact influence events:

1. Effective demand will not change in exact proportion to the quantity of money.

2. Since resources are not homogenous, there will be diminishing, and not constant, returns as employment gradually increases.

3. Since resources are not interchangeable, some commodities will reach a condition of inelastic supply whilst there are still unemployed resources available for production of other commodities.

4. The wage unit [wage rates] will tend to rise before full employment has been reached.

* * * Thus instead of constant prices in conditions of unemployment and of prices rising in proportion to the quantity of money in conditions of full employment we have in fact a condition of prices rising gradually as employment increases * * *.

Of course, insofar as with the expansion, additional capital is made available, the rise of unit costs would be less than assumed here.

4. FOREIGN AID

An important factor in determining the future net balance of payments is of course foreign aid. The authors estimate that foreign aid will rise from \$4 to \$6.4 billion from 1961 to 1968, but the net deficit effect would only be around \$300 million. It is hard to believe in view of the present attitude toward foreign aid, that there would be an increase in these proportions in the next few years. (The authors did not, as the writer of this critique has, have the advantage of considering developments in the summer of 1963.) Foreign aid has been fairly stabilized in the last few years at around \$4 billion and it looks now (September 1963) as though for 1963-64 there may be a drastic cut. Moreover I am not sure that a \$2.4 billion increase in foreign aid would bring an increase in deficits in the balance of payments of but \$300 million even if we allow for tied aid and the large amount of aid to Latin America, a rich market for American exports.

Foreign aid indeed does result in a large rise of exports, in part because the foreigner getting the aid tends to buy in the United States, and partly because of the policy of tied aid. Nevertheless, Brookings estimates of the adverse effects of additional aid on the balance of payments seem rather low. Foreign countries receiving aid and required to purchase in the United States are likely to offset this to a substantial degree by diverting purchases to other countries which

ordinarily might have gone to the United States. AID has shown that exports of the United States tend to rise especially to countries obtaining U.S. aid. But this is still consistent with a tendency for countries forced to buy in the United States with aid dollars to increase their free purchases to non-U.S. markets. Moreover, any rise of foreign aid also does bring about some increase of U.S. imports, and in many markets where there are shortages or distant delivery days, may result in reductions of other exports. (If the bottlenecks spring up abroad, then this would help the United States.)

On the issue of capital movements, the Brookings report argues that there will probably be a substantial reduction by 1967. This may indeed well happen. But in view of the dramatic rise of capital movements in the last few years out of the United States, one may raise some questions here. It may well be that such measures as the interest equalization tax and ultimately, perhaps even persuasion or control, may cut these capital movements. But the Brookings report does not take into account any such possibilities and argues largely on the basis of the change in relative attractiveness of investments of capital in the United States and abroad, and from these assumptions concludes that there would be a reduction of net capital movements from the United States. The relatively low rates of interest on long-term securities here and the availability of large amounts of savings, are factors that tend to stimulate borrowing in the United States.

5. PROJECTIONS OF EXPORTS

It is of some interest to study the expected rise of exports and imports in the years 1961 to 1968 and compare it with the actual rise from 1954 to 1961. Actually, according to the Brookings report, the increase in exports of goods and services on the initial assumptions would be a rise of \$14.3 billion, and \$10.6 billion on the alternative assumption (p. 216). The rise of merchandise exports would be \$11.2 billion on the initial assumption and \$7.6 billion on the alternative assumption. But the annual increase of exports of merchandise anticipated for 1961-68 is about twice as great as from 1954 to 1961, a period of equal length and both were years of recession. Walther Lederer, of the Department of Commerce pointed out that the trend for 1962 in exports to Europe was way off from that given by the equation based on the experience of 1948-60.¹

When one in 1954 was projecting exports of goods for 1961 and with the 1947-54 results before him he would be most unlikely to estimate the 1961 results with any accuracy. From 1947 to 1954, exports of merchandise declined by \$3.2 billion or 20 percent. Who would have guessed that they would rise by \$7.1 billion or 40 percent by 1961? These results emphasize the difficulties of forecasting trade and even more difficult, services. On the basis of the trends from 1954 to 1961 who would have anticipated a changeover from 20 percent decline in 7 years 1954-61 to a 40-percent rise in 1954-61? In 1954 the view widely held was dollar shortage and a strong competitive position for the United States. It required several years of a trend to rising surpluses and dollar saturation for the industrialized world outside of the United States before economists (inclusive of the writer) recognized what was happening.

¹ Walter Salant replies that Lederer did not really apply the Brookings equation.

The large rise of exports of the United States from 1954 to 1961 may well be associated with the unusual prosperity in Western Europe and Japan and with an assumed relative decline, for the United States. But if, as is assumed, the outside industrialized world does not gain relative to the United States as in the 1950's, then are we likely to have such large gains of exports? Here a crucial point is the trend of competitive prices.

After making careful calculations of future trade it is interesting that the report near the very end concludes as follows (p. 225) :

On the foregoing assumptions and considering the period from 1962 to 1968 as a whole, we conclude that the net effect of the underlying factors taken into account in the projections will be pressure toward a basic surplus. It should be stressed, however, that even if the underlying forces are strong enough to produce a substantial surplus in conditions when their effects could be freely worked out, existing international monetary arrangements may not provide that freedom. Under existing monetary arrangements, the size of the actual U.S. surplus would be limited by policies in Western Europe designed to limit the deterioration in the balance of payments that a large shift in the basic balance would almost certainly imply.

6. WESTERN EUROPEAN ANTI-INFLATIONARY POLICIES

Throughout, the report assumes that Western Europe will not cut employment by anti-inflationary policies. And this is one reason for the improved competitive position of the United States. Here, clearly, the Brookings authors have some doubts about the validity of this assumption. In other words, the United States may not be allowed to obtain the improvement in the basic balance. In 1961 the basic balance was a deficit of \$800 million. Under the initial assumption, it would be converted into a positive basic balance of \$1.8 billion and under the alternative assumption we would have a basic deficit of \$600 million. Obviously, the improvement on the basis of the initial assumption would largely solve our deficit problem. But this, of course, does assume certain policies on the part of Western Europe, and of this Brookings cannot be certain.

7. EXPORTS AND JOBS

Brookings authors also try to estimate the net effect on jobs as a result of an increase of exports of goods and services of about \$11 billion. The conclusion is that \$11 billion additional exports would provide about a million more jobs, a figure obtained by comparing employment and the GNP.

But this is not satisfactory. If one compares the marginal increase in GNP and the increase in jobs, one does not get a ratio of one job equals roughly \$10,000. From 1960 to 1962 employment rose by 1.4 million, the rise of GNP was \$38 billion, and hence a rise of \$27,000 in GNP was required to add one job. But the Brookings study leaves out of account here the gains of productivity and thus obtains a smaller marginal GNP per added job.

8. STRATEGIC IMPORTANCE OF WESTERN EUROPE

One of the interesting conclusions drawn by the Brookings report relates to the strategic importance of Western Europe to the U.S. balance of payments.

*** an examination of the reserve changes that have occurred in the rest of the world in recent years, however, shows that the total deficits and surpluses of the rest of the world corresponding to U.S. total deficits and surpluses have been earned primarily by the Western European countries and Japan. Over the years and in the aggregate, the world outside the United States, Western Europe, and Japan has not had large and persistent net surpluses or deficits (p. 23).

*** this chart shows that the growth of gold and foreign exchange reserves of industrial countries other than the United States and the United Kingdom increased more or less steadily from about \$4.6 billion in 1947 to about \$23.9 billion in 1962; the reserves of underdeveloped countries in the aggregate rose and fell (since 1951, for which comparable data are not available), within a range of only about \$2.5 billion *** (p. 25).

This is an interesting conclusion, and on the whole, seems tenable. But I should point out that from the years 1950 to 1962 the United States had a basic deficit of \$25.4 billion. European countries had a basic surplus balance of payments in these years of \$16.9 billion or roughly two-thirds of the U.S. deficit. The signs are always in the opposite direction, that is, when the United States had a deficit, European countries had surpluses, except in 1 year, and that was in 1951. The Japanese account for a very small part of the basic deficit of the United States, for its positive balance was only \$0.4 billion in these years, or roughly 2 percent of the U.S. deficit.

But it seems as though Brookings does not give adequate weight to the primary producing countries. In these 13 years when the United States had deficits in all years on basic account, the primary producing countries had 8 years of surpluses and 5 of deficits in their basic accounts. Moreover, their surpluses exceeded their deficits by \$4.16 billion or 15 percent of U.S. deficits on basic accounts. I cannot entirely rule out, therefore, the relevance of the balance of the underdeveloped countries. (Based on materials on p. 26.)

9. POLICY RECOMMENDATIONS

I would like to comment briefly on some of the policy recommendations which result from this particular statistical analysis. Brookings comes out strongly for increased international liquidity. Oddly enough it ties the need for increased liquidity to the necessity of dealing with structural changes in the economy. This is indeed a relatively heavy burden to be imposed on the liquidity weapon. The IMF Charter provided for help to countries that experienced fundamental disequilibrium. But one could scarcely conclude that required adjustments have generally been made in response to IMF. Mr. Salant assures me that the increased liquidity was not wanted primarily to deal with fundamental disequilibrium but rather to finance imbalances. I nevertheless think that the report depends excessively on rising liquidity.

The Brookings report recognizes that it may take some years to effect the necessary structural changes, though it seems to emphasize the point that there are some factors in the situation such as the response of European export industries to changing conditions or governmental intervention that would hurry the structural changes. Nevertheless, in my opinion, there is no doubt that attempts to rely on rising liquidity to treat structural problems would in an important degree postpone the necessary structural changes. These structural changes are not merely related to price factors. They include loss of

markets due to changing patterns of demand, agricultural failures, financial crises, and so forth.

Consider what is happening in the United States. We have been incurring large Federal deficits, as much as \$12 or \$10 billion in some years, and yet the problems of the regions or industries that need adjustment continue to trouble the country. The point is that it requires a tremendous deficit for increased liquidity to effect a cure of the sick industries or regions. Similarly, the problem of treating disequilibrium on an international level is not likely to be very effective. No one, for example, could claim that \$10 or even \$20 billion deficits could solve the problem of the coal and textile industries, or the railroad industry. Indeed, with more liquidity and increased demand there is some improvement in these industries or at least they do not decline as drastically. Furthermore, the Government does not and will not seek \$10 billion deficits in order to deal with sick industries or regions. It will have recourse to large deficits to treat general insufficiency of demand, and will use smaller resources to treat the depressed regions or industries.

Moreover, as Under Secretary Roosa has said more than once, provision of adequate liquidity means making credits available to those that are running deficits. This means that agreements have to be made that are satisfactory from the viewpoint of both creditor and debtor nation. This is not an easy goal to achieve. In fact, a large amount of the opposition to the original Triffin plan was based on similar considerations.

The Brookings report also seems to support the view that the amount of liquidity required is determined by the amount of trade. Actually liquidity needs are more properly tied to the imbalances in the balance of payments. It should be noted that a given amount of liquidity is likely to be much more effective today than several years ago, partly because of the increased cooperation among central banks and treasuries and also partly because of the development of new techniques to deal with the problem of imbalances. It does not follow, therefore, because trade would rise by 30 to 40 percent that a similar amount of liquidity would be necessary by 1968.² As Secretary Roosa has said we now have the orthodox types of reserves; but we have also much potential help from various sources.

U.S. Government policy so far has been to try new techniques for increasing liquidity. There has also been a great concern that there should not be massive changes, partly because of the effects on confidence and the sensitivity of the whole international machinery, and also partly because of the fear that excessive liquidity may discourage fundamental adjustments.

Indeed, it is now clear that because of pressure from both political parties in Great Britain and also some desire for further advances in some departments of the U.S. Government that experimentation will continue—as it should. Both the President and the Treasury have made clear their willingness to consider further discussion of these problems. But there is a great fear among authorities in Washington that guarantees, which would be required if the balances of \$22 billion of short-term dollar liabilities, of which \$12 billion are official,

² Mr. Salant writes me that Brookings needs no instruction on this point. They are aware of the overriding importance of the size of imbalances.

were to be transferred to an international organization would not be acceptable to the U.S. Congress. Official policy seems to be to continue to experiment in this area, to make advances as the need for liquidity becomes clear, but not to move too rapidly.

Aside from the various measures, such as swapping currencies, increased lending authority of the IMF, agreements among the major countries to provide \$6 billion additional credit, though this is not a commitment, attempts to deal with speculation in dollars through operation in the futures market—these and similar measures are held to be helpful in solving the problem of liquidity. The U.S. Government would also like to make provision so that there would be a larger use of currencies other than the dollar for reserve purposes and smaller dependence on gold. This would reduce the burden on the dollar.

The Brookings report says, and quite properly, even as Triffin had said a long time ago, that once the United States does balance its accounts that there will be serious problems for the rest of the world which has been depending upon building up of dollars in the United States as a means of supplementing their reserves. This is one reason for the desire to substitute additional facilities for increasing liquidity. It is not clear to me that one need go nearly as far as the Brookings suggests, though further analysis is needed. It is much better to do what is necessary rather than to take extreme measures.

Because of the fear that Western Europe may not agree to the United States proposals in this general area of liquidity, for example, the proposal that the dollar be made more secure through greater investment by foreign authorities in dollars, the Brookings authors suggest an alternative solution; namely, the use of flexible rates of exchange. This is indeed a radical proposal. All economists know that flexible rates do tend to bring automatic adjustments in the economy, for example, when the dollar is weak, to allow the dollar to depreciate would increase the export balance because domestic prices would not rise as much as the price of the dollar.

There are many practical difficulties in introducing flexible rates. The Canadian experience is not a very helpful one. In fact, the Canadians had great difficulty in bringing their exchanges down when they wished to do so in 1962 and also to stop the declines when it once started. Yet they had the advantage of tying their exchanges to a fixed currency. The Brookings proposal is to have two centers, (1) the United States and United Kingdom axis with some associated countries, and (2) the other Western European countries. Then the problem would simply be to adjust rates between these two galaxies.

If, for example, the United States-United Kingdom galaxy should, because of the difficulties with the balance of payments, allow their exchanges to decline, would the Western European axis allow this to take place or would they introduce various controls of imports, and of capital movements, and the like. We are not all convinced that each of these groups would allow the flexible rate program to operate. Moreover, Brookings very much underestimates the difficulty of achieving the appropriate exchange rates, say as between the United States and Canada or France and Germany. One can only go back to the 1962 Canadian-United States dollar experience to realize that these are not easy problems to solve. Brookings also recognizes

that the flexible rate program may have serious effects on trade and capital movements. This is an interesting proposal, but it seems to me it leaves out of account the practical administrative and political difficulties involved. A good economic case might be made for this, but certainly not a good political—economic case.

The Brookings report also suggests widening of the gold points to 3 or 4 percent. I think this is a reasonable proposal. I should be inclined to limit the range for the present to the 2 percent provided by the International Monetary Fund. Our own range is only one-half of 1 percent. The major advantage of the 2-percent range is that short-term capital movements for speculative purposes would be discouraged because of the greater risks involved.

They also suggest the removal of the various reserve requirements against Federal Reserve notes and Federal Reserve deposits. This is a silly requirement and makes a large part of our gold reserve useless from the viewpoint of international requirements. It should be removed immediately.

In his "Treatise on Money" (II, p. 272), Mr. Keynes wrote:

* * * But the legal reserves of the central bank merely lock away reserves where they are useless and the effective strength of a central bank depends in practice on the amount of its excess reserves. Thus we have the paradox that the more strictly and conservatively the gold reserves of a central bank are presented by law, the weaker it is and the more utterly exposed to disastrous disturbances from every wind which blows. A central bank which was compelled to keep 100 percent of its assets in gold would be not much better off than one which had no reserves at all.

10. ANALYSIS OF LARY AND LEDERER

I should perhaps comment on two statements made before the Joint Economic Committee on the Brookings report, one by Hal Lary, National Bureau of Economic Research, and the second, by Walther Lederer of the Department of Commerce.

Lary says that the emphasis of the Brookings report should be on the analysis, not on the quantitative results. The analysis is most helpful but there are large questions about the quantitative results. Lederer also points to the fact that Brookings offers a projection, not a forecast. He adds, however, that sometimes the authors in their recommendation seem to forget that they have produced a projection based on various assumptions.

Lary seems to agree with the authors that the continued expansion in Western Europe will result in rising costs and prices as compared to movements in the United States, and is likely to result in a conversion of the U.S. deficit in the basic balance to a surplus. This may well be so, although as the Brookings authors themselves recognize, the basis on which this is built; namely, the improved competitive position of the United States, is subject to many reservations.

Lary shows that the Brookings projection of the 1961-68 change in the export trade really implies a doubling of the exports of manufacturing products in these 7 years. This would be a rather remarkable achievement, and especially in view of the continued technical progress abroad, and the much slower rise of U.S. exports in recent years.

Lary also makes another point of importance; namely, that the effects of direct investment on exports and imports is not really given

adequate consideration in the Brookings report. He points out especially that according to one study, the export performance of the U.S. manufacturers is especially bad where substantial manufacturing facilities have been built abroad by U.S. corporations. It is well to recognize the point that as direct investments are made abroad, the United States loses markets in these countries and also in third countries, as well as to some extent takes imports from the production of the affiliated corporations operating abroad. These may result, therefore, in large losses of U.S. exports. It is not clear, as Lederer points out, that direct investments are going to decline by one-half by 1968 as the Brookings report suggests. Actually they continue to rise, even in 1963.

On the projections of the competitive gains for the United States, Lederer has a good deal to say. Of the \$5.7 billion rise in merchandise exports from 1961 to 1968, \$3.5 billion are accounted for by Brookings by the improved competitive position of the United States. But Lederer finds that from 1952 to 1961 real income accounted for 69 percent of the improvement of exports and the improved competitive position only 19 percent. This suggests at least that there is no reliable basis, on the basis of past experience, for estimating the effects of price changes, and they may be greatly overdone by the Brookings report.

On the whole, Lederer seemed to think that the Brookings report tended to overstate the advantages that would likely accrue to the United States. Lary, on the other hand, does suggest some instances where they have underestimated the possible gains of the United States. Lederer notes that the gains of trade projected for the United States may be two times those achieved from 1953 to 1960. It should be noted, however, that this is on the Brookings first assumptions, not the alternative ones.

Lederer doubts that, with the projected substantial rise of GNP for the United States, price stability should be assumed for the United States. This is an issue that the Brookings report does not deal with, a frequent gap in Washington studies.

Another favorable assumption for the United States is that Western European demand and investment will increase relatively more than output, a favorable development for the United States. With investments rising more than output, one would expect an increase in the rate of interest in Western Europe. But the report assumes no relevant change. Again Lederer notes, as I did earlier, that the report assumes appropriate monetary and fiscal policy in Western Europe. In other words, as reserves rise the supply of money will continue to increase, wages and prices will rise, with favorable effects for the United States. But I should note what Lederer has not noted: that the report does suggest the possibility that Western Europe may not play this game and, therefore, the results may not be so favorable.

Again Lederer points out that the assumption of no increase of reserves for the underdeveloped countries is not necessarily binding in the years to come. Finally, Lederer also notes the assumption that the irregular transactions, for example, government prepayments to the United States and the like, and short-term capital movements assumed to be balanced by 1968, is rather an optimistic assumption for the United States. It should be noted that in the years 1960-62, short-term capital movements and unreported transactions amounted to more than \$6 billion, and they have not been reversed as yet as had

been predicted for such a long time. This might be compared with a total of only \$4.7 billion (credits) over a period of 9 years from 1951 to 1959. Credits during these 9 years only averaged \$500 million as against a \$2 billion average deficit in the years 1960-62.

11. CONCLUSION

The Brookings report is a highly original volume. As a method of analysis, it is both novel and provocative. In the limited time available and the difficult conditions of work, the authors have achieved much.

On the whole, I am not sympathetic with the policy recommendations. If further major steps are required, and I am hopeful they will not be, I would much prefer a broadening of the gold points to 2 percent and a limited supervision of capital movements. Should U.S. exports rise and imports decline relatively in response to the relative rise in wage rates, costs and prices abroad—as they have not by early 1963—then we may not even need limited supervision of capital movements. The failure of trade to respond so far may be explained by lags of trade to relative price movements, to continued large productivity gains abroad and also to some nonprice advantages of Western Europe and Japan. But I would wager that by 1964, there should be some improvements in the U.S. trade and service account associated with relative price movements since 1960.

One can have only limited confidence in the quantitative results—and for all kinds of reasons, most of which are not related to inadequate treatment by the authors. I am inclined to be optimistic as are the authors. But that is an intuitive rather than an econometric judgment.

In the need of getting on and simplifying the problem, the Brookings authors were able to obtain more precise results than the underlying situation justifies. For example, in assuming, (1) that all countries but Western Europe and the United States could be abstracted, and (2) that the problem could be treated merely by concentrating on trade and omitting short-term capital movements, the authors facilitated their analysis but reduced the value of the results. Moreover, the assumptions made tended to give a more favorable projection for the United States than justified by the likely trends.

STATEMENT BY SIR ROY HARROD

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1. It is a great honor for one who is not a citizen of the United States to be invited to submit a memorandum to the Joint Economic Committee. I have accordingly felt a great sense of responsibility and endeavored to bear in mind the needs of the United States, no less than those of the whole free world. There is no contrast between these two objectives, since what is conducive to the prosperity of the United States is likely to be conducive to the prosperity of the free world generally. In regard to my qualifications for dealing with the affairs of the United States, I will say only that I have endeavored to study them for a great many years, and as early as 1925 gave a course of eight lectures on the Federal Reserve System in the University of Oxford, which I repeated, as duly modified, in every alternate year until the outbreak of World War II. I was much honored by being invited to appear in person before a subcommittee of the U.S. Senate Committee on Currency and Banking, 83d Congress, 2d session. Unhappily I was unable to appear, but submitted a memorandum which was placed on the record (March 30, 1954).

2. In my judgment the Brookings report is a document of outstanding importance, which is likely long to remain a source of reference. It has analyzed recent trends in a highly scholarly manner. It has brought the same qualities to its attempts at prognostications, while itself recognizing that these can only be of a very speculative character. It is proper that the main part of my comments should deal with its conclusions and recommendations.

3. Among the latter I choose the following for early reference. (1) "No position of the balance of payments—whether surplus, deficit, or balance—would simultaneously free the United States from undesirable constraints and provide for needed expansion of international monetary reserves. It is clear, therefore, that the present problem is not primarily a balance-of-payments problem. More fundamentally the problem is the basic inadequacy of the international monetary mechanism in relation to the requirements of the free world" (p. 242). (2) "Our studies have led us to conclude that the relation between imbalances and the total volume of transactions is more likely to increase than to decrease * * *. Imbalances will often pose painful conflicts between domestic and international objectives of policy. The most constructive form of adjustment entails gradual changes in costs or shifts of resources over relatively long periods. Thus imbalances may tend to persist over long periods" (pp. 236-237). (3) At various points in the policy recommendations it is stressed that the main remedy should be, not interest rate changes that do not accord well with domestic requirements, but policies of restraint in respect of wages and administered prices.

4. It may be desirable, in the attempt to assess these findings, to revert to a larger background. Since the war, countries of the free world have stressed two major objectives of policy. One is the maintenance of full employment and a high growth rate. The other, advocated especially by the United States, but favored also by many other free enterprise countries, is the development of a regime of unrestricted, multilateral, nondiscriminatory international trade. It is recognized that developing countries may find it difficult to comply fully with the second of these objectives. Freedom of international capital movement may be considered to be part of the second objective, but it does not have the same priority as freedom of trade, and the President's proposal for a temporary interest equalization tax should not be deemed to infringe the second objective in any important sense. It is certain that these objectives cannot both be achieved, unless there are adequate reserves available for financing international imbalances of payments for sufficient periods to enable them to be corrected gradually, as desiderated by the Brookings report.

5. The imbalances referred to are likely to occur from time to time as between free enterprise economies, owing to changes in tastes, technologies, availabilities of resources and entrepreneurial outlooks. They are the inevitable consequence of freedom.

6. In former days, if an imbalance occurred owing to one or other of these causes, the automatic working of the gold standard insured a rectification of the balance of a debit country by causing a downward movement in its activity and income. At a later date the purely automatic effect of a gold outflow on the money supply had to be reinforced by a credit restriction on the part of the central bank which was losing gold. Later still, when the gold standard ceased to work so automatically, most central banks nonetheless did restrict credit when a deficit in the balance of payments occurred, thereby reducing employment and income. The changed attitude on the part of governments, especially since World War II, whereby deliberate measures to reduce employment and incomes are regarded as undesirable, has deprived the authorities of what used to be the prime method for correcting external deficits.

7. If this method of prompt correction is ruled out, another method is still available; namely, the deliberate tailoring down of imports by administrative action to the level allowed by realized export proceeds. This method is largely adopted by developing countries, most of which are under heavy pressure in relation to their balances of payments. But it is hoped that the more advanced countries will avoid such measures to the greatest possible extent, and great progress has been made in that direction since the end of World War II. It is to be feared that, if all countries adopted a system of planned imports by reference to export proceeds in the preceding period, there would be a gradual shrinkage in the volume of international trade, which would be most detrimental to the prosperity of the free world.

8. If the authorities are denied the only two known methods for getting a quick restoration of balance; namely, internal deflation and import restriction, then it is clear that, when a structural imbalance occurs, only a slow-working remedy is available. In accordance with this it is needful for all countries to have sufficient reserves to tide over rather lengthy periods of imbalance. The only alternative for them would be to default on their obligations, and that must be ruled out.

9. It is to be remarked that until the most recent years the United States has not been faced with this dilemma owing to the fact that it has had more than its proportionate share of the world's monetary reserves. While one would expect that, in the normal course of events, the great industrial position of the United States would cause it to acquire a large share of the world's reserves, this was not the reason for its having acquired, as it did, a disproportionately large share. The reasons for that were its special position in being able to supply needed goods during and immediately after World War I, the massive flow of capital from Europe when the shadow of Hitler began to fall upon it, and the favorable position of the United States as a supplier during and for a number of years after World War II.

10. Having acquired so large a share of world reserves at an early date, the Federal Reserve System was able to adopt whatever internal policy it deemed best for ironing out the business cycle; it continued to pursue this policy almost uninterruptedly from 1922 until 1958. There may have been an exception in the year 1927, not in the direction of deflation, but rather in the direction of making money a little easier to help European countries which had recently reestablished their gold standards after World War I. Again in the period between the end of World War II and its accord with the Treasury in March 1951, it may have pursued an easier policy than suited the needs of the business cycle; but this was due to quite a different cause; namely, the supposed needs of Federal finance, and had nothing to do with the external balance.

11. I cannot forbear mentioning a passage in Mr. Roosa's most masterly testimony to your committee on July 9, 1963, in which he said, "We have a problem they (Europe) have not yet experienced. We have large unemployment at the same time as we have a balance-of-payments deficit. No country in the world has ever had that combination of conditions in the way in which we have experienced it in the last few years" (p. 122 of hearings). Many countries in Europe had precisely that problem during the thirties. They had far heavier unemployment than the United States has now, but they also had external deficits. The trouble was that they resorted to the remedies of import restriction, bilateralism, and discrimination, which are precisely what we want to avoid today, the United States in particular. Thus new thinking is required.

12. In my opinion it is desirable, both for the United States and the whole free enterprise world, that the problem created by a deficit should be solved gradually. It may be thought by some that the gradual method of solution has been proceeding too slowly in the United States and that it should now be expedited. Indeed the U.S. authorities will be subject to embarrassment in the dealings that they have been so skillfully executing with other central banks, if there are not signs of a speeding up in the progress of solution. I shall deal with this in a later paragraph. It is my opinion that the problem now takes on so urgent an aspect only because of a worldwide shortage of reserves for international settlement.

13. While it is recognized in many quarters that, if and when the United States cures its deficit, there may be an international liquidity problem, since the increase in available liquidity in the world in recent years has been mainly due to the U.S. deficits themselves, which have provided the world with a continuing increase of dollar balances

in their reserves, I submit that there has already been a shortage of international liquidity for a number of years, and that it is this shortage which has given the U.S. deficit so much more urgent an aspect than it ought to have. In this I agree with the Brookings report.

14. It is often said that one is not entitled to assess the adequacy of international liquidity at present by comparison with any particular period in the past. This is doubtless perfectly correct. But I submit that if the present level of liquidity falls far below the level obtaining before World War II, that gives a prima facie case for study. It is argued that we get different results if we take other periods for comparison. It is suggested that we might take 1928; but, considering the worldwide slump that very shortly followed, I submit that this would be a most unfortunate year to take. It is suggested that we should take 1913. But conditions in that year were entirely different in a number of respects:

(a) The whole world monetary system was more unitary than it is at present, being to so large an extent based on sterling, which was managed in London.

(b) Although the British worked upon a very narrow gold reserve, they had an enormous second-line reserve, constituted by foreign bills accepted and discounted in London and due to mature within 90 days. These short-term assets far exceeded the sum total of London's short-term external liabilities. It is sometimes said that a bank is sufficiently liquid if 30 percent of its assets are liquid. But that was not the case with London, considered as a world banking center; its liquid assets constituted far more than 100 percent of its sight or short-term liabilities.

(c) The domestic currency consisted almost entirely of gold coins. This fact dispensed the authorities from the idea that they must have a reserve additional to what was needed for day-to-day requirements, to meet such an emergency as a war. The vast reserve constituted by the gold coins could always be mobilized in such an event; and it was so mobilized in 1914.

15. World imports in 1938 were worth \$23,556 million and in 1962 \$131,600 million. If we put 1938 = 100, this gives an index number for 1962 of 559. The gold and foreign exchange reserves of central banks in 1937 were \$27,450 million and in 1962 were \$61,365 million; this gives an index number of 223. If we add in the drawing rights on the International Monetary Fund, the sum total of reserves in 1962 was \$78,523 million, giving an index number of 286. Thus the value of world imports has almost doubled relatively to that of reserves. Surely this gives a prima facie case for holding that reserves have recently been inadequate.

16. While it is true that this comparison cannot be decisive, one might think on general grounds that a larger, rather than a smaller, reserve would now be needed, because of the fact that, owing to the policy objective stated above, the authorities are no longer able to get a quick remedy for an imbalance by deflation causing unemployment.

17. The British Treasury was convinced, at the time of the discussions prior to the Bretton Woods Conference, that, if other countries were to agree to the laudable American aim of greater freedom of multilateral, nondiscriminatory international trade, a larger amount of international liquidity would be necessary than was available before

World War II. If this was not done, it was feared that the nations would have to continue for an indefinite period with those restrictive practices, as needed to correct trade deficits, that were so widely adopted in the thirties and were so objectionable.

18. Further evidence for an existing, as distinct from a prospective, shortage of international liquidity, is to be found in all the arrangements that have been hurriedly devised in the last few years—Basel Agreement, Paris Club, swap arrangements, gold pool, U.S. medium-term obligations—whether demoninated in dollars or in foreign currencies. All these arrangements are excellent in themselves, and it is to be hoped that they may be continued for specific purposes, even if a more far-reaching reform of the world monetary system occurs. But no one can think that by themselves these constitute a solid and enduring structure. They are all too clearly ad hoc and provisional; and I believe that the able central bankers, who are responsible for them, recognize this themselves. Surely they are evidence that, during the period in which they were devised, there was a shortage of normal media for settling international imbalances.

19. Now it may be thought by some that these special arrangements were necessitated by a quite abnormal and unique phenomenon; namely, the large U.S. deficit. It may be thought that once that deficit is cured, as surely it will be, no comparable phenomenon is likely to occur again, so that there will not be a continuing need for an ever-greater increase in ad hoc expedients. I submit, on the contrary, that there is nothing very abnormal, still less unique, about the recent U.S. deficit, but that it is the kind of phenomenon that is likely to recur, time and again, as the inevitable result of the chops and changes incidental to a system of private enterprise. It is true that if an equi-proportional imbalance occurs in a country of smaller size, it will not be of so large an absolute amount and will therefore give rise to less widespread ramifications. But a number of countries may simultaneously incur such deficits, as did those of Europe in the period following World War II. In believing that such imbalances are likely to recur, I follow the line of thinking of the Brookings report.

20. In order to clarify this matter, it may be well to take a good look at the U.S. deficit. To ask what is the cause of that deficit may be to ask a question that gives rise to philosophical or semantic controversy. Anyone would be well entitled to say that its cause is the unique generosity of the United States in providing aid around the world. The justification for such an ascription of cause would be that the United States is hereby doing something in excess of what other countries have been doing and in excess of anything that has ever been heard of in the past. But from the point of view of diagnosis this is not a satisfactory ascription, for the reason that the United States had been providing a comparable quantity of aid for a number of years before the deficit grew serious. From the point of view of diagnosis one is more interested in a cause that began to operate at the time that the deterioration occurred. If one looks at the matter in this way, there is no doubt that the cause was the greatly enlarged outflow of private U.S. capital overseas, which started in 1956.

21. It is true that the serious deterioration in its balance of payments started only in 1958. This was due to the fact that U.S. exports had a quite abnormal boost in the years 1956 and 1957, as a cursory

glance at the figures makes evident. This abnormal boost was due (1) to the peak of the European investment boom, which caused the European countries to become heavily dependent on marginal supplies from the United States, and (2) the Suez crisis. It is to be noted that, if another investment boom of comparable magnitude occurred in Europe again, it would not be likely to have the same effect on U.S. exports, since the European countries have meanwhile built up larger margins of spare capacity for meeting their own needs. If we cut the hump off the exports in those two particular years (1956 and 1957), it is evident that the more serious deterioration in the U.S. balance of payments was coincident with the large upsurge of private U.S. capital outflow.

22. I have noticed that in previous hearings before this committee there has been a tendency to ascribe this increase of outflow to the initiative of foreigners in using the excellent facilities of the New York market. There may be some truth in this. But does the outflow not also represent some change of attitude among American citizens? This would apply anyhow to the growth of direct investments abroad. But, even if we take the case of portfolio investments, the fact that American banks undertake such foreign issues surely indicates that they know that the American public has a greater appetite for them than it would have had 10 years earlier. In the earlier period foreign firms seeking to place such issues would surely have been discouraged from doing so by the American banks, who would have explained that they would be unlikely to be able to get them subscribed for in full. I submit that this greater outflow of capital reflects, in part anyhow, a more outward looking attitude on the part of the American investors. And this is in itself not an unhealthy symptom.

23. In the years 1960 to 1962 the outflow of U.S. private capital averaged \$3,772 million. It appears that during 1963 it has increased further. According to the release by the Department of Commerce on August 19, it was running at "well over" \$1½ billion in the second quarter of 1963; this gives an annual rate of "well over" \$6 billion. (It is to be noted from previous years that the figure for a second quarter is deemed to require an upward seasonal adjustment.) In relation to the U.S. balance of payments this further increase presents a formidable problem, and fully justifies the deterrent measure proposed by the President. Nonetheless it cannot be regarded as anything extraordinary. It is not a high figure in relation to a national income rising toward \$600 billion a year. For a standard of reference we may think of private British overseas investment before 1914, which was rising from £100 to £200 million a year, out of a national income of no more than about £2,000 million. Thus, while the larger outflow of U.S. private capital is an awkward phenomenon, it cannot be regarded as abnormal or unhealthy, given the assumption that freedom of private initiative is a good thing. Why should not American capitalists begin to look around the world for opportunities more actively? This will certainly be good for the U.S. balance of payments in the long run.

24. Now we do not know if this high level is a passing phase only. The amount of capital going out may in due course fall back to the pre-1956 level. It would be well if the United States were able to adopt a moderate policy as regards its external deficit, pending the

outcome of events, as it could do if its reserve remained adequate. While the U.S. authorities deserve great praise for their moderation and their abstention from taking unneighborly actions during the last few years, it is to be recognized that even their moderate measures may be hurtful. For instance, the U.S. authorities themselves urge that the tying of a larger part of aid to American goods should be thought of as a temporary measure only, and thereby recognize that it is intrinsically undesirable—although, of course, it is absolutely justifiable. Curtailments of military expenditures, even if not really damaging to NATO defense, may nonetheless do some harm by undermining morale in certain countries.

25. However, we have to recognize that the position as regards capital outflow may not be reversed; indeed it may be aggravated. In this case it will be needful for the various credit items in the U.S. balance to rise relatively to the other debit items, so as to cover the increased debit due to the capital outflow. We may revert to the doctrine of the Brookings report that it is desirable that this correction should occur by a gradual process, as constituted by a structural readjustment of the application of productive resources.

26. The question may be raised whether, during the period since the serious deterioration occurred, there has been any tendency toward rectification at all. If there is none, this does present a rather serious problem.

27. I am sure that even Americans will agree with me that, despite the admirable attempts of the Department of Commerce to introduce progressive clarifications in the balance-of-payments accounts, these are not easy to interpret, especially if one is seeking comparison with earlier years. I am bound to proceed cautiously and with diffidence. I have been studying these figures very closely for a number of years and worked with them in various different ways. In what follows I shall attempt to present the figures in a very simple way, in order that what I have done can easily be checked, and fearing that, by introducing refinements, I might fall into error. I have the idea that the improvement that has occurred in the basic U.S. balance of payments tends to be underestimated both by Americans and others. I have omitted any figures for 1963. If the increased outflow of private capital in that year proves permanent, that will constitute a fresh problem.

[In millions of dollars]

	Recorded private net U.S. capital outflow (i)	Overall deficit (including unrecorded transactions) (ii)	Overall deficit (omitting unrecorded transactions) (iii)
1952 to 1955, inclusive (annual average).....	1,089	1,275	1,629
1956 to 1957, inclusive (annual average).....	3,095		
1958.....	2,844	3,415	3,856
1959.....	2,301	5,201	5,984
1960 to 1962, inclusive (annual average).....	3,772	3,510	2,638
Increase of 1960 to 1962, inclusive, over 1952 to 1955, inclusive..	2,683	2,235	1,009

Sources: Statistical Abstract of the United States (1959) for 1952-57, and thereafter successive issues of Survey of Current Business. Cols. (ii) and (iii) above: for 1952-57, Statistical Abstract, p. 870, "foreign capital and gold, total" minus "Foreign Capital, long-term investments in United States"; for 1958, Survey of Current Business (March 1960), line 47 minus line 42 in table 2; for 1959, Survey of Current Business (March 1961), line 47 in table 4; for 1960-62, Survey of Current Business (March 1963), "Balance on items in A" in table 1.

28. I have not supplied figures for 1956-57 in columns (ii) and (iii), since these, being so strongly affected by the abnormal boost of exports, as explained in paragraph 21 above, might confuse the issue for one studying this table.

29. The question of unrecorded transactions is clearly one of great importance. It is often said that these may include items that escape the statistical net and really constitute part of what should be regarded as the basic balance of payments. This may well be true. I should suppose, however, that such items, constituting normal business transactions, would not be likely to vary from year to year by a large amount; rather they would be likely to remain constant, or show a gradual steady improvement or deterioration. When there are big swings in the unrecorded transactions, these are surely likely to be caused by changes in short-term capital movements, mainly of a speculative character, or taking account of interest differentials, e.g. in the Euro-dollar market. It accordingly appears to me that the column in the above table that omits unrecorded transactions gives the better view of the underlying U.S. deficit.

30. From column (i) we learn that the average annual recorded private capital outflow in 1960 to 1962 exceeded that in 1952 to 1955 by \$2,683 million; but the overall deficit, as shown in column (iii), only increased by \$1,009 million. This must mean that the other items in the total account improved in total by the amount of the difference between these two figures. In other words, the problem having been posed of finding by an improvement in all other items enough to finance an increase in the capital outflow of \$2,683 million, no less than \$1,674 million (almost two-thirds) was thus found. This is surely fairly encouraging. More than three-fifths of the rectification has already been achieved, if my figures are correct.

31. The answer to the question how this rectification has been achieved depends on how much of the exports now financed by Government grants and loans would have occurred anyhow. If we think that none of them would have occurred in the absence of Government finance, then the improvement in the balance must be mainly attributed to the administration's activities in tying AID to American goods, including agricultural surpluses; if we think, on the other hand, that all of them would have occurred anyhow, then the improvement reflects a healthy movement in the merchandise account. The truth is probably betwixt and between. The income from foreign investments has continued to rise in a helpful and significant manner. Other items have become more adverse. On the whole, the record has not been as good as one could wish, and justifies specific measures to improve it. Perhaps the Brookings report goes too far in saying, "We do not recommend that the Government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves" (p. 253).

32. On the other hand, the record to date is not so bad as to justify measures likely to stunt economic growth in the United States—so helpful to the outside world—or to interfere with a full employment policy.

33. The Brookings report holds that "it is inadvisable to raise interest rates in an attempt to affect international flows of capital, unless, as seems unlikely at present, the adverse domestic effects of higher rates can be fully offset by fiscal expansion" (p. 253).

34. I disagree with the foregoing quotation to the extent that I believe that the apparently successful attempt by the Federal Reserve to get an upward edging of short-term rates relatively to long-term rates is a most valuable line of policy, and one which may be an important precedent for other countries in a similar predicament.

35. Nonetheless I am in substantial agreement with the Brookings report. I believe that long-term rates in the United States are now too high for full employment. In my opinion a country so well endowed with capital equipment as the United States is at present, needs very low long-term interest rates. With these I associate a fully adequate "money supply"; the relatively high long-term rates at present prevailing are a reflection of an insufficient "money supply". It is the latter which prevents firms of medium and small size, a very important constituent part of a free economy, from obtaining all the finance that they need for expansion and modernization.

36. It has been suggested that the flow of savings in the United States is now so adequate that it does not need to be supplemented by the Federal Reserve. I hold, on the contrary, that a large flow of savings does nothing to make things easier for those firms that cannot rely wholly on autofinance, unless it is complemented by a commensurate increase in the money supply by the Federal Reserve, and that, unless thus complemented, the high saving level merely causes a squeeze on profits (through deficient spending), such as the United States has recently been experiencing.

37. It has been stated by high authorities that the long-term interest rate in the United States is, and must be, determined by world forces, notably by the universal capital hunger. I take this to be a fallacy. If only the developing countries could put forward viable capital requirements, based on a sufficiency of expert personnel and adequate entrepreneurship, there might be a worldwide capital hunger. As things are, their viable demands could probably be met from the present propensity to save in the United States (and in the United Kingdom, which is also impeded by excessively high long-term interest rates). Meanwhile the prevalence of high interest rates in these two countries makes it more difficult to offer those moderate amounts of capital that the developing countries can absorb, except on aid or soft-loan terms. It is most important that long-term interest rates should be reduced in the United States and the United Kingdom, both from the point of view of economic growth in those two countries, and also from the point of view of the developing countries, which may need to borrow on commercial terms, in addition to what they can get by soft loans.

38. Now if the Federal Reserve used the techniques readily available to it to reduce long-term rates, this would probably entail a corresponding fall in short-term rates, despite its ingenious contrivances for altering the differential between the two. It is for this reason that, while not deprecating at all the excellent efforts of the Federal Reserve to manipulate the differential between long and short term, I agree with the Brookings report in holding that economic growth and full employment are endangered by an interest rate policy geared to the balance of payments.

39. In the passage of the Brookings report quoted in paragraph 33 above, the doubt about the possibility of offsetting higher interest rates by fiscal expansion is stated in a rather passive manner. I

personally believe that for the United States it is desirable that, taking good years with bad, there should be a net deficit in the Federal budget. I have to state this, despite my sense that it may be unpopular. It is not inconsistent with holding that in years of proved demand inflation a Federal budget surplus may be required. But I would greatly deprecate the view that, for maintaining full employment and growth, we should rely upon Federal deficits alone and leave interest rate policy to be determined exclusively by the exigencies of the external balance of payments. We need fiscal policy, by which I mean, to put it quite bluntly, Federal deficits. But these, if relied on as the sole weapon, may not sufficiently encourage investment, especially by medium and small enterprises. We need also, in parallel, the opportunities given by monetary ease, as and when justified by the current phase of the business cycle and the growth prospect.

40. Finally, as regards the best method of rectifying the external balance, I agree with the Brookings report in holding that the main reliance should be on a policy of restraint in wage and price increases.

41. If continuing progress in rectifying the basic U.S. balance can be achieved, the point will come when there will be a swing around in the unrecorded transactions, and that will make everything very much easier. There was indeed a great reduction in the figure of unrecorded transactions for the first quarter of 1963. But if, of course, the recorded capital outflow remains at the high level obtaining in the first half of 1963 and the recorded overall balance deteriorates accordingly, then we can hope for no immediate respite through a lasting swing around in the unrecorded items. We shall have to wait for a longer period before the American authorities are relieved of their acute embarrassments.

42. Further to this, I desire to emphasize again that the upsurge of private U.S. capital outflow, even if it remains at the high level of 1963, and even if it gets higher still and remains so, is nothing out of the ordinary in a free enterprise world, and is the kind of thing that is liable to happen, whether in the United States or in other free enterprise countries, from time to time. In this case it simply represents the emergence of a healthy tendency of American citizens to take a closer look at investment opportunities arising abroad.

43. Surely it is desirable that there should be enough international liquidity, both in the United States and in other countries, for changes of this sort to happen and to be carried on normal reserves, without the countries in question being compelled either to take deflationary measures restricting their own growth or to adopt unneighborly import restrictions. Furthermore, if reserves were adequate, and were seen to be, the situation would not be aggravated by perverse capital flows, such as are reflected in the unrecorded transactions.

44. The Brookings report recommends a radical reconstruction of the international monetary system, but it specifies how this should be effected only in very general terms. It is clear that it envisages something more far reaching than those measures that have already been adopted (cf. par. 18 above). The question remains how a reconstruction can be effected.

45. I feel bound to disclose that I have long been in favor of a rise in the dollar price of gold, simultaneously with an upward valuation of gold in terms of other currencies also, as the simplest method of

solving at least the major part of the problem. Members of the committee will know that there is little support for this view in the United Kingdom or in most other places. Nonetheless I feel bound in honor to repeat it in this memorandum.

46. The Brookings report states that "a measure as drastic as the devaluation of the dollar should also be rejected. Devaluation might really weaken, rather than strengthen, the dollar if other countries—especially those in the European Economic Community—devalued their currencies in line with the dollar" (p. 254). I believe that the use of the word "devaluation" has been somewhat confusing in recent American discussions. I am not here concerned with a devaluation of the dollar relatively to other currencies; I am not sure if that would have a favorable effect on the U.S. balance of merchandise trade; but I judge that it would have a very unfavorable effect on the worldwide position of the dollar and thereby on the overall U.S. balance of payments. What I am concerned with here is an upward valuation of gold in terms of all currencies. This would be a very tricky operation. But it would be much facilitated by the existing close cooperation between the principal central bankers. Great secrecy would be required during preliminary discussions. If a few key figures in the U.S. administration agreed with leaders in Congress that the thing should be done, I should suppose that the necessary legislation could be put through in a couple of days under cover of a worldwide moratorium.

47. This is not the place to deal with various objections that have been raised. I confine myself to mentioning a very broad objection, with which I have sympathy, which runs as follows: Why should mankind undergo the toilsome process of digging gold out of the ground in order to bury it again in bank vaults, when media of international reserve and settlement could be more "rationally" contrived by the issue of pieces of paper in appropriate amounts?

48. My main reason for adhering to the idea that a change in the value of gold is the simplest way of increasing international liquidity, is doubt whether any alternative system can be devised and agreed upon.

49. First there is the question of the dimensions of the problem. If we had to raise the existing amount of liquidity up to the prewar level—and I have given reasons for suggesting that we need a larger amount in existing conditions (par. 6 above)—this would require an increase in reserves of no less than \$75 billion. Of course it could be argued that we could get along with less. If we are to have a growth of 4 percent per annum in world trade, we shall need an annual increase of reserves in proportion. If we take the existing level of reserves, that would be about \$3 billion a year; but if we take the existing level supplemented as proposed above, that would involve an annual increase of about double that amount. The greater part of this could be achieved if the price of gold in terms of currencies was raised in proportion to the general rise of prices in terms of currencies since before the war, i.e., approximately doubled. This would increase the monetary gold stocks by about \$40 billion; on this basis it would be perfectly feasible to have a supplementary increase in foreign exchange reserves and in International Monetary Fund drawing rights of, say, \$35 billion together.

50. Since the Brookings report stressed the need for a major reform, it may be in place for me to touch, very briefly, on methods of achieving this otherwise than by raising the price of gold.

51. If I were permitted to be visionary, I should recommend, as the best plan, and superior to raising the price of gold, the creation of additional world liquidity by the finance, by credit "created" by a world central bank or a reformed IMF, of commodity buffer stocks. These have been under discussion ever since World War II. Quite apart from international liquidity, they are needed to bring greater stability into the economies and export proceeds of those developing countries that rely mainly on primary products.

52. Starting, perhaps, from modest beginnings, one might work to the position in which the dollar, and other currencies linked to it, would have a stable value in terms of basic commodities generally. One would have replaced a gold standard by a commodity standard. This has long been recommended by some American economists of distinction.

53. Such a commodity stabilization plan must be sharply distinguished from one in which prices are fixed by bargains between producers and consumers acting as bilateral monopolists. The prices would be stabilized (not each individual price separately but the average of prices as a whole) by the willingness of the central buffer stock to buy and sell without limit of quantity, just as on a gold standard the currency price of gold is fixed by the willingness of the central bank to buy and sell it. The money required for purchasing the stocks would not be raised by subscriptions, but would be "created" by the issue by the central agency of notes or certificates, which would be international legal tender, just as a national central bank issues notes against the receipt of gold, without having to ask for capital subscriptions. The notes issued by the central agency would be 100 percent backed by commodities, dollar for dollar.

54. It would presumably be desirable and natural for the buffer stocks of commodities to rise year by year in proportion to the world turnover of those commodities. Therefore purchases would normally exceed sales. Thus, every year additional liquidity would be created. Whether the additional liquidity so created would suffice to meet the world's needs I will not venture to pronounce. That would be eminently a matter for a study group.

55. While I would gladly renounce the gold standard in favor of a commodity standard, I must record my doubt whether world opinion is yet ready for this change.

56. There is, however, the idea that we can get an increase of world liquidity without the additional liquidity being based either on gold or on commodities. This could be done; but I believe there are serious misconceptions about the matter. It is sometimes glibly supposed that it would be just as easy for a world central bank to create media of international liquidity as it is for a national central bank to create media of domestic liquidity, granted agreement and goodwill. But this is not sure.

57. It is sometimes suggested that international liquidity could be created by "lending" by the world central bank. It might indeed be its duty to "lend" from time to time. But it is to be noted that national banks do not create the main mass of liquidity in this way. The Federal Reserve banks may lend to member banks from time

to time, whether because the requirements of the latter are going up owing to a boom in business, or because the member banks are coming back upon Federal Reserve banks after the latter have executed a squeeze in the market by open market sales. Borrowing from the Federal Reserve is usually temporary only; the outstanding amount of borrowing does not go up year after year. This is true also of the British system.

58. The main mass of domestic liquidity rises year by year because the Federal Reserve holding of Government bonds or bills rises through open market operations; similarly with the Bank of England. The domestic money supply, apart from that arising through an inflow of gold, is almost entirely based on open market purchases of Government securities by the central bank.

59. In the case of a world central bank, similarly, one could not get a yearly increase in the volume of international means of payment by a cumulative rise in the amount of "lending." Loans are in due course paid off. What would be needed would be purchases of securities. The question is how this would be done. If these purchases were conducted as open market operations, they would have to be made in countries with good capital markets—unfortunately a very small number—and presumably would have to be in terms of securities of good standing. This means that the initial benefit of such purchases would go exclusively to the rich countries, which might be thought inequitable. There is a still graver difficulty. Credit management by open market operations implies the possibility of selling, e.g., when inflation has to be checked. I have the idea that the U.S. authorities would not agree to a plan by which a world central bank could unload U.S. bonds in large quantities from time to time in the New York market for reasons which had nothing to do with the U.S. economy, but related to the condition of world liquidity. I am absolutely confident that the British authorities would not agree to such a plan.

60. I believe that reflection upon this will suggest the idea that the world central bank would not conduct its "credit creating" operations in the open market, but would obtain the securities by direct purchase from the monetary authorities of countries. In this way the difficulty about the poorer countries could be overcome, since the world central bank could accept the I O U's of their government's even if the market for these was extremely defective. But there would not be a real increase in liquidity if the various governments remained under the obligation to repurchase these I O U's, since they would have to set this liability off against any increase in their assets. The Brookings report itself says in relation to "substantial amounts of credit which should be obtainable automatically" that "there should be no fixed repayment dates" (page 249).

61. Further reflection suggests that such a scheme would really amount to an annual "handout" by the world central bank. A certain number of I O U's would be bought each year from the various countries, perhaps more in some years (those of world recession) than in others; since it is desired that the quantum of liquidity should rise progressively, the I O U's would never be redeemed. Doubtless this could be arranged on the basis of criteria relating to the annual growth of liquidity required and an equitable distribution of it among the various countries.

62. But I greatly doubt whether such a system would be acceptable— for two reasons: (1) The very idea of a “handout” is not at present acceptable; (2) there would be political difficulties in getting governments to entrust this power to any international authority. There would be fears that, whatever the system of voting, such an authority might come under pressure to make overissues. If it did so, this would lead to a depreciation of its paper. Such a depreciation might also be caused, in advance of any actual overissue, by the mere fear that such an overissue might at some time occur.

63. If I raise these objections to the idea of a “handout,” it is not because I object to it on principle. Quite the contrary. Rather it is because, as a realist, I do not believe that it would be accepted.

64. I should like finally on this topic to suggest that the difficulties that I have raised are not merely technical, but essential to the idea of credit creation by a world central bank, and unavoidable. In an attempt to demonstrate this, I would call attention to the age-old system by which individuals or nations have acquired liquid resources. First we may take the historic media, the precious metals. Countries acquiring gold or silver from their own production have done so only at a cost, namely the cost of production. If the producing countries then export gold or silver to finance deficits on their external balances, the countries receiving the gold and silver have to pay for it by their own excess of exports. Similarly when the gold and silver goes further in circulation. In the course of creating additional liquidity in the form of the precious metals, no one ever gets something for nothing. The same is true of the acquisition of “foreign exchange” for use as a medium of central bank reserve. The same is true also of the creation of credit domestically. If a central bank makes purchases in the open market, the seller of securities to the central bank, who thereby acquires the extra liquidity “created” by the central bank, will have had previously to acquire those securities by working and saving. No one in this process gets something for nothing. But in the process of “creation” of credit by a world central bank, the constituent countries would be getting something for nothing. This is a most fundamental difference. The fact that people and nations have been used for thousands of years to acquiring liquid resources in the hard way means that there will be an extreme mental block preventing acceptance of a plan by which they can secure them by means of a mere “handout.” One cannot easily alter engrained habits of thought which are thousands of years old.

65. Finally, one may consider the alternative of getting the required increase of liquidity by a large extension of mutual credits as between central banks on the lines that have recently been so skillfully devised by Mr. Roosa and by his coadjutors in other countries. What may be called the Roosa system has been a most admirable contribution to the solution of temporary difficulties, especially those due to the U.S. deficit and to occasional speculation against the two key currencies. The whole plan is marked as temporary by the firm understanding that there is an obligation to repay within a fairly short period. I would not say that the Roosa system has not caused any increase of liquidity; but the obligation to repay in a relatively short period greatly reduces the increase in true liquidity involved in the operations, and is in contrast with what I believe to be intended by the Brookings report re-

quirement for "no fixed repayment dates." It might be possible to simplify and consolidate the Roosa system by establishing large automatic mutual lines of credit as between the central banks, which, if the requirement for world liquidity is to grow year by year, must themselves grow year by year. If there are no fixed repayment dates and no presumption that repayment will be made at a fairly early date—both necessary prerequisites for an increase of true liquidity—this system also might well be deemed to involve what would be, so far as anyone could foresee, large "handouts."

66. It is to be noted that a once-over increase in the price of gold would serve to raise the rate at which liquidity in the form of gold is likely to increase for a good many years ahead, (1) because it would increase the dollar value of future output, (2) because it would stimulate output, and (3) because it would reduce seepage into private hoards. I am confident that world opinion would accept a present revision in the price of gold in amount proportional to the wartime and postwar loss in the commodity value of the dollar as a once-over operation, not likely to be repeated.

67. I would advance a basic proposition. I do so with great diffidence and complete readiness to be corrected if I am wrong. There are only three ways in which a permanent rise in the rate of increase in the amount of liquidity available for international settlement can be generated, namely (1) by a once-over increase in the currency value of gold, (2) by using actual commodities as the basis for a world central bank note issue, and (3) by annual handouts. I believe that the unwillingness of opinion to accept the idea of handouts, rather than any technical difficulties, is what will prevent the creation of a world monetary system alternative to the use of gold. As a visionary I would give preference to the three schemes in the following order: (1) handouts, (2) a world currency based on commodities, and (3) a rise in the price of gold. But in my estimate of probabilities, as a realist, I believe that the likelihood of their adoption is in the reverse order, despite the oft-repeated statements by the U.S. authorities, including the President himself, adverse to raising the dollar price of gold.

68. I am convinced that an increase in international liquidity is the most important single thing that can be done to insure the viability of the system of free enterprise and to promote human welfare.

STATEMENT BY HANS HEINEMANN

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My criticism of the Brookings report is that it is primarily an economic study, and the projections are based on assumptions drawn almost entirely from past behavior. While the study expresses an awareness of changing and possible future patterns, these are not and cannot be part of the assumptions on which the projections are based. The projections are an interesting exercise in historicism, but, in my opinion, are very open to question as indicators on which to base future U.S. monetary and fiscal policy.

For example:

1. Projection of investment in foreign dollar bonds

On the basis of past behavior, it is projected that there will be a net increase in U.S. investment in foreign dollar bonds of \$5 billion between 1961 and 1968.

(a) Already the proposed 15-percent tax on the purchase of foreign securities makes this projection very doubtful.

(1) It is very questionable whether U.S. institutions or the borrowers will pay an additional 15-percent tax to buy or sell foreign dollar bonds.

(2) The countries which are exempt from the tax are not in a position to attract as much as \$5 billion in additional U.S. dollar bonds between 1961 and 1968.

(b) Even if the 15-percent tax is not approved by Congress, it is questionable whether \$5 billion will be available in foreign exchange. The United States does not have a billion dollars a year in foreign exchange for this purpose. To invest this amount in foreign dollar bonds, it would have either to—

(1) Tie its private loans to purchases in the United States, as often done in Switzerland, Holland, and other countries, or

(2) Borrow on a short- or long-term basis abroad. In this case, U.S. tax laws would have to be changed as present laws practically prevent private U.S. corporations from borrowing in foreign capital markets.

In any event, the Brookings report does not discuss tied loans in the private sector or U.S. borrowings abroad. It does not say where the money will come from, bases its projection only on past behavior.

2. Projection of interest and dividend income on investments abroad

(a) Interest income, which the Brookings study has said will increase from \$697 million to \$925 million from 1961 to 1968, can be reasonably projected on the basis of outstanding and potential loans, with proper allowance for default. However, if the 15-percent tax goes into effect, the Brookings figure appears optimistic, as new loans will decline.

(b) The study has projected an increase in dividend income from direct investments from \$2.7 billion to \$4.5 billion from 1961 to 1968.

Dividend income reflects—

- (1) Business conditions abroad,
- (2) Corporate payout policies,
- (3) The political decisions of host countries as to convertibility and as to their potential local participation in the foreign enterprise concerned.

It is possible to make a fairly reasonable projection on interest income, but because of the above elements affecting direct investments it is hardly possible to estimate dividend income. Any projection which fails to take the above elements into consideration is meaningless, and it is not possible to measure these elements economically.

3. *Projected increase in "GNP prices" in Europe*

The Brookings study predicts price rises from 1961 to 1968 of 3 percent per annum in Italy, France, and West Germany, of 2.1 percent in the United Kingdom, an average of 2.75 percent for the four countries.

Since the study has been made, prices have gone up by 8 percent in Italy in 1963. Recently Italy has gone sharply to the left politically, an event which may well cause further inflation.

It is quite possible that Labor will go into power in the United Kingdom.

There is a leftward political trend in Europe, and as a government with leftward leanings will be less committed to orthodox methods of financing, price increases are apt to be further stimulated in this kind of political climate. A leftish government is also likely to have less interest in heavy dividend remittances abroad and in sharing military expenditures.

To repeat, a statistical projection of price increases without consideration of political trends has little meaning, as proven by the fact that actual developments have already overtaken the projection in the Brookings study.

4. *Projections of military and other foreign aid expenditures*

These projections are based on conditions which existed before the Chinese-Russian break. This break could have considerable effect on international trade, on Russia's whole relationship to her European satellites and, perhaps, consequently on the U.S. military posture, giving the Brookings projections little real meaning.

The above examples, taken at random, indicate that I consider an economic approach to the problem of the U.S. balance of payments as totally inadequate.

I miss in the report a penetrating analysis of the causes of the balance-of-payments problem in the United States of today and tomorrow. We need a study of the philosophy of American business as stated by American business leaders and the philosophy as stated by political leaders of the host countries such as Mr. Diefenbaker and Mr. Gordon of Canada and Mr. Calwell of Australia. We need a discussion of the philosophy of U.S. Government foreign aid as expressed by the Eisenhower and Kennedy administrations, on the one hand, and the philosophies of their opponents on the other; a discussion of the present American foreign military policies on the one

side, and the alternative policies advocated by those who recommend that the United States should have a token military establishment in European countries to serve as an alarm clock, but not as military establishments in depth.

I am of the opinion that basically the U.S. economy is a very strong one, and that with discipline the country can handle its balance-of-payments deficit. It cannot afford to rely on inflationary policies in Europe to resolve the problem.

STATEMENT BY RANDALL HINSHAW

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Claremont, Calif.

At the outset, I would like to associate myself with the many expressions of high praise for the Brookings analysis of American payments difficulties and prospects. The quality of this thoroughly professional study is exceedingly high, reflecting throughout the most careful and patient consideration of the discouragingly large number of variables which could significantly affect the payments outlook.

Seldom, moreover, have economists been more candid about the limitations of their projections. Repeatedly, the authors refer to the many possibilities for error in view of the numerous road-forks in their assumptions, and it is clear that no one will be less surprised than they if their projections should miss the mark. Accordingly, they properly place greater emphasis on their analysis of current difficulties than on what, despite their warnings, will undoubtedly be widely regarded as predictions.

In their projections for 1968, the authors envisage a situation in which the existing "basic deficit" either is replaced by a surplus or, under a less favorable set of assumptions, is reduced to modest dimensions. That is to say, they deduce from their assumptions that the American export surplus of goods and services in the late 1960's will be large enough to outweigh, or at least roughly to balance, the net outflow of private long-term capital plus the net outflow of U.S. Government grants and loans. Since the authors assume that the sum of the two latter net outflows will be somewhat greater in 1968 than in the early 1960's, the projected improvement in the basic balance is entirely attributable to a large increase in the export surplus.

This rather optimistic deduction rests mainly on the assumption that forces are at work which are restoring the United States to a more competitive position, particularly in relation to Western Europe. As I read the Brookings study, I get the distinct impression that the authors are persuaded that, in the arena of international competition, time is on our side. Since this is obviously a matter of central importance to the outlook for the late 1960's, and since it is the only factual matter on which I find myself seriously at issue with the authors, I would like to limit my comments to some broad observations relating to the recent and prospective competitive position of the United States. In doing so, I would like to make it clear that I am under no illusion that my crystal ball is less clouded or more reliable than that of the authors; I wish merely to state that, for the time being, it reveals a somewhat darker picture.

I agree with the Brookings authors that, with regard to international competition, attention should be centered on the sector of manufactured goods, particular with reference to Western Europe and Japan. Like the authors, I am impressed with the decline in the

American competitive position during the 1950's, as evidenced by the falling share of the United States in world exports of manufactures and by the rise in U.S. relative prices of capital equipment, vehicles, and other manufactured goods. But the authors are persuaded that the competitive outlook has altered considerably for the better since 1959 and, partly for this reason, they project a decline in U.S. relative prices during the 1960's.

This assumed future decline in U.S. prices relative to prices abroad is of great importance in accounting for the projected improvement in the American balance of payments. Under the initial set of Brookings assumptions, the net effect of the assumed price changes, according to table III-8 of the study, is to improve the U.S. trade balance from 1961 to 1968 by \$4.4 billion. Under the less favorable alternative set of assumptions, the net effect is to improve the trade balance by \$1.3 billion. In either case, the projected improvement in the trade balance is much greater than the projected improvement in the basic balance, mainly because of a projected sharp increase in Government grants and loans.

Since the assumed price changes, particularly under the initial set of assumptions, are by far the most important source of the assumed improvement in the U.S. balance of payments, a great deal depends on whether these price assumptions are realistic. It is here where I find myself taking a more somber view than the Brookings authors.

My reasons can be briefly stated. In the first place, I attach considerable importance to the steady decline over the past decade in the share of the United States in world exports of manufactured goods (see Brookings table III-1). Moreover, I am impressed that, except for 1960, the U.S. share has continued to decline since 1959, and in 1962 reached a new low.

In seeking an explanation for such a trend, I would be strongly inclined to suspect a persistent rise in U.S. export prices of manufactured goods in relation to the corresponding export prices of our principal competitors. And this is exactly what the available export price indexes show.

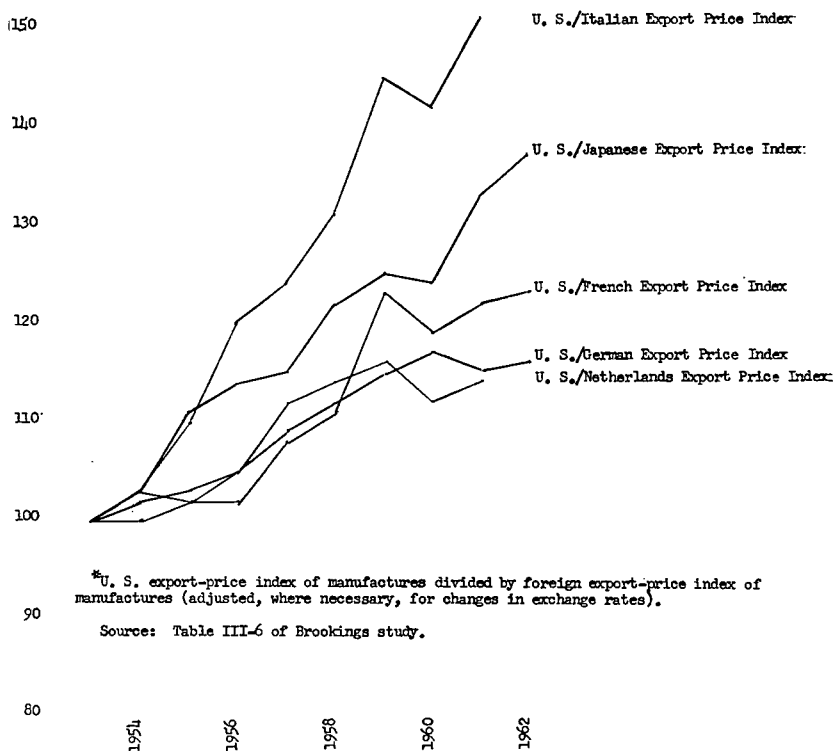
Chart 1 is derived from the data in table III-6 of the Brookings study. The series are obtained by dividing the U.S. export price index of manufactures by the corresponding export price index (adjusted, where necessary, for changes in exchange rates) of selected leading competitors in the sector of manufactured goods. In each case, relative U.S. export prices have risen sharply during the past decade. Indeed, with reference to Italy, United States relative export prices of manufactures were (on the average) 51 percent higher in 1961 than in 1953 while, with reference to Japan, they were 33 percent higher (37 percent higher in 1962).

To me, the striking thing about this chart is that, while it reveals an interruption in the upward trend of U.S. relative prices from 1959 to 1960, the interruption appears to have been temporary. In particular, there is no indication of a reversal in the trend. And if the U.S. export price index of manufactures is divided by the U.S. import price index of manufactures (the latter index of course being a measure of the export price level, in dollars, of the rest of the world in its trade with the United States), the trend of U.S. relative prices from 1951 through 1962, except for a slight drop from 1953 to 1954, is evenly

CHART 1

U. S. RELATIVE PRICES OF EXPORTS OF MANUFACTURED GOODS*

(1953 = 100)



Figures for chart 1

	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
United States-Italy.....	100	103	110	120	124	131	145	142	151	137
United States-Japan.....	100	103	111	114	115	122	125	124	133	123
United States-France.....	100	100	102	102	108	111	123	119	122	123
United States-Germany.....	100	103	102	105	112	114	116	112	114	114
United States-Netherlands.....	100	102	103	105	109	112	115	117	115	116

upward, with no interruption after 1959.¹ In this connection, it is interesting to note that while the U.S. export price index of manufactures was 23 percent higher in 1962 than in 1951, the U.S. import price index of manufactures was actually 2 percent lower.

Chart 1 reveals a disturbing picture, and a number of efforts have been made to show that the situation is not as alarming as it looks. The Brookings authors, for example, point out that the upward movement in the U.S. export price index since 1959 has not been matched by the U.S. wholesale price index of manufactures, which has remained stable. They attribute part of the discrepancy between the two series to certain well-known deficiencies in the export price index, but they do not explain why these deficiencies should give the index an upward bias. Until this mystery is satisfactorily explained, it would seem to me ill advised to discount the persistent rise in the export price index.

In any case, my assessment of the competitive outlook for the United States does not rest solely, or even mainly, on the behavior of export price indexes.

What impresses me more is the spectacular increase during the past decade in output of manufactures per man-hour in Western Europe and Japan, compared with the more modest increase in the United States. This development is shown in chart 2 in which, for each country, an index of production of manufactures is divided by an index of man-hours in manufacturing. Perhaps the most significant fact about the chart is that the dramatic increases in Western European and Japanese output per man-hour, which I would attribute mainly to the high rates of investment that have prevailed during the postwar years, have shown little, if any, tendency to diminish; and I would guess that, as long as the rate of investment in these countries remains substantially higher than the rate of investment in the United States, the relatively weak performance of the United States will continue.

To some extent, of course, this development has been offset by a tendency for wage rates to rise more rapidly in Western Europe and Japan than in the United States. But, for the countries in chart 2—with the conspicuous exception of Germany—the offset has been only partial. Hourly wage rates in manufacturing, when corrected for changes in output per man-hour, were between 2 and 3 percent higher in the United States in 1962 than in 1953 whereas, in Italy, they were 12 percent lower and, in France (after adjustment for the French devaluations), were 18 percent lower. In Japan, according to one wage index, labor cost per unit of output in manufacturing was about 1 percent higher in 1962 than in 1953 while, according to another wage index, it was 6 percent lower. Thus in Italy, France, and Japan, the labor-cost position relative to the United States was more favorable in 1962 than in 1953. It should be remembered, moreover, that 1953 was not a year of overall balance in the U.S. international accounts, but was rather a year in which the basic deficit was \$2.6 billion.

The improvement in the Italian, French, and Japanese competitive position has not been shared by Germany, where the rise in labor cost

¹ To avoid confusion, this series is not shown in chart 1. The figures for the series are as follows: 1951, 100; 1952, 102; 1953, 104; 1954, 103; 1955, 106; 1956, 109; 1957, 114; 1958, 117; 1959, 120; 1960, 121; 1961, 122 and 1962, 126.

per unit of output during 1953-62 was much greater than in the United States. A factor contributing to the rise in German costs was the 5-percent appreciation of the deutsche mark in 1961. The deterioration in the German competitive position has been reflected in a shift from a large overall payments surplus to a situation of approximate overall balance.

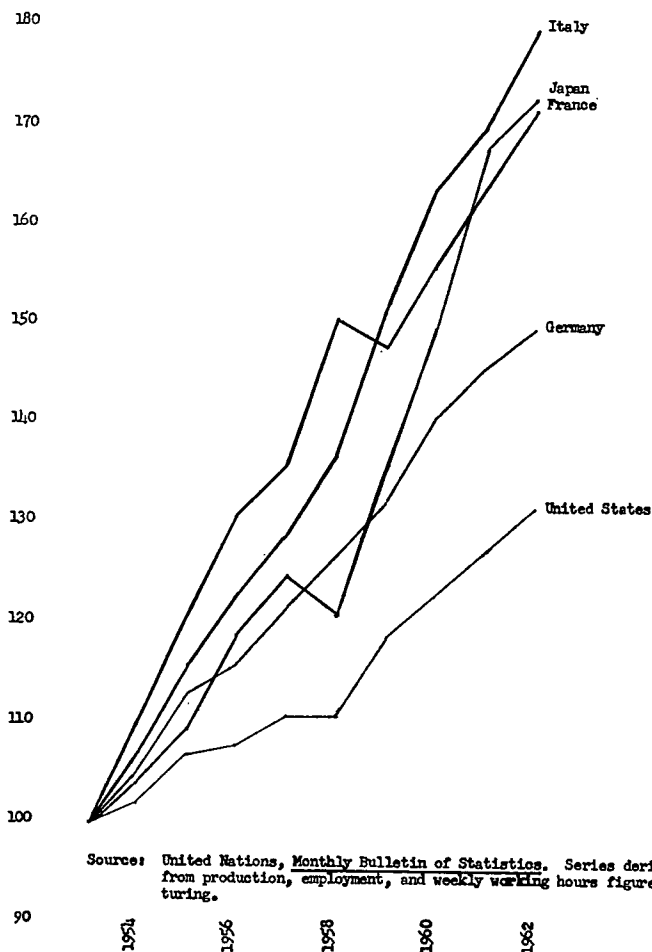
The foregoing considerations lead me to the view that hopes for an improvement in the American balance of payments, based on a projected decline in U.S. prices relative to those of our principal competitors, may be sadly misplaced. Of course, there are many imponderables. For example, the European Economic Community may move in the direction of increased protectionism, with unfavorable effects on European costs and prices. Under these conditions, the American trade balance in manufactures might improve both in relation to Western Europe and in relation to those areas where the United States and Western Europe are competitive suppliers. But such a gain in the sector of manufactured goods would probably be offset by a decline in exports of American foodstuffs to the important European market. On the other hand, it is conceivable that there may be an increasing cash market for American foodstuffs behind the Iron Curtain.

All of this, however, is highly speculative, and I remain skeptical of the Brookings projections, mainly because they rest in considerable degree on optimistic assumptions which the authors apparently had no part in choosing. Partly because I am less optimistic than the authors are about the American balance of payments, I am less impressed than they appear to be with the virtues of rigid exchange rates—particularly since our competitors, when confronted with serious payments difficulties, are far more likely to alter these rates than we are. The result, for us, may well be the worst of both worlds.

CHART 2

OUTPUT PER MAN-HOUR IN MANUFACTURING IN SELECTED COUNTRIES

(1953 = 100)



Figures for chart 2

	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
Italy.....	100	107	116	123	129	137	152	164	170	180
Japan.....	100	104	110	119	125	121	136	150	168	173
France.....	100	110	121	131	136	151	148	156	164	172
Germany.....	100	105	113	116	122	127	132	141	146	150
United States.....	100	102	107	108	111	111	119	123	127	132

STATEMENT BY HENDRIK S. HOUTHAKKER

Professor of Economics, Harvard University, Cambridge, Mass.

The Brookings report is clearly an important document. It presents a thorough and competent analysis of the American balance of payments which leads to definite predictions and recommendations. Its influence is already visible in recent policy developments, for it not only provides much needed arguments in support of established policies (such as tax reduction and the maintenance of prevailing exchange rates), but it also appears to be behind the recent switch in the official U.S. attitude concerning international liquidity. Its principal conclusion, put briefly, is that the balance-of-payments problem will in due course disappear without additional measures, and that official attention should now be concentrated on the liquidity problem.

A detailed critique of the report would require at least as much work as its numerous and distinguished authors put into it and is, therefore, out of the question here. Nevertheless it is possible to indicate some areas where the Brookings analysis is unconvincing or seriously incomplete. As it happens, these areas of doubt are of crucial significance to the conclusions of the report. They can be discussed under two headings: the competitive position of the United States and the relation between GNP and the balance of payments (including the effect of a tax cut).

THE COMPETITIVE POSITION OF THE UNITED STATES

In the Brookings report the problem of competitiveness is studied almost entirely from the behavior of price index numbers here and abroad during the 1950's and early 1960's. Although some valid and useful conclusions can be derived from this approach, it is too limited in scope. The underlying assumption (see footnote 1 on p. 70 of the report) is that the early 1950's, and in particular 1953, were a "normal" period, and that the balance of payments only deteriorated thereafter. This assumption cannot be accepted. As table I-4 of the report shows, the U.S. basic deficits in 1950 and 1953 were among the largest since World War II, being exceeded only in 1958 and 1959. Indeed this table does not bear out the common belief that the U.S. deficit has become worse in recent years; what has happened is merely that the deficit has become more obvious because foreigners gradually lost their initial eagerness to accumulate dollar balances for reserve purposes. It is, therefore, an exaggeration to attribute as much importance to relative price movements during the 1950's as the report does.

For a more adequate understanding of the competitive position of the U.S. economy it is necessary either to go further back in history than the 1950's or to rely on direct comparison of the general price levels in different countries. The historical approach is a little difficult to carry out because it requires going back before World War II, but in one case at least (that of the United Kingdom) it can be shown

that the present official value of the dollar in terms of another currency is too high in relation to its prewar value, after allowance for price movements.¹

Direct price comparison also presents problems, but they are not insuperable either. Some official German data on purchasing power parities were discussed in an earlier paper written for the Joint Economic Committee.² Just recently the well-known OEEC study by Gilbert and Kravis for the years 1950 and 1955 was carried forward to 1960.³ Although these figures are still not as up to date as one would like, they are useful as a partial corroboration of the German data just mentioned. From them the following table is derived:

Overvaluation of the dollar with respect to various currencies in 1960

<i>Currency</i>	<i>Percentage</i>	<i>Currency</i>	<i>Percentage</i>
Pound sterling-----	16	Italian lira-----	30
German mark-----	22	Dutch guilder-----	34
French franc-----	22	Danish crown-----	23

Since 1960 the overvaluation of the dollar has been somewhat reduced, mostly because U.S. prices have not risen as much as European prices, and in the case of the mark and the guilder also because of the revaluations in 1961. Even now, however, the dollar is probably overvalued by some 15 or 20 percent with respect to most European currencies.

This overvaluation is at the heart of the American balance-of-payments problem. It can be traced to the European devaluations of 1949, which turned out to have been excessive. The existence of overvaluation is evident not only from price comparisons (whether static or dynamic), but also from the joint appearance of domestic unemployment and an international deficit in the United States.

The failure of the Brookings report even to consider this point (which is not new) detracts seriously from the reliability of its conclusions and forecasts. In essence the competitive weakness of the American economy is not due to the minor movements in relative prices that occurred during the 1950's; it already existed at the outset of the period analyzed in the report. In the early 1950's, however, American exports were temporarily stimulated by the aftermath of World War II, which had destroyed the export potential of Europe and Japan and created an abnormal demand for investment goods and farm products from the United States; this explains the high U.S. share in world exports during those years of recovery.

That the approach of the Brookings group leads to an overemphasis on short-term price movements appears to be implicitly admitted on page 82 of the report. There the Polak-Rhomberg equation for European imports from the United States is found to yield an unacceptably high price elasticity and is therefore arbitrarily reduced from 4 to $2\frac{1}{2}$.⁴ The high elasticity estimate was probably due to neglect of the factors mentioned above. In this context it should also be noted that there is really no such thing as "the" elasticity. This concept

¹ See the author's calculations in *Challenge of October 1962*, based on an OEEC study by Paige and Bombach.

² "Exchange Rate Adjustment" in *Factors Affecting the U.S. Balance of Payments (1962)*.

³ By Kravis and Davenport in the *Journal of Political Economy*, August 1963.

⁴ The coefficient of European GNP in the same equation, used in ch. II, is not modified, which leads to an inconsistency in the forecasts.

should more properly be defined with reference to a time interval; it will generally not be the same for the short run as for the long run. The unhappy history of the econometrics of international trade suggests that this dynamic element should always be taken into account.

The upshot of the preceding comments is that the Brookings report, having put too much weight on past price movements, may also be too optimistic in its appraisal of future movements and their favorable effect on the U.S. balance of payments. Indeed it is quite likely that the existing overvaluation has not yet exercised its full impact on the pattern of world trade. As was argued elsewhere⁵ the large volume of U.S. direct investment in Europe may be attributed in part to differences in money costs of production caused by unrealistic exchange rates. In many cases the output produced from this investment will compete directly with U.S. exports. For instance, office equipment manufactured by an American firm in Europe is likely to be more competitive with American-built office equipment (which will usually be of identical or similar design) than with purely European products. The American firm, in fact, will often be tempted to sell its European output to its established market in the United States. There are, however, a number of offsets, for which see Table V-8 of the report. Much of this direct investment is of recent date and not yet in full use, so that its ultimate influence on the balance of payments is mostly a matter of conjecture.

THE STATE OF THE DOMESTIC ECONOMY IN RELATION TO THE BALANCE OF PAYMENTS

It has been one of the principal tenets of the modern theory of international trade that a country's international deficit is larger (or its surplus smaller) the higher the level of its GNP, economic conditions abroad remaining the same. This short-run relation holds primarily because the demand for imports tends to increase with domestic income; the supply of exports (which often contain an element of surplus disposal) will reinforce this tendency. Although it has also been recognized that capital movements may go in the opposite direction, this countereffect has customarily been regarded as minor. By means of the overall relation it is possible to explain the joint movement of national income and international payments, whether under the classical gold standard, under flexible exchanges, or under the prevailing gold exchange standard. A remark made previously, namely that the simultaneous occurrence of unemployment and an international deficit indicates overvaluation, is also based on this generally accepted theory.

The Brookings report argues that the opposite is true. The favorable effect of full employment on capital movements will be larger, it is held, than the unfavorable effect on current transactions (see especially pp. 21-23). No one should object to the author's refusal to follow a theory merely because it is widely accepted, for in this field there remains much room for honest differences of opinion. Unfortunately the evidence offered by the authors in support of their heresy is slender indeed. It is mostly derived from a study of the 19th and early 20th centuries, even though (as the report admits) its relevance to present conditions is very doubtful. During this early period the

⁵ See the paper quoted in footnote 2 above; the same point is made on p. 139 of the Brookings report.

United States was a capital importer, and the evidence for the interwar period, which is more like the present, does not confirm the Brookings view. This is another essential point on which the report is unconvincing.

In this connection the Brookings interpretation of the Japanese case (pp. 27-28) is remarkable. For the past decade or more Japan has maintained full employment with an exceptionally high rate of growth, and it has also had recurrent balance of payments difficulties. This, of course, is just what the accepted theory would predict. The report argues that the Japanese economy would have grown even more but for the balance-of-payments constraint. While it would be hard to disprove this hypothetical contention, it should be noted that it does not fit in with the Brookings view discussed above, according to which the boom in Japan would attract so much foreign capital that no balance-of-payments problem would ever emerge.

The Japanese case, incidentally, is also a striking instance of the power of overvaluation and undervaluation in determining a country's economic progress. Although the available data on Japanese prices are not easily comparable with American and European data, there is reason to think that the yen is even more undervalued in relation to the dollar than most European currencies. This is no doubt one reason why Japan, a country heavily dependent on exports, could so rapidly expand its output despite the virtual loss of traditionally important markets (notably China). The exchange difficulties which it experienced nevertheless are attributable to the tremendous demand for investment goods associated with the steep rise in productive capacity.

To return to the United States, the question discussed in this section has a direct bearing on the tax cut that is still before Congress. As far as the domestic economy is concerned the case for a tax cut is beyond dispute. In its support we are also told, however, that it will improve the balance of payments, in accordance with the Brookings position. It must be feared that this particular argument contains a generous dose of wishful thinking. If a tax cut is enacted and employment increased the balance of payments is likely to deteriorate further, and the need for corrective action (such as devaluation of the dollar) will become even more pressing.

CONCLUDING REMARKS

There are several other matters on which it is possible to disagree with the Brookings report, but they are mostly of minor importance and do not reflect on its generally high quality of analysis. One not so minor matter, which has attracted worldwide attention even though it appears only as an afterthought in the report, is the emphasis on international liquidity, which seems greatly exaggerated. It would be highly regrettable if as a result of the report intensive efforts were made to solve the secondary problem of liquidity while the primary problem of international equilibrium continues to be ignored.

STATEMENT BY JAMES C. INGRAM

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Economists may occasionally foresee with accuracy the broad results of a given policy, but economic science does not equip them to make precise calculations of future magnitudes. The usual hazards of numerical prophecy are greatly increased when one is required to estimate the net outcome of several items, where the value of each item is subject to large error. I predict that the most frequent comment made in critiques of the Brookings report will be some variation on G. D. A. MacDougall's remark about the difficulty of predicting changes in the marginal part of a marginal part.

The Brookings authors are of course well aware of the enormous difficulty of their task. The report is full of hedges, qualifications, and warnings to the reader that the numbers are not really to be relied upon or taken very seriously. I think the authors would agree that, even if the 1968 basic balance should turn out to be exactly equal to their projection, it would probably be a lucky accident, and that such an outcome would have occurred for reasons quite different from those they used to obtain the projection. Still, despite all their qualifications and warnings, they do set forth numerical estimates for the several items in the U.S. balance of payments for 1968, and for the "basic balance" in that year, and these estimates are (in some places) solemnly used in the discussion of policy.

One wonders why the numbers were retained. Perhaps the prevailing fashion for quantification in all things was partly responsible. While a physicist might firmly decline as unfeasible an assignment that lay beyond the reach of existing knowledge, techniques, and data, economists are prone to accept any quantitative challenge, bravely marshaling equation, regression, a few past observations, and "our best guess." Of course the numbers do serve as a useful expository device, and the Council of Economic Advisers did ask for them. Still, numbers are seductive, and many readers will take the final estimates more seriously than the text of the report warrants. Indeed, in some places the Brookings authors are themselves seduced by the numbers (no pun intended) and led to treat them as a basis for the determination of policy.

My own opinion is that no confidence whatsoever can be placed in the numerical estimates, gross or net, if judgment is based on the evidence presented to support them. The study director himself states that "the value of the projection lies less in its quantitative result than in the process of obtaining the result (p. 31)," a judgment I would entirely agree with, for this report certainly contains much valuable and illuminating analysis of various factors affecting the U.S. balance of payments. I think myself that the report might have been stronger and more useful if the discussion had centered on the probable direction of effect of various factors and

policies bearing on the basic balance, with some attempt to assess the extent to which the United States might have to press policy in particular directions, given alternative European reactions, in order to eliminate the deficit. Such an approach would surely have been attacked as excessively vague and qualitative, however, and it would have yielded no easily summarizable results.

Leaving entirely aside the methods and assumptions used by the Brookings authors, one might well prophesy a similar change in the basic balance simply by arguing that the United States is now so exercised about her deficit that she is bound to press for improvement, while Western Europe is prepared to relax a bit, and perhaps even to accept the elimination of its surplus, which means that the U.S. basic balance could swing to a surplus equal in size to net absorption of gold into monetary reserves—i.e., about \$650 million, a figure about halfway between the two Brookings estimates.¹ This outcome might occur with a great many different combinations of growth rates, price changes, and policy combinations in Europe and the United States. Given the determination to carry out policies leading to this outcome, the chances that the particular combination of fact and policy assumed by the Brookings authors would turn out to be the actual one seem extremely small.

PROJECTIONS AND PROCEDURES

In inviting comments on the report, the Joint Economic Committee asked especially for an appraisal of the procedures leading to the numerical projections, rather than for a discussion of policy recommendations. Broadly speaking, the report uses a simple model, based on 1948–60 least-squares estimates plus exogenously determined assumptions for income growth and price change, to project the current account. A variety of methods are used to project the remaining items—capital movements, economic aid, and military expenditures—as well as to modify parts of the initial current account estimates, but the subjective element plays a substantial role, and economic models a rather minor one, in these latter projections.

The economic model used for current account projections has a conventional emphasis on price and income effects. Rising income tends to worsen a nation's merchandise trade balance; so does a rise in a nation's prices relative to foreign prices. Some attention is given to the supply or capacity effects of economic growth in the text discussion, but the actual estimating technique seems to make little allowance for this effect except insofar as it influences the magnitude of price changes. I consider this a defect in the report. Although the authors argue that rapid growth may be accompanied by (perhaps even cause) a strong balance of payments, the model used for current-account projection does not work this way. Since the Brookings authors were instructed to assume that the U.S. growth rate (4.8 percent per year) exceeded that of Western Europe (4.3 percent per year), the income effect taken alone tends to worsen the U.S. basic balance; but the assumption that European price rises will exceed those in the United States leads to an even larger improvement in the U.S. basic balance. These assumptions, crucial to the numerical re-

¹ Note, however, that the Brookings authors say their own best guess is that the U.S. basic deficit will be eliminated, but not turned to surplus, by 1968 (p. 230).

sults, have drawn some fire in the press, and they do seem a little odd when compared with the 1950's, as follows:

[In percent]

	United States		Western Europe	
	Assumed, 1961-68	Actual, 1953-60	Assumed, 1961-68	Actual, 1953-60
GNP growth rate.....	4.8	2.5	4.3	4.7
Prices of GNP.....	1.5	2.2	2.7	3.2

Thus it is assumed that the U.S. growth rate will nearly double, but despite this rise toward full employment the rise in U.S. prices will be only two-thirds as fast as in the 1953-60 period when unemployment was higher. Europe, on the other hand, will have a slightly smaller rate of growth and a slower price rise, but still European prices are expected to rise by nearly twice the U.S. rate. (The task of projection requires many such sweeping assumptions about complex matters. One might say that the continuing debate about the compatibility of growth and price stability is here settled by assuming that rapid growth without inflation can be achieved in the United States, though a slower rate of growth will produce more inflation in Europe. Some rationale is offered for these assumptions, but we obviously could not expect definitive treatment of such central issues in economic theory and policy in this report.)

The income and price effects projected in chapters II and III are not predictions of the most likely actual results but are estimates of the results to be expected if the stated assumptions and aspirations of the CEA are achieved. The authors clearly state that their task is to deduce the results of given assumptions, but in some places they veer toward prediction of magnitudes actually to be expected in 1968.

The treatment of policy response by governments is ambiguous. Sometimes a policy response is allowed for, sometimes not. For example, in estimating price and income effects in chapters II and III, price increases arising from cost-push factors in Europe are projected. These price rises are incorporated in the estimated price-effect on merchandise trade, and they have a powerful effect on the net balance. Although the income and price projections imply the development of excess demand in Europe and additional inflationary pressure on that account, no allowance is made for additional price rises on the ground that European governments probably would not tolerate it. "Governments might seek to limit inflationary pressures by scaling down their expenditures, or by raising taxes to keep consumer demand from growing as quickly as projected (p. 52)." Why the probable policy response is allowed for in one case but not in the other is not explained.² Other examples of differential treatment of policy response are found in other chapters.

I do not mean to imply that the Brookings authors were unaware of any of the above matters. Taking the report as a whole, one is impressed by the lengths to which they go to qualify statements and warn

² It should be noted, however, that in the alternative set of assumptions the European price rise is scaled down specifically to reflect a different policy response on the part of the governments concerned.

readers about reliability of data. Thus they question whether the tendency they foresee toward a U.S. surplus can in fact occur in view of the likely European response. "West European countries probably would take measures to cut their imports and restrain demand—even at the cost of slower growth (p. 242)." My point is that one can't see why some such response is allowed for in the projections themselves, and some is not.

The price effect is a very large element in the projected change in the U.S. basic balance. It converts a \$2.6 billion net debit arising from the income effect into a \$1.8 billion net credit—i.e., its total effect on the basic balance is plus \$4.4 billion. However, as the author of chapter III emphasizes, the analytical basis for projecting the price effect is quite unsatisfactory, and little confidence can be placed in the results. Another interesting departure from the model was made in this chapter. The elasticity coefficient implied by the model, over 4, was thought "too high to be plausible," so the figure 2.5 was used, a change that had a very substantial effect on the final estimate of the basic balance. Despite the unsatisfactory numerical results, chapter III is a valuable analysis of the vital question of the U.S. competitive position vis-a-vis Europe. The difficulties are clearly set forth, and some urgent research tasks are indicated.

The more subjective estimates of capital movements, economic aid, military expenditures, and the effects of the European Economic Community are accompanied by explanatory discussion that is interesting, thoughtful, often ingenious, and plausible, but the numerical estimates finally made are not particularly convincing. Here, too, the chief merit of the report lies in its analysis of the issues and of the direction of effect of possible U.S. actions. The authors obviously regard the analytical discussion as their chief contribution; the numbers are sometimes supplied almost as an afterthought. With each item subject to a wide margin of error, the net effect on the basic balance of the sums of debit and credit items can have no statistical significance.

Some miscellaneous comments follow:

1. I think the statement in chapter I, that "the outflow of private capital appears as the biggest 'cause' of the increase in the basic U.S. deficit" between 1953-55 and 1958-60, is unfortunate. Although it is immediately qualified in the subsequent section, the statement stands as ammunition for those who wish to use it. It is not supported by any evidence and, indeed, seems contradicted by later sections, especially chapter V.

2. The alternative set of assumptions does not alter much except the projections of merchandise trade. Since the United States-Europe growth rate differential is preserved (both rates lowered), the adverse income effect still remains. But the assumption of smaller price changes in Europe removes most of the favorable influence of this effect and thus the U.S. basic balance remains in deficit.

The Brookings authors devote most space to the initial set of assumptions, but they show a slight preference for the alternative set as a prediction of the 1968 position (pp. 225-226).

3. An ingenious analysis of the EEC tariff is contained in chapter IV. The external tariff is compared with the former national tariff of the chief exporter in the EEC, on the assumption that the protection accorded the lowest cost producer is the vital issue as far as

U.S. exporters are concerned. It is shown that on this interpretation the formation of the EEC has distinctly increased the level of protection in Europe. More detailed studies along this line should be undertaken and used to guide U.S. negotiators in GATT.

The importance of U.S. agricultural exports to Europe is properly stressed in this chapter. The outcome of U.S. efforts to persuade the EEC to accept freer trade in agricultural products conceivably could affect our payments position as much as any other issues discussed in this report. These efforts deserve the highest priority.

4. Even though excess demand, labor shortage, and rising prices were envisaged for Europe in chapters II and III, in chapter IV it is argued that no pressures toward retardation of European exports can be expected. The argument on this point is curiously weak ("in an industrially advanced country, output usually can be increased" (p. 113)).

POLICY

In their final chapter, "Policy Recommendations," the Brookings authors are primarily concerned with reform of the international monetary system. This emphasis follows from their argument that a shift to a surplus in the U.S. basic balance would not solve our "balance-of-payments problem," but would merely change its form and in such a way as to produce grave difficulties for the world economy and to imperil U.S. objectives. The argument centers on the adequacy of international monetary reserves, and it is shown that probable fresh supplies of monetary gold will not be large enough to supply the minimum increment to world reserves in the 1961-68 period. The world has no mechanism capable of generating the needed increase in liquidity.

It is also emphasized (correctly, in my opinion) that the key issue in the U.S. deficit is the willingness of owners of wealth to hold dollar assets, and thus the question of confidence becomes crucial. Governments will require larger reserves in 1968, but will they accept dollar assets? Given complete confidence in the maintenance of present exchange parities and the present price of gold, governments might accept or even prefer dollar assets. Furthermore, if capital movements became freer, equilibrating capital movements could be expected to take some of the pressure off the official reserve element, and international adjustments could become more similar to interregional adjustment. This last possibility is regarded as rather far off, however, and the Brookings authors therefore urge international cooperation to develop new institutions capable of supplying the growing requirements for liquidity.

My own opinion is that the Brookings authors devote too little space to positive actions that could be taken to move toward a system of permanently fixed exchange parities; they underestimate the importance of interest-rate differentials; they exaggerate the need for an international institution to supply additional liquidity; and they do not sufficiently emphasize the need for bold steps to remove restrictions on capital movements. Such an emphasis conceivably might have headed off the unfortunate proposal to tax portfolio investment abroad. This tax represents a significant step away from the kind of international monetary system viewed most favorably by the Brookings authors. Space does not permit further elaboration of these opinions.

STATEMENT BY NORRIS JOHNSON

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THE ESSENCE OF THE MATTER

The Brookings report has attracted widespread interest for its findings, for the choice of assumptions (expressed or implied) underlying the statistical projections, and particularly for its characterization of the dollar as "a weak currency." However industriously and successfully we try to reduce our balance-of-payments deficit, it appears, the dollar is of dubious value as an international standard of value: even elimination of the deficit "may not suffice to restore the dollar's strength because that alone might not increase the attractiveness of the dollar for foreign and domestic holders."

This categorical conclusion is unacceptable. It is contradicted by the fact that far more international long-term lending is done in dollars than in any other currency. Evidently, there is greater faith in the lasting value of the dollar than in any other currency. This faith is supported by the fact that the dollar has held its value, in terms of internal buying power, better than almost any other currency. If "weak," the dollar nevertheless is about the best currency this poor world has to offer. The authors of the Brookings report are remiss in failing—after opening the provocative question—to propose means for improving the general health of world currencies. The unstated assumption is that currencies will always be weak, wasting away in value, stirring people to seek out, as repositories of saving, inflation hedges in stock, land, gold and silver coins, antiques and objects of art.

THE PROPOSAL

The central conclusion of the report is one quite unrelated to the statistical projections:

* * * no position of the balance of payments—whether surplus, deficit or balance—would simultaneously free the United States from undesirable constraints and provide for needed expansion of international monetary reserves. It is clear, therefore, that the present problem is not primarily a balance-of-payments problem. More fundamentally, the problem is the basic inadequacy of the international monetary mechanism in relation to requirements of the free world.

The implicit "requirements of the free world" would seem to be for toleration of price inflation so that higher wages (ordained by governments, sought by unions and granted by employers) will not create unacceptably high levels of unemployment.

The authors propose reconstructing the international monetary system, setting up a new supercentral bank, abandoning the dollar as the international standard of value, and substituting a currency unit which the bank would create and lend to various countries to give

them plenty of time to finance protracted deficits in their balances of payments. If the innovation of a new supercentral bank with powers of money issue were not to usher in an era of worldwide inflation, the first and most difficult task the institution would have to face would be to insist that the U.S. Government get its balance of payments in order. We should be wise enough to see this need ourselves, without prompting and without advocating our role of international financial leadership.

The authors detour two central, sensitive, difficult questions: (1) How, if at all, can aspirations for full employment be reconciled with price stability? (2) How, if at all, can a fixed price of gold be reconciled with institutionalized wage inflation? Clearly, their answers would be that these are impossibilities. But then all currencies forevermore must be "weak."

The problem is to make the dollar better, not to spare our national pride and seek an international substitute which would tend to be weaker because its management would be diluted by pressures from nations less willing to accept responsibilities of monetary and fiscal self-control. A new international unit of account—neither gold nor dollars—would become subject to faster depreciation than the dollar, if only because the purpose would be to release us and others from "constraints."

Means are available for making the dollar better: The attractiveness of the dollar saved can be and has been enhanced by higher interest rates. The attractiveness of the dollar earned can be enhanced by proposed easier income taxes. The attractiveness of the dollar for all purposes can be enhanced by checking the wage-price creep and inflation of Federal spending.

There is widening public recognition of the fact that we have had in recent years the wrong blend of public powers to achieve our goals of fuller utilization of productive resources, faster economic growth, stable money, and balances in the budget and international payments. We have had a tight tax policy counteracting a loose Federal spending policy and a prevailing easy money policy. It does not require reorganization of the international monetary system to effect an appropriate modification of our policy mix. We should be able to provide a working example of how to get the most out of a free enterprise, market economy.

THE SPECIFIC ASSUMPTIONS

While deprecating the importance of the U.S. balance-of-payments position, the Brookings group calculates that our basic balance of payments in the year 1968 will have moved into a surplus position of \$1.9 billion. This is under the so-called "initial assumptions." The figures under the alternate, less optimistic set of assumptions would leave a modest deficit of \$0.6 billion in 1968. But the authors offer their "best guess" that the basic deficit will be eliminated.

The basic deficit is the one which leaves certain items out of account, principally changes in private short-term investments abroad and "net errors and omissions," believed to represent largely unrecorded flows of such funds.

The charts presented herewith are mainly drawn from the Brookings report and reflect the judgments of the authors on questions of

classification. There are many differences of opinion as to how balance-of-payments data should be presented. I am glad that a special expert group has been appointed to propose clarifications and improvements. The concepts stand in need of close review.

The following are among the specific assumptions on which I would like to comment:

1. The United States will improve its performance relative to that of continental Western Europe in gross national product, output per man-hour and utilization of productive resources. Specifically, it is assumed that the unemployment percentage in the United States will be "rapidly" reduced to 4 percent of the labor force. Europe, it is assumed, will remain fully employed.

This hopefully can prove correct. It is nothing to take for granted. To improve our performance will take real effort. The spirit of enterprise will have to be encouraged by income tax rate reforms and the importance of cost control drilled home to everyone concerned.

On the record, we would be likely to be confronted with wage-price spiraling if the conditions which lead to rapid reduction of unemployment should be conditions (1) in which the strength of demand for goods and services permit cost advances to be passed on to customers in higher prices and (2) in which business accepts excessive employment cost increases in competing for manpower or in seeking to maintain continuity of production in the face of strike threats.

We can have full employment—suitably defined—if we can maintain cost and price discipline. This is a tough order because conditions of labor shortage are conditions under which wage-price spiraling comes quite naturally.

2. The annual rate of rise in average hourly earnings will continue at the recently prevailing rate of 4.4 percent a year in the United States. Exceeding a 2.9 percent a year rate of productivity increase, this will raise prices here an average of 1.5 percent a year. This figure is a price index for everything going into the gross national product; it rises over the past 10 years has been 1.8 percent per annum. (The annual average rise in the cost-of-living index has been 1.3 percent.)

This represents a projection of what is described as past experience in the United States. In other words, the Council of Economic Advisers' guideposts to noninflationary wage settlements will be exceeded sufficiently to create a continuing upward creep in prices. We could get our house in order faster if we could accept a temporary pay pause as some other nations in balance-of-payments difficulties have done. This would not take anything out of pockets of workers. It would allow the benefits of improving productivity to assert themselves in lower prices for the benefit of everyone. As a matter of fact, if the tax bill is enacted, the worker will get a "raise" in pay January 1 by reduction in withholding tax.

3. The annual rate of rise in hourly earnings in France, Italy and Germany will average 8.7 percent a year, exceeding a 4.9 percent a year productivity increase. This will not only squeeze down profits in Western Europe but also force prices up to the tune of 3 percent a year. (Figures for the United Kingdom would fall between those of the United States and the Continent.)

The presumed improvement in our international competitive position would help lift U.S. exports from \$20.5 billion in 1962 to \$31.4 billion in 1968. With imports rising from \$16.1 billion to \$23.3 billion, the favorable balance on merchandise trade would move up from \$4.4 billion to \$8.1 billion.

Assumption numbered 3 is vital to the validation of the projected improvement in the favorable merchandise trade balance. Admittedly, continuation of wage-price spiraling on the Continent of Europe could hurt European exports, and help U.S. exports, enough to wipe out our balance-of-payments deficit. The trouble, in my judgment, is that the assumption is neither politically nor economically acceptable to Western Europe. It would portend not only of balance-of-payments crises for the thriving European Economic Community but also social discontent growing out of the injustices of inflation.

Incomes policy—to deal with wage-price spiraling—is under sober study in Europe. My own assumption would be that remedial actions will be taken, though it is impossible to foresee precisely what measures may be taken at the points of time when particular governments will be moved to act.

Denmark, which had let wage-price inflation get out of hand 2 or 3 years ago, acted last March to prohibit strikes and establish strict regulatory controls over wages, prices, gross profits, and dividends. In Germany, at the expense of a temporary shutdown of its metalworking industry, the pace of wage inflation has been measurably slowed. More recently France has launched a stabilization program. We should not want or expect Western Europe to imperil its own progress, prosperity and stability in order to bail us out of our balance-of-payments difficulties.

This is by no means to deny that the nations of the free world have a difficult problem: how to reconcile price stability with full employment. The most important assumption underlying the Brookings report—not specifically stated but nevertheless permeating the whole of the document—is that costs of doing business are bound to rise faster than productivity gains. In other words, inflation is institutionalized; price stability is impossible except at the unacceptable price of increased unemployment. It would be useful if this subject could have been introduced openly into the discussion. The implication of accepting inflation as a way of life, and reconstructing the international monetary mechanism to accommodate rising prices, is that the supply of money for long-term lending will be constricted by apprehensions of continuing currency depreciation with the result of retarding availabilities of long-term capital to finance economic growth. At the very least, this would imply higher general scales of interest rates to compensate for slow burning inflation. At most, it could provoke precipitous runs from money into equities, upsetting economic stability and perverting investment decisions.

4. Government long-term capital and aid extended abroad will rise from \$3.9 billion in 1962 to \$5.8 billion in 1968.

5. Direct investment by American business overseas will shrink from \$1.6 billion in 1962 to \$0.9 billion in 1968, while foreign investments in the United States (direct and portfolio) will increase from \$0.3 to \$0.6 billion. Nevertheless, net dividend and interest

earnings on private account are figured to rise from \$3.2 to \$4.3 billion.

If realized, these assumptions numbered 4 and 5 would represent a reversal of basic American policy since World War II of encouraging private capital to fill the gap of financial needs overseas and replace aid programs financed by our taxpayers. The projections have government playing a bigger role, private capital a diminishing role.

This drift of prospective events requires searching reappraisal. It implies constriction of opportunities for private enterprise abroad as well as at home, greater burdens for American taxpayers providing grants in aid to governments abroad. It conflicts with the established course of fiscal policy, as described by Chairman Mills of the House Ways and Means Committee, of opening larger opportunities for the private sector by income tax rate reductions and checking the growth of the public sector.

“HIGHER PRIORITY OBJECTIVES”

Some of the most tantalizing language in the report is found in a section which sets out four national objectives that should have priority over balance-of-payments discipline:

1. Achieving domestic economic stability and sustained growth at full employment.
2. Maintaining the military strength of the free world.
3. Promoting and supporting economic development of underdeveloped areas and avoiding injury to the continued growth of other countries.
4. Assuring the greatest possible freedom of economically productive international transactions in the free world.

The authors say that balance-of-payments discipline “is not desirable if it requires the subordination of higher priority objectives.” But a nation cannot, willy-nilly independently decide to have any dimension of balance-of-payments deficit it chooses. An internal budget deficit can be financed by paper money issues, without specific consent of individual lenders. But this is not true of a balance-of-payments deficit. Someone outside the country has to be willing to pick up the I O U's.

We have gotten rather spoiled from lack of experience in facing up to balance-of-payments discipline. At the close of World War II, we had the undamaged plant capacity plus the generosity to help. Dollars were eagerly sought, for the command that they offered over our resources and, indeed, over the resources of all other nations having exports to offer. We have helped innumerable other nations over balance-of-payments crises, both directly and indirectly under international auspices. But we are deluded if we think that the world (i.e., Western Europe) is under some obligation to pile up dollar holdings and make good, in the tangible terms of goods and services, on capital and aid we want to send abroad.

The financial leadership of the United States imposes harder rules upon us as the cost of earning and holding that leadership. Certainly the enumerated four objectives are laudable. But we are not “maintaining the military strength of the free world,” or “supporting the

economic development" in a tangible sense when we ship out dollars without a counterpart of exports but instead expect other nations to provide the goods and accept and hold the dollars. Indeed, we injure the solid growth of other countries if, through excessive balance-of-payments deficits, we export inflation. Our balance-of-payments deficit does not assure "the greatest possible freedom of economically productive international transactions." It has led some nations to erect barriers against capital imports. Freedoms of trade and payments depend not on availabilities of credit but on removals of specific barriers.

AN ENDEMIC PROBLEM

Balance-of-payments problems are endemic to the free society. They are as natural and normal as fluctuations in prices and market demands for particular products. If structures of production and consumption, incomes and prices, were somehow held rigid among the nations, balance-of-payments problems could be avoided. But we would no longer enjoy either a free society or dynamic progress. People would lose freedoms of choice; individual countries would lose sovereign powers. The problem for nations, striving for economic growth through world interdependence, is to keep reasonably in step, avoiding policies that lead to serious or chronic balance-of-payments problems and adopting policies that relieve imbalances that, for one reason or another, do occur.

Imbalances in international payments should be resolved by means consistent with internal price stability and liberal trading policies. In 1961 Germany and the Netherlands upvalued their currencies by 5 percent, thus correcting excessive devaluations undertaken 12 years earlier, in 1949. Many students diagnose the improvement in French reserves since 1958 as evidence that the last devaluation of the franc, undertaken in that year, was excessive to the needs. For political reasons countries tend to put off needed devaluations too long; then, for economic reasons, they devalue too much.

The Brookings report recognizes the virtues of fixed exchange rate. It rejects the idea of dollar devaluation.

I would argue that the United States lacks effective power to devalue its currency; the dollar is the benchmark in which the values of other currencies are stated. The United States cannot have a "floating dollar" because the dollar is the sea on which other currencies float. In this situation, we stand at the mercy of other countries, excessively devaluing their currencies to the disadvantage of our balance of payments.

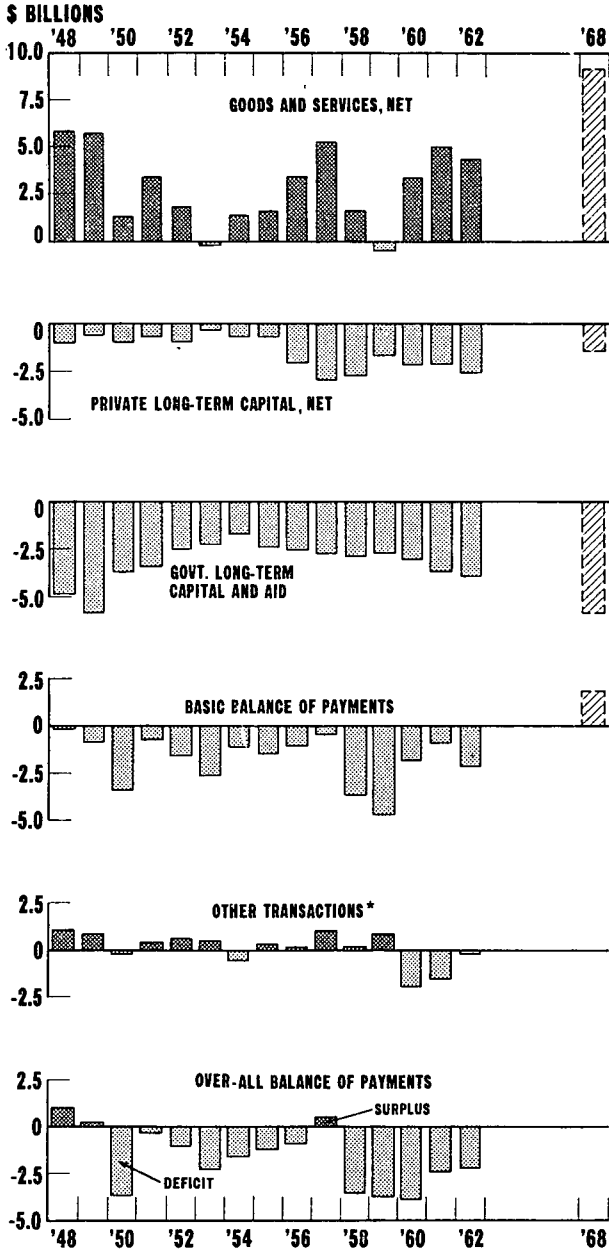
Countries which feel confident that the dollar is overvalued in terms of their own currencies should upvalue them, though not before testing them out against the full strength of the dollar, by removing import barriers and giving their citizens freedom to invest in the American market as much as they please.

Responsibilities for international trade imbalances are two sided. If we hew the line and protect the dollar, our balance of payments will take care of itself.

SUSTAINED GROWTH AT FULL EMPLOYMENT

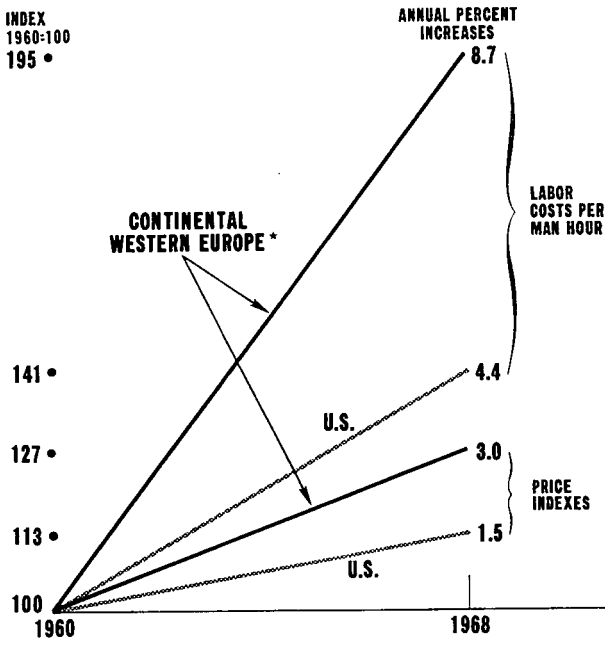
The first high priority objective—"achieving domestic economic stability and sustained growth at full employment"—is one that has the largest appeal. No one would seriously ask that the United States accept spiraling deflation, with all the unemployment and business failure inevitably involved, as a price for correcting the balance-of-payments deficit. No one is asking us—in William Jennings Bryan's historic words—to "crucify mankind on a cross of gold."

The real importance to us of the balance-of-payments problem is that it is inducing us to take measures for our own good, protecting the buying power of the dollar—the real values in the social security check, in the workman's pay envelope, in the goods we have to sell to buyers at home and abroad.



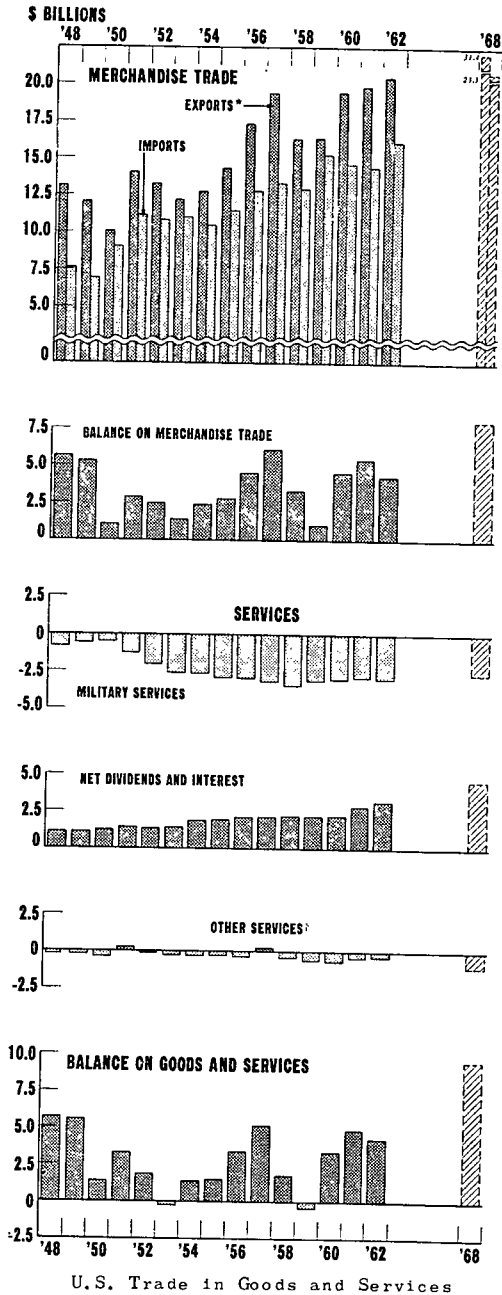
The Basic and the Over-all Balance of Payments

*Short-term capital flows, prepayments by foreigners of U.S. Government loans and other special transactions, and "errors and omissions."
 Source: The Brookings report. In all charts, projections for 1968 are those based on "initial" (more optimistic) assumptions.



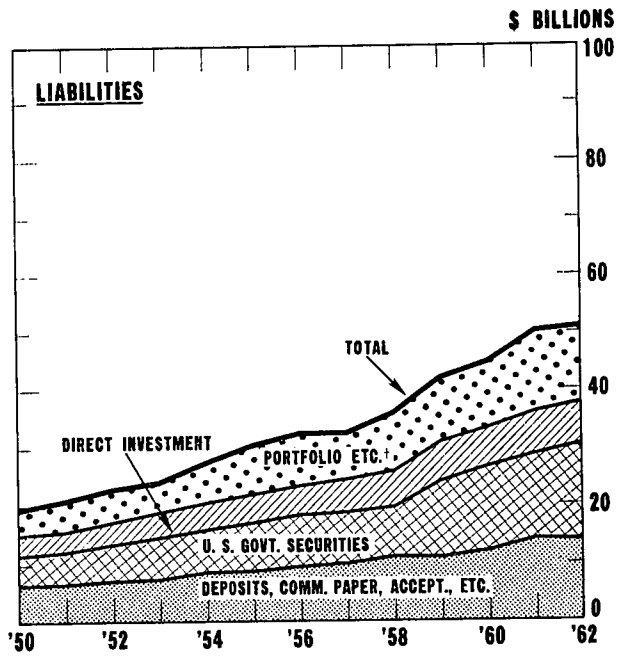
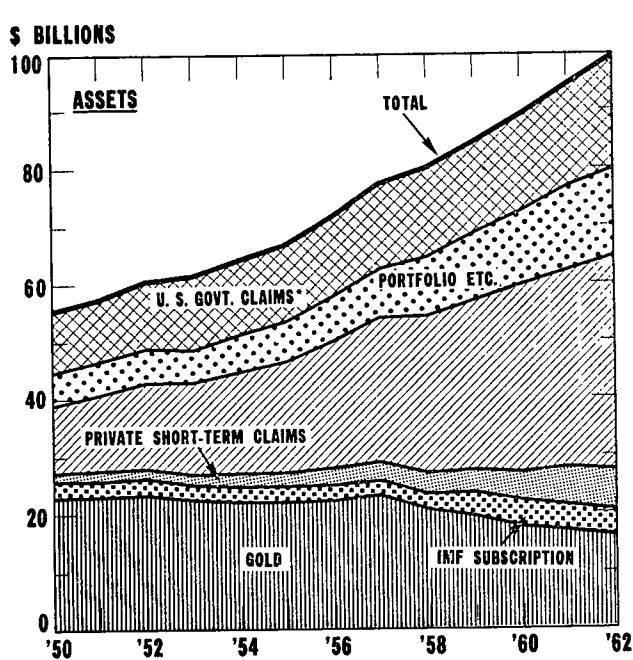
Projected Cost and Price Rises

*France, West Germany and Italy.
 Source: The Brookings report.



*Excludes military aid shipments but includes other exports financed by foreign aid. †Includes primarily travel, transport and private remittances.

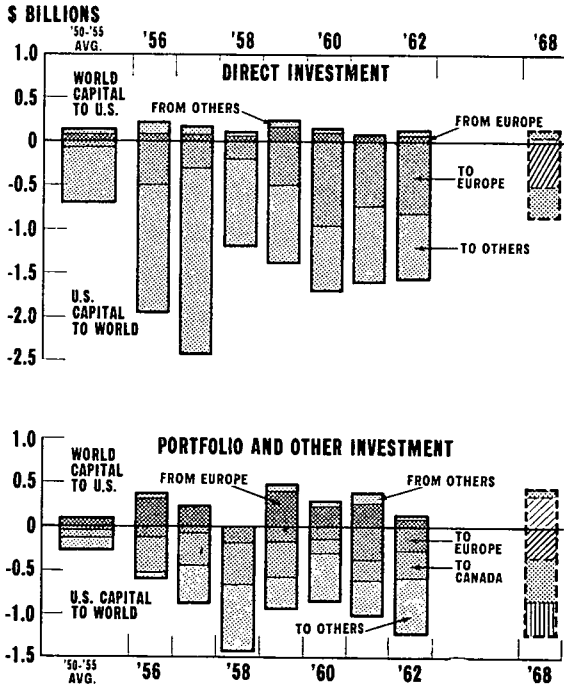
Source: The Brookings report.



International Assets and Liabilities of the United States
(End of Year)

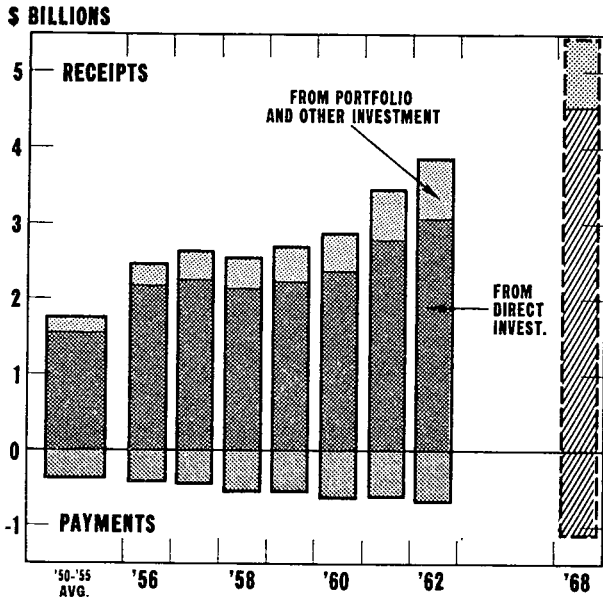
*Excluding World War I loans. +Other than U.S. Government bond and note holdings.

Source: U.S. Department of Commerce.



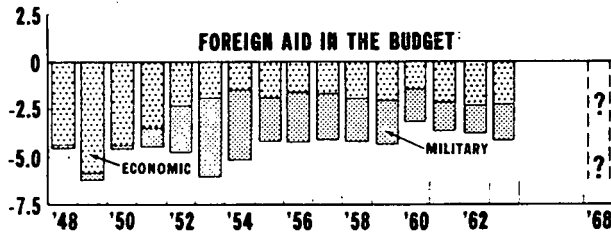
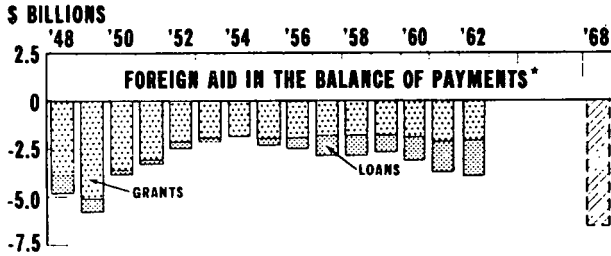
Long-Term Private Capital Flows of the United States

Source: The Brookings report.



International Private Investment Income Flows of the United States

Source: The Brookings report.



U.S. Grants and Loans

*Calendar years. +Fiscal year expenditures on budget basis. Includes subscriptions to the World Bank, the International Development Association and the Inter-American Development Bank, net loans of the Export-Import Bank and disbursements and receipts under the 1946 loan to the United Kingdom. Excludes sales of surplus farm production for local currencies under P.L. 480.

Source: Department of Commerce; Bureau of the Budget; Agency for International Development.

STATEMENT BY PETER B. KENEN

Associate Professor of Economics, Columbia University, New York, N.Y.

This memorandum is divided into three parts. The first deals with the analytical framework of the Brookings report. The second comments on several of the separate projections. The third is devoted to policy. As it necessarily takes issue with detail, I would first like to record my admiration for the Brookings study and my agreement with its chief projections.

Walter Salant and his colleagues have performed an impressive feat. Their report will be a milestone in international financial analysis. It makes imaginative use of economic theory and exploits almost all the available data. In order to finish their work on time, the Brookings group had to employ several strategic simplifications. But these are extremely efficient. They do not distort reality beyond recognition nor suppress vital relationships. The report is remarkably consistent in its application of these simplifications and its analytical apparatus—all the more so for being a joint product. Most of the sector forecasts are entirely plausible, given the underlying assumptions regarding growth and prices. The report deserves a wide audience, and should serve as a model for future research.

THE ANALYTICAL FRAMEWORK

The Brookings report employs two major simplifications. First, it directs attention to the "basic" balance of payments rather than studying the "overall" or "monetary" balance. Second, it divides the outside world into two groups of countries, those that accumulate reserves and those that are apt to spend all their receipts. These simplifications allowed the Brookings group to work with a manageable number of transactions and relationships and to complete its work on time. But they may exert a systematic bias on its projections.

The Brookings group defends its use of the "basic" balance with two kinds of arguments. First, it appeals to symmetry. An American deficit on "basic" transactions implies a surplus on "basic" transactions for some other country or group of countries. This would not be true of an "overall" deficit as defined by the Department of Commerce. But it would be true of the "overall" deficit as defined by the International Monetary Fund. If it were measured by the change in official holdings of gold and convertible currencies here and abroad, an American "monetary" deficit would be matched by some other country's "monetary" surplus, apart from the effects of new gold production and the well-known statistical problems (which also afflict the "basic" balance).

The Brookings group may have felt constrained to use the concepts hitherto employed in official U.S. presentations. Otherwise, its projections could not be compared with past performance. It was right to use a symmetrical concept, as symmetry supplies a useful check on a

projection; one can ask if the foreign surplus or deficit implied by a projection of the U.S. position would change policy abroad and thereby invalidate the forecast. But the "basic" balance may not be the best one to study; the "monetary" balance would tell us more about the prospects for the dollar.

The Brookings group also defends the "basic" balance on practical grounds. The transactions that enter the "basic" balance are the least volatile and most easily projected. But the short-term capital movements that fall outside the "basic" balance may have trends or structural components, and may not be more volatile absolutely, only in relation to their structural elements. Furthermore, several lines of long-term capital include short-term movements and react to the same evanescent influences as "short-term" capital. Direct investment includes intercompany accounts that may behave much like commercial credit. Portfolio investment includes arbitrage in long-term securities and transactions for currency speculation. Finally, the Brookings projections of long-term capital, especially portfolio investment, are constructed without much more econometric information than we have for short-term capital. They are mere averages of past flows crudely adjusted for trends in gross savings, the availability of securities, and so on.

One can produce a similar projection for the structural component of the short-term flow. A shirt cuff calculation appended to this memorandum argues that the 1968 balance of payments should allow for a \$600 million outflow of U.S. funds and a \$250 million inflow of foreign funds, giving a \$350 million net outflow on account of recorded short-term private capital.

The Brookings report provides statistical support for its supposition that countries outside Europe will not take in reserves. But its figures pertain to the "basic" balance of payments not to movements in reserves, and the figures on reserves give a somewhat different picture. (See table 1.) Although Japan's "basic" balance has been small, its reserves have grown hugely since 1958. This accumulation has been based on short-term borrowing, but may not be reversed when these credits are repaid. Japan may seek to generate a "basic" surplus. Canada has also gained reserves since 1958, mainly since mid-1962 when it abandoned exchange-rate flexibility. It may continue its accumulation for some time because it needs more reserves to defend its fixed exchange rate.

Oddly enough, the Brookings view of Japan fits Britain much better. Reserve accumulation has long been an objective of British policy, but rapid growth is the more urgent objective, and British growth has been slowed by the measures taken to defend the pound. Future studies should make separate projections for Britain and continental Europe. It might actually be best to make two sets of forecasts—one which treats Britain, Canada, and Japan as reserve-accumulating countries and one which assumes that they spend their receipts. Assumptions regarding the behavior of these three may have a large effect on projections of the U.S. balance of payments.

THE INDIVIDUAL PROJECTIONS

Transactions in goods and services

The Brookings projections of current account transactions are based on an elaborate econometric model. But they might be improved in

three ways: (1) Separate projections might be made for each group of commodities (crude materials, crude foodstuffs, and so on); (2) additional independent variables might be used to forecast merchandise flows; and (3) transactions in services might be grouped differently for econometric purposes.

The income and price elasticities used in the Brookings report may be satisfactory averages of the parameters pertaining to each class of commodities. But the spread within the averages may be very wide. The Ball-Marwah estimates for U.S. imports assign a very high price elasticity to finished manufactures, but no significant price elasticity to crude materials. (See table 2.) These parameters are not necessarily better than the Polak-Rhomberg estimates; they cannot even be compared with the Polak-Rhomberg version because they do not use the same explanatory variables. Yet they have important implications for the merchandise projections. If the Ball-Marwah estimates are nearly correct and Europe's parameters evince a similar spread, they imply that the large "competitive effects" forecast by the Brookings group will appear in a narrow commodity class. Most of the \$3.8 billion increase in exports to Europe and the \$1.3 billion increase in other exports will be manufactured goods. If this is so, however, the U.S. share of world trade in manufactures may grow large indeed. The change in the U.S. competitive position would involve an increase exceeding \$4 billion, and the income effects may yield another \$1 billion as the income elasticity of demand is also high for finished manufactures. In brief, U.S. manufactured exports might increase by more than 50 percent. Such an increase may be fully feasible, looked at from this side of the Atlantic. But would it be acceptable to our competitors? It could cause an absolute displacement of European output and engender a policy response abroad that would vitiate much of the projected improvement. Disaggregation would allow us to study this possibility.¹

The Polak-Rhomberg choice of explanatory variables—national product and relative price—is quite satisfactory. But one wonders why the Brookings group suppressed the separate inventory argument used in the first version of the model. They may have supposed that an inventory term has no place in a long-term forecast. But by suppressing it, they have probably biased the income parameter. GNP and inventories move together much of the time. If, then, the inventory argument is deleted, income may pick up some of the trade changes caused by inventory fluctuations. The income propensities used in the Brookings study may be too high, reflecting large changes in imports at business cycle turning points. One wonders, too, why the Brookings group did not employ the rate of fixed capital formation as a separate explanatory variable; U.S. exports of capital goods seem quite sensitive to changes in foreign growth rates, not just to the levels of income or output.

The grouping of service transactions in the Polak-Rhomberg model misses several opportunities. The equations seek to forecast transport, travel, and "other services" as though they were independent. In one case, the forecast is merely a trend; in several, the Durbin-Watson ratios are not satisfactory. Better forecasts might be obtained if the transport series were broken down into its three chief components—

¹ Disaggregation might also reveal the locus of the serial correlation denoted by the low Durbin-Watson ratio for M_2 , though Ball and Marwah did not have much better luck.

freight payments, port payments, and passenger travel. The first component could then be projected using merchandise trade as the explanatory variable. The second could be projected using freight and passenger payments to predict U.S. port receipts, then freight and passenger receipts to predict U.S. port payments. The third component should be grouped with travel payments, being truly part of them, then forecast with consumption and relative prices as the explanatory variables. Similar problems arise with "other private services." These include fees and royalties that may behave much like income from direct investment.

Incidentally, the "feedback" from trade and service payments to countries outside Europe was forecast using crude trade data—a "first round" procedure. One wonders why the more sophisticated "feedback ratios" (app. VI) were not used for this important allocation. They were used to allocate the "feedback" from U.S. aid and investment, but not to allocate the larger sums supplied by U.S. imports and service outlays.

Finally, I object to the presentation of the military estimates. Scanning table VII-4, one discovers that the bulk of the projected improvement can be imputed to item (3), "Spending by other agencies." The reduction in Defense Department spending from 1963 through 1968 is more than offset by the anticipated drop in receipts for military sales. Then the table promises a \$230 million cut in item (3). Yet the chapter never describes item (3), nor does it explain the drastic decline from \$250 million to a mere \$20 million.

The impact of the EEC

Europe's inflation is the hero of the Brookings report. The EEC is its villain, stealing \$750 million from the U.S. "basic" balance. The pessimism of chapter IV may be fully justified. A \$350 million export loss due to agricultural protection is not so very large when set against the grim forecast of EEC policy. The \$100 million loss through third-country trade is also plausible. But the projected declines in exports of manufactures (\$200 million) and nonagricultural materials (\$100 million) may be excessive.

The Brookings report argues that trade diversion will be large, and gives two kinds of evidence. First, it shows that the EEC countries have increased their share in EEC imports. Then it shows that there has been a broad and steep increase of industrial protection. One cannot argue with the first demonstration (although the instability of other countries' shares weakens the inference). But the second demonstration has grave flaws. The Brookings group tried to measure the protection afforded the "dominant supplier" within the Common Market. They find that the common tariff increases this protection in 46 of 61 cases. But they have really measured something quite different—the increase in protection afforded the dominant supplier in its own national market, not in the Common Market. If this supplier was already a net exporter to other EEC countries, its producers may not have needed domestic protection. The dominant supplier would normally have a low national tariff and, therefore, a rate below the unweighted average entering the common tariff. If the dominant supplier gains protection in its own market, however, it may lose protection elsewhere in the EEC; if its own national tariff was below the EEC average, those of some other EEC countries must have been above the average.

I am not saying that the dominant supplier has suffered because of European integration. Contrarily, it will reap the full gains from discrimination, as an outsider will have to pay the whole common tariff while it will not pay any duty. But there may be no increase of protection per se. Even if there were, moreover, one could not qualify its impact on the U.S. balance of payments without knowing two things: (1) How much can the dominant supplier increase its exports before it encounters rising marginal costs; how large is the dominant supplier and how elastic is his supply curve after allowing for "dynamic substitution"? (2) How much will output contract elsewhere in the EEC as internal tariffs come down? I doubt that any calculation can answer these questions precisely. I am sure that the Brookings calculation falls far short of doing so.

Capital transactions

As we still know very little about the true causes of capital movements, we cannot do more than extrapolate past averages, then revise the averages to reflect our best judgment as to the importance of interest rates, savings and the like. This may be reason for providing several forecasts of the 1968 capital account. It is also reason for the critic to beware, lest he merely substitute his own fragile judgment for that of the Brookings group. At a few points in chapter V, however, the report may go astray or overlook relevant scraps of information.

The figures for direct investment are satisfactory midpoints, but should be straddled by a wide range of alternative projections. On the one hand, the "bandwagon effect" may be dying; fewer new foreign subsidiaries are being established now than a year or two ago. Furthermore, European costs are rising and European profit margins may fall far below their recent peaks. On the other hand, local financing may not be easy in 1968. European credit conditions may tighten if inflation continues, and lower profit margins may curb reinvestment, leading to larger capital outflows from the United States. Most important, trade displacement may have just begun. The plant and equipment put in place since 1957 may not have had its full effect on output and trade. The Brookings report makes no allowance for trade displacement. There is, indeed, no way to do so. The report notes that our exports have grown more slowly than our direct-investment production, but one can find few hints of actual displacement in the detailed data for 1957-61. (See table 3.) If there were substantial trade displacement, one would predict an inverse correlation between the rate of growth of oversea output and the rate of growth of U.S. exports. No such correlation is visible thus far. Taking generous account of all these possibilities, we ought not to be surprised if direct investment exceeds or falls short of the Brookings projection by as much as \$500 million.

The projections of portfolio investment are also quite plausible, but do not use all the available data. The recent Treasury study of capital movements reports a significant relationship between securities transactions and long-term interest rates. European investors purchase more American securities when our long-term rates are high; American investors buy more British securities when U.S. rates are low compared to British rates. Furthermore, the Brookings projections are based on our experience in 1957-61, and the figures for 1960-62 give a very different picture. (See table 4.) The 1957-61 data imply a \$200

million annual inflow from Western Europe; the figures for 1960-62 imply a \$50 million annual outflow. There has been a large increase in U.S. purchases of foreign bonds, and a large decline in foreign purchases of U.S. Government bonds (due, perhaps, to foreign governments).

Viewed against this very different background, the Brookings projections of securities transactions seem slightly optimistic. The report forecasts a \$150 million annual outflow through U.S. purchases of European bonds. It notes that this projection is quite different from our 1957-61 experience but gives good reason for expecting a major change. Yet its projection is not quite so different from the 1960-62 average. If, then, the Brookings analysis is right, the 1958 outflow may be even higher than its forecast for that year. Next, the report foresees a \$150 million outflow through U.S. purchases of foreign stock. But the 1960-62 average was already that high, and there may be further growth. Finally, the report foresees an annual inflow of \$300 million through European purchases of U.S. equities. But the 1960-62 average was a mere \$180 million. As with direct investment, then, the range of error may be huge. In this case, moreover, the Brookings forecast may be off center.

THE POLICY RECOMMENDATIONS

This is not the place for another long discussion of international liquidity, flexible exchange rates, and the other matters covered in the final chapter of the Brookings report. The Joint Economic Committee has reviewed these issues several times. But I am moved to comment on two of the policy recommendations made by the Brookings group.

Negotiations with the EEC

In the chapter on the Common Market, the report discounts the prospective gain from tariff reduction if the reduction is small and confined to manufacturers. I quote the relevant passage (p. 116) in full:

A small reduction in this [EEC] tariff, however, might not cut sufficiently below the excessive protection now present, and therefore, might not lead to any significant increase in EEC imports. On the other hand, an equal percentage cut of U.S. tariffs offered in return would reduce effective protection of U.S. goods and increase U.S. imports.

This passage puts excessive stress on the "dominant supplier" findings I have already criticized. It likewise neglects an important difference between the American and European economies. There is substantial slack in our economy, while Europe faces labor shortages and industrial bottlenecks. In these circumstances, Europe may be hard pressed to exploit U.S. tariff cuts while our firms can exploit European concessions. It would, of course, be better to make large cuts on both sides and to strike a bargain on farm products too. But small tariff cuts on manufactured products might not be harmful, however inferior.

International liquidity

The Brookings analysis of international liquidity is superior to most. It stresses prospective volatility, not mere growth in gross transactions, and argues that the disturbances afflicting foreign trade and payments will grow larger and more stubborn. The report refers

to studies that bear out its forecast. Unfortunately, it does not describe them. Nor does it see their relevance to flexible exchange rates. If the disturbances are apt to grow and last longer than they have, the exchange-rate changes needed to curb them may also be quite large and the danger of destabilizing speculation may be greater than we usually suppose.

My own work, still in progress, comes to a similar conclusion about prospective volatility. If international economic growth increased the number of transactions rather than their size, and if the disturbances afflicting transactions were fully independent, growth might stabilize the balance of payments. The disturbances would tend to cancel out. But growth is apt to mean larger transactions, not a wider range of small transactions, and the disturbances are not independent.²

Yet the Brookings inference may be quite wrong. The report is right to urge a major reform of the international monetary system. But if the United States presses for reform while it is still in deficit, it will engender suspicion abroad. Our proposals will be viewed as devices for financing our deficits and we will encounter more resistance than support. As the report's "alternative" projection of liquidity seems more nearly right than its more alarming forecast, the problem of reform might best be deferred until the U.S. balance of payments has begun to improve.

TABLE 1.—*Reserve accumulation, 1953-62*

[Millions of dollars]

Region	Total reserves, end of period			Increase	
	1953	1958	1962	1953-58	1958-62
Continental Europe.....	9,990	17,240	24,945	7,250	7,705
United Kingdom.....	2,546	3,105	2,809	559	-296
Canada.....	1,827	1,948	2,547	121	599
Japan.....	823	861	1,842	38	981
Latin America.....	3,300	3,110	2,265	-190	-845
Other countries.....	10,962	10,454	10,803	-508	349

Source: International Financial Statistics, August 1963.

TABLE 2.—*Selected parameters of U.S. import demand*

Community group	Income elasticity	Relative price elasticity	Ratio of stocks to output
Crude foodstuffs.....	0.49	-0.34	-----
Manufactured foodstuffs.....	.96	-1.87	-----
Crude materials.....	.87	1-.26	-----
Semimanufactures.....	1.22	-1.88	-1.75
Manufactures.....	2.47	-3.50	-----

¹ Not significantly different from zero at the 0.05 level.Source: R. J. Ball and K. Marwah, "The U.S. Demand for Imports, 1948-1958," *Review of Economics and Statistics*, XLIV(4), November 1962, p. 397.

² Furthermore, independent disturbances of constant amplitude could still have a growing impact if they enter the balance of payments in a multiplicative fashion. If, for example, freight rates move with constant amplitude but are applied to growing commodity trade, the transport accounts will show a growing variance. If the fraction of U.S. exports financed by private capital remains fairly stable but exports go on growing through the years, capital movements are apt to make larger swings.

TABLE 3.—Percentage growth in U.S. exports and production by direct investment enterprises, 1957-61

Commodity class	Exports	Direct investment enterprises production
All countries:		
Total, selected manufactures	9.3	42.3
Paper and allied products	39.8	48.7
Chemicals	24.2	64.9
Rubber and rubber products	10.0	25.5
Machinery, except electrical	13.8	43.7
Electrical machinery	7.0	20.7
Transport equipment	-18.2	41.9
Europe:		
Total, selected manufactures	72.3	71.7
Paper and allied products	96.7	105.9
Chemicals	62.6	83.7
Rubber and rubber products	24.7	52.7
Machinery, except electrical	84.7	62.0
Electrical machinery	86.0	54.9
Transport equipment	46.1	80.6

Source: Data from Survey of Current Business, September 1962.

TABLE 4.—Net transactions in securities, cumulative, 1957-61 and 1960-62

[Millions of dollars]

Type of transaction	1957-61	1960-62
Net U.S. purchases (-) from Europe:		
Foreign bonds	333	-101
Foreign stock	-696	-466
Total	-363	-567
Net European purchases (+) from the United States:		
U.S. corporate bonds	188	51
U.S. corporate stock	887	539
U.S. Government bonds	355	-165
Total	1,430	425
Net capital outflow (-)	1,067	-142

Source: Figures for 1957-61 from "The United States Balance of Payments in 1963," p. 131; figures for 1960-62 from Treasury Bulletin, July 1963.

APPENDIX

PROJECTING SHORT-TERM CAPITAL MOVEMENTS

This appendix makes a crude projection of recorded short-term capital movements for 1968. The calculations are based on data published in the Federal Reserve Bulletin and Survey of Current Business. They could be improved using more detailed data and more sophisticated techniques. But they may still show that short-term capital movements are amenable to forecast using methods not too different from the ones employed in the Brookings study.

(1) EXPORT FINANCING

Several types of U.S. claims on foreigners can be regarded as financing for U.S. commercial exports. Bank loans to "other" foreigners, collections reported by U.S. banks, acceptances issued against U.S. exports, and some of the reported claims of U.S. nonfinancial concerns belong to this category. Here, then, is a rough estimate of claims created by U.S. exports:

End-year data in millions of dollars

	1960	1962
Bank loans to "other" foreigners.....	618	651
Items in collection as reported by banks.....	605	686
Acceptances issued against U.S. exports.....	669	778
Claims of U.S. nonfinancial concerns.....	841	1,102
Total.....	2,733	3,217
U.S. commercial exports.....	17,540	18,134

The claims of U.S. nonfinancial concerns included in this tabulation are estimates derived from the published statistics by deducting an allowance for "financial" claims:

	1960	1962
Total reported claims.....	1,541	2,102
Less estimated foreign currency claims.....	-500	-300
Less estimated Euro-dollar claims.....	-200	-700

The 1960 estimate of foreign currency claims includes an allowance for interest-arbitrage to London during the last months of 1960. The estimate of Euro-dollar claims may be conservative, even for 1962; the foreign currency deposit liabilities of Canadian banks (including large liabilities to Americans) increased by \$1 billion between 1960 and 1962. The totals and components, incidentally, reflect improved reporting since 1960.

The figures for "commercial exports" are those supplied in the Survey of Current Business ("merchandise exports other than those financed by Government grants and capital").

If, next, we assume that short-term claims average 6 months maturity, the ratio of outstanding claims to related exports works out to 31 percent for 1960 and 36 percent for 1962. The 1962 figure is probably more accurate, but may be higher than the long-run average, as U.S. short-term interest rates have been low relative to rates abroad. Hence, I shall suppose that the long-run ratio lies near 25 percent for Europe and near 40 percent for Canada, Japan, and other countries.

The "initial assumptions" used by the Brookings report project as \$5.8 billion increase in exports to Europe and a \$4.9 billion increase in exports to other areas. The report goes on to make several adjustments, reflecting projected changes in foreign aid and private investment and the effects of EEC discrimination. The effects of foreign aid are not directly relevant to changes in commercial claims, as the increased exports will be financed by public funds. The other changes are directly relevant, although the impact of the EEC may be exaggerated. I shall therefore suppose a \$5.2 billion increase in exports to Europe and a \$4.1 billion increase in exports to other areas, taking full account of all these adjustments.

Next, I shall assume that these export changes will be accomplished in equal semiannual steps. This is a conservative supposition for present purposes, as the changes are more apt to bunch near 1968 and produce larger capital flows. On this assumption, exports to Europe will increase by \$250 million every half year, augmenting U.S. commercial claims by \$62.5 million ($0.25 \times \250 million), and causing a \$125 million annual capital outflow. Similarly, exports to other areas will increase by \$195 million every half year, augmenting U.S. commercial claims by \$78 million ($0.40 \times \195 million), and causing a \$155 million capital outflow.³ The overall outflow of commercial credit will be \$280 million.

³ This last figure may be too high, as some of the increase in U.S. exports on which it is based represents a shift from European sources of supply. These goods may already be financed by the United States.

(2) OTHER SHORT-TERM CAPITAL EXPORTS

Recorded short-term claims on foreigners include several other items:

End-year data in millions of dollars

	1960	1962
Bank loans to foreign banks and governments.....	772	1,010
Other dollar claims reported by banks (less export acceptance in 1, above)....	564	1,136
Foreign currency claims reported by banks.....	480	650
Euro-dollar deposits and foreign currency claims reported by nonfinancial concerns (as listed in 1, above).....	700	1,100

Euro-dollar deposits may stabilize, but foreign-currency claims are apt to go on growing. The Brookings report suggests that banks and traders will require larger working balances as world trade expands. This suggestion should be applied to U.S. balances abroad and to foreign balances in the United States—but may have stronger application to the former than the latter. The figures given above imply an annual increase of \$275 million. But the 1960 total was abnormally high, depressing the implied flow for later years. A further annual increase of \$175 million may therefore be forecast as a conservative minimum for 1968.

The figures on bank loans and other dollar claims likewise imply an average annual increase of \$405 million, but this pace reflects very large Japanese borrowings in 1961. Hence, I take \$150 million as the 1968 projection.

(3) U.S. COMMERCIAL LIABILITIES

The balance-of-payments statistics separate U.S. commercial and brokerage liabilities from other liabilities. These are the recent net changes:

	<i>Million</i>
1960.....	-\$90
1961.....	177
1962.....	-116

Repayments exceeded new borrowing in 1960 and 1962. The largest quarterly figures were -\$55 million (1962, IV) and +\$79 million (1961, II). Though a longer statistical series might reveal trends or patterns, there are none apparent in the available data, and I shall not project a structural component.

(4) U.S. LIQUID LIABILITIES

The Brookings report suggests than an increase in U.S. liquid liabilities to foreign banks and other private institutions will offset the increase in U.S. short-term claims. It evokes the need for larger working balances as international trade continues to expand. But if the United States continues to run an overall deficit through the mid-1960's foreigners may be reluctant to increase their dollar holdings.

The figures for 1960, 1961, and 1962 are, perhaps, encouraging:

	<i>Million</i>
1960.....	\$289
1961.....	1,083
1962.....	200

But a third of the large increase in 1961 must be attributed to international institutions; they enlarged their holdings of Government securities by \$532 million and ran down their banking claims by only \$260 million. Setting this one change aside, the recent data give an annual increase of \$430 million, a rate slightly higher than the annual average for 1956-62. Over that longer period, foreign banks and "other" foreigners increased their banking claims by about \$400 million per year. They may also have bought Government securities, but I would discount this possibility. Abstracting from a further large increase in the holdings of international and regional agencies and allowing for foreign doubts about the dollar, I would project the structural increase at \$250 million per year.

(5) ERRORS AND OMISSIONS

Although this line in the balance-of-payments records a large net outflow for each of the last 3 years—and much of this outflow may be short-term capital—I have not made any projection of errors and omissions. The summary statistics below, then, refer to recorded capital movements.

(6) SUMMARY

The estimates in sections (1) through (4) give the following projection as the structural component of short-term capital:

	<i>Million</i>
Export financing.....	-\$280
Other short-term capital exports:	
Euro-dollars and foreign currency claims.....	-175
Other dollar loans and claims.....	-150
Commercial and brokerage liabilities.....	250
Foreign dollar balances.....	250
Net outflow(—).....	-355

To be consistent with the Brookings report, we should adjust U.S. receipts from Canada, Japan, and other countries, offsetting part of this net outflow. But the offset may be small, save for the part that corresponds to the \$155 million of commercial lending to "other countries."

More sophisticated estimates could be made using the techniques described by Prof. Philip Bell in his paper for the Joint Economic Committee and in the Treasury study of short-term capital movements. But new equations should first be developed to replace the published versions. We must construct estimators that will take account of the trade effects stressed by Professor Bell and the interest rate effects studied by the Treasury. Preliminary work on this problem argues for relationships that are logarithmic in trade and linear in interest rates.

STATEMENT BY HUGH B. KILLOUGH*

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Messrs. Salant et al. of the Brookings Institution have provided a penetrating, imaginative, informed, and well-balanced analysis in their report on the U.S. balance of payments in 1968. As the authors of the report state, again and again, a forward estimate of the payments balance position of the United States is subject to large possible error. Such error may be a result of incorrect assumptions, a result of the kind of statistical techniques employed in making extrapolations, or of inadequate base periods used for extrapolations. In our evaluation, statistical techniques and base periods used in the Brookings analysis are not challenged. There is no valid reason to believe that other techniques and base periods would provide a forecast on which one could place a high degree of confidence.

The writer of this paper would question some of the assumptions in "The U.S. Balance of Payments in 1968." The effect of our modification of assumptions is to reduce confidence in the U.S. balance of payments 1968 forecast of a near balance or substantial surplus in U.S. basic international payments and receipts in 1968.

MODIFICATIONS OF PRICE ASSUMPTIONS AND GNP ASSUMPTIONS AND SUGGESTED CHANGES IN THE PAYMENTS BALANCE PROJECTIONS

If, by a policy of continued deficit financing, the U.S. Government succeeds in generating an increase in the growth rate of the U.S. real GNP from approximately 2.3 percent to the 4.8 percent¹ assumed in the Brookings study, with a 4-percent unemployment rate,² for 1968, it is the judgment of this writer that GNP prices and prices of export goods in the United States likely will rise at average rates greater than those assumed by the Brookings analysis; i.e., rises of 1.5 percent a year for GNP prices and 0.5 percent a year for export prices.³ These price changes would result in a worsening of the U.S. payments balance position as projected by the Brookings study.

Within a framework of the foregoing GNP, unemployment, and price assumptions for the United States, and other assumptions for the West European economy and for levels of U.S. foreign aid, offshore defense expenditures, and especially, foreign investments⁴ the Brookings analysis projects a probable \$1.9 billion surplus in the U.S. basic international payments balance in 1968.⁵ Based on an alternate assumption of a U.S. real GNP growth rate of 4.2 percent⁶ a year

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¹ "The U.S. Balance of Payments in 1968" (hereinafter called "USBP"), GNP assumption, p. 40, and 1955-60 statistics, p. 44.

² USBP 1968, p. 40. Unemployment for the period 1958 to 1962 was about 6 percent of the labor force. See USBP 1968, p. 46, and "Statistical Abstract of the United States," 1962, p. 215.

³ USBP 1968, pp. 40 and 81.

⁴ *Ibid.*, pp. 42 ff. and pp. 283 ff. and chs. IV, V, VI, and VII. See p. 12 of this paper for an evaluation of the Brookings foreign investment assumptions.

⁵ *Ibid.*, pp. 216 and 283.

⁶ *Ibid.*, pp. 42 ff. and 285.

(U.S. price assumptions not modified but European assumptions changed somewhat), the Brookings projection indicates a probable deficit of \$0.6 billion in the U.S. basic international payments balance in 1968.

Examination of price assumptions

If U.S. Government deficits persist, and aggregate spending is sufficient to raise the U.S. GNP growth rate to 4.8 percent (or to 4.2 percent) and reduce unemployment to 4 percent of the labor force, the author of the present evaluation believes that stronger inflationary pressures than those assumed by the Brookings study may be set in motion. These pressures, especially in some of the mass production segments of U.S. industry, may be so great that "guideline" persuasion cannot hold price increases within the assumed limits of 1.5 percent for GNP prices and 0.5 percent for export prices.

Among the reasons for the foregoing judgment are two of particular significance. First, the available supply of skilled personnel may become short before total unemployment drops to 4 percent of a rapidly increasing labor force including many unskilled workers. This condition would tend to generate upward wage rate pressures and increases in per unit costs of goods produced. Second, "guideline" policy has favored, in a general way, wage rate increases in proportion to increases in average⁷ productivity of wage earners (output per worker).

If European and Japanese producers are increasing investments per worker and productivity per worker in export industries, competing U.S. exporters must do likewise in order to remain competitive on a price per unit basis. If, as investment per worker increases in an export industry, wage rates in the industry rise as fast as average labor productivity rises, profits tend to be squeezed. With less profit and a resulting tendency to curb increases in investment per worker, the U.S. industry may become less competitive internationally.⁸ As a result exports may decline.

If domestic demand for the products of such an industry is not price elastic and if its prices are administered, the industry may press hard for higher domestic prices and tariff protection from imports. Such pressures may arise from attempts to maintain profit margins per unit of output. The steel industry is an example.

The Brookings projection of a surplus in the U.S. payments balance for 1968 is based in important part on estimates of a favorable relation of U.S. export prices to European GNP prices and European export prices. The study projects a U.S. export price increase of 0.5 percent per annum, a European GNP price increase of 2.75 percent per annum, and a European export price increase of 1.5 percent per annum (initial assumptions).⁹

⁷ As distinct from "marginal productivity," a concept used in competitive equilibrium analysis.

⁸ If investment is increased and the number of production worker hours and price per unit of output remain unchanged, the total value of output per worker will tend to increase. If wage rates are increased in proportion to the average increase in value of output per worker the percentage increase in return to capital tends to be less than the percentage increase in investment. Hence the incentive to increase investment is likely to be insufficient to bring forth continued increases in investment per worker. "* * * a country with a deficit can reduce the general level of money costs per unit of output, slowly over time, by preventing the general level of money wage rates from increasing as fast as output per man-hour." USEP 1968, p. 248.

⁹ See USEP 1968, pp. 81, 82, 83, 283.

In view of possible upward price pressures in the United States of the kinds cited above, the author of the present article would anticipate less improvement of the U.S. international competitive position and less improvement in the U.S. payments balance position than that projected by the Brookings study, unless the European price increase assumptions are too low.

Examination of GNP assumptions

The Brookings study makes initial and alternative assumptions for GNP growth rates in Europe and the United States. The initial assumptions put the growth rate for real GNP in Europe to 1968 at 4.3 percent a year as compared with 4.8 percent for the United States.¹⁰ The alternative assumptions put the European real GNP growth rate at 3.8 percent per year as compared with 4.2 percent for the United States.¹¹ The relatively high U.S. GNP growth rate is predicated largely upon labor scarcity in Europe and a more abundant supply of labor in the United States.¹² Government fiscal policy in the United States, according to the Brookings assumptions, will induce a high utilization of a rapidly expanding labor force. These relatively high GNP growth rates in the United States would tend to increase U.S. imports and thus contribute to an increase in the size of the U.S. balance-of-payments deficit. The Brookings study concludes, with respect to GNP assumptions, "that the primary consequences of real income changes between 1961 and 1968 in Western Europe and the United States upon the U.S. current accounts will be unfavorable to the United States."¹³

The Brookings final payments balance projections for 1968, of a \$1.9 billion surplus under the initial assumptions and of an \$0.6 billion deficit under the alternative assumptions, are the results of combined effects of the foregoing price and GNP projections, and of other developments analyzed in chapters IV, V, VI, and VII of the Brookings study.

The growth rate projections for European GNP call for a relatively high rate of increase in labor productivity. The Brookings study's initial assumption calls for a 4.6 percent a year increase in European labor productivity. The alternative assumption calls for a 4.2 percent a year productivity increase. Parallel labor productivity assumptions for the United States are increases of 2.9 and 2.3 percent a year.¹⁴

If Europe does not realize these relatively high rates of increase in labor productivity, or if the United States realizes higher rates than those assumed, European real GNP growth will be less relative to that of the United States than the Brookings study estimates. This possible change in GNP assumptions, like changes in the price assumptions, would tend to worsen the projected U.S. balance-of-payments position.

Generalizations with respect to changes in payments balance estimates incident to changes in price and GNP assumptions

For reasons cited in foregoing paragraphs it is the judgment of the author of this paper that if U.S. GNP rises to a 4.8-percent or a 4.2-

¹⁰ GNP at 1961 prices; *ibid.*, pp. 283, 285.

¹¹ *Ibid.*, pp. 283, 285.

¹² *Ibid.*, pp. 45, 60, 61, 283.

¹³ *Ibid.*, p. 58.

¹⁴ *Ibid.*, pp. 45, 283, 285.

percent growth rate for the period to 1968 with a 4-percent unemployment figure, the U.S. basic balance of international payments likely will be less favorable in 1968 than the projections made by the Brookings study. The projections, as already stated, are a \$1.9 billion surplus under the initial assumptions, and an \$0.6 billion deficit under the alternative assumptions.

During a period of years prior to World War I it was accepted practice in a gold standard country for monetary authorities to raise the central bank discount rate when the country experienced persistent international payments deficits and loss of gold reserves. During that period the price of gold was fixed at \$20.67 or approximately 4 pounds and 5 shillings per ounce. Exchange rates of the currencies of gold standard countries remained approximately stable.

When the central bank discount rate of a payments deficit country was raised, money and credit became tighter and prices and gross national product tended to fall in relation to prices and gross national product abroad. Deficit country exports were thus stimulated because of relatively lower prices at home and relatively higher GNP abroad. Deficit country imports tended to decline because of relatively lower GNP at home and relatively higher prices abroad. Also the higher short-term interest rates in the deficit country tended to attract short-term capital from abroad. These developments contributed to elimination of the payments balance deficit. Furthermore, readjustments of domestic price-cost relations in the deficit country were forced by severe competition in the period of tight credit following the increase in the discount rate. These price-cost adjustments tended, in time, to guide the deficit country's domestic economy to a new position of near equilibrium with high-level employment. However, unemployment increased during the adjustment period and high-level employment did not return until after the payments balance deficit was eliminated and the discount rate was reduced, or at least ceased to rise.

In periods of large readjustment and severe business depressions this kind of payments balancing procedure and competitive self-stabilization of domestic economies was costly in terms of low levels of gross national product during the deflationary adjustment period. Avoidance of such losses (in terms of unrealized potential production and accompanying unemployment) is a principal purpose of a new approach to domestic economic planning. This new approach makes use of fiscal policy to prevent unacceptable levels of unemployment.

A currently acute economic issue, in the United States and Europe, centers about the question of whether payments balance deficits can be corrected by government regulation of relative amounts of planned inflationary expansion in a community of trading nations. Under this kind of a system, if foreign exchange rate stability were maintained, planned GNP expansion and price increases would be expected to be greater in payments balance surplus countries than in payments deficit countries.

At present this kind of policy approach to international payments balancing is not working in a satisfactory manner from the point of view of the United States. Price increases and GNP increases in Europe, since achievement of near stability in exchange rates, have been insufficient in relation to price and GNP increases in the United States to dampen European payments balance surpluses, eliminate

U.S. payments balance deficits and stop a U.S. gold outflow. Furthermore, the United States has not as yet achieved a principal objective of its post-World War II national economic planning, viz, maintenance of full employment¹⁵ without persistence of an inflationary trend.

Table I indicates that wholesale prices in the United States increased about 19 percent from a base period 1947-49 to 1962 and that consumer prices increased by about 29 percent during the same period. In only 1 year during this period was unemployment less than 3 percent of the civilian labor force; it was 2.9 percent in 1953. The 3-year averages for unemployment shown in table I range from 3.9 percent of the civilian labor force for the period 1950-52 (Korean war period) to 6.7 percent of the civilian labor forces for the period 1959-61, and 5.6 percent for 1962.

TABLE I.—Wholesale and consumer price indexes and civilian unemployment for the United States, 1947-62¹

Years.	Price indexes (1947-49 average equals 100 percent)		Percent of civilian labor force unemployed
	Wholesale prices	Consumer prices	
1947-49.....	100	100	4.5
1950-52.....	110	109	3.9
1953-55.....	110	115	4.3
1956-58.....	117	120	5.1
1959-61.....	119	126	6.7
1962.....	119	129	5.6

¹ Source: "Statistical Abstract of the United States," 1962, pp. 215, 343, and 348, and Survey of Current Business, June 1963, p. S12.

A more rapid rate of increase in GNP in the United States, generated by deficit financing to increase employment, might worsen the U.S. payments position vis-a-vis Europe. A less rapid rate of increase in GNP in the United States might result in more unemployment. A more rapid rate of increase in GNP and prices in the United States accompanied by even greater increases in GNP and prices in Europe might correct the payments balance deficit of the United States. However, these changes might also necessitate increases in the price of gold for reasons explained in a section to follow. An alternative to changes in the price of gold might be establishment of some kind of international payments clearing system different from that which is in operation at the present time.

Conclusions reached by the present writer thus far are as follows: If the U.S. Government (by deficit financing) succeeds in generating a real GNP growth rate of 4.8 percent a year (or even 4.2 percent a year),¹⁶ and in thus reducing unemployment to 4 percent of the labor force,¹⁷ prices in the United States will rise by amounts greater than the Brookings projections indicate. If European prices should rise faster than those in the United States, with no further devaluation of European currencies in terms of U.S. dollars, the U.S. balance of

¹⁵ Unemployment not in excess of 3 to 4 percent of the civilian labor force.

¹⁶ Real GNP in the Brookings study is referred to as GNP at 1961 prices. The 4.8 percent and the 4.2 percent real GNP growth rates are Brookings study initial and alternative assumptions. See footnote 5, this article.

¹⁷ A Brookings study assumption.

payments might tend to be improved. In this event, however, inflationary trends, throughout the world trading community and accompanying increases in the dollar volume of world trade, might largely increase the world demand for gold at a price of \$35 an ounce. (This increase in demand for gold would be for hoarding in anticipation of a gold price increase as well as for reserve uses of central banks, governments, and international clearing agencies.)

LIKELIHOOD OF AN INCREASED DEMAND FOR GOLD AT \$35 AN OUNCE

Prices in many countries and the dollar volume of world trade appear to have increased in recent years faster than the world's monetary gold reserves. U.S. wholesale and consumer price changes for the period 1947-49 to 1962 are presented in table I of the present paper. Price changes in West European countries and in the United States (1953 to 1962) are presented in table III-5, page 73, of the Brookings study. The dollar volume of world trade is estimated to have increased as follows during the period 1948 to 1961 (table II).

TABLE II.—*World trade (millions of U.S. dollars)*¹

Year	Imports (c.i.f.)	Exports (f.o.b.)
1948.....	63,400	57,300
1953.....	83,800	82,000
1958.....	113,100	107,300
1961.....	140,200	133,400

¹ Trade of China (mainland), Mongolia, North Korea and North Vietnam with each other excluded.

Source: United Nations, "Statistical Yearbook," 1962, pp. 428-429.

World total monetary gold holdings are reported to have increased from \$39,445 million in 1958 to \$41,430 million in 1962.¹⁸ World gold production (excluding the Soviet area and in terms of a \$35-an-ounce price) is estimated to have increased from 1958 to 1962 by \$4,824 million.¹⁹ The difference between changes in the world's monetary stocks of gold and world production of gold, 1958 to 1962, presumably went into industrial uses and gold hoards. These data are in rough conformity with estimates published by the Federal Reserve Bank of New York as follows:

The supply of newly mined and Russian gold reaching the market is now running at an annual rate of approximately \$1.5 billion. Industrial uses of gold normally take up \$400-\$500 million annually and in recent years much of the remaining supply has been absorbed by private speculative buying.²⁰

Under current practice of cutting the direct ties between national expansion of money and credit and monetary gold reserves, demand for gold for international clearing uses may not increase as fast as the dollar value of world trade. Increased need of gold for use in clearing international payments is essentially a problem of dealing with possible increases in the size and duration of payments balance deficits and surpluses. There is no definitive answer to the question of how fast, if at all, the size and duration of payments balance deficits

¹⁸ International Monetary Fund, "International Financial Statistics," August 1963, p. 16.

¹⁹ *Ibid.*, p. 18.

²⁰ Federal Reserve Bank of New York, "Monthly Review," August 1963, p. 117.

and surpluses will increase as the money value of world production and trade increases. If, however, actual monetary need of gold increases faster than the world's supply of monetary gold, or if it is widely believed that monetary demand plus industrial demand for gold are increasing faster than world supply of gold available for these uses, pressures in the direction of increases in the price of gold will rise. Failure of the United States to eliminate its payments balance deficit within a short period of a very few years almost certainly will increase speculative demand for gold hoards at a \$35-an-ounce price. If inflationary price increases tend to accelerate in the community of trading nations, growing uncertainty may increase the demand for gold even though the size and duration of international payments deficits and surpluses do not change. For these reasons the \$35-an-ounce price of gold and the existing international clearing system likely will remain vulnerable if price inflation in the United States is permitted to increase.

This conclusion appears to be in general conformity with that of the Brookings study as implied by the policy recommendations in chapter IX.

OTHER PAYMENTS BALANCING CONSIDERATIONS

Impact of European Economic Community

Chapter IV of the Brookings study examines possible effects of European Economic Community policy upon the U.S. payments balance. The conclusion is that EEC policy likely will contribute to reduced U.S. exports to Europe and third countries.²¹ The author of the present paper agrees with the Brookings conclusion that EEC policy is likely to have an unfavorable effect upon the U.S. payments position during the period to 1968.

Private foreign investment effects

Chapter V of the Brookings study estimates that the net effect of U.S. private investing abroad by 1968 will be substantial improvement of the U.S. balance-of-payments position. This conclusion is based in part upon a long-term tendency for foreign investment income of a net lending country to exceed, in the course of time, the annual level of new investment outflow. The Brookings conclusion assumes some reduction in U.S. private foreign lending in the late 1960's and economical use of private U.S. funds invested abroad. It assumes also ability and willingness of foreign countries to release and transfer anticipated interest and dividends earned on an accumulating large total of U.S. investments in Europe, Canada, Latin America, and elsewhere. Political uncertainty, currency convertibility uncertainty, and foreign exchange rate uncertainty lend a highly speculative element to this kind of forecast. The author of the present paper is inclined to accept the Brookings projections of foreign investment effects upon the U.S. 1968 balance of payments because the estimates appear to be based on reasonable expectations, if all goes well.

Foreign economic assistance and defense transactions

Chapters VI and VII of the Brookings study are concerned with the possible impact of U.S. foreign economic aid and U.S. defense

²¹ USBP 1968, p. 112.

expenditures abroad upon this country's payments balance. The study concludes that a large part of the U.S. funds spent for foreign economic aid are used to purchase U.S. goods and services for export. If U.S. foreign economic aid were increased or reduced, U.S. exports of goods and services would likewise be increased or reduced by possibly as much as 70 to 80 percent of the change in economic aid. Hence a change in the amount of U.S. foreign economic aid would modify the U.S. payments balance deficit by a relatively small amount. Likewise some part—a smaller part—of the U.S. moneys spent abroad for defense purposes serve to increase purchases of U.S. exports of goods and services. The Brookings study projects an increase in U.S. expenditures for foreign economic aid and reduced offshore defense expenditures to 1968. The author of this paper is inclined to put the figure for foreign economic aid expenditures (1968) somewhat lower than that assumed by the Brookings study. A result of this change in assumptions might be some improvement in the U.S. payments balance position as projected by the Brookings study. This favorable effect may be more or less offset, however, by a smaller reduction in offshore defense expenditures than the Brookings study assumed.

POLICY CONSIDERATIONS

For reasons analyzed in foregoing parts of this paper, the writer reaches a conclusion that, in the absence of changes in basic national policy in the United States, this country's payments balance position in 1968 is likely to be less favorable than that projected in the Brookings study.

The Brookings study indicates that continuous full employment policy in the United States is in conflict with foreign exchange rate stability in a framework of existing international monetary institutions. This conclusion suggests to the author of this paper and to the authors of the Brookings study that unit costs and prices of U.S. export goods and services are not sufficiently competitive with costs and prices abroad to promote a volume of U.S. exports necessary to balance U.S. international payments and receipts. The Brookings study suggests that improvement in the U.S. competitive position may occur as a result of price increases abroad greater than those in the United States. Alternatively an improvement in the U.S. competitive position might occur as a result of reduction in U.S. export prices. However, price reduction likely would be accompanied by increased unemployment. Rising unemployment likely would accompany reduction in costs and prices of U.S. export goods because wage rate rigidities, price rigidities, and other types of competitive friction would have to be overcome before full employment with lower prices could be achieved.

The experience of free-enterprise economic systems, and those parts of the economic theory of free enterprise which have been validated by experience records to date, suggest that U.S. Government policy-makers are faced with difficult choices incident to this country's persistent gold losses. On the one hand, elimination of the U.S. payments balance deficit without disruption of the existing international monetary system may call for competitive adjustments in the United States that involve, for a time, more unemployment and less economic growth or for price controls and wage rate controls more stringent

than so-called guideline policy. On the other hand, fiscal policy designed to force a higher rate of economic growth and less unemployment in the United States, in the absence of stringent price and wage controls, may call for abandonment of foreign exchange rate stability or extensive changes in the international monetary system, as suggested by the Brookings study.

A monetary system that provides international liquidity, without definite limits, to particular payments-deficit nations (as suggested by the Brookings report) would permit those nations to pursue domestic economic policies with a minimum of international restraint. Such a system, however, does not have a definite mechanism for the coordination of rates of monetary and price expansion in different nations, thus to facilitate the ultimate balancing of international payments within a framework of stable exchange rates. Successful operation of such a system probably would necessitate resort in many countries to governmental economic controls more stringent than those customarily used, in peacetime, in free enterprise countries (price controls, wage rate controls, and foreign trade controls, for example).

Abandonment of foreign exchange rate stability among nations, or blocs of nations, likewise is a kind of policy that has no specific mechanism for coordinating national rates of price inflation and encouraging international economic cooperation.

STATEMENT BY MORDECHAI E. KREININ

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I. INTRODUCTION

Given their next to impossible assignment, Salant and his associates at the Brookings Institution have produced an admirable document. Their selection of the "basic balance" as the item to be projected for 1968 is sound, since it avoids preoccupation with short-run fluctuations, and helps center attention on underlying trends. The division of the world into three regions is useful in reducing the problem to manageable proportions without losing a great deal of information. Through this approach, the authors were able to sort through an amazing amount of details, bringing to bear on the problem just about all the factors which merit consideration.

Not only does the study exhibit a superb mastery of the relevant facts and figures; it is also careful to point out the hazards involved in making balance-of-payments projections and to underscore the limitation of the data at every stage of the analysis. Indeed it is the explicit recognition of all the factors that makes possible an evaluation of the conclusions reached. The authors are to be commended on the general framework, the focus, and the comprehensiveness of the report. On all these counts, this study is a landmark in the field as well as an important policy document.

For policy purposes, however, it is always useful to hope for the best, but plan for the worst. This is all the more so when one deals with projections which by their very nature (for reasons which are well articulated in the report and need no repetition) tend to be inaccurate. But this dictum was not always adhered to in the Brookings study. Some of the assumptions underlying the projections, which are in large part responsible for the optimistic conclusion reached, appear to have little foundation in recent experience. It seems to me that the overall projection, yielding an elimination of the basic deficit by 1968, is overly optimistic, and cannot be taken as the sole guide for policy planning. Consequently, the policy recommendations contained in the last chapter are incomplete, and should be supplemented with concrete measures designed to remedy the basic U.S. deficit. Before discussing the reasons for this view, it would be useful to summarize the features of the report on which it is based.

II. SUMMARY OF THE BROOKINGS STUDY'S ASSUMPTIONS AND CONCLUSIONS

Two sets of assumptions underlie the Brookings report, yielding vastly different projections for the U.S. balance of payments. They are shown in table 1.

On the "initial" assumptions, the report projects a change from a \$0.8 billion basic deficit in 1961 to a \$1.9 billion basic surplus in 1968.

On the other hand, the alternative assumptions leave the 1961 deficit largely intact, reducing it by a mere \$0.2 billion. The choice between the two sets of assumptions is thus vitally important. The authors apparently suppose that the "correct" assumptions lie somewhere between the two sets examined in the report. Their "best guess" is that the basic deficit would be eliminated by 1968 (p. 230). However, they do not expect this to be achieved before that year; nor do they anticipate fundamental signs of improvement to be discernible before 1965-66. This prediction confirms the expectation prevailing in official circles that the balance-of-payments problem will essentially take care of itself.

TABLE 1.—*Assumptions and results of the Brookings report*

	ASSUMPTIONS			
	"Initial"		"Alternative"	
	United States	Western Europe	United States	Western Europe
	<i>Percent</i>	<i>Percent</i>	<i>Percent</i>	<i>Percent</i>
Annual rise in real GNP.....	4.8	4.2	4.5	3.8
Annual increase in GNP price deflator.....	1.5	2.75	1.5	1.75
Ratio of United States to Western Europe GNP deflator (1961=100).....	92		100	

CHANGES IN THE U.S. BALANCE OF PAYMENTS BETWEEN 1961 AND 1968

[In billions]

	On "Initial" assumptions	On "Alternative" assumptions
Merchandise balance.....	-\$2.4	-\$0.3
Balance on services (including investments income).....	+1.8	+2.0
Net private long-term capital.....	+6	+6
Government transfers.....	-2.1	-2.1
Basic balance.....	+2.7	+2

Source: The Brookings study, tables VIII 1 and 2; appendix tables 3 and 5.

Two factors play a key role in producing the projected elimination of the deficit. Substantial reduction in the American-European price ratio is expected to improve the competitive position of the United States and increase considerably the surplus on goods and services; and the flow of investments and investment income is expected to change "in favor" of the United States. The difference between the two sets of projections is dominated by the relative price factor. The price ratio is considerably more favorable to the United States under the initial than the alternative assumptions, yielding a substantially higher surplus on merchandise trade.

III. GENERAL FRAMEWORK

Despite the comprehensiveness of the report and its sound approach, two methodological assumptions might be questioned. The authors include Japan and Canada among the countries considered likely to spend all their foreign exchange earnings. Although on page 230 they allude to the possibility that these nations may attempt to accumu-

late international reserves, they do not incorporate such an assumption in the computations. Yet this is very likely to be the case. Appendix table 2 (p. 282) shows that both nations have quite consistently accumulated reserves in the past 4 years. Japan was one of only four nonreserve currency nations which accumulated over \$1 billion in reserves during 1958-62.¹ Since Canada and Japan are included in the American rather than the European "trade orbit," and since even under the most optimistic assumptions Japan's competitive position is not likely to deteriorate and may even improve (p. 91), this factor may have caused a significant overstatement in the projected improvement of the American basic balance.

Another more minor factor is the possible effect of the European Free Trade Association (Outer Seven) on American trade. Although less important than the European Economic Community (which is estimated in chapter IV to cause a \$¾ billion payments loss to the United States), EFTA may cause some loss through trade diversion, partly because of the excess industrial capacity in Great Britain.

A partial offset to these forces may lie in the foreign assistance program. Recent congressional sentiments indicate that the authors may have overstated the projected American contribution to foreign aid. However, considering the procurement policies envisaged in chapter VI, the reduction of foreign assistance would not markedly affect the balance of payments. On balance, the factors discussed in this section are likely to reduce the projected improvement in the United States basic balance.

IV. PRIVATE CAPITAL FLOWS

Next to the change in relative prices, the expected shifts in the flow of private capital and investment income are the main forces responsible for the projected improvement in the basic balance. The foreign investments item is expected to show an improvement of \$0.6 billion, a change which is largely predicated upon the attainment of a high growth rate in the United States. The inflow of investment income is expected to rise by over 50 percent between 1961 and 1968.

Both these changes are consistent with a priori expectations. But their size is of necessity an educated guess and does not readily lend itself to objective assessment. Although the authors take great pain to list all the considerations which have bearing on these figures, their arguments are qualitative rather than quantitative in nature. The reader cannot determine how each component of the estimates is arrived at. We shall therefore accept them as the best available estimates. Looking beyond 1968, however, it ought to be emphasized that the decline in the net outflow of private capital would bring about a deceleration of the annual increase in the inflow of investments income.

V. RELATIVE PRICES

We turn now to the most important assumption on which the optimistic forecast rests—the relative price level in the United States and Europe. The decline in the American competitive ability vis-a-vis Europe in the 1950's is usually held responsible for the balance-of-

¹ Federal Reserve Bulletin, April 1963, p. 424.

payments problem (see the next section for further discussion), and a reversal of this trend in the sixties is expected to cure it. The degree of decline in the American-European price ratio dominates the difference between the "initial" and the "alternative" projections, and is therefore very important. It is my view that the "alternative" forecast is more realistic, and is perhaps the best that can be expected without drastic government action. Consequently, the selection of some point between the two sets of assumptions is not a legitimate procedure. The basis for this view revolves around possible price development in the United States rather than in Europe.

It is difficult to believe that an annual growth rate of 4.8, or even 4.5 percent in real GNP, over a continuous period of 6 years, can be accomplished with as small a degree of inflation as 1.5 percent annual increase in the GNP price deflator. The contention that as long as unemployment remains above 4 percent of the labor force (and the presently proposed fiscal program aims essentially at this figure) there is little fear of inflation, has no basis in recent American experience. During the past decade, a growth rate of the magnitude envisaged here was never sustained for more than 1 year. Table 2 shows that the 3 years in which such a growth rate was attained or surpassed (1955, 1959, 1962) were not only "isolated" years, but were also preceded by years of slow and even negative growth. The Brookings study appears simply to extrapolate the rate inflation in the 1960-62 period. "This rate" (1.5 percent), it states, "is about equal to the rate at which GNP prices have actually been rising in the past 3 years" (p. 81). But only in one of these years did the economy experience the growth rate envisaged in the report. On what basis the authors selected the last 3 years and not the 4 years preceding them for extrapolation into the future is not made clear. The fact is that there exists no empirical basis in recent experience on which to determine the price rise that might accompany a consistent growth rate of 4.5 percent. But it is likely to be above the assumed 1.5 percent; a figure twice this amount may be more realistic.

The skepticism raised here casts serious doubt on the validity of the projection. If, for Western Europe, we assume an annual price increase of somewhat above the midpoint between the "initial" and "alternative" assumptions, any American price increase of above 2.3 percent per year would upset the authors' conclusion concerning the elimination of the basic deficit.

TABLE 2.—*Real gross national product (in billions of 1954 dollars) and GNP price deflator (1954=100) in the United States*

Year	Real GNP	Annual change	GNP price deflator	Annual change
1952	353.5	-----	98.1	-----
1953	369.0	15.5	99.0	0.9
1954	363.1	-5.9	100.0	1.0
1955	392.7	29.6	101.2	1.2
1956	400.9	8.2	104.6	3.4
1957	408.6	7.7	108.4	3.8
1958	401.3	-7.4	110.8	2.4
1959	428.6	27.3	112.6	1.8
1960	439.9	11.3	114.2	1.6
1961	447.7	7.8	115.7	1.5
1962	474.8	27.1	116.9	1.2

Source: Survey of Current Business, July 1963.

It is of course entirely possible that price stability in the United States would be maintained if the projected growth rate is not achieved. In that case, assuming that the projected rise in European prices would take place, the balance-of-payments problem could be remedied via the classical mechanism, i.e., persistent domestic recession. This, however, is much too high a price to pay for the cure. Very few economists would advocate that the United States should forgo the benefit of some \$50 billion per year worth of goods and services, in order to eliminate by 1968 an annual deficit of \$1 or \$2 billion in the balance of payments.

But even if price stability were achieved at the expense of economic growth, the improvement in the basic balance would not be as great as projected. A major component of the improvement (\$0.6 billion) under both sets of assumptions is a favorable shift in the flow of investment funds, which is predicated on a high domestic growth rate. Failing this, private capital would continue to be attracted to Europe as before.

In sum, the Brookings optimistic projection is based on the expectation of a high rate of growth and continuous price stability in the United States. The first factor would attract long-term capital while the second would improve the American competitive position. It is my view that while this combination is highly desirable it is not realistic. Thus, if the President's fiscal program is enacted and proves successful, and barring unforeseen inflationary pressures in Europe, it is overly optimistic to expect elimination of the basic deficit by 1968. This conclusion is strengthened by the two points discussed in section III of this paper.

To say this is not to deny the possible emergence of circumstances which might alleviate the external payments problem (at least temporarily). For example, the expansion of international trade in agricultural products (either among Western nations or with the Communist bloc) would strengthen the balance-of-payments position, since the United States enjoys a comparative advantage in this sector. But the solution is not likely to come from the factors considered in the Brookings report.

This conclusion as well as the differences that emerge in the Brookings study between the two sets of projections, underscore the hazard of making balance-of-payments forecasts. Data limitations make it difficult to diagnose a problem *ex post facto*, let alone establish accurate projections. For this reason, the Brookings study ought to be reexamined by its authors somewhere in the 5-year span between now and 1968—perhaps in 1965-66. It is at that time that they expect a discernible trend of improvement to emerge (p. 23). With the benefit of hindsight, and the use of more accurate data which can be developed in the meantime, the assumptions and projections can then be either verified or modified.

Barring upsetting developments, whatever happens in the next 2 years would still leave the United States with a large volume of international reserves. There would still be time to plan and take drastic steps to cure the imbalance. It would be the purpose of the intermediate forecast to determine if such action is necessary.

In view of the importance of the relative price factor in causing (and curing) the basic deficit, and in light of the limitations placed

by data availability on international price comparisons, the next section offers a supplementary approach to the problem.

VI. THE QUESTION OF PRICE COMPARISONS

The authors of the Brookings study along with other students of the subject, trace the main reason for the basic external deficit to price-cost disparity between the United States and Europe. A sample of recent studies demonstrates the point. R. Cooper presents costs and price comparisons for the manufacturing sector between the United States and other industrial countries, and concludes:

There are unmistakable signs that the competitive trade position of the United States has indeed slipped somewhat in recent years * * *. Rising costs seem to be due less to excessive wage increases relative to those abroad, than to our very unimpressive improvement in labor productivity in manufacturing compared with that of the world's industrial countries.²

Similar conclusions were reached by Cheng³ and Benoit.⁴ In Benoit's study the cost-price comparisons were supplemented by a sample survey of American corporations, whose reported experience seems to substantiate the statistical calculations. The cost-price comparisons undertaken by MacDougall⁵ point in the same direction, but he considers them less convincing.

All this evidence, pointing to a decline in the competitive position of the United States between 1953 and 1958, is based strictly on international comparisons. It is well known however, that such purchasing power parity computations are hazardous,⁶ and are not completely reliable when the price movements have been of modest proportions. The Brookings study states (p. 79) :

There is thus a strong prima facie case for the conclusion that a decline in price competitiveness has been responsible, at least to some extent, for the decline in the U.S. export share. The question remains how important a factor it has been. This question cannot be answered with any real confidence for two reasons.

The first is the questionable reliability of the price indexes, especially for purposes of intercountry comparison. Indexes for highly fabricated and heterogeneous products such as capital equipment, which are so important in U.S. exports and which are responsible for such a large part of the unfavorable price showing of the United States, are especially unreliable. The rise in U.S. price indexes exceeded those of other countries, taken as a whole, by enough to suggest that it was at least partly the result of genuine price movements. But this does not mean that the evidence of the indexes can be accepted at face value.

The second difficulty in appraising the importance of price movements as an influence on export shares is the problem of untangling their effects from those of other factors operating in the same period * * *.

While in the final analysis there is no escape from making international comparisons of costs and prices, the often expressed reservations suggest that such comparisons ought to be supplemented,

² R. N. Cooper, "The Competitive Position of the United States," in "The Dollar in Crisis," edited by Seymour Harris (New York: Harcourt, Brace & World, Inc., 1961), pp. 162-163.

³ H. S. Cheng, "Relative Movements in the Prices of Exports of Manufactures," International Monetary Fund Staff Papers, vol. IX, No. 1 (March 1962), pp. 80-107.

⁴ E. Benoit, "Europe at Sixes and Sevens" (New York: Columbia University Press, 1961), pp. 137-170.

⁵ Sir Donald MacDougall, "The Dollar Problem: A Reappraisal," Essays in International Finance (Princeton University), No. 35 (November 1960).

⁶ See G. Haberler, "Domestic Economic Policies and the United States Balance of Payments," *The Dollar in Crisis*, op. cit., pp. 63-72.

whenever possible, by other kinds of data. One such supplementary approach may consist of interindustry comparisons within the United States, and within any of the surplus countries. What follows relates to the United States (the deficit country), but could be duplicated in Europe.

Suppose data were available on costs, prices, and foreign trade for each manufacturing industry. Then interindustry comparisons over time could indicate the effect of price movement on the foreign trade position of individual industries. For consistency with the hypothesis that the U.S. competitive position deteriorated during the 1950's, one would expect changes in exports to be negatively related and changes in imports positively related to movements of prices and costs. Ideally, such a test should be based on a fairly refined industry breakdown—say, the four-digit standard industrial classification (SIC).

Unfortunately, performance of this test is significantly constrained by the availability of data. Foreign trade statistics have been converted to the SIC basis only since 1958. While a study by Vaccara⁷ provides the data for 1954, the census classification itself was changed in 1957, so as to make 1954-58 comparisons at the four-digit level virtually impossible. Likewise, figures on prices and costs are available to the scholarly community only at the two-digit classification level⁸ for 1947-58. Consequently, the data used here relate to changes between 1954 and 1958 in 19 two-digit and 1 three-digit (motor vehicles) SIC industry groups in the manufacturing sector.

Table 3 presents correlation coefficients between percentage changes in prices and costs in each of 20 U.S. industry groups, and percentage changes in imports, exports, and their ratio to shipments for the same industries. The results lend additional support to the argument that there has been a decline in the American competitive position. They can be summarized as follows: (a) Changes in imports are positively related to changes in wholesale prices, (b) changes in exports and the export shipments ratio are negatively related to changes in labor costs, and (c) changes in imports and the import shipments ratio are positively correlated, while changes in the export shipments ratio are negatively correlated with changes in production workers' cost per unit of output. The last relationship is reversed when the productivity factor is ignored (see last column). Changes in hourly earnings are positively related to changes in exports and negatively related to changes in imports. That is, the positive relation between exports and money wages, detected by Kravis,⁹ was intensified during the period considered here.

⁷ B. N. Vaccara, "Employment and Output in Protected Manufacturing Industries," the Brookings Institution, 1960.

⁸ See H. M. Levinson, "Postwar Movement of Prices and Wages in Manufacturing Industries," Study Paper No. 21, Joint Economic Committee Study of Employment, Growth and the Price Level, Jan. 30, 1960, pp. 28-48.

⁹ See I. B. Kravis, "Wages and Foreign Trade," Review of Economics and Statistics, vol. 38, No. 1 (February 1956), pp. 14-30.

TABLE 3.—*Correlation coefficients between changes in foreign trade and changes in costs and prices for 20 U.S. industry groups,¹ 1954-58*

Percentage change in	Percentage change in—			
	Wholesale price index	Total labor cost per unit of output	Production workers cost per unit of output	Hourly earnings
Import.....	+0.523	+0.031	+0.520	-0.185
Export.....	-.005	-.278	-.070	+ .375
Import shipment ratio.....	+ .111	+ .062	+ .492	-.204
Export shipment ratio.....	+ .059	-.321	-.391	+ .329

¹ 17 cases were used in the 1st (left hand) column, because wholesale price data were missing for 3 industry groups: printing and publishing, transportation equipment, and instruments. The next 2 columns are based on 19 industries, as labor cost data were not available for the motor vehicles industry. The same correlation coefficients were computed for these data, weighted by shipments. They all have the same signs as the coefficients based on unweighted data, and the absolute figures are remarkably similar.

Sources: Exports and shipments figures are derived from B.N. Vacca, *op. cit.*, appendix table A-7 for 1954; and from Bureau of the Census, "U.S. Commodity Exports and Imports as Related to Output, 1958" (Washington: 1962), for 1958. The reconciliation of industrial classification between the 2 years is based on Harold T. Goldstein, "From the Old to the New 1957 SIC", Bureau of the Census. Cost and price data were obtained from H.M. Levinson, *op. cit.*, pp. 28-48.

The small number of cases employed in the computations, and the relatively small coefficients obtained, make these results highly tentative. They are presented mainly as a demonstration of the proposed approach. Should the Bureau of Labor Statistics develop series of cost-price indexes for some 70 three-digit SIC industries, the number of cases included in the test would not only yield more reliable results, but would also make possible the use of more refined statistical techniques.

Another hypothesis which could be tested is the contention that the external imbalance is due to monopoly power in American industry, and can be reduced by increasing competition.¹⁰ As a measure of monopoly power one can use the concentration ratios (namely, the proportion of an industry's output produced by the four largest, and eight largest companies in that industry) which are available in census years for four-digit SIC industries.¹¹ While some industries would have to be combined to achieve comparability with the foreign trade statistics converted to the SIC basis, there would still be close to 200 cases to employ in the test. The change in foreign trade indicators used in table 3 could then be correlated with the change in the concentration ratios over the same period. Alternatively, one may assume a lagged effect and correlate the change in the foreign trade variables with a preceding change in industrial concentration. Available data to date do not permit performance of these computations because of the revision of the census industrial classification in 1957 and the non-availability of foreign trade data on SIC basis before 1958.¹² But in the future, the calculations described here could shed light on such problems as the effect of awarding large contracts to foreign suppliers

¹⁰ See G. Haberler, "Domestic Economic Policies and the United States Balance of Payments," in S. Harris (ed.), "The Dollar in Crisis," *op. cit.*, p. 66.

¹¹ See for example: "Concentration Ratios in Manufacturing Industry, 1958," report by the Bureau of the Census for the Subcommittee on Antitrust and Monopoly, U.S. Senate (87th Cong., 2d sess.), pt. I (Washington: 1962), table 4.

¹² I did, however, perform some "illegitimate" computations, relating flow to stock variables: correlation coefficients were computed between the percentage change in the four foreign trade variables between 1958 and 1960 and the 1958 concentration ratios. The coefficients are far too small to be of any significance. But their signs indicate that industrial concentration may indeed affect imports favorably and exports unfavorably.

when the domestic bids are much too high because of concentrated power.

VII. POLICY CONCLUSIONS

The proposed reexamination of the Brookings projections in 1965-66 would be designed to determine more accurately what might happen in 1968. Should the present Brookings projections prove overly optimistic (as I suspect they would if a desirable growth rate is achieved in the United States), the policy conclusions of the report would also be affected. Such a finding would mean that the balance-of-payments problem is not likely to disappear by itself, and may not be susceptible to the stopgap administrative measures taken to date or contemplated in the near future. More drastic steps may be called for.

This, however, would not invalidate the author's discussion of the international currency standard in chapter 9. Whether the U.S. external problem takes care of itself, or whether it is cured by direct policy measures, steps may have to be taken to increase the volume of international liquidity. Also, the author's basic policy premise that the balance-of-payments problem should not be permitted to interfere with the attainment of important policy objectives (such as a high growth rate and a desired level of foreign aid) is indisputable.

Assuming away any restrictions on trade and payments as contrary to the national interest, what "drastic" measures would be appropriate towards the end of the decade to cure the balance-of-payments problem? Suppose that the conditions prevailing in 1968 are as follows: the United States experiences an annual growth rate of 4 to 5 percent, but continues to have excess industrial capacity, and 4 to 5 percent unemployment (part of which is structural and frictional while part is a result of deficient aggregate demand). Western Europe, on the other hand, continues to grow at a fast rate with a considerable amount of excess demand. As projected by the Brookings study (p. 52) potential European GNP would be \$422 billion at 1960 prices, coupled with aggregate demand of \$439 billion, yielding an excess demand of 4.2 percent. At the same time the United States continues to have balance-of-payments deficits to the tune of \$1 billion a year, which have their counterparts in European surpluses. But by 1968 American gold reserves would have declined and European reserves risen, by several billion dollars. Under these conditions, bankers on both sides of the Atlantic would probably view further deterioration in the American position with considerable anxiety.

Since the dominant factor causing the external deficit appears to be price disparity, it would be best to attack the problem at its source. However, attempts to influence the domestic price level on either or both sides of the Atlantic are not likely to succeed. In the United States, significant inflationary pressures (mainly of the cost-push variety) are likely to accompany a reasonably high growth rate—inflation which may not respond well to restraining public policy. At the same time, it would be unrealistic to expect European governments to accelerate their rate of inflation in order to eliminate the external surpluses. Indeed they are more likely to pursue an opposite policy. Thus the only way to change relative prices is through exchange rate adjustment. While exchange variations under the present system of adjustable peg should be used very sparingly and with great care, it

would be a folly to abandon them altogether as an instrument of public policy.

Had the dollar been the currency of a small nation, its devaluation would have been an ideal solution. It is a remedy often advocated for a country faced with a combination of an external deficit and unused resources. The main objection to devaluation, expressed by both bankers and economists, is its implications for the gold exchange standard system in which the dollar occupies a major role as a reserve currency. To quote two recent statements:

It is clear that the United States has rightly rejected devaluation of the dollar or any impairment of the interconvertibility of gold and the dollar at the fixed price of \$35 per ounce. Such a step would be a breach of faith with our friends abroad, and with our own citizens, that would undoubtedly wreck the international financial structure we have been building since World War II.¹³

Whatever other consequences would follow from a devaluation of the dollar, I am convinced that it would immediately spell the end of the dollar as an international currency and the beginning of a retreat from the present world role of the United States that would produce far-reaching political, as well as economic effects. It would, in my judgment, invite the disintegration of existing relationships among the free nations that are essential for the maintenance and extension of world prosperity and even world peace.¹⁴

Other reasons for opposing devaluation are the stimulus it would provide to the uneconomic activity of mining gold, and the benefit it would bring to Russia and South Africa as the major gold producing countries.

A final objection to devaluation, all too often overlooked, is the unfavorable effect it would have on many countries who do not enjoy external surpluses and may even be beset by deficits. The surpluses occasioned by the American deficits are concentrated in a few countries;¹⁵ but the dollar plays an important role in the trade and payments of all nations. Dollar devaluation may, therefore, upset the external balance of many regions, thereby producing far-reaching repercussions on exchange relations. It may, for example, result in comparable devaluations in all but the few surplus countries; and such extensive exchange realignments cannot fail to disrupt the entire system. Of equal significance is the effect of devaluation on the major surplus nations. Without international cooperation, even these countries may choose to retaliate, thus nullifying the entire gain from devaluation. The net effect would then be gross disruption and no gain. Any realignment of the major exchange rates would require concerted action on the part of the countries involved.

But should the necessary cooperation be forthcoming, the realignment of exchange values can be better accomplished through revaluation of the several surplus currencies. None of the objections to devaluation would apply to this course of action, although both would produce the same effects on United States-European exchange rates. The very act of revaluation would provide a strong indication of international financial cooperation. One of the main criticisms of the gold exchange standard is the deflationary bias which it produces when

¹³ Alfred Hayes (president of the Federal Reserve Bank of New York) "The Dollar: National and International Bulwark," Federal Reserve Bank of New York Monthly Review, May 1963, p. 71.

¹⁴ Chairman W. M. Martin of the Federal Reserve Board, "Monetary Policy and International Payments," Journal of Finance, vol. XVIII, No. 1 (March 1963), p. 6.

¹⁵ Of the nonreserve currency countries, only West Germany, France, Italy, and Japan each accumulated over \$1 billion in reserves during 1958-62—the figures being \$1.8, \$3.5, \$2.3 and \$1.5 billion respectively. See Federal Reserve Bulletin, April 1963, p. 424.

the burden of adjustment falls solely on the deficit nations (since the surplus countries are under no pressure to take remedial action). Revaluation of the major undervalued currencies would demonstrate that such a bias is not a necessary part of the system; that cooperation of the surplus countries is forthcoming, and can be counted on in the future; and that the system can operate more smoothly than it did in the interwar period. While dollar devaluation would weaken confidence in the system, the suggested revaluations are likely to strengthen it.

Revaluation is tantamount to dollar devaluation only as far as the relationship between the dollar and the few revalued currencies are concerned. Its effect on all other currencies would be precisely the reverse. Instead of hurting countries who are currently in balance or in deficit, and perhaps forcing realignment of their exchange rates, it would improve their competitive position. This is all the more important in view of current developments in the trade field. Three major surplus countries (plus three others) are in the process of forming the European Economic Community. Through its discriminatory effect on outsiders, a customs union is usually expected to improve its own terms of trade and, therefore, its balance-of-payments position.¹⁶ P. J. Verdoorn suggested that European currencies would have to appreciate by 2 to 10 percent in order to maintain equilibrium with the outside world.¹⁷ Revaluation of their currencies would help cushion the impact on nonparticipating nations.

Finally, the suggested revaluation would not result in an "unecomic" increase in gold production,¹⁸ and would not benefit the main gold-producing countries.

In sum, the concentration of reserve gains in several countries, and the widespread use of the dollar, place the burden of exchange adjustment on the surplus countries. Remedial action, taken right at the source of reserve accumulation, would call for no larger amount of international cooperation than devaluation of the dollar, and in the process the gold exchange standard would be strengthened rather than weakened.

The surplus countries would derive the same benefits from revaluation that they would from dollar devaluation. By discouraging exports and encouraging imports, revaluation would help them control their boom and ease the labor shortages. By improving their terms of trade,¹⁹ revaluation would raise their standard of living. Exchange adjustment can be used as one way to reap the benefits of rising productivity. Thirdly, revaluation would eliminate their external surpluses and arrest the somewhat embarrassing accumulation of reserves. There is no advantage to any nation to go on piling international reserves beyond a certain point. What the level of sufficiency might be cannot be determined a priori. But since reserves are held to tide a country over a deficit period, that level is related to the country's an-

¹⁶ See the discussion of the "tertiary repercussions" in J. E. Meade, "The Theory of Customs Unions," North Holland Publishing Co., 1955.

¹⁷ Quoted from Erik Thorbecke, "European Economic Integration and the Pattern of World Trade," *American Economic Review*, vol. LIII, No. 2 (May 1963), p. 152.

¹⁸ This of course means that some measures would have to be adopted to supply reserves to the system, should their quantity prove inadequate.

¹⁹ This statement implicitly assumes that European producers, faced with excess demand at home, would not feel compelled to resist any contraction in their export markets. Consequently they would not lower export prices (measured in terms of their own revalued currencies) in proportion to decline in their import prices.

nual import bill (and the instability of its balance of payments) which the reserves may have to finance. It has been suggested that most of the major industrial countries would regard as satisfactory a reserve level of about 40 percent of annual imports.²⁰ In the case of Germany, France and Italy, accumulated reserves at the end of 1962 exceeded half of the annual imports of goods and services, and were above two-thirds of yearly commodity imports. They may approach the value of annual commodity imports by the end of the decade. When reserves reach this level, further accumulation cannot be regarded as desirable.

The suggested revaluation would improve the competitive position of the United States, and would enable this country to generate sufficient surpluses on current account to finance the necessary international commitments and the desired level of capital outflow. In the process income and employment would rise, and the administration would be freed of the external constraint on further domestic expansion.

How much revaluation is necessary to restore equilibrium is difficult to determine in practice. In view of that difficulty, this recommendation may be coupled with another one—namely, the widening of the spread between the buying and selling rates of the revaluing currencies. If rates are allowed to fluctuate within wider margins, it would not be necessary to pinpoint the new equilibrium level (which, in any case, is subject to future changes.) A reasonable approximation would suffice for setting the upper and lower limits; and within them the equilibrium exchange rates would be established through the interplay of market forces. While this is not a recommendation for freely fluctuating exchange rates, the arguments advanced in favor of such a system²¹ would apply here to some extent. But in the short run, the widening of the spread would facilitate the realignment of exchange rates to new equilibrium levels.

²⁰ Robert Triffin, "Gold and the Dollar Crisis," New Haven, Yale University Press, 1961, p. 45.

²¹ See Egon Sohmen, "Flexible Exchange Rates," Chicago, University of Chicago Press, 1961, and his "International Monetary Problems and the Foreign Exchanges," International Finance Section, Princeton University, April 1963.

STATEMENT BY JOHN M. LETICHE

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These comments on the "United States Balance of Payments in 1968" are made on the basic postulate that the problem is at present both real and urgent. Its deleterious effects on the domestic economy are to be matched only by its massive hampering of our foreign policy objectives. I was requested to appraise the projections of the Brookings' report along three lines: Findings, inferences, and recommendations.

FINDINGS

The authors of the Brookings' report are to be congratulated on their presentation and analysis of the necessary factors involved in the formulation and solution of the U.S. balance-of-payments problem. On the basis of recent experience, the early assumptions provided by the Council of Economic Advisers appear to be realistic for Western Europe, but not for the United States. In examining the long-term forces at work, the authors of the report have used the concept of the "basic balance." This approach correctly assumes that normal short-term capital movements are a consequence of balance-of-payments disturbances and, with gold flows, are utilized to settle net balances. Because of the serious U.S. balance-of-payments deficit since 1958, however, short-term capital movements have become a cause, well as a result, of the crisis. The more than \$22 billion of U.S. short-term liquid assets held by foreigners are, in effect, the most important single disruptive element in the financial mechanism which can at any time produce the kind of gold drain that no liquidity center could withstand.

As the Brookings' report indicates, the assumptions in regard to the U.S. economy are not to be considered as the basis for forecasts. A reasonable degree of reliance may be placed upon their findings if they are interpreted merely as projections to explore the extent to which a high level of employment might be consistent with the restoration of equilibrium in the balance of payments. But because the assumptions are too optimistic, and the emphasis is on the long-term "basic balance," the inferences and conclusions are not realistic.

Therefore I present two sets of more pessimistic assumptions regarding the U.S. growth rate and price movements in the United States and Western Europe. The report also assumes that a relative price rise of say 10 percent in European GNP prices to U.S. export prices would increase U.S. exports to them by 25 percent (i.e., a price elasticity of 2.5). In my more restrained assumptions, a similar improvement in U.S. competitive position would expand the value of U.S. exports to Western Europe by only 20 percent (i.e., a price elasticity of 2). The other assumptions of the Brookings' report remain fundamentally unaltered.

On the basis of the Brookings' initial assumptions; namely, an annual growth rate of GNP in the United States of 4.8 percent and in Europe of 4.2 percent, the real income changes in the United States would result in expanding imports more rapidly than exports, drastically reducing the U.S. trade surplus by 1968. The primary effects of these income changes were then counterbalanced by assuming that the U.S. competitive position would greatly improve relative to Western Europe. It was postulated that the European GNP deflator between 1961 and 1968 would rise 3 percent a year as compared to 1.5 percent in the United States; export prices would rise 1.5 percent in Europe as against 0.5 percent in United States. These optimistic assumptions envisaged that U.S. competitiveness would improve to such an extent as to yield a trade-balance surplus of \$5.3 billion by 1968. Considering all the other items which enter into the balance of payments, the report concludes that the U.S. "basic deficit" of \$850 million in 1961 would be reversed into a "basic surplus" of \$1.9 billion in 1968. By revising their assumptions to a GNP growth rate of 4.2 percent for the United States (with the same price changes), and of 3.8 percent for Western Europe (with the related slower rate of price increases of 1.5 percent for the GNP deflator and of 1 percent for exports), the authors showed that the trade-balance surplus would be \$2.6 billion in 1968, and that the "basic balance" would be a deficit of \$600 million.

My own projections are based on the relationships of imports and exports to GNP that have prevailed in the postwar period.¹ My first hypothesis is a U.S. annual GNP growth rate of 3.5 percent, accompanied by a rise of 1 percent in export prices, and a European annual GNP growth rate of 4.2 percent. All other assumptions remaining the same, I obtained the result that the relatively lower growth rate of the United States will bring about a sufficiently smaller increase in U.S. imports as compared with exports which will yield a trade balance in 1968 similar to that of 1961—\$3.5 billion. With my lower assumed improvement in the U.S. competitive position, this figure is raised to a trade-balance surplus of \$6.5 billion. Incorporating all other items, these assumptions yield a surplus in the "basic balance" of \$3.5 billion for 1968.

By combining my own revised assumptions of a 3.5-percent U.S. growth rate with those of the Brookings' alternative assumptions of a lower 3.8-percent growth rate for Western Europe—i.e., approximately comparable rates of growth for the two regions—and similar price increases in Europe as in the United States, my projections result in a trade surplus of \$3.4 billion for 1968, and a "basic surplus" of \$300 million.

If, under my first set of assumptions, I propose that U.S. capital movements would be maintained in 1968 at the 1961 level, rather than be reduced as the Brookings' report assumes, the "basic surplus" would be lowered to \$2.9 billion. Under my second set of assumptions, it would be reversed into a deficit of \$300 million. Moreover, if all the trade projections are based on an abnormal prospective expansion of net U.S. exports to Europe, either because the base period of the postwar years was unduly favorable to the United States, or because the

¹ For the conclusions and methods used see the statistical appendix to this paper.

trend of commercial policy of the European Economic Community might become less advantageous to the United States, the "basic surplus" of \$3.5 billion under my first assumptions would be reduced to a "basic surplus" of approximately \$2 billion. If the U.S. competitive position were not to improve, a deficit of \$1 billion would result. This illustrates dramatically how important it is for the United States to maintain and improve its competitive position vis-a-vis other countries—primarily Western Europe.

It must be emphasized that comparatively small changes in the assumptions, either in relative growth rates or in competitive conditions, drastically alter the results both of the Brookings' and my own projections. This is to be expected from the fact that the "basic balance" is the result of differences in large gross sums or receipts and payments. The formulation of policy on the basis of balance-of-payments projections is therefore, by its very nature, a precarious undertaking. Nevertheless short-term and long-term U.S. planning with respect to the balance of payments would be more productive if an approximation could be determined of the most likely long-term structural forces at work. And on the basis of my not unreasonable assumptions, the basic U.S. position in 1968 would still appear to be favorable. (See table I.)

TABLE I.—Summary table of U.S. trade and payments balances: Actual 1961 and various estimates for 1968¹

[In billions of dollars]

	Actual 1961	Estimated for 1968			
		Optimistic		Less optimistic	
		I Council	II Brook- ings	III My	IV My
Projected U.S. exports.....	18.0	28.6	25.0	26.0	23.1
Projected U.S. imports.....	-14.5	-23.3	-22.4	-19.5	-19.7
U.S. trade balance.....	3.5	5.3	2.6	6.5	3.4
Basic balance of payments.....	-.85	+1.85	-.62	+3.5	+3

¹ The assumptions under which the various estimates were derived are as follows:

ANNUAL RATES OF GROWTH

[In percent]

	I Council	II Brook- ings	III My	IV My
United States:				
GNP growth.....	4.8	4.2	3.5	3.5
GNP deflator.....	1.5	1.5	1.5	1.5
Export prices.....	.5	.5	1.0	1.0
Western Europe:				
GNP growth.....	4.2	3.8	4.2	3.8
GNP deflator.....	3.0	1.5	3.0	1.5
Export prices.....	1.5	1.0	1.5	1.0

INFERENCES

My conclusions, although similar to those of the Brookings report, but drawn for totally different reasons, were obtained primarily from the view of a relatively lower growth rate in the American economy as contrasted with that of Western Europe. Their conclusions, on the other hand, resulted from a comparatively higher American growth rate, inflation in Western Europe, and the greater response of American sales to an improved U.S. competitive position. On the basis of these different points of view, the inferences drawn from our respective conclusions diverge. With the lower growth rate in the United States, short-term and long-term capital outflows would tend to be maintained, if not increased. For the achievement of our long-term domestic and international objectives, a satisfactory solution to the balance-of-payments deficit, therefore, necessitates measures that would reduce such capital drains. I propose to consider this matter in terms of the significance of the American dollar in performing: (1) a trading-liquidity function; (2) a reserve-liquidity function; and (3) a growth-liquidity function in the world economy. These functions are interrelated, but it is useful to treat them separately in order to point out their relative importance, for this estimate of importance determines in large measure the degree of urgency in solving the U.S. balance-of-payments problem.

(1) *The trading-liquidity function*

The trading-liquidity function of the U.S. dollar permits nations to exercise a choice as to the timing of their imports of goods and services. The United States now possesses monetary gold holdings, convertible foreign currencies, standby facilities, and drawing rights on the International Monetary Fund that exceed the projected value of U.S. annual imports for the period 1961-68. These reserves, in proportion to U.S. imports, are larger than those of any other important trading country. This fact explains the strength that the U.S. dollar has maintained in recent years. Foreign countries hold huge dollar balances as trading reserves because there is more security in their future value, at going rates of return, than in that of any other currency. For these reasons, I agree with the report that the reserve position of the United States with respect to the trading-liquidity function of the dollar is fundamentally strong.

(2) *The reserve-liquidity function*

This function allows countries to hold U.S. short-term securities as secondary reserves. The sale of these securities serves a mutual purpose of financing U.S. outpayments and providing a secure income-earning asset to foreign banks. The Brookings report claims that the requirement of the 25-percent gold reserve against Federal Reserve notes and deposit liabilities can be suspended in an emergency, and its abolition would release U.S. gold reserves for normal international settlements in the future. Allegedly: "This would make clear that the reserves are available to the full and at all times, not merely in emergencies, to serve their only useful function" (p. 252). Clearly, this cannot mean that our gold reserves can be fully used without maintaining some floor beyond which they cannot fall if pressure on the U.S. exchange rate is to be avoided. The chief reason that

other governments use the dollar in regard to its reserve-liquidity function is the confidence they have in its future value. It cannot be exaggerated that the potential pressure upon the dollar is now more contingent upon a change in the willingness of foreigners to retain this stock of short-term claims than the long-term basic balance-of-payments position of the United States. Therefore, the recommendations of the Brookings report for present expenditure of a substantial sum of gold—\$3 to \$5 billion—to purchase foreign currencies which could then be used as needed to finance the deficit over a prolonged period “without further outflow of gold” to me appears ill-advised.

Should serious pressure on the dollar occur, the American Government would probably have to resist such forces by imposing controls on capital movements and, if need be, on imports, before devaluing the dollar. Such restrictions would be even more deleterious to the European than to the American economy. The need for such measures should be prevented. A continued liberalization of Western European and U.S. trade policies would curb inflationary and monopolistic tendencies, promoting appreciable rates of economic growth and international equilibrium.

The authors of the report maintain that the United States should deal with its balance-of-payments deficit in ways that do not hamper other national objectives. But it is manifestly impossible to separate domestic and foreign policies; in effect, the achievement of equilibrium in our balance of payments is now inextricably linked with our major domestic and international goals. The report claims that “it is inadvisable to raise interest rates in an attempt to affect international flows of capital, unless, as seems unlikely at present, the adverse domestic effects of higher rates can be fully offset by fiscal expansion” (p. 253). On the basis of my analysis, the most efficacious solution would be the stimulation of the American economy by tax reduction and the further increase of interest rates on short-term capital.

(3) *The growth-liquidity function*

This function serves the purpose of augmenting the volume of reserves in proportion to the volume of international transactions attendant upon economic growth. It is ironic that the richest country in the world should permit its rate of economic growth to lag because of insufficient reserves. It is regrettable that national security and foreign aid are influenced by this fact. Contrary to the widespread belief, the United States has not been living beyond its means either in domestic or foreign expenditures. The U.S. balance-of-payments crisis has not been the result of an excess of domestic expenditures over production. Our long-term investments abroad have, in effect, increased as rapidly as the total foreign holdings of U.S. liquid claims.

RECOMMENDATIONS

If my appraisal of the evidence appears reasonable, then the report's recommendations for the solutions of the U.S. balance of payments need to be distinguished between those measures that pertain to the present situation as it relates to the trading and reserve functions of the dollar, and those that pertain to the longer term requirements of economic growth and international liquidity.

In regard to the present situation, the following policies appear to be consistent with the most reasonable projections for the next quinquennium and require early implementation:

(1) The passage of a tax-reduction bill to stimulate the economy and an attendant further increase in short-term rates of interest to check the outflow of capital.

(2) The maintenance and, if need be, strengthening of the "tax equalization" scheme until our external accounts are in reasonable balance.

(3) The establishment of a temporary capital issue committee with powers to supervise, register, and control the flotation of foreign securities in the American market beyond prescribed limits.

(4) The continued more general sale of U.S. short-term securities in terms of foreign currencies and/or in terms of an index of the four or five key international currencies.

(5) The pursuance of emergency measures with respect to checking all possible outflows of funds to Western Europe that do not manifestly endanger the national security.

(6) The preservation of foreign aid at no higher figure than that currently proposed by the administration until the balance-of-payments crisis is solved. For such expenditures indirectly divert American resources from potential commercial exports and import substitutes.

(7) The creation of a National Balance-of-Payments Advisory Committee with the responsibility of integrating the efforts of all the Government agencies and private business organizations in this regard. To dramatize the urgency of solving the problem, say within 2 years, the Committee should consist of a distinguished Chairman and representatives of the U.S. Treasury, the Federal Reserve Board, and the Departments of Commerce, Agriculture, Labor, and Defense.

(8) The formulation of an annual budget by the Department of Commerce covering estimates of all our significant international transactions for both the current and the following year. This procedure would be helpful to the National Balance-of-Payments Advisory Committee in formulating recommendations to the President for his personal consideration and decisions on appropriate measures.

With respect to the longer term, my projections lead to the same conclusions as those of the report regarding the need for an increase in international liquidity. But I believe that a solution to the present imbalance is a primary requisite for the effective implementation of these more long-term policies. A gradual increase in international liquidity is nevertheless important, for the projections of the Brookings report, and my own, have shown how precarious it can be to formulate policy decisions on the basis of uncertain estimates as to balance-of-payments surpluses or deficits. To provide greater maneuverability and flexibility in dealing with short-term balance-of-payments disturbances, the following long-term policy measures appear to deserve consideration.

(1) The removal of the 25-percent gold reserve requirement against Federal Reserve notes and deposit liabilities at an appropriate time after our external accounts have reached reasonable balance. These funds should be deposited into an exchange equalization account and utilized by the Treasury to help maintain the long-term domestic and international strength of the dollar. Alternatively, the Federal Re-

serve Board might be granted authority to raise or lower the gold reserve requirements against Federal Reserve notes and deposit liabilities within a range of 15 to 25 percent.

(2) The strengthening of the International Monetary Fund so that it would be able to deal not only with moderate and isolated balance-of-payments strains, but also with more severe and general liquidity shortages. It would be of mutual advantage to all concerned if the provisions of the International Monetary Fund were made more consistent with respect to the practices of surplus as well as deficit countries. Industrial nations that experience balance-of-payments surpluses should be required to deposit, say 15 or 25 percent of their surpluses with the International Monetary Fund in the form of convertible currencies at previously agreed upon rates of interest.

(3) The recommendation of the Brookings' report to establish a system of flexible exchange rates between the dollar-sterling bloc, on the one hand, and the European Economic Community, on the other, appears to me ill-advised: (a) it would aggravate the long-term relations between the two sets of countries which for the long pull share common responsibilities and obligations, (b) the assumption of common currency interests of the United States and the United Kingdom, or of all the Common Market countries, is not realistic; (c) the adoption of this system implies cutting the tie between gold and the dollar and assumes that fluctuating exchange rates would not be vehicles of disturbing speculation. Under present conditions, no useful service would be rendered by considering policy formation on the basis of these postulates.

Once the short-term, primarily financial, U.S. balance-of-payments problem is solved, my evidence strongly suggests that the dual objectives of economic growth and international equilibrium of western countries would not be impeded by long-term structural U.S. balance-of-payments deficits.

STATISTICAL APPENDIX A—PROJECTED U.S. TRADE, UNDER MY REVISED ASSUMPTIONS III

U.S. TRADE WITH WESTERN EUROPE

It should be noted that under the assumptions used in table I, and specified below, the projected GNP of the United States for 1968 would be \$672 billion, in 1961 prices, as compared with \$743 billion under the more optimistic initial assumptions of the report provided by the Council of Economic Advisers.

The report projected an increase in U.S. imports of 80 percent from Western Europe between 1961 and 1968. These projections were derived from a set of equations utilizing the base period of 1954-60, a period which was characterized by extraordinarily great productivity improvements in Western Europe. It appears unlikely that U.S. imports from Western Europe will rise as rapidly in the future as they did during that interim. I have, therefore, derived another projection for U.S. imports from Western Europe. Two methods were used, both providing practically the same results: (a) U.S. imports from Western Europe in 1961 amounted to 0.77 percent of U.S. GNP (\$4.0 bil./518 bil.). On the assumption that this proportion will remain constant during the next quinquennium, U.S. imports from Western Europe in 1968 would be 672 (0.77/100) = 5.3

billion, in 1961 prices. (b) The GNP growth rate of the United States during the period 1950-60 was 3.2 percent, and the growth rate of the volume of imports was 3.8 percent, yielding a GNP elasticity of demand for imports of 1.2. Assuming that this elasticity coefficient will remain the same, and combined with my assumption of a U.S. GNP growth rate of 3.5 percent for the period 1961-68, the annual growth rate of U.S. imports from Western Europe would be 3.5 percent \times 1.2=4.2 percent. Projecting the 1964 \$4 billion U.S. level of imports from Western Europe at this growth rate of 4.2 percent provides, again, an estimate of U.S. imports from Western Europe in 1968 of \$5.3 billion, in 1961 prices. Converting this figure to 1968 European export prices, gives a level of U.S. imports from Western Europe of \$5.9 billion (see table 1, lines 7, 8, and 9).

TABLE 1.—*Estimate of U.S. trade in 1968 under my less optimistic assumptions*¹

[Money figures in billions of dollars]

U.S. exports to Western Europe:	
(1) 1961, actual-----	\$7.0
(2) Projection under initial assumptions (I. Council) 1961 prices----	\$8.9
(3) Projection, converted to 1968 U.S. export prices (III. My) : Line 2 \times 1.07 -----	\$9.5
(4) Percentage increase in volume of U.S. exports to Western Europe resulting from changes in relative prices (III. My) : 2($12\frac{1}{107}$ -1.0) (percent)-----	24.0
(5) Increase in U.S. exports due to change in competitiveness (3) \times (4)-----	\$2.3
(6) Projected U.S. exports to Western Europe in 1968 (line 3 \times line 5)-----	\$11.8
U.S. imports from Western Europe:	
(7) 1961, actual-----	\$4.0
(8) Projection, under revised assumptions (III. My) 1961 prices----	\$5.3
(9) Projection, converted to 1968 European export prices (line 8 \times 1.11) -----	\$5.9

¹ NOTE.—The assumptions under which the various estimates have been derived are as follows, and will be designated by I, II, III, and IV, throughout the appendix.

ANNUAL RATES OF GROWTH

[In percent]

	I Council	II Brookings	III My	IV My
United States:				
GNP growth-----	4.8	4.2	3.5	3.5
GNP deflator-----	1.5	1.5	1.5	1.5
Export prices-----	.5	.5	1.0	1.0
Western Europe:				
GNP growth-----	4.2	3.8	4.2	3.8
GNP deflator-----	3.0	1.5	3.0	1.5
Export prices-----	1.5	1.0	1.5	1.0

U.S. TRADE WITH THE REST OF THE WORLD

Under the report's initial assumptions (Council I), the rise of U.S. GNP between 1961 and 1968 was assumed to have the effect of increasing imports from non-European countries (that is the Rest of the World) by \$4.7 billion. Under the Brookings' alternative assumptions (Brookings II), the rise amounted to \$4.1 billion. The data imply a U.S. income elasticity of imports from the Rest of the World of 1.1. Applying this elasticity coefficient to my revised assumption of

a U.S. GNP growth rate of 3.5 percent (assumptions III), U.S. imports from these third countries would increase by \$3.1 billion from 1961 to 1968, reaching a total of \$13.6 billion, in 1961 prices. Under the initial assumptions (Council I), Western Europe, on the other hand, would increase its merchandise imports from the Rest of the World by approximately \$4 billion. U.S. and Western European imports from the Rest of the World would thus be expected to increase by about \$7.1 billion. Subtracting the projected fall in U.S. military expenditures of \$200 million in the Rest of the World (report, page 84), the aggregate increase in foreign exchange receipts of the Rest of the World would amount to \$6.9 billion.

On the basis of the report's basic postulate that third countries will neither accumulate nor lose international reserves, and on the further assumption that the increase in imports of the Rest of the World between 1961 and 1968 will be distributed between the United States and Western Europe in the same ratio as in 1961, namely 36.4 and 63.6 percent, imports of these economies from the United States would amount to \$13.5 billion, before allowing for changes in competitiveness (see table 2). According to the report's first set of assumptions (Council I), European export prices by 1968 will have risen 11 percent. Using this figure with my revised assumption of a 7-percent increase in U.S. export prices during the same period, a ratio of European to U.S. export prices of 111/107 is obtained. By applying the report's assumed elasticity to substitution of 2.0 to this ratio, one finds that the ratio of U.S. Europe's relative share of exports to the Rest of the World will increase 8 percent by 1968, that is 2 (111/107-1). This means that the ratio would increase from 0.572 (i.e. 36.4/63.6) in 1961, in the absence of price changes, to 0.618 (i.e. 0.572×1.08) by 1968. The U.S. share of the combined total of Western European and U.S. exports to the Rest of the World in 1968, after taking account of the projected changes in relative prices, would be 38.2 percent, as compared with the actual share of 36.4 percent in 1961. Accordingly, U.S. exports to the Rest of the World would rise from \$13.5 billion in 1961 to \$14.2 billion in 1968 (see table 2).

TABLE 2.—Imports of the rest of the world from United States and Western Europe, actual 1961 and estimated 1968, under assumptions III

[In billions of dollars]

Imports of rest of the world	Actual, 1961	Estimated for 1968 after changes in—			
		Real incomes		Competitive position	
		Increase	Total	Increase	Total
(1) From the United States.....	11.0	2.5	13.5	+0.7	14.2
(2) From Western Europe.....	19.2	4.4	23.6	-.7	22.9
(3) Total.....	30.2	6.9	37.1	.....	37.1

U.S. BALANCE OF TRADE IN 1968

The projected balance of trade of the United States for 1968, under my revised assumptions III, is presented in table 3. These projections show that from 1961 to 1968 the total merchandise trade balance

would increase \$3 billion; i.e., from \$3.5 to \$6.5 billion. Practically all this expansion would be caused by an improvement in the competitive position of the United States vis-a-vis Western Europe. The level of U.S. exports in 1968 would be \$26 billion and imports \$19.5 billion, an increase of 44 and 35 percent, respectively, over 1961 levels.

TABLE 3.—U.S. trade: Actual 1961 and various estimates for 1968¹

[In billions of dollars]

	Actual, 1961	Estimated 1968 after changes in—		
		Real incomes	Price level	Competi- tiveness
Council assumptions I:				
Exports to Western Europe.....	6.98	8.85	9.20	12.74
Exports to rest of world.....	11.00	14.65	14.65	15.90
Total, exports.....	17.98	23.50	23.85	28.64
Imports from Western Europe.....	-3.98	-7.31	-8.11	-8.11
Imports from rest of World.....	-10.49	-15.23	-15.23	-15.23
Total, imports.....	-14.47	-22.54	-23.34	-23.34
Balance with Western Europe.....	3.00	1.54	1.09	4.63
Balance with rest of world.....	.51	-.58	-.58	.67
Total, balance.....	3.51	.96	.51	5.30
Brookings' assumptions II:				
Exports to Western Europe.....	6.98	8.57	8.91	10.42
Exports to rest of world.....	11.00	14.04	14.04	14.57
Total, exports.....	17.98	22.61	22.95	24.99
Imports from Western Europe.....	-3.98	-6.85	-7.33	-7.84
Imports from rest of world.....	-10.49	-14.54	-14.54	-14.54
Total, imports.....	-14.47	-21.39	-21.87	-22.38
Balance with Western Europe.....	3.00	1.72	1.58	2.58
Balance with rest of world.....	.51	-.50	-.50	.03
Total, balance.....	3.51	1.22	1.08	2.61
My assumptions III:				
Exports to Western Europe.....	7.0	8.9	9.5	11.8
Exports to rest of world.....	11.0	13.5	13.5	14.2
Total, exports.....	18.0	22.4	23.0	26.0
Imports from Western Europe.....	-4.0	-5.3	-5.9	-5.9
Imports from rest of world.....	-10.5	-13.6	-13.6	-13.6
Total, imports.....	-14.5	-18.9	-19.5	-19.5
Balance with Western Europe.....	3.0	3.6	3.6	5.9
Balance with rest of world.....	.5	-.1	-.1	.6
Total, balance.....	3.5	3.5	3.5	6.5
My assumptions IV:				
Exports to Western Europe.....	7.0	8.6	9.2	9.9
Exports to rest of world.....	11.0	13.2	13.2	13.2
Total, exports.....	18.0	21.8	22.4	23.1
Imports from Western Europe.....	-4.0	-5.3	-5.7	-6.1
Imports from rest of world.....	-10.5	-13.6	-13.6	-13.6
Total, imports.....	-14.5	-18.9	-19.3	-19.7
Balance with Western Europe.....	3.0	3.3	3.5	3.7
Balance with rest of world.....	.5	-.4	-.4	-.4
Total, balance.....	3.5	2.9	3.1	3.4

¹ Under assumptions I, II, III, and IV as specified in table I.

STATISTICAL APPENDIX B

PROJECTED U.S. TRADE, UNDER MY REVISED ASSUMPTIONS IV

By combining my revised assumptions for the United States with the Brookings' alternative assumptions for Western Europe, my set of assumptions IV were obtained. They yield strikingly different results, presented in table 4. With the lower rate of growth in European GNP, the volume of U.S. exports to Western Europe would rise only to \$9.9 billion by 1968—this even after taking into account the improved competitive position of the United States. American imports from Western Europe, however, would increase to a greater extent than under our assumptions III; i.e., to \$6.1 billion by 1968. Almost one-half billion dollars of this increase in imports results from the reduced relative competitive position of the United States, with an assumed U.S. price elasticity of imports of 1.7.

U.S. exports to the rest of the world, dependent as they are on the latter's foreign exchange receipts, are shown to be reduced by the assumed lower growth rates in both European GNP and export prices. They are projected at \$13.2 billion for 1968, while U.S. imports from these countries would amount to \$13.6 billion, as previously noted.

Under my revised assumptions IV, the projected trade balance for 1968 amounts to \$3.4 billion, virtually no change from the 1961 figure (see table 3).

TABLE 4.—U.S. trade with Western Europe, actual 1961 and estimated 1968, under my assumptions IV

[Money figures in billions of dollars]

U.S. exports to Western Europe :	
(1) 1961, actual	\$7.0
(2) Projection under alternative assumptions, 1961 prices	\$8.6
(3) Projection under alternative assumptions, 1968 prices (line 2 times 1.07)	\$9.2
(4) Percentage increase in volume of U.S. exports to Western Europe resulting from relative price changes (2 times (111/107 minus 1))	8.0
(5) Increase in U.S. exports due to change in competitiveness (3) times (4)	\$0.7
(6) Projected U.S. exports to Western Europe in 1968 (line 3 plus line 5)	\$9.9
U.S. imports from Western Europe :	
(7) 1961, actual	\$4.0
(8) Projection under revised assumptions, 1961 prices	\$5.3
(9) Projection under revised assumptions, 1968 prices (line 8 times 1.07)	\$5.7
(10) Percentage increase in volume of U.S. imports from Western Europe resulting from changes in price relations (1.7 times (111/107 minus 1))	6.8
(11) Increase in U.S. imports resulting from change in competitiveness (line 9 times line 10)	\$0.4
(12) Projected U.S. imports from Western Europe in 1968 (line 9 times line 11)	\$6.1

TABLE 5.—Imports of the rest of the world from the United States and Western Europe, actual, 1961 and estimated, 1968, under my assumptions IV

[In billions of dollars]

	Actual, 1961	Estimated for 1968 after changes in—			
		Real incomes		Competitive position	
		Increase	Total	Increase	Total
Imports of the rest of the world:					
(1) From the United States.....	11.0	2.2	13.2	-----	13.2
(2) From Western Europe.....	19.2	4.0	23.2	-----	23.2
(3) Total.....	30.2	6.2	36.4	-----	.4

PROJECTED U.S. BALANCE OF PAYMENTS, 1968

For purposes of comparison, I have attempted to integrate the trade projections obtained under my revised assumptions III and IV with the other items that enter into the balance of payments without making any major changes in the autonomous transactions estimated by the authors of the report. The results are tabulated in table 6. In addition to the projected merchandise accounts (lines 5, 6, 7, and 25), I have revised the figures for both exports and imports of freight and transportation services to and from Western Europe (lines 19 and 28).² The remaining estimates are assumed to be the same as those provided under the Brookings alternative assumptions (II), except for the item "loss of exports due to EEC discrimination" where the higher initial estimate of \$600 million was used. The net effect of these changes, as summarized in table 6, is an estimated total surplus in the basic balance of \$3.5 billion under my revised assumptions III, and of \$300 million under my revised assumptions IV, as compared with a basic surplus of \$1.85 billion under Council assumptions I, and a basic deficit of \$620 million under Brookings assumptions II.

² The projection of transport services, under Council assumptions I, was estimated by the authors of the report at \$990 million. This estimate was obtained by inserting the export figure of \$8.85 billion in the equation of their app. II, p. 268. No attempt was later made by the authors to revise this figure to take account of the subsequent increase in exports due to the improvement in the U.S. competitive position. If we insert, instead, the total export figure arrived at by the authors, of \$12.7 billion, subtracting from it a \$600 million loss due to EEC discrimination, i.e., \$12.1 billion, the export of transport services is found to be \$1.27 billion instead of \$990 million, a rise of about a quarter of a billion dollars. The basic surplus on the U.S. balance of payments would thus reach \$2 billion, under Council assumptions I.

TABLE 6.—U.S. basic balance of payments: Actual, 1961 and various estimates for 1968¹

[In billions of dollars]

	Actual, 1961	Estimated, 1968			
		I Council	II Brookings	III My	IV My
(1) Exports of goods and services, total...	28.31	42.57	38.91	40.1	37.1
(2) Total projected.....	25.83	40.09	36.43	37.6	34.6
(3) Merchandise total.....	20.18	31.40	27.80	28.8	25.9
(4) 1961 level, gain/loss due to.....	20.18	20.18	20.18	20.2	20.2
(5) Increase in Western Europe and U.S. incomes.....		5.52	4.63	4.4	3.8
(6) Increase in U.S. export prices.....		.35	.34	.6	.6
(7) Improvement in U.S. competitiveness.....		4.79	2.04	3.0	.7
(8) Increase in U.S. foreign aid.....		2.04	2.04	2.04	2.04
(9) Increase in Western Europe foreign aid.....		.10	.10	.10	.10
(10) Loss from European Economic Com- munity discrimination.....		-.60	-.55	-.60	-.60
(11) Change in rest of world capital re- ceipts.....		-.68	-.68	-.68	-.68
(12) Decrease in rest of world payments to U.S. Government.....		-.06	-.06	-.06	-.06
(13) Decrease in rest of world military re- ceipts.....		-.10	-.10	-.10	-.10
(14) Military exports shifted to transac- tions.....		-.14	-.14	-.14	-.14
(15) Investment income.....	3.84	5.76	5.76	5.76	5.76
(16) Private.....	3.46	5.45	5.45	5.45	5.45
(17) Government.....	.38	.31	.31	.31	.31
(18) Military transactions.....	.40	1.00	1.00	1.00	1.00
(19) Transportation, Western Europe only.....	.78	.99	.97	1.19	1.08
(20) Travel, Western Europe only.....	.09	.18	.17	.17	.17
(21) Other services.....	.53	.76	.73	.73	.73
(22) Total not projected.....	2.48	2.48	2.48	2.48	2.48
(23) Imports of goods and services, total.....	-23.34	-33.43	-32.24	-29.3	-29.5
(24) Total projected.....	-19.93	-30.02	-28.83	-25.9	-26.1
(25) Merchandise.....	-14.47	-23.34	-22.38	-19.5	-19.7
(26) Investment income, private.....	-.60	-1.12	-1.12	-1.12	-1.12
(27) Military expenditures.....	-2.93	-2.56	-2.45	-2.45	-2.45
(28) Transportation, Western Europe only.....	-1.07	-1.43	-1.38	-1.33	-1.34
(29) Travel, Western Europe only.....	-.60	-1.09	-1.02	-1.02	-1.02
(30) Other services.....	-.25	-.48	-.48	-.48	-.48
(31) Total not projected.....	-3.41	-3.41	-3.41	-3.41	-3.41
(32) Net goods and services, total.....	4.97	9.14	6.67	10.8	7.6
(33) Total projected.....	5.90	10.07	7.60	11.7	8.5
(34) Total not projected.....	-.93	-.93	-.93	-.93	-.93
(35) Total private long-term capital.....	-2.14	-1.50	-1.50	-1.50	-1.50
(36) Private U.S. capital, net.....	-2.61	-2.08	-2.08	-2.08	-2.08
(37) Private foreign capital, net.....	.47	.58	.58	.58	.58
(38) Government transfers and loans.....	-3.68	-5.78	-5.78	-5.78	-5.78
(39) Total projected.....	-3.45	-5.55	-5.55	-5.55	-5.55
(40) Total not projected.....	-.24	-.24	-.24	-.24	-.24
(41) Total basic balance.....	-.85	1.85	-.62	3.5	.3
(42) Basic balance projected.....	.31	3.01	.54	4.7	1.5
(43) Basic balance not projected.....	-1.17	-1.17	-1.17	-1.2	-1.2

¹ Based on assumptions I, II, III, and IV (see table 1).

Sources: The Brookings' Report, app. 10, p. 289, and my estimates.

STATEMENT BY STAFFAN B. LINDER

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CHARACTERIZATION OF THE REPORT

The Brookings report on the U.S. balance of payments in 1968, prepared by a team of economists, is a hopeful document foreseeing a definite improvement in the "basic balance" of the U.S. balance of payments by at least 1968. The concept "basic balance" differs from the ordinary "total balance" in that it excludes short-term private capital movements (and "errors and omissions," believed to consist mainly of such capital movements).¹ Interestingly enough, the report manages to reach such an optimistic conclusion in spite of the fact that the whole approach of the report amounts to an implicit recognition of the weakness, or absence, under modern conditions of the traditional balance-of-payments equilibrium mechanism. The improvement in the U.S. balance of payments is expected to be achieved not through determined policy actions but through the favorable play of circumstances.

Our international payments system, as it presently works, could be described as a "disequilibrium system." This disequilibrium system is characterized by the fact that the classical self-correcting forces in the balance of payments, working through monetary contraction and expansion, no longer function with any degree of smoothness. Domestic economic and political considerations lead to the neutralization of the self-correcting forces through monetary and fiscal policy. The conventional adjustment methods have become very unpalatable.

Instead, countries with balances of payments which have been thrown into deficit through balance-of-payments disturbances of various kinds pursue "breath-holding policies." Such policies mean that deficits, irrespective of their nature, are financed through the running down of reserves or building up of liabilities. The rationale of the breath-holding policies is that if the breath can be held there will probably occur "offsetting disturbances" which, although not engineered through economic policy to equilibrate the balance of payments, will in fact have such an effect. The breath-holding policies can also be applied in the hope that various new adjusters, which can be tested instead of the conventional ones, will prove efficient.

The conventional adjustment methods become relevant only if the breath-holding policies prove unsuccessful; i.e., if no offsetting disturbances occur in time. The conventional equilibrating methods will then be forced on the country.

¹ Short-term official capital movements are excluded in the calculation of both the total and basic balance, since, if they were included, the balance of payments would by definition always be in equilibrium, credits being equal to debits.

The Brookings report fits well into this analytical scheme.² In its projections of the balance of payments in 1968, the report implicitly assumes that output, employment, and price levels—the magnitudes conventionally believed to be manipulated through economic policy in order to equilibrate the balance of payments of a country—will be unaffected by any economic policy measures prompted by the balance-of-payments situation itself. This is the setting of the disequilibrium system.

It might be thought that instead it is a method of simplification where a first step in the analysis is to see how output, employment, and price levels develop if influences from balance-of-payments changes are neutralized and domestic considerations determine economic policy. However, although the matter is never, unfortunately, argued in the report, it is quite clear from the absence of a second step that treating these magnitudes as being independent of the balance-of-payments situation is not just a first simplification of the analysis but, in fact, a sign of the authors' subscription to the idea of the present system being a disequilibrium one where the traditional equilibrium mechanism does not, due to domestic political difficulties in making use of it, function well. If the authors had thought themselves entitled to speak about a balance-of-payments mechanism in the conventional sense, the approach would have been very different. Indeed, there would have been no particular point in preparing such a report forecasting whether there would be a deficit or surplus in 1968 as long as we think the conventional, strong, equilibrating forces are in operation. Only projections of the individual items in the balance of payments might, from certain other viewpoints, have some interest.

Instead of being generated by specific policy measures, the improvement in the balance of payments which is forecast in the report will occur as a result of offsetting disturbances over the next 5-year period. These offsetting disturbances primarily consist of favorable price and income effects in the United States and Western Europe. The report is also sprinkled with references to new adjusters to be applied during the coming years. The intervening deficits should, according to the recommendation of the report, be covered through breath-holding policies.

MORE DETAILED COMMENTS

From this characterization of the report, it is evident that the following questions can be raised: (1) Is the disequilibrium approach a valid one? (2) Are the basic assumptions underlying the projections of the offsetting disturbances reasonable? (3) Is the method of making projections on the basis of the assumptions an acceptable one? (4) Is the treatment of the new adjusters satisfactory? (5) Are the possibilities of pursuing breath-holding policies while waiting for the offsetting disturbances adequate? In the following, a number of highly condensed comments will be made pertaining to these questions.

1. *The validity of the disequilibrium approach.*—As can be gathered from the introduction, the author wholeheartedly agrees with the report that, for internal political reasons, it has become so difficult to institute rash monetary and fiscal policies to correct a balance-of-payments deficit that the present system is best referred to as a dis-

² The description of the present international payments system follows a paper to be published in *Kyklos* by Dr. Benjamin J. Cohen and the author.

equilibrium one. The conventional equilibrating measures have become so unpalatable that they are used only meekly but as an ultima ratio when adjustment is forced on the country, no matter how repugnant the method of adjustment may then appear.

Often in the report, however, the interrelations between components of the balance of payments are stressed. As examples of these feedbacks, one can mention the export-inducing effect of direct foreign investment or of foreign aid. Another instance is that some countries, notably the underdeveloped ones, have foreign exchange expenditures which are closely geared to their foreign exchange earnings. Such feedbacks obviously constitute a remnant from the more or less automatic forces which constituted the old mechanism. In the mechanism analysis there was no particular need to discuss such feedbacks since they were incorporated in the general equilibrating forces. However, if we now have in many countries an economic policy which, to achieve internal balance, does not permit the self-correcting forces in the balance of payments to work, it perhaps becomes necessary to distinguish, as implied in the report, between those elements of the automatic forces which are still automatic and those which are neutralized. The original practical context in which this need asserted itself was, in the view of the writer, in discussions on the balance-of-payments effects of U.S. foreign economic aid, where it must be pointed out that the full amount of economic aid does not constitute a burden on the balance of payments. The report certainly stresses the feedbacks of economic aid but makes use of the feedback argument in a number of other contexts, too, most importantly in relation to the balance-of-payments effects of foreign investment. However, it is not self-evident where the line should be drawn between the neutralized and the nonneutralized forces, and it is a deficiency that no attempt is being made to make the distinction clearer.

Previously, it was found to be a convenient simplification to talk about the equilibrating process as a mechanism although it never was quite mechanical. Today, it is appropriate to talk about a disequilibrium system although there is still some automatism through these feedbacks, the nature of which should be further explored.

2. *The basic assumptions.*—In order to make projections of merchandise trade and long-term capital movements, i.e., the most important items in the balance of payments, the report has had to make certain assumptions as to income and price changes. Two sets of assumptions are used, namely, the "initial" assumptions and the "alternative" assumptions. According to the initial assumptions, the annual rate of growth in the United States would be 4.8 percent and the annual rate of inflation 1.5 percent annually—figures suggested by the Council of Economic Advisers. The rate of growth in Western Europe is in accordance with the OECD targets, assumed to be 4.2 percent per year. The expected rate of inflation is put at 2.75 percent per year. According to the alternative assumptions, growth rates have been adjusted downward in both the United States and Western Europe, but, whereas the U.S. rate of inflation is taken to be unchanged, the rate of inflation in Western Europe is put at only half of the rate under the initial assumptions. Growth and inflation in other parts of the world are ignored since these are not assumed to be reserve-accumulating areas.

The projections made on the basis of the two sets of assumptions differ substantially. Under the initial set, the basic balance in 1968 is expected to show a surplus of \$1.9 billion, whereas under the alternative set there would be a deficit of \$0.6 billion. Since both sets of assumptions can be regarded as equally plausible or implausible, the marked difference in results must be a warning against the unguarded application of the report. Of course, the report makes no pretense of the fact that the assumptions, and the results they yield, are but guesses. It is even argued that "projections of net balances in international payments, even of net balances in basic transactions, are still more speculative than most economic projections" (p. 211). It is certainly healthy to be aware of the difficulty, or impossibility, of making reasonable forecasts.³ The skepticism of the authors should not be taken as modesty but as a serious exhortation against misinterpreting the precise figures given in various tables, leading to complacency in the wake of the optimistic tone of the projections.

It might be noted that, for exactly the same reasons as those making it necessary for us to guard ourselves against accepting the assumptions, it would be futile to criticise the assumptions which have actually been made. They are definitely within the range of the possible, and still other alternative sets of assumptions could hardly give greater insight. However, it must be pointed out that the relatively high rate of inflation assumed for Western Europe is the crucial assumption that provides the offsetting disturbances expected to turn the U.S. balance of payments in a favorable direction. This means that the report is pinning its hopes on a single factor wholly outside the control of the United States; namely, financial mismanagement in Western Europe.

3. *The method of projecting.*—The crucial projections relate to the functional relationship between the assumed price and income changes, on the one hand, and trade and private foreign investment, on the other hand. Everybody who has had the slightest acquaintance with balance of payments theory must be aware of the vagueness of the theory that deals with the interaction of price and income effects on the balance of payments. This theory hardly permits any precise projections. In order, nonetheless, to reach quantitative results, the authors of the report make use of regression equations based on data from 1948–60 to predict exports and imports for 1968.

We can make the same observation about this method as is made in the report; namely, that it would be a mere coincidence if such equations gave an accurate picture of future developments. As the relationships summed up in the equations change through time, the question is whether or not the accuracy of the projections based on the equations is impaired to the extent that these projections are rendered misleading, i.e., leading to erroneous action or inaction. And since the theory underlying the functional relationships is so vague, there is no possibility of modifying the equations so as to take into account new developments.

To illustrate the difficulties of projecting, one could even challenge the generally accepted notion, reflected in the regression equations, that an increase in income causes a deterioration of the balance of trade. In fact, one need thus not even be sure of the direction in

³ It is, as the Danish humorist Storm has pointed out, "hazardous to make forecasts, particularly about the future."

which an income change affects the balance of trade. If it is capacity that grows, particularly in import-competing industries, rather than demand, the possibility that an income change has a positive effect on the balance of trade cannot be excluded. The expansion of production of compact cars, for instance, has, although adding to income, hardly led to a deterioration of the U.S. balance of payments. Adjustment in this way depends upon the aggressiveness of businessmen and can certainly have an important impact. The report is only concerned with the favorable effects of growth on capital movements. Also, in the modern disequilibrium system, the only situation in which it might be politically possible to reduce domestic demand (absorption) in relation to output, thereby in a more traditional way improving the balance of payments, is when only a relative and not an absolute contraction is necessary. An absolute reduction in absorption can be avoided when output grows. The present balance of payments difficulties for the United States would not, after all, exist if the rapid income growth in Western Europe after the war had not, both through its direct effects and by making economic policy easier, been connected with an improvement in the balance of trade.

There are thus two major sources of unreliability in the projections of trade flows in 1968. First, as observed under point 2, the underlying assumptions as to income and price changes might be erroneous. Second, the projections based on these assumptions could be inaccurate. This does not mean that it would be easy to do better than the report. On the contrary. As concerns at least the projections, it is difficult to criticize them constructively. The only criticism that can perhaps be made is of the acceptance of the invitation to undertake such projections, considering the enormous margin of error and the danger of faulty projections giving to some policymakers a false sense of knowledge which could be worse than a true sense of nescience.

The methods of projecting foreign economic assistance and defense transactions are of a different nature and their institutional character makes it inappropriate, or at least unnecessary for an outsider, to comment upon them to the Joint Economic Committee.

The chapter dealing with the effects of EEC on the U.S. balance of payments is, however, of a more theoretical kind. It is possible to quarrel in various ways with this analysis. The table on page 102 setting out the alleged increase in the average common tariff of EEC is, to say the least, peculiar. The new external tariff is compared with the original tariffs of the major exporter within EEC and it is found that there are considerable increases. In the conclusions, it is stated (p. 220) that the relevance of this kind of comparison is established in the chapter on EEC, but in that chapter, there is just an assertion that the comparison in question is a revealing one. But, after all, it is not to be expected that the original national tariff rate on a particular product is relatively low in the major exporter country, considering that this country needs no or low protection on that product if it wants to keep out imports. A better comparison would be the conventional one between tariffs in the major importer country and the new common external tariff. But this kind of comparison is also misleading since a major importer is likely to be a major importer precisely because of its low tariff level, whereas the originally bad customer with heavy protection may well have a good potential market which can be penetrated once the national tariff is reduced to the average rate which

forms the common external rate. Although space does not permit my arguing that the EEC external tariff is not more restrictive than the original tariffs, it does allow me to point out that the report in no way shows the reverse to be true.

The possibility that there might be some export retardation in EEC through increased intratrade is discussed. To the extent the increased trade is the result of substituting one exporter for another within the customs union (trade creation), resources, employed by the uncompetitive producer, are freed and match the resources absorbed by the competitive producer. However, when an inside exporter is substituted for an outside one (trade diversion), resources are drawn into production in one industry without any matching resources being simultaneously freed elsewhere by an uncompetitive producer in the same branch of industry within the customs union. This difference is important. In cases of trade diversion, when foreigners thus become the victims of discrimination, the trade diversion itself—by drawing resources from other occupations—affects the relative competitiveness of these other industries, whether import-competing or exporting ones. The overall economic effects of trade creation and trade diversion thus differ in this respect, and this is not well shown in customs union theory. It must, however, be this kind of argument which lies behind the vague references in the report to export retardation through the possibility of an "absolute physical limitation on expansion of output," when the internal market of the member countries is widened as a result of the formation of EEC (p. 113). It is a powerful a priori argument and thus it is surprising that the report dismisses it after having observed that the EEC share of the world market has so far increased rather than decreased. The alternative could certainly have been a still bigger increase.

4. *The use of new adjusters.*—So far, it has been pointed out in these comments that the income and price development will be independent of the balance of payments situation—this being a disequilibrium system—but that, according to the report, the autonomous price and income movements will be in such a direction that they nonetheless contribute to the reestablishment of equilibrium, thus functioning as offsetting disturbances. But here and there in the report there are references to various economic policy measures which are expected to contribute to balance of payments equilibrium. These measures can be referred to as "new adjustment methods." It is to be expected that the search for such new adjusters has been intensive in the present disequilibrium system. As examples of such more or less new adjusters, some of which are referred to in the report, we could mention tariff reductions under, for instance, the coming Kennedy round; export promotion measures; changes in the pattern of military expenditures; the tying of aid; "voluntary" export restrictions by foreign competitors like those of the Japanese type; and interest equalization taxes. Attempts at speeding up the rate of growth and pressure on surplus countries to redirect their state trading (e.g., in military equipment), to prepay their debts, or to change their economic policies in general also constitute examples of non-traditional ways of favorably influencing the balance of payments.

In view of the impotence of the conventional adjustment forces, and in view of the possibility that the new adjustment methods can be quite effective, it is perhaps a pity that the report does not single them

out for more systematic consideration. It is, for instance, surprising, considering the enormous importance attached to advertising in pushing products on the domestic markets, that export promotion has attracted little attention as a balance of payments adjuster. Generally speaking, it is certainly becoming important to know the extent to which it is possible to rely on such new adjustment methods, and a systematic study of them might even lead to the formulation of more new adjusters. An inquiry into the new adjusters might, under the present circumstances, be the most fruitful task within balance of payments theory and policy.

5. *Possibilities of pursuing breath-holding policies.*—Pending the improvement in the U.S. balance of payments projected in the report, it is suggested that breath-holding policies, i.e., policies aimed at making it possible to finance the intervening deficits through the running down of reserves or the accumulation of liabilities, should be pursued.

In this context, at least two observations must be made. First, the projections need not come true. In fact, as we have observed when we discussed both the basic assumptions underlying the projections, and the projections themselves, the margin of error must be thought of as substantial. Thus, the appropriateness of continued breath-holding policies need not, considering the risk of an overoptimistic assessment of the prospects, be as great as it appears to be from projections of the report.

Second—and more important perhaps—even if the projections do come true the intervening deficits must necessarily affect the confidence in the dollar although various ways of financing the deficits might be designed. It is surprising to see that the authors continue to the policy conclusions in the report, after having projected the basic balance, without using this projection to assess the impact of the short-term capital movements that might be induced through the basic deficits. The size of the task facing those who will have to design the breath-holding policies will, after all, depend upon the magnitude of the total deficit rather than on the deficit on the basic balance. A strategic chapter dealing with private short-term capital movements in the light of the projections of the basic balance is conspicuous through its absence.

Since before 1968, even under the initial assumptions, a deficit of \$5 billion on the basic balance seems possible—a deficit which might be twice as big under the alternative assumptions—there is a definite risk that the leverage on the sensitive short-term capital movements can abruptly become threatening in the sense that the lung capacity for further breath holding is exhausted before equilibrium on the basic balance is reached. From a confidence point of view it is, by the way, interesting to speculate in what the consequences would have been if the report had come up with the projection that there would be a further deterioration in the U.S. balance of payments by 1968. Would it, at present, have been permissible to publish a semiofficial document of that type?

POLICY RECOMMENDATIONS

The air and the bookshelves are full of policy recommendations as to methods of solving the U.S. balance of payments problem. I shall not add anything to these—apart from the suggestion already made

that we should explore the "new adjusters"—not because I do not have any ideas but because in my view the giving of policy recommendations is, under present circumstances, futile.

Urging the adoption of the conventional measures such as exchange rate adjustments, strict monetary and fiscal policy, or controls is of no avail since such measures will never in a disequilibrium system be taken unless they are forced on the authorities. And, if they are in the end forced on the politicians, the particular policy to be pursued—preferred as the least evil one—will be chosen on considerations of economic circumstances, the nature of which cannot be visualized until we find ourselves close to that moment of action which, hopefully, will never come. Also, to avoid increasing the risks of premature forced adjustment, any unpalatable suggestions, like the Brookings alternative with flexible exchange rates, must be rejected out of hand so as not to impair confidence. Similarly, the policy discussions which really matter near the moment of action must be confined to a small group of influential people with insufficient time at their disposal to take into account all the more or less conflicting policy advice from all economists. Thus, current suggestions as to conventional corrective measures will be emphatically rejected or unheard now, and antiquated in the future.

Instead, breath-holding policies will be pursued whether they ultimately prove sufficient or not. Thus, in a sense, the report must under present conditions be a failure; the reason behind its commissioning makes it well-nigh impossible to heed its results unless they conform with a policy which would be pursued in any case.

STATEMENT BY DR. ROLF E. LÜKE

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I feel deeply honored by the invitation of the Joint Economic Committee to write a critical analysis of the Brookings study "The U.S. Balance of Payments in 1968." The letter of invitation emphasizes the primary interest of the committee to be an assessment of the likelihood that the study's projections will be realized. I will try to meet this request within the limits set forth for the statement.

It is evident that the projections and the chances of their realizations merit a thorough reappraisal. However, with regard to the findings and conclusions of the study it has to be borne in mind that they represent only one aspect of the U.S. balance-of-payments problem; namely, the question whether, by the relative overall development of the real GNP's of the United States and Western Europe, the U.S. balance-of-payments deficit will, in the projection year of 1968, either be eliminated, brought to manageable proportions, or converted into a surplus.

It must be stressed right from the beginning that the projections of the study refer to what is called the "basic balance" which excludes short-term private capital movements. Since the study itself clearly points to the fact that the United States plays a dominant role as the world's banker and provider of the key reserve currency, the first question mark has to be put to this basic approach of the study; namely its concentration on the basic balance only. Even if the projection materializes, the results would be irrelevant. Taking, for example, the optimistic projection of the study leading to a surplus of the basic balance in 1968 of \$1.9 billion, even that surplus would not only disappear but be turned into an overall deficit if there were an outflow of short-term private capital as occurred during 1961, i.e., 2.38 billion U.S. dollars.

One cannot help feeling that this limitation of the study to the "basic balance" is done deliberately, in order to assure that the scope of the study is bound to lead to certain foregone conclusions. Actually, the study points to this impression on page 1 where it says that—

The implication for the future is that elimination of the deficit may not suffice to restore the dollar's strength because that alone might not increase the attractiveness of the dollar for foreign and domestic holders. Moreover, achievement of a U.S. balance-of-payments surplus could have damaging consequences for the economies of the free world unless it were part of a broader change in international economic policy. It might convert the present payments surplus of the rest of the world into a deficit and reduce the international reserves of major foreign countries, most of which regard their present reserves as no more than adequate.

Another support for this feeling appears on page 31 where the study states that—

The value of the projection lies less in its quantitative result than in the process of obtaining the result, for that process identifies the kinds and directions of influences that will determine the future development of the basic payments position of the United States.

It is exactly this “process of obtaining the result” which should be scrutinized in order to judge the validity of the findings and conclusions, for if it can be proven that the limitation of the scope, which implies the process to be used, must itself lead to preconceived conclusions, then this proof would already suffice to invalidate the study, irrespective of whether the projection might materialize or not.

The main conclusions of the study are that (a) the deficit of the U.S. balance of payments is bound to disappear in 1968 without particular efforts of the U.S. Government, simply because the higher degree of inflation in Western Europe would do the job of increasing U.S. exports and decreasing the outflow of long-term private capital sufficiently; and that (b) having achieved this aim, the inadequacy of international reserves would be so obvious that a reform of the international monetary system is bound to occur, shifting again the responsibility for the strength of the dollar—and, hence, for the role of the United States as the free world’s banker—away from the U.S. authorities.

In order to end with these conclusions the study tries, by focusing on the balance of goods and services and of long-term private capital movements only, to establish a direct relationship between the United States and Western Europe through the assumption that (p. 25)—the movements in the net basic balance of the United States have their approximate counterpart in the basic balances of the industrialized countries—particularly Western Europe—

and that—

the explanation of the fact that underdeveloped countries do not have large and persistent imbalances is of great importance for our analysis of future trends.

This latter explanation, that the underdeveloped countries’ “aspirations to expand their domestic absorption of goods and services are so intense that with few exceptions they eagerly use in foreign markets virtually all the foreign exchange receipts that accrue to them,” must lead to the conclusion that whatever their performance the results would be reflected in the United States and the Western European balances of payments as the only determinants, the underdeveloped countries being the dependents.

This is stated quite clearly in the study on page 26 :

Their [i.e. the underdeveloped countries’] combined cumulative net position over a period of years may be neglected in projecting broad trends affecting the U.S. balance.

And on page 27 :

The assumptions that these countries will have negligible changes in their net balances in the next 5 or 6 years implies that any persistent changes in the basic balance of the United States that exceed the change of the increase in the free world’s holding of monetary gold must have their counterparts in an opposite change in the combined basic balance of Western Europe and Japan.

And, finally, on page 28—

that only the changes in United States and Western European domestic economic variables—changes in domestic demand, output potential, and relative supplies and costs of labor and capital—need be considered as the major determinants of the changes in the U.S. basic balance.

This “theory” must be challenged for several reasons. The first reason refers to the proportions. The United States, though listed in international statistics under “manufacturing countries” like all European countries and Japan, is also, in part, a “primary products country.” Taking the year 1961, somehow the base year of the study, the total of nonmilitary merchandise exports of the United States amounted to \$19.913 billion, of which—according to United Nations, Monthly Bulletin of Statistics, June 1963, \$12.87 billion were manufactured goods. This is roughly two-thirds. Now, if the exports of a country comprise primary products to an extent of one-third of all exports, it follows that to this extent the country must be regarded also as a primary products country. Therefore it must be to that extent also subject to fluctuations of primary products prices—a fact which, actually, is refuted in the study on page 32 :

General price movements of primary products are of secondary importance as a cause of change in the U.S. basic balance.

The second reason is that total exports of manufacturing countries to primary products countries in 1961 were \$32.95 billion, in which the United States participated with \$12.36 billion, including its own primary products exports, whereas the participation of Western Europe was \$17.97 billion; i.e., one-third more, not taking into account how much of American exports consisted of primary products. It follows, therefore, that primary products on the one hand, and trade with primary products countries on the other, cannot be discarded as co-determinants for the balances of United States and Western Europe, particularly when nearly 40 percent of world trade consists of exports of primary products countries—not including the U.S. proportion of primary products. Adding in the latter, exports of primary products make up nearly 50 percent of world trade. For reasons of magnitude and proportion alone, it cannot be assumed that it is only the domestic demand of the industrial or manufacturing countries which determines the production and the exports of primary products.

Furthermore, there is also a striking difference in proportions between the United States and Western Europe even with regard to manufactures only. The share of the United States in world exports of manufactures in 1961 was only 20.6 percent, whereas the share of Western Europe and Canada (which might be neglected with regard to the resulting proportions) was 72.6 percent. If one then reads on page 67 of the study that “if a country is to retain its competitive export position, it must adapt its exports to changes in the relative importance of different markets,” one fails to understand why this “relative importance” is so completely ignored with regard to the foreign trade positions of the United States and Western Europe vis-a-vis third markets and the resulting interrelations.

Finally, it is well known that the relation between foreign trade and GNP is much higher in Western Europe than in the United States. Though the main criticism under this particular aspect would refer to the influence of different growth rates of GNP on the development of foreign trade of the countries concerned, the argument may serve

here as another pointer to the fact that, with regard to the balance-of-payments relations of the United States and Western Europe, the role of the primary products countries cannot possibly be ignored or limited to the problem of relative competitiveness.

The only impact which the study seems to be willing to allow these countries and their respective internal developments to exert on the balances of Western Europe and the United States is the amount of the net increase in short-term borrowing of these countries—exactly that sector which—by the “basic balance approach”—has been deliberately excluded from the scope of the study.

Thus, both the exclusion of the short-term capital sector and of the primary products countries serve the purpose to show that “only the changes in the United States and Western European domestic economic variables—changes in domestic demand, output potential, and relative supplies and costs of labor and capital—need be considered as the major determinants of the change in the U.S. basic balance.” Even if one would follow the reasoning of the study so far, it remains to be seen whether—in this restricted approach—the respective assumptions bear a realistic or even probable significance. As mentioned above, the domestic economic variables of Western Europe and the United States are taken as the principal factors in determining their future basic balance position. Admittedly, the study itself puts up a great many reservations against this approach, indeed, so many that one wonders whether these projections and the conclusions based on them could have any significance at all, except to serve the stated purpose that “the process (wrongly!) identifies the kinds and direction of influences” which the study wishes “to determine the future developments of the basic payments position of the United States.”

Since the domestic economic variables are those comprised in the definition of GNP computations, the study then undertakes to project the respective GNP components of the United States and Western Europe of the past period into 1968, applying on the one hand definite assumptions given by the Council of Economic Advisers and partly by the OECD, on the other its own assumptions—however, with reservations downgrading these assumptions to “guesswork.” One need not deal with the methods applied in this context, though the study admits that even the methods imply a considerable degree of error, for it is more the validity of the assumptions which is important.

In a summarized and simplified way one could say that the study makes the assumption that for the United States the GNP would rise by an average annual rate of 4.8 percent and that the GNP price deflator would rise by 1.5 percent annually. There are the further assumptions that employment would increase by 1.9 percent per year and that average hours worked per week will remain unchanged, which then would lead to an increase in output per man-hour required to achieve the growth rate for GNP of 2.9 percent per year. This implies an increase of average hourly earnings in the United States of 4.4 percent.

It should be left to the American experts to judge whether these assumptions are realistic, though, even as a foreigner, one could doubt at least the assumption that (p. 41) —

since if the problem of unemployment is substantially solved by expansion of demand, no strong reason can be seen for expecting any further reduction in hours worked per week.

One could point to the hearings before the Committee on Ways and Means, House of Representatives, August 20-23, on H.R. 8000, where the New York Chamber of Commerce stated that—

the electrical workers of New York City forced acceptance of a new contract prescribing 25 hours workweek * * *. Inevitably, new contracts will be sought by other unions in industries throughout the country patterned generally after the New York settlement.

Indeed, if one takes the view that unemployment in the United States is not only a cyclical problem but, as least to quite an extent, structural, one could also doubt whether the problem of unemployment could be "substantially solved by expansion of demand."

Turning to Europe, the study assumes an annual average growth rate of GNP of 4.2 percent, compared with the U.S. growth rate of 4.8 percent. Though one could, of course, argue whether the U.S. growth rate, which had an average of 2.5 percent in constant prices during the period of 1953-60 as compared with an average European growth rate of about 4.7 percent during the same period, would actually nearly double in the period up to 1968, there seems to be the likelihood that the future growth rates in Europe would level off and even fall under the U.S. growth rate, given practically full employment in Europe against an annual inflow of about 1.5 million into the labor force of the United States. What seems to be more important than the respective relations in growth rates and the GNP deflators is the respective development of export prices.

The study points to the fact that prices of the GNP rose by 3.2 percent in Europe during the reference period, compared with 2.2 percent in the States, whereas export prices, as measured by unit values of total exports, rose less in Europe than they did in the United States, by only 0.2 percent in Europe and by 1.1 percent in the United States. In the movements of unit values of exports of manufactured goods (on which the study puts so much emphasis) the difference is even more striking. In Western Europe, the increase was 0.3 percent per year; in the United States 2.4 percent.

The hypothetical character of the respective growth rate assumptions may be shown best by directly confronting them rate by rate, and by showing past performance as well as to future expectations.

Annual increase	United States		Western Europe	
	1955-60	1968	1955-60	1968
GNP.....	2.5	4.8	4.3	4.2
Employment.....	1.1	1.9	1.2	0.6
Output, man-hour.....	1.5	2.9	3.5	4.9
Hours per week.....	40	40	46	42
Hourly earnings.....	3.8	4.4	6.7	7.9
GNP price deflator.....	2.2	1.5	3.2	2.75
Export price deflator.....	2.4	0.5	0.3	1.5

It may suffice to point to the most striking differences. For the United States alone the study assumes that in the coming years the growth rate of GNP will be nearly double that achieved in the preceding years. The same applies to output per man-hour, meaning to say that the increase in productivity will also double. Working hours would remain constant, the rate of increase in the GNP price deflator would fall by about one-third, in the export price deflator by nearly

80 percent. It is particularly the last figure which must raise serious doubts, since, as mentioned before, the "downgrading" of the GNP price deflator to the export price deflator is bound to be much less in a country where exports play a much smaller role with regard to GNP. Actually, even under the most optimistic 1968 assumptions U.S. GNP would come to \$743 billion and exports to \$42.6 billion, representing a relation of exports to GNP of only 5.7 percent.

Taking Western Europe separately, the comparison shows as most striking items the sharp increase in average hourly earnings and in the export price deflator, which seems rather doubtful in itself, since this could only occur if the resistance to inflationary developments would be much less in Europe than it actually is. Contrary to the views held by the study it must also be stated that the leeway for anti-inflationary policies is bound to be greater in countries with full employment, since they could easier afford a slight drop in employment than countries with say 5 percent unemployment. It is always difficult to ascertain how much unemployment is due to insufficient demand and how much to structural factors.

The impression created by the study's assumptions of a strong inflationary trend in Western Europe is even more pronounced when comparing the assumptions for the United States and for Western Europe with regard to price deflators both for GNP and for export prices. The increase in the GNP price deflator in Western Europe is assumed to be double and the export price deflator to be three times as high as in the United States.

It can be taken for granted that, with the possible exception of the United Kingdom, no Western European country could and would possibly tolerate such an inflationary development over 5 years, leaving alone the assumption that developments in the United States with the high amount of deficit spending officially announced would be as favorable as put forward in the projections.

Taking further into account all the reservations which the study itself makes with regard to the assumptions and projections, there is no need to go any further into the details of growth rates mathematics which bear more resemblance to the theory of games than to even estimates and guesswork.

Some remarks should, finally, be made with regard to private long-term capital movements, foreign economic aid, and military expenditure in foreign countries.

With regard to private long-term capital movements which many experts both in the United States and in Europe would regard as the main leakage in the U.S. balance of payments, one must distinguish between direct investment and portfolio investment and their determinants. Direct investments in Europe have been less than \$1 billion in the years 1960, 1961, and 1962; namely, \$962, \$724, and \$808 million, respectively. They have, in all probability, been induced mostly by higher profit margins in Europe, lower production costs, and the incentive to get behind tariff walls such as result from the formation of a common EEC tariff. On the other hand, these investments produce income which, in the long run, not only compensate but may even exceed the outflow. The same holds true for portfolio investments, whether in outstanding foreign securities or in new issues. In the hearings on H.R. 8000 before the Committee on Ways and Means, practically all experts were unanimous in pointing out that

the real problem was not in the sector of private long-term capital movements and that, whatever measures were to be taken to reduce the flow from the United States and to increase the flow to the United States, either by direct intervention or by autonomous changes in the investment climate, there would be compensatory effects which tend, on the average, more toward improvement of the U.S. balance of payments than to the opposite. One can, therefore, more or less, agree with the assumptions of the study with regard to private long-term capital movements' impact on the future U.S. balance of payments.

However, I am in a complete disagreement with the study with regard to foreign aid. Though the study assumes a rise of foreign economic aid from \$4 billion in 1961 to \$6.4 billion in 1968, it does not believe that this will cause "much additional strain on the balance of payments." The reasons for this belief are on the one hand the projected shift in the geographical distribution of U.S. foreign assistance toward Latin America which will likely return, directly or indirectly, to the United States as additional exports. The other reason is that also the remaining U.S. foreign aid will be more and more "tied" to expenditures in the United States, to quote Secretary Dillon in the hearings on H.R. 8000, 80 percent of all AID expenditures.

I think that this belief is just an illusion and a misunderstanding of the real impact of foreign aid, particularly if it is in the form of "tied aid." Tied aid is nothing but the transfer of goods and services to foreign countries against payments of the Treasury; that is out of the national budget. It is, in effect, a similar economic problem particularly with regard to the balance of payments as had to be faced by Germany after 1918 within the scope of reparations and which led to the famous "transfer problem." It might be worthwhile to recall and to reread the famous discussion between J. M. Keynes, Bertil Ohlin, and Jacques Rueff in the *Economic Journal* of 1929. The problem as such had never been solved at that time but the venture had finally to be given up.

The similarity lies in the following situation: The transfer of funds as aid with subsequent deliveries in kind might finally lead to a corresponding fictional equilibrium in the balance of payments (which it actually did not achieve in the German case since there were not even subsequent deliveries in kind). However, the deliveries in kind (and the services) are actually not paid by the receiving country but by the delivering country; that is by its treasury. The consequence is that the respective funds have to be raised through the budget. It was generally agreed in the twenties that the upper limits for such transfers were internally a balanced budget and externally a surplus in the commercial balance of goods and services, whereby the internal budget surplus more or less determined the external surplus of the commercial balance. It follows, therefore, that, even leaving aside the question of relations between the internal and the external surplus, the upper limits to such gratuitous deliveries would be set by the commercial export surplus of goods and services.

If the assumptions of the study for the foreign aid program in 1968 would materialize, then the commercial export surplus of goods and services must at least be equal to the amount of foreign aid, if the equilibrium should be maintained. Whether this target could be achieved, however, does not depend only on the relations between the

United States and Western Europe as established by the study but particularly by the behavior of the developing countries who, to a large extent, are also receivers of U.S. aid. It is quite obvious that the more this aid is tied to expenditure in the United States, the more these countries will be inclined to import from other countries against their own export proceeds. It can, therefore, very well be the case that the tying of aid, though eliminating the direct impact on the U.S. balance of payments, would reduce the U.S. exports against genuine foreign exchange (i.e. not provided for by the U.S. Treasury) and thus curtail the surplus of commercial exports of goods and services.

The problem is, therefore, an internal one, since it cannot be denied that by raising the corresponding funds through the budget there must be an impact on the domestic economy. Even granted that deficit spending might be called for in order to reach full employment and full utilization of existing capacities, it is quite clear that the budget must finally be balanced when full employment and full utilization of existing capacities are achieved. Given these achievements, then foreign aid must either be financed out of a balanced budget, which means higher taxation and corresponding strain on the domestic economy or by further deficits which mean additional purchasing power beyond the full employment equilibrium and, hence, inflation and a further weakening of the competitive position vis-à-vis other countries.

On principle, the same holds true for military expenditure in foreign countries. However, both foreign aid and military expenditure abroad are problems of a more political character and, therefore, subject to political considerations and decisions. The only thing economists can do is to put the problems into their proper economic framework in order to enable the political authorities to draw the necessary conclusions. Though it happens all the time and all over the world that political authorities make the decisions and leave it to the private sectors of the economies to solve the problems, it is still the responsibility of economists to present these problems in their proper aspects.

In summing up my analysis of the Brookings study I want to state that the study, in my mind, fails for the following reasons:

1. The restriction of the scope of the study to the "basic balance" leaves out the important sector of private short-term capital movements, even more important in the case of the U.S. balance of payments, since the United States provides the key reserve currency and acts as the world's largest banker.

2. The exclusion of primary products countries and their autonomous behavior is not justified and, therefore, only serves the purpose of maintaining the thesis that only the changes in the United States and the Western European domestic economic variables need be considered as the major determinants of the changes in the U.S. basic balance.

3. Even under these limitations, the comparisons between different growth rates in the United States and in Western Europe are, to a large extent, unrealistic, and the validity of the projections is thus limited to mere conjecture.

4. However, even if these projections were to materialize, they would not solve the U.S. balance-of-payments real problems, since, the impact of foreign aid and of military expenditure abroad, or, to put

it in a different way, public sector spending abroad against private sector earning abroad, is misinterpreted with regard to the U.S. balance of payments and completely neglected with regard to the U.S. national budget and its effects upon the domestic economy.

I have, in correspondence with the letter of invitation, deliberately abstained from commenting on the policy recommendations of the study. It is my feeling that exactly this chapter contains the basic philosophy of inadequate international reserves and, hence, the need of a reform of the international monetary system. It is exactly this kind of philosophy which guides the study in such a way as to prove and to confirm that there is no need for the U.S. national authorities to face hard economic facts not only in their external, but also in their internal policy decisions.

STATEMENT BY FRITZ MACHLUP

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It is notoriously difficult to do the impossible. Some of us will not even try. The Brookings team, with Walter Salant as its able captain, did try, and no one can reasonably contend that anybody else could have done better than they. They were under no illusion about the feasibility of their assignment—of figuring out what the U.S. balance of payments may look like in about 1968. But figure they did and they came up with the finding, pleasing to many, that the U.S. “basic balance” will be greatly improved. Depending on which of their projections you prefer to believe, the basic deficit will have declined to \$0.6 billion or it will have given place to a surplus of \$1.9 billion.

PROJECTIONS AND ASSUMPTIONS

There are significant differences between unexplained prophecies, unconditional forecasts, conditional predictions, and hypothetical projections. The public, however, is rarely discriminating enough to appreciate the differences and, since there is a tendency to “believe” even the most carefully hedged projections, projectors ought to realize that they are often mistaken for prophets if they don’t repeat their disclaimers in every sentence. The Brookings projectors repeat their warnings only every few pages, and this is not enough to guard against misinterpretation.

Almost every criticism that can be made of the Brookings report was actually anticipated by the reporters themselves. A recitation of their own warnings, disclaimers, and hedges would sound as if it were a ruthless attack on their analysis. The reader is told, again and again, that the projections are “not unconditional forecasts;” that they were made “without assessing the probability that the assumptions will be realized;” that the estimates are “highly speculative;” that “relatively small errors in the projections of gross receipts or payments would make for large errors in the projection of the net balance;” that the value assumed for a particular elasticity is merely “a reasonable guess;” that some results from computation were arbitrarily changed because they did not look “plausible;” that the estimates of past relationships may have been “erroneous,” may have “omitted factors” of great importance; that the relationships “may change in the future;” that errors may arise from extrapolating “beyond the numerical range of some of the variables on which the equations are based;” that factors which in the future “may have profound effects on international trade” are “left out of account” because “quantitative estimates of their effects” cannot be made; that a particular assumption of strategic importance “is largely a guess;” and so on and so forth. All of this adds up to the conclusion that the system of assumptions, estimates, and guesses which supports the projections has considerable

academic interest but should not be used as the basis of policy determinations. At best it can be used to show policymakers on how many unknown variables and uncertain relationships the outcome depends, and how many things, therefore, can go wrong.

Highly instructive in this respect is the material in the appendices to chapters III, V, and VI, relating, respectively, to the wholesale price indexes weighted by export values and the U.S. share in imports of the rest of the world, to the estimates of direct investment, and to the derivation of feedback ratios. Anyone inclined to "believe" the results of projections in this area should try to understand the methods by which the estimates of significant relationships are arrived at. He will soon realize that it would be folly to rely on projections based on computations of this sort. In saying this, I do not mean to disparage the effort invested in these empirical analyses; on the contrary, I regard them as most useful demonstrations of the impossibility of quantitative forecasts of economic changes that will have taken place, in a free society, at an even approximately specified point of time.

The specification of assumptions or assumed responses seems inadequate with respect to the policies of the monetary authorities of different countries. The "feedbacks" described in the report, the interrelationships between transactions that come under different headings in the balance of payments, are not independent of the operation of the monetary system and, hence, of the reactions of central banks to the effects of transactions upon their foreign reserves. In other words, the "feedbacks" in a system where the central banks observe the old rules of the gold standard are quite different from the "feedbacks" where the central banks offset the effects of inflows and outflows upon the domestic money supply. At some points, the analysis implicitly presupposes a policy of offsetting to be pursued in all European countries. Thus it is assumed that Western European governments "will not be both willing and able to carry vigorous anti-inflationary policies far for any prolonged period." This assumption is based upon the belief that "political pressures and strong commitments to full employment policies will prevent Western European governments from making significant sacrifices in the form of unemployment to avoid increases in the general price level" (p. 214). It is true that several governments in Europe have allowed inflation to proceed with little restraint in the last 4 years, but these have been expansions due to surplus balances of payments, that is, expansions due to their central banks' purchases of gold and dollars. What these governments will do if the surpluses give way to deficits cannot be "projected" or predicted with any degree of confidence.

The cautions expressed by the Brookings projectors regarding their estimates of private foreign investment appear to be insufficient. The attempt to examine and estimate the "induced" portion of foreign investment—induced by relative incomes, profits, and other factors operating as incentives to invest—is highly commendable. But there should be a clearer understanding that the "autonomous" portion, which cannot be associated in a definite manner with changes in specified and ascertainable variables, may be so large that even the best projection of induced foreign investment is of no use in guessing the total.

The projections by the Brookings team are confined to the "basic" balance, which excludes short-term capital movements. This limita-

tion is, of course, justified since the volatility of short-term transactions defies any attempt to forecast, predict, or project. But it should be pointed out that the "problem" of short-term capital movements, including the unrecorded transactions reflected in "net errors and omissions," has in recent years been more troublesome than the basic balance. In 1960 and 1961 the outflow of U.S. short-term capital plus unrecorded transactions exceeded the deficit of the basic balance; in 1961 it was almost three times the basic deficit. Comparing the volatile transactions with the "total deficit" (meaning the balance offset by gold losses and increases in liquid liabilities), we find that over the 3-year period 1960 to 1962 they amounted to 71 percent of the "total deficit." Hence, what has hurt us most during the last 3 or 4 years is that part of the total payments balance which is not subject to projection and which may be explained partly in terms of interest differentials but chiefly in terms of a "lack of confidence" in the future of the U.S. dollar.

Since future differentials between interest rates at home and abroad will depend on policy decisions subject to change on shortest notice, and since confidence in the dollar will depend both on our policies and on foreign hunches and anxieties regarding the effects of these policies, not even the most hypothetical projections of the magnitude of future movements of short-term capital would have made any sense. But, if this is so, no degree of accuracy in the hypothetical projections of the basic balance will allow us to predict the strength or weakness of the dollar in the future.

Even the total balance, the algebraic sum of basic and volatile items, cannot tell us anything about the strength or weakness of the dollar in the market. The deficit in the accounting balance of payments of a key currency country may to some extent explain the supply of its currency in the world foreign exchange markets, but it can say nothing about the demand for it. The deficit in the U.S. balance may equally well constitute dollar shortage or dollar glut, depending on the other countries' desires to build up or to keep down their dollar holdings.

To these themes, the speculators' and reserve holders' demand for dollars, we shall return after a brief digression on the presumed desirability or necessity of eliminating the deficit in the basic balance.

THE BASIC BALANCE OF A BANKER COUNTRY

There is, I believe, insufficient awareness of the influences upon the balance of payments that are exerted by the financial position of the United States as world banker, financier, and capitalist. The fact that the dollar is international money and international currency reserve is mentioned often enough, but some of the implications are not. If they were fully understood, it would not be possible to entertain the notion that the United States must completely remove the deficit in its balance of payments. In order to make this clear I propose to employ an analytic device: to break up the U.S. economy into parts and to single out for special examination the sector consisting only of banks, financial intermediaries, brokers, and capitalists. Assume that all American stock and bond holders, all the bankers and brokers, and all Americans working in financial firms live in a separate country, called Bankland. How will the balance of payments of Bankland look?

The balance on current account is particularly easy to picture. Since Bankland produces only services and no goods, the credit items on current account consist of receipts for interest, dividends, commissions, and profits from capital transactions. If the Banklanders live within their incomes, the debit items on current account will consist of imports of goods and tourist expenditures abroad, and will total somewhat less than the receipts. The difference will be used for capital exports. If this was a country of capitalists only, and not also of bankers, capital exports would be limited to current savings. But we have assumed that there are bankers too and that the banks have plenty of foreign depositors; and we now add the further assumption that the world's economic activities and Bankland's banking operations are expanding. Expansion of the banks' operations means that they make loans and acquire securities, and thereby increase their deposit liabilities. Thus, there will be capital exports from Bankland, both short term and long term, and there will be capital imports into Bankland, chiefly short term. If the expansion of credit proceeds too fast, there will also be gold exports from Bankland.

Here is a typical balance of payments from Bankland:

<u>Credits</u> (in millions)		<u>Debits</u> (in millions)	
Commissions, profits, dividends, and interest received	20	Merchandise imports	13
Foreign capital		Travel (tourist exp.) abroad	3
long-term net (inflow)		Unilateral transfers (donations)	2
[Portfolio investment in Bankland]	11	Bankland capital, net (outflow)	32
-----		Direct investment abroad	8
short-term net (inflow)		Portfolio " "	12
[increase in foreign holdings of liquid Bankland assets]	15	Short-term capital " "	12
Gold exports	<u>4</u>		
	<u>50</u>		<u>50</u>

If the increase in Bankland's liquid liabilities and the reduction in its gold holdings are regarded as the correct measure of the deficit in its balance of payments, we find the deficit to be 19 (million Bankland dollars). Now let us consider the proposal that Bankland ought to strive to remove the deficit.

The gold exports of \$4 million may be taken as an indication that foreigners were not inclined in the particular year to increase their holdings of liquid Bankland assets by as much as \$19 million. Even the increase by \$15 million may not have been entirely voluntary; somewhat embarrassingly, a part of Bankland's liabilities may be held by reluctant creditors. This would indicate that Bankland has over-expanded its credit. But what about the advice that Bankland get into balance with the rest of the world, that the deficit be reduced to zero? This would be tantamount to an advice that Bankland get out of the banking business or at least that it stop expanding its business no matter how fast the world economy grows. Since Bankland's growth depends on its banking business, to stop bank expansion is to impose stagnation on its economy. In addition, since Bankland dollars

are international money and international reserves, to stop expansion of Bankland's liquid liabilities to the rest of the world is to force other countries to adopt relatively restrictive monetary policies.

Of course, one may reject a system in which one country's liabilities are other countries' monetary reserves; indeed, I do not understand why so many of my fellow economists think that this troublesome system is worth conserving. The system is troublesome and it probably will not endure despite the most ingenious props that are employed to make it viable. For, as a rule, banks and banking systems can go on expanding their earning assets and their deposit liabilities only if either their deposits are inconvertible or their holdings of the reserve money into which the deposits are convertible increase proportionately (or at least without drastic decline in the reserve ratio). For a banker country whose liabilities are money for other countries this would mean either the need for increasing gold holdings or the need of increasing holdings of deposits in an international reserve bank. Otherwise the expansion is liable to result in collapse sooner or later.

But this is not the point at issue. The point is that, as long as the system is maintained, it can function only if our imaginary Bankland, or the country that comprises a sector with the properties of Bankland, continues to run a deficit in its balance of payments, if not year after year then at least on the average over the years. It is the very essence of commercial banking that the banker accepts demand deposits and makes loans not payable on demand. If loans to foreigners are among the negative items in the balance of payments, whereas the increase in deposits of foreigners is regarded as "financing the deficit," a growing banking business necessarily implies a basic deficit in the balance. Not to have this deficit would involve stagnation of the international banking activities of the banker country as well as possible stringency in the credit supply to other countries. I conclude that complete elimination of the deficit, let alone creation of a surplus, in the basic balance of the United States is an ill-conceived objective.

PROJECTS AND PROPOSALS

Let us return to the question of volatile shortrun capital movements which the Brookings projectors chose to leave out of account. To discuss this aspect of the problem was perhaps outside the scope of their assignment, though the report contains some brief allusions to it. It points, for example, "to the possibility that pressures on the dollar will continue or even increase when the basic U.S. deficit is eliminated" (p. 9). Why then make such an effort to know the exact shape of the basic balance of 1968 or thereabouts? Evidently because the Brookings researchers believe that, since "a substantial basic deficit cannot be sustained indefinitely," the dollar cannot possibly "cease to be weak while the deficit persists." In other words, whereas the elimination of the "basic deficit" may not eliminate the total deficit, one cannot expect the total deficit to disappear as long as the basic deficit persists. More briefly, to remove the basic deficit is seen as a necessary but not sufficient condition for removing the total deficit.

The Brookings projectors may be right in this pessimism, though not in all circumstances. There are conditions—hypothetical, of course—under which confidence in the dollar can be restored even

while the basic deficit continues. Confidence is a relative matter. People "distrust" the dollar when they believe there is something better to hold than dollars. A policy of maintaining the prestige of the dollar as being "as good as gold" means in practice to have the dollar regarded as "almost as good as gold." This is so because people are convinced that gold can only rise in price and never fall. Hence, the faintest rumor about the faintest possibility that the price of gold may eventually be raised makes people anxious to convert their dollars into gold. If the monetary authorities of the major countries had the courage to adopt a policy of reducing the price of gold in very small, previously announced, steps, people would become aware that the dollar can be "better than gold." This awareness could well restore the confidence and make the dollar "strong" even if the U.S. basic balance continues to be negative for several more years. I have no hope, however, that such a bold policy would actually be adopted. The maxim: "Don't ever try what has not been tried before," seems to be the categorical imperative of the financial community.

This fear of "radical" change of financial institutions is probably the reason for the unfavorable reception given to the last chapter of the Brookings report, the "Policy Recommendations." The importance of this chapter lies chiefly in the influence which it may have (and perhaps has had) on governmental circles and, maybe even on persons in the financial community. Two alternative plans for monetary reform which had been taboo and could hardly be mentioned in earnest without risking official frowns—the creation of an international reserve bank (or payments union) and, alternatively, flexible exchange rates between the dollar and European currencies—have now become at least "debatable," thanks to the Brookings report. The lesson which it tries to convey and which people will eventually have to learn is that "independent" national currencies in quantities nationally controlled in the pursuit of national goals are essentially incompatible with the maintenance of fixed exchange rates. It may take several more reports of this sort until this idea is sufficiently understood, but in its dissemination the Brookings report will have been a significant step.

Perhaps it will be helpful to point out why it is so hard to comprehend this seemingly new idea (which in actual fact is not new, but was well known to the classical economists 150 years ago). Fixed gold parities and fixed exchange rates are the basic requirements of the gold standard. The gold standard of old times was really an almost magic formula: for it was in effect an abdication of national sovereignty in monetary management, but without any loss of national pride. On the contrary, the nations were proud of their sound and solid gold standard. That it implied surrender of national independence in credit policy was understood by only a few "high priests." Some of them saw in this surrender (to which they gave the names "automaticity of adjustment" and "balance-of-payments mechanism") the greatest merit of the system, as it served as a barrier against "easy-money policies" (which they abhorred while the people clamored for them). The operation was, of course, not completely automatic and the mechanisms worked only because certain rules were more or less strictly observed: broadly speaking, interest rates were raised and credit was restricted when the balance of payments showed a deficit.

This has changed and the trick of gold-standard "automaticity" works no more. National governments are no longer prepared to obey the rules of the gold standard game. They insist, instead, on using monetary policy for purposes other than securing "balance" in international payments; namely, for promoting employment and accelerating growth by creating effective demand. We need not ask here whether such policies actually achieve these objectives, and to what extent the financial community favors the pursuit of this type of monetary policy; it suffices to note that the government is more or less committed to employ monetary policy in this manner. Yet, and this is the point at issue, monetary policies to promote employment and growth may be incompatible with the determination to maintain or restore balance in international payments at fixed exchange rates.

Regarding the conflicting goals of monetary policy, the Brookings report is outspoken in assigning priorities to full employment and speedy growth as against balance in international payments. This is a value judgment which one may share or reject, but which one cannot profitably discuss in a brief critique. The main point is that the Brookings analysts have clearly seen the conflict between goals, and this is a great advance, since many "authorities" fail to perceive it or choose to close their eyes to it. Some of these authorities still regard the balance-of-payments problem as a problem of financing "swings" from deficit to surplus and back. To interpret a large deficit as a mere phase in a swing is to apply the theory of the self-correcting balance-of-payments mechanism to situations where it does not fit. This theory presupposes the observance of the old rules of the gold-standard game, including the rule that deficits engender deflationary measures. If there is no preparedness to deflate, the theory of the self-correcting deficit does not hold, and the talks about financing "swings" in the balance of payments—beyond seasonal or other really structural fluctuations—reflect pious hopes and untutored optimism.

My statement must not be interpreted as a plea for deflation; it is meant to be a plea for consistency. If we are prepared to subject the economy to occasional deflationary pressures, we may count on the working of the self-adjusting mechanism, talk about swings from deficit to surplus, and believe in the maintenance of fixed exchange rates between national currencies without the aid of an international reserve bank. On the other hand, if we are not prepared to suffer even short spells of deflation (with money tight enough and credit restricted enough to make some people scream), then consistency demands that we endorse one of the two reform plans recommended by the Brookings team: either fixed exchange rates maintained with the aid of an international reserve bank or freely flexible exchange rates equalizing supply and demand so that no surpluses and no deficits can exist.

A system of fixed exchange rates under which surplus nations are obliged, or feel obliged, to purchase the currencies of deficit nations at fixed prices, and under which the "remedial" or "equilibrating" actions exclude measures with deflationary impact, is inherently inflationary on balance. For clearly, the refusal to deal with deficits in the balance of payments by monetary contraction throws the responsibility for corrective action upon the surplus countries. This implies that the surplus countries have to engage in monetary expansion (by purchasing all the excess supply of the currency of the deficit country) with

the result that incomes and prices in the surplus countries are inflated. Since there are always some countries in deficit, the prescription for adjustment—expansion in the surplus countries but no contraction in the deficit countries—implies continual inflation for the world operating under this system.

In view of this inflationary bias of the gold-exchange standard—of the present “dual currency-reserve standard” and even more so of the “multiple currency-reserve standard” recommended in several quarters—it is strange to see that the open license to inflate is widely regarded as the most objectionable feature of the two systems recommended by the Brookings projectors. The plan to centralize reserve-creating powers in an International Reserve Bank (an extended International Monetary Fund) would transfer the license to inflate from the national central banks to the supranational central bank. Most governments apparently include the power to inflate among the prerogatives of national sovereignty; many declare that they would not entrust that power to a supranational body; they hold, in effect, that if somebody can produce inflationary pressures in their country they would rather do it themselves. The alternative plan, to unpeg all exchange rates and allow free markets to determine exchange rates according to supply and demand, would leave the power to inflate entirely with the national monetary authorities. They alone would have the responsibility for the stability of their national currency. The objection is that one cannot trust them not to misuse their power.

No one can say with any degree of certainty which of the three international monetary systems that are here compared would provide the best safeguards against both inflation and deflation. There is no conclusive empirical evidence to decide the conflicting claims. Assume we had had freely flexible exchange rates in the last 5 years: most likely, the United States would have had a little more inflation, but France, Italy, Germany, and other European countries would have had much less. (Their inflations have been due entirely to their purchases of reserve moneys at pegged prices.) Assume we had had an international Reserve Bank in the last 5 years: most likely, it would have acquired the dollars supplied by the U.S. payments deficit and would have exerted the same “pressures” upon the United States which the U.S. Government has exercised through self-restraint; and the European countries might have had just about the same inflations that they have had in actual fact; but they would now hold reserves in the form of deposits in the International Reserve Bank instead of in U.S. dollars and the world could not speculate against the dollar and would not have to tremble in fear of an impending collapse.

I endorse the recommendations of the Brookings experts. Their statistical projections may have been unfounded, but the policy projects which they advocate deserve serious consideration.

STATEMENT BY EDWARD MARCUS

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In order to assess the Brookings Institution projections of the 1968 U.S. balance of payments it would be helpful if we first summarized the sources of the current deficit. To do this it is necessary to recast the 1962 data, the latest full year, thus separating the transient from the more enduring forces. This has been done in the accompanying table I.

TABLE I.—*The U.S. balance of payments in 1962 (adjusted)*

[In millions of dollars]

Competitive merchandise exports (adjusted)-----	17,768
Other (untied) current receipts-----	8,773
Current payments-----	-24,964
Private remittances-----	-491
Pensions and other transfers-----	-245
Balance of above*-----	841
Government: Other grants-----	-1,903
Long-term capital (less ordinary repayments)-----	-1,516
Exports involving no dollar outflow-----	2,883
Net Government*-----	-536
Long-term private capital: Direct-----	-1,557
Exports for new direct investment-----	366
Net direct investment-----	-1,191
Other long-term-----	-1,209
Net private long-term capital-----	-2,400
Foreign capital-----	155
Balance of ordinary capital transactions*-----	-2,245
U.S. short-term capital (net)-----	-507
Special Government items-----	1,286
Errors and omissions-----	-1,025
Balance of other items*-----	-246
Balance (sum of items with *)-----	-2,186

Source: "Survey of Current Business," June 1963, page 22 (table 4); September 1963, page 13 (table 2).

The major difference between this table and the Department of Commerce presentation is the treatment of exports. We can regard somewhat loosely as noncompetitive those sales that are tied to funds coming from this country. Most obvious, of course, is the tied aid associated with the Government assistance and loan programs. But in addition there is also an element of this in our direct investment

abroad. As the 1960 Commerce study showed,¹ the outflow of U.S. capital results in a partial feedback for U.S. capital equipment. Hence, to get a clearer picture of both the net effect of these capital flows and the more competitive aspects of U.S. current exports of goods and services it was therefore necessary to adjust the published figures.

Table 2 (p. 13) of the Survey of Current Business, September 1963, permitted identification of those merchandise exports and services which could properly be regarded as tied to Government foreign aid; this adjustment was supplemented by the data in the June 1963 Survey presentation of the balance of payments. These two reported figures were therefore deducted respectively from reported merchandise exports and reported other current receipts. In addition, an estimate of those capital goods exports arising from the flow of direct investment was also made and deducted from reported merchandise exports.² The net figures we have called "competitive merchandise exports" and "other current receipts," since essentially they can be regarded as goods and services whose purchase was not influenced by the source of the funds used in payment.

It should be remarked that the adjustments do not take into account exports of U.S. companies to their oversea branches and subsidiaries. Although these are often tied, since the recipient is a captive operator, they have been omitted, for the 1962 shipments would represent mostly the purchases of firms established in prior years. Since we are interested only in the 1962 influences, this group of exports would probably have been of the same magnitude regardless of what had been done to alter the volume of U.S. private capital flows in 1962. Future years' exports, of course, would be influenced, as the new 1962 installations became operating units and started to buy some of their producers' materials from the U.S. parent.

When these adjustments are made the effects of the two major gross outflows become clearer. The various U.S. Government aid programs are now seen to be relatively unimportant contributors to the overall deficit—only \$536 million. But the net effect of long-term direct investment—after deducting the feedback for U.S. exports of capital goods—amounts to almost \$1.2 billion. Note also that even without these tied exports and including our military outlays the U.S. current account shows a surplus of slightly more than three-quarters of a billion dollars.

¹ U.S. Department of Commerce, Office of Business Economics, "U.S. Business Investments in Foreign Countries" (Government Printing Office: Washington, 1960). References to the Survey of Current Business are to the balance-of-payments articles in the issues cited.

² Table 33 of the 1960 Commerce study furnishes data on capital equipment imported from the United States in 1957 by U.S. firms operating abroad. We have assumed that this flow reflected only gross new direct investment abroad, the sum of new outflows from the United States (table 49) plus the U.S. share in the undistributed profits of foreign subsidiaries (table 46). For each major area (Canada, northern Latin America, southern Latin America, other Western Hemisphere, European Common Market, other Europe, Africa, Asia, and Oceania and international institutions) and for each major industrial category (mining, petroleum, manufacturing, and other) we calculated the ratio of capital equipment imported to the sum of new capital flows plus undistributed profits. This ratio was then applied to the data for 1962 as reported in the Survey of Current Business, August 1963 (net capital outflows from table 3, p. 18, and undistributed subsidiary earnings from table 3, p. 19). The implicit assumption was that the 1962 exports of U.S. capital equipment were the same proportion of gross direct investment abroad for each category as they had been in 1957. Note that the overall ratio would differ since there were shifts in the industry and geographical proportions. In 1957 such merchandise exports were 17 percent of estimated gross direct investment abroad, whereas, as a consequence of these shifts, the calculated overall ratio had declined to 13¼ percent.

The other major longer-term contributor to the deficit, as is well known, is the outflow of portfolio investment, roughly items 33 to 36 in the aforementioned June Survey (table 4), amounting to slightly more than the net payments for direct investments. These two contributed \$2,400 million net to our deficit.

If we then estimate short-term outflows by combining the reported U.S. short-term capital³ with errors and omissions⁴ we get the other major source of our payments difficulties, which in 1962 amounted to \$1,532 million. This item, however, as the Brookings study rightly points out, is probably a transient influence. It responds mainly to two factors, short-term interest rate differentials and possible doubts about the future exchange value of the currency. Assuming that neither of these considerations has a relatively long-run relationship—that is, assuming confidence in the dollar continues and also U.S. short-term rates normally neither below nor above those in Western Europe—we can project a zero figure for this movement in our hypothetical year. In effect we disregard this item as a permanent contributor to the payments balance, implying that the chance distribution of interest rate relationships could be in favor of a flow in either direction. It is of interest to note that two Government receipts also of a temporary nature almost offset this outflow in 1962: advance payments on exports (\$470 million) and special prepayments of Government loans (\$666 million), or a total of \$1,136 million.

The implication of the recasting of the payments statement is to focus attention on the outflow of U.S. private long-term capital as the major enduring factor that has given rise to our excess of payments. Assuming that we do not take Government action to change this item—that is, assuming, for example, that the July 1963 proposals of the President do not receive congressional approval—then the Brookings study must be evaluated on this new basis: how correct is it that the projected shifts will produce enough of a surplus of other receipts to offset the continued net outflow of American capital?

THE OVERALL IMPROVEMENT IN OUR DEFICIT

Before discussing the individual items it is necessary to make a few comments about the overall trends foreseen. It is possible that the individual projections, when studied in isolation, appear generally to be acceptable, yet the combined effect could be doubtful. Such, in brief, may be the major fault of the Brookings study. While most of the figures for 1968 do appear to be in line with current trends—indeed, some may be unduly cautious—yet the sum of the changes may then produce reactions abroad that evoke policies to counter the net improvement in our balance. As the study implies in chapter IX, there is doubt that the international payments mechanism could with-

³ Item 37 in table 4 of the June 1963 Survey.

⁴ *Ibid.*, item 52, table 4. For this combination cf. P. W. Bell, "Private Capital Movements" and the "U.S. Balance-of-Payments Position" in the Joint Economic Committee print, "Factors Affecting the United States Balance of Payments" (87th Cong., 2d sess.) (Government Printing Office: Washington, 1962), pp. 447 ff. Note that the omission of short-term capital from the Brookings projections for 1968 omits the movement of trade credit. As a result our prospective receipts from added exports are overstated by any accompanying increase in this item. For comments on the possible magnitude implied, cf. B. J. Cohen, "A Survey of Capital Movements and Findings Regarding Their Interest Sensitivity" in the Joint Economic Committee hearings, "The United States Balance of Payments" (88th Cong., 1st sess.) (Government Printing Office: Washington, 1963), pp. 199-202.

stand the ending of our deficit, since that would mean the end of the major source of additions to the other countries' stock of reserves. Hence, before entering into an analysis of the major items a disclaimer is called for, questioning the assumed degree of neutrality of the trading partners whose balances would deteriorate. It is very possible that a shift of the magnitude projected, especially if we accept the swings associated with the initial assumptions, would call forth actions to reduce our trade expansion, and thus the resulting improvement in our overall payments. (The "initial" and "alternative" assumptions referred to throughout this assessment are those of the Brookings study, such as in the discussion on page 60 of the report.)

If we accept the initial assumptions, the main improvements come through a greater rise in merchandise exports than in imports, increasing our visible trade balance by \$1.8 billion (excluding tied Government aid), plus a rise in private investment income of \$2 billion. Under the alternative assumptions the trade balance would deteriorate by \$0.9 billion. These two items together more than offset alternative items that would worsen our position, so that our net balance would improve by either \$2.7 or \$0.24 billion. The doubts, therefore, can be expressed as follows: if the reduced U.S. deficit does produce a reaction to mitigate its amplitude, will this be in the form of trade—either more intensive export efforts abroad or tightened restrictions on imports? Or will it show up as a decline in economic activity abroad, reducing profits, and thereby the U.S. earnings from oversea investments? Or, perhaps, both? A sharp change in either of these could have a fundamental effect on the projected change in our 1968 position.

EXPORTS

Actually, as already implied, it is possible that the visible trade improvement for this country will be even greater, if we accept the basic GNP projections used in the study. This belief is based both on the effects of the rising European output and a greater deterioration in its competitive position.

The American GNP is expected to rise some 43 percent (initial assumption), whereas our imports from Europe are projected up 83 percent. Yet a European GNP rise by a third is expected to increase imports from the United States by only a quarter. Since some three-quarters of our exports are manufactured items and non-competing agricultural products, these should increase more than proportionately to the rise in Europe's GNP,⁵ because they are subject to a fairly high income elasticity of demand⁶—just as is expected to occur for our imports from Europe. This difference alone could raise our exports by at least half a billion dollars more. If we assume an income elasticity equal to that used for projecting U.S. imports, the prospective rise in shipments to Western Europe could be as great as \$2¾ billion more than the Brookings figure.

An analogous question applies to Western Europe's projected imports from the rest of the world. The initial assumption is that Western European GNP will rise about 34 percent from 1961 to 1968, whereas imports from the rest of the world are projected to rise only some 19 percent. The alternative assumption of a 29-percent rise in

⁵ Even after allowing for the loss because of EEC discrimination.

⁶ Cf. p. 54 of the Brookings study.

European GNP results in an import rise of only 15½ percent. Put another way, the Brookings study expects European imports from the rest of the world to drop at least one-half percent as a proportion of GNP. Unless this results from so great a shift arising from EEC preferences⁷ it would seem that here, too, the study understates European imports—perhaps by as much as an additional \$2 to \$3 billion. This, in turn, underestimates the additional feedback to U.S. exports, perhaps by as much as three-fourths of a billion dollars to \$1 billion.

The study also expects a narrowing of European profit margins on export sales, thus holding down the excessive rise in their prices as compared with ours. Yet profit margins abroad have been narrowing for the past year or two, so that it is doubtful that European business would be willing to undergo a still further shrinkage. Indeed, since the projected rate of growth is in line with the recent experience, and this has caused intensive pressure on the available supply of productive factors, it seems illogical to expect such a development in profit margins. If anything prices should rise faster to recover previous operating ratios. Consequently, it would seem more likely for European exports to lose even more in relative competitiveness than is projected, and thus aid our export increase even more. Even assuming no further shrinkage in margins would call for a European price rise greater by one-fourth percent per annum than that projected, and could add at least another \$0.5 billion to our visible surplus. In view of the current price pressure being experienced abroad it would seem that even this revision may turn out to be low—unless the U.S. price level unexpectedly speeds up its rate of inflation over the next half dozen years. It is possible, therefore, to argue that our exports could rise by as much as \$3 to \$4 billion more than the projected figure, if we assume favorable income elasticities, and at least three-quarters of a billion dollars more assuming income elasticities abroad are lower than appears logical. By either yardstick the Brookings export projections appear to be unduly conservative.⁸

On the other hand, one can ask if even the Brookings projection is realistic when viewed historically. The figure for U.S. exports shows a rise of about 60 percent in 7 years, from 1961 to 1968. While such a rate of increase has been attained it has usually been only during exceptionally favorable periods. If, for example, we measure the change from, say, 1952 to 1959, or 1955 to 1962, our exports for those 7-year periods rose by 22 and 43 percent respectively. From 1950 to 1957, it is true, the rise was 92 percent, but this was from the pre-Korean recession level to the Suez boom. This, incidentally, is the only postwar 7-year period that shows a rise in our exports comparable with the projected Brookings figure. Furthermore, if this qualifying paragraph is correct, then the greater export volume suggested by this paper would be even more unrealistic when measured against our historical performance. This is the kind of contradiction referred to earlier, in which the total is less than the sum of the component parts.

⁷ The shift arising from EEC preferences accounts for only a small fraction—perhaps 10 percent of this difference. Cf. pp. 111–112 of the Brookings study.

⁸ To the extent that we revise upward the estimated profit margins in Western Europe we would also have to increase our investment income from that area and perhaps the outflow of U.S. capital attracted by the higher earnings potential abroad. This in turn would help our merchandise exports, too (cf. footnote 2). It is unlikely, however, that these various offsetting forces would affect the final projected payments balance appreciably.

A qualification to the projection should also be added for the tied shipments. In 1961—the base year used by Brookings—\$2.2 billion of our nonmilitary exports were financed by Government grants and capital, or about 55 percent of total Government grants and capital outflows. Hence, the 1961 export data should exclude these tied shipments in making the projections, and it is assumed that this was done. In addition, the exports tied to direct investment flows should also be projected on a separate base, related to our capital movement. However, this latter adjustment would probably not be significant for the Brookings study, for the inclusion of greater unremitted (reinvested) profits in the calculation would probably offset the decline in our capital goods exports as a result of the decline in capital outflows projected. The projected rise in investment income, that is, implies a greater volume of unremitted profits, also, which in turn would raise our capital goods exports. It is assumed that these adjustments are offsetting, so that the net effect on projected exports to Western Europe would not be significant.

The exports to the rest of the world did not have to be corrected for this tied component, since the Brookings approach is to project the receipts of this area, and from that to deduce their purchases in the United States and Western Europe. Using the more direct approach, and correcting for the tied element, it appears that the export figure in the Brookings study employed as its basis for projections is reasonable, and so no further correction was believed necessary.

For Western Europe, repayments of Government loans exceeded other grants and new Government loans in 1961, the base year. Hence, it was assumed that the tied aid would not be an influence on the projection of our trade with this area.

To recapitulate our suggested increases in projected U.S. exports:

[Billions of dollars]

	Initial assumption	Alternative assumption
Effect of European GNP:		
Unit income elasticity.....	+0.5	+0.5
Higher income elasticity.....	+2.75	+2.5
Feedback from rest of world.....	+ .75-1.0	+ .75-1.0
Profit margin improvement abroad.....	+ .5	+ .25
Total improvement, range.....	+1.0-4.25	+ .75-3.75

GROSS NATIONAL PRODUCT ESTIMATES

With respect to the gross national product estimates used in the study two questions should be raised: one regarding the implicit savings-investment rate for Europe; the other with respect to the composition of the growth in the United States and its effect on imports.

The study projects a rise of 0.6 percent per annum in Western European employment. Using the usual capital-labor ratio of 4 to 1, this growth implies a need for savings for this additional work force of about 2.4 percent of GNP per annum. The remaining rise in GNP because of the increasing output per man-year is estimated at 3.7 percent per annum, which implicitly requires that 14.8 percent of GNP be saved, or a total annual savings investment proportion of about 17¼ percent, which is close to that used in the study. This annual

investment figure, however, is at a rate higher than the past few years, which implies that the savings ratio must step up. Yet the study assumes a shift of incomes toward labor and away from profit—toward the low savers and away from the high savers. Either the desired volume of savings and investment will not be forthcoming because of this adverse effect on the propensity to save, or the expected share in the proportion of incomes accruing to profits will be higher than anticipated. We have already indicated why we expect the latter to be true, which means that European export prices will be higher than those used in the study.

IMPORTS

The recent history of the United States indicates that more of the overall price rise is attributable to services. This is a category whose competitiveness with imports is relatively nonexistent, although some components may feel this effect, such as travel. But it seems generally true to say that in any average price rise for the United States the cost of material things will lag behind that for services. In any average price rise projected it would be expected that those items that must face the brunt of foreign competition—merchandise—will go up less in price than the overall GNP. Therefore, it is possible that the price estimates used in the study should be revised downward to some extent. In particular, it seems unlikely that the effect of the growth in U.S. GNP would raise our imports from Western Europe by as much as the proportionate rise in, say, travel abroad. The latter should rise faster than GNP—perhaps at a rate twice as fast⁹—but it seems unlikely that our merchandise imports would also increase at so great a rate. Yet the Brookings study has gone even further; imports from Western Europe are expected to more than double, whereas travel rises only 82 percent.

The study projects two GNP figures for the United States in 1968 at 1961 prices—\$743 billion or \$710 billion. It also projects an average price rise for the period of 11 percent, which would raise these figures at 1968 prices to \$825 billion and \$798 billion, respectively. We can then compare the projected rise in U.S. imports by first abstracting from the price effect—using the 1961 price base—and then adding the price and competitive effects on imports by relating the final figure to GNP at 1968 prices.

In 1961 the ratio of U.S. imports¹⁰ from Western Europe to the U.S. GNP was a bit more than three-fourths of 1 percent, while imports¹⁰ from the rest of the world were just in excess of 2 percent of GNP. As a result of the rise in our GNP, but before adjusting for price changes, the Brookings study raises the ratio of Western European imports to our GNP to almost 1 percent. After adjustment for relative price changes the ratio is about as high, or a more than one-quarter improvement compared with 1961. In effect the study projects almost one-fourth of 1 percent rise in the ratio of Western European imports to our GNP if our GNP rises by 54 to 59 percent. For the rest of the world the price adjustment actually lowers the ratio of its supplies to our GNP by about one-sixth of 1 percent.

⁹ Cf. the Survey of Current Business, June 1963, p. 27. The projected rise in travel abroad in the Brookings study appears to be in line with Commerce estimates after adjustment for relative price changes.

¹⁰ Brookings study, appendix table 9.

This relative rise in the Western European import ratio appears to be too great when compared with recent experience. During the past decade, especially in the earlier years, it is true that this ratio has been rising. During the period there had been a relative rise in U.S. prices compared with those for Western Europe, partly the consequence of the 1949 devaluations abroad. As a result we would expect to see a sharp rise in imports, as well as an increase because of our growing GNP and high import-income elasticities. Yet despite all these favorable factors the growth in the proportion of imports coming from Western Europe was not much different from that projected for 1968, a period in which the U.S. price relationship should improve. If we select the adjusted merchandise imports reported in the balance of payments, the proportion of imports from Western Europe to the American GNP rose from 0.58 to 0.82 percent from 1952 to 1962. In particular, this ratio showed a sharp rise from 1958 to 1959 (from 0.74 to 0.93 percent), but since then, as our own relative inflation has slackened, the ratio has actually declined, from 0.93 to 0.82 percent last year (1962). Even if we omit services from the GNP figure—since merchandise imports would not be greatly affected by this component—the ratio rises from 0.86 percent in 1952 to 1.17 percent in 1958, jumps to 1.47 percent in 1959, and drops back to 1.33 percent for 1962. Roughly, it can be said that the proportionate rise during the past decade—when all the forces were in favor of increasing the relative position of Western European supplies—was not much more than in the Brookings projection, when the price forces are expected to be adverse to these imports and the stimulus of the 1949 devaluations will have been ended.

It is difficult, of course, to estimate the extent by which we should reduce the expected import figure. The evidence for the years since 1959 shows a decline in the import ratio; this has also been a period when the United States has experienced less of a price rise than has Western Europe. We can conclude, therefore, that the projected continued greater price rise abroad should improve our competitiveness still more, thus holding down the prospective rise in our merchandise payments to Western Europe. If we assume that the 1962 import ratio will hold for 1968, then imports from that area should be no more than \$6¾ billion for the initial assumption, as against \$8.11 projected by Brookings, or \$6.5 billion for the alternative assumption, compared with \$7.84 billion projected. Either way our prospective payments will amount to \$1½ billion less than that in the study.

The Brookings projection for imports from the rest of the world appears to be more plausible. Implicitly it assumes that the increasing need for imports as our growth outpaces our own natural resources, which would tend to raise the import ratio, will be balanced by our ability to economize on the use of materials, which would tend to lower the ratio of raw materials to GNP. Since there does not appear to be any discernible trend—in fact, over the past decade the ratio of all other imports¹¹ to GNP has declined from 2.5 percent to 2.1 percent (or from 3.7 percent to 3.4 percent if we exclude services from GNP)—it seems that conservatism would call for acceptance of the Brookings figure. However, some argument could be made for a continued re-

¹¹ We have used balance-of-payments data, which differ somewhat from the Brookings imports.

duction in the ratio, so that it is possible that the other imports could be reduced by, say, 7 percent.

REST OF WORLD'S RESERVES

The study assumes that any receipts accruing to the rest of the world—other than to Western Europe—will be spent on imports, either from the United States or Western Europe. This is open to doubt, for the weakened reserve position of so many of these countries calls for some increases. Certainly it seems unwise to expect that neither Japan nor Canada will allow their reserves to remain stable. Over the past year—from the end of March 1962 to the end of March 1963—these two have added more than \$400 million each to their gold and short-term dollar holdings. In view of their important trading positions it would appear to be more likely that each will tend to show a longrun rising volume of reserves as their trade expands. This necessary qualification is implicitly recognized on page 230 of the study, but is attributed to short-term capital flows. Yet it would seem likely—especially in view of recent trade surpluses—that Canada, at least, will wish to hold a larger reserve obtained through means other than capital imports, to protect itself against swings such as were experienced in July 1963 after the announcement of the proposed U.S. tax on the purchase of foreign securities. A similar reaction can be expected for Japan. The projected enlargement in our trade surplus with the rest of the world, especially under the initial assumptions, may well prove to be excessive, as a result.

The Brookings study implies a rise in our payments surplus with the rest of the world of at least \$1¼ billion and perhaps as much as \$1¾ billion. Using the initial assumptions, our overall balance would rise by \$2.7 billion; of this our investment income from the rest of the world will contribute \$1.1 billion, the major factor accounting for the deterioration in this sector's balance. Since the rest of the world's trade balance is not expected to improve,¹² and its capital imports from the United States are to decline by more than \$300 million,¹³ it is not clear how the worsening in the rest of the world's balance will be financed.

GOVERNMENT AID

Although this implies some political forecasting, there could be doubts raised about the extent of the U.S. dollar loss arising from the projected 1968 foreign aid. For one thing, 1968 AID expenditures are more than double the 1961 total;¹⁴ is so large a rise politically feasible, in view of the increasing resistance in Congress to these programs? If we assume that we were to freeze our aid at current levels we would reduce projected dollar losses for 1968 by \$400 to \$700 million, depending on the degree of tied stipulations.

In table VI-6 of its study Brookings postulates two different ratios of tied aid (the amount spent in the United States as a proportion of total aid)—either 62½ percent if we do not adopt the irrevocable letter of credit proposal, or 77 percent if we do. Yet even now the proportion appears to be about 80 percent, and efforts are to be made to raise

¹² Brookings, table III-7.

¹³ *Ibid.*, table V-10.

¹⁴ Table VI-2.

this even more. The higher this ratio, of course, the smaller the projected loss of dollars.

Moreover, it is not clear why Brookings is so skeptical about the effectiveness of the proposed introduction of letters of credit. The aforementioned table indicates that its use would reduce foreign reserve additions by \$568 million. Yet on page 172 of the study it appears that there is little additional benefit to be expected for our payments balance through this new financing approach.

WORLD LIQUIDITY

The Brookings assessment of reserves needed (study table VIII-4) appears to have overlooked some recent developments. For example, the figures do not include the 1962 International Monetary Fund agreement under which that organization may borrow an additional \$6 billion. There is also no recognition of the growing use of bilateral swap facilities. If we have full confidence that these new trends will continue, then much of the expected shortfall of reserves disappears. However, this comment is not meant to imply that there is no need for reform of our present international payments machinery. On the contrary, there is a danger that our present system could precipitate a financial panic, and the suggestions in chapter IX of the study are warmly endorsed. It is only because the instructions precluded comments on this problem that the remarks have been limited to this one table.

SUMMARY

The accompanying table II brings together the various [range of] suggested estimated revisions in the Brookings study. Because of the crudity of all such projections it does not differentiate between the initial and alternative assumptions. It indicates that our minimum estimated payments surplus is at least as much as the Brookings conclusion based on the more optimistic initial assumptions. It also implies that we could have a surplus so large as to threaten a return to the dollar shortage difficulties of the late 1940's. Obviously, no such magnitude is foreseen. As remarked earlier, the overall effects of summing any set of individual projections could still give a different result from that implied by the simple addition. Well before any such U.S. surplus began to emerge we would expect the trading partners abroad to take steps to stop such an unhealthy trend. Therefore, if our higher estimates should prove correct, the U.S. payments balance would improve more quickly, rather than in greater amount. These counteracting forces abroad would then slow down any further rise in our surplus.

TABLE II.—*Range of possible adjustments for the Brookings projections*

[Billions of dollars]

	Increase in receipts or decrease in payments	
	Minimum	Maximum
Increase in U.S. receipts over projection:		
Effect of European GNP growth.....	¹ 0.5	² 2.75
Feedback from rest of world.....	0	1.0
Improved European profit margins.....	.25	.5
Decrease in U.S. payments from projection:		
U.S. Imports:		
From Western Europe.....	1.33	1.33
From rest of world.....	0	1.0
U.S. foreign aid.....	.4	.7
Possible payments balance improvement:		
Brookings.....	.24	2.71
Brookings, adjusted.....	2.72	9.99
Projected payments balance:		
Brookings.....	³ - .62	⁴ 1.85
Brookings, adjusted.....	⁴ 1.87	⁴ 9.14

¹ Assuming unitary income elasticity of demand.² Assuming income elasticity of demand comparable with United States.³ Excess of U.S. payments.⁴ Excess of U.S. receipts.

The gist of this judgment can be put another way. The Brookings conclusions regarding an improvement in our payments position are plausible; if anything the figures are overly cautious. But an improvement may not be allowed to work itself out completely if other countries then try to counteract the shifts. This is a very likely possibility, and it is here that the study's remarks in chapter IX are most applicable. In effect the study is saying that our present international payments mechanism cannot allow the projected improvement to go on; that the other countries will be forced to take measures to stop its development. It is for this reason that a fundamental change in the monetary reserve base is so necessary.

STATEMENT BY LAWRENCE A. MAYER

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The Brookings study is a penetrating and in many ways ingenious analysis which throws some new light on the workings of the U.S. balance of payments. And its projections could turn out to be correct. Yet I am left with a feeling of uneasiness.

Whatever the qualifications mentioned along the way, the main line of the study in effect asserts that economic developments here and abroad are likely to be such that our balance-of-payments deficit will simply disappear by 1968. I agree that there will be tendencies in this direction—and they could be strong—but I think it sensible to assume that conscious policies to assure this outcome will be necessary, or at least prudent. The only direct policy actions the study takes into account are the two programs which have been underway for some time: reducing net U.S. military expenditures abroad, and tying foreign aid to U.S. exports. In point of fact, even as the study was about to be published, the United States both stiffened its monetary policy and proposed a tax on purchases of foreign securities in order to help redress the balance of payments. Consequently one unsettling aspect of the study is that it never firmly addresses itself to the question of what might be specifically done to improve the balance.¹ Another is that its stand that the balance will be righted by natural forces requires further buttressing.

The study's point of departure is to assume high economic growth rates for the United States (averaging 4.8 percent a year)² and for Western Europe (4.3 percent a year). Alternative calculations based on slightly slower growth rates for each area are also given, but nowhere are more polar possibilities considered. Will our balance-of-payments problem persist if our growth rate were to remain at the 1957-63 average of 3.2 percent, for example, while Europe's reaches the 4.3-percent target (about the rate actually being achieved in 1957-63)? There is at least a question as to what the Brookings answer would be, since the study strangely offers us no thorough appraisal of the causes of recent deficits.³

What if roles were reversed and the United States grew by 4.8 percent and Europe by 3.2 percent? Would the resulting improvement

¹ This probably follows from the belief that "the present problem is not primarily a balance-of-payments problem" (pp. 242-243). It is not clear to me whether this feeling results from the analysis of the U.S. balance or from more general considerations (pp. 241-242). At any rate, there seems to be an underlying implication that it is not so much the condition of the balance of payments that determines foreign attitudes toward the dollar, as it is attitudes toward the dollar and the character of the world monetary mechanism that shape the way in which our balance-of-payments position is appraised (middle par., p. 9; pp. 241-242).

² Although Brookings itself often mentions this percentage (e.g., on pp. 41, 44, 213, and app. table 5), it is not actually the ongoing rate throughout the period. The growth rate is faster in the early years and slower in subsequent ones, for "We assumed that growth would be somewhat more rapid as full employment was attained, and would then be moderately lower" (p. 40).

³ Not so strangely, perhaps, in light of the positions mentioned in footnote 1. above. Incidentally, I ought to add that I think the U.S. growth rate for 1963-68 will exceed that of 1957-63 by a good margin.

in our capital account offset the worsening in our trade balance? On page 231, item (3) says that in such a situation our basic deficit (defined to exclude flows of short-term capital and errors and omissions) would increase. In this brief passage, the possibility of a short recession or slowdown in the rate of growth in Europe by 1964 is mentioned. Because of this as well as other possible unfavorable developments in the next 2 years, the study says "substantial improvement" in the U.S. balance is first "likely to show up clearly in 1965 or 1966" (p. 231). But with the timing of business cycles being what they are, if there is a slowdown in Europe in the next year or two, there could well be a second by 1968. If so, the balance would then presumably worsen again, and so cause the trend of U.S. 1963-68 payments experience to show less improvement than Brookings suggests.

In lumping all areas outside of Europe into one rest-of-the-world group, the study may have glossed over too much. Canada might well have been given some individual treatment. First, our payments relations with Canada are very large in size (current account transactions total about half as much as with all of Western Europe, and U.S. capital outflows to each area are of even more equal dimensions). Any unusual political or economic developments in connection with our single largest customer—which Canada is—could have important effects on the U.S. balance, as was demonstrated during 1962.⁴ It is true that the latter was a transitory occurrence, but if it becomes recurrent, the U.S. balance will be subject to a series of shocks not encountered before. Second, the assumption that Canada spends all the foreign exchange it gets may no longer be true.⁵ Canada had little need to increase foreign exchange holdings while operating with flexible exchange rates (as variations in the external value of the Canadian dollar, rather than gains or losses of exchange, bore the main burden of payments adjustment). So for years foreign exchange reserves remained at about \$1.9 billion. But since Canada adopted a fixed exchange rate a little over a year ago, reserves climbed to \$2.7 billion by last May, which, however, were already subject to a \$200 million decline by August. In light of such fluctuation as well as future rises in imports and other foreign transactions, it may turn out that Canada wants a basic level of reserves well in excess of \$2.7 billion. Third, there is some evidence that the United States has been losing some of its share of the Canadian market.

Though the United States still accounts for two-thirds of total Canadian imports, it has supplied less than 50 percent of the gain (in Canadian imports) since 1953-55. The change, though important in crude materials and semi-manufactures, has been particularly marked in finished manufactures. * * * Given the exceptional importance of the Canadian market to the United States, these changes need to be studied in much more detail and a search made for their causes and significance.⁶

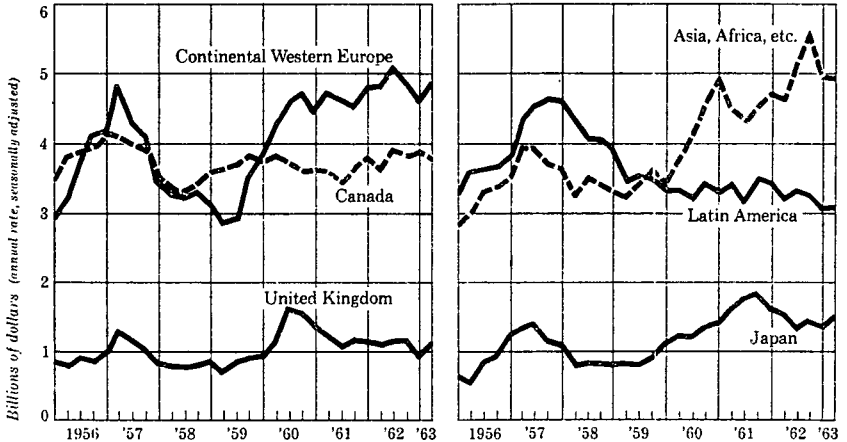
It might also have been appropriate to subdivide the rest of the world still further, between Latin America and all others (omitting

⁴ And was demonstrated again just recently when the Canadian Government told U.S. officials that it wanted to reduce imports of automotive products from the United States by about \$200 million. (The New York Times, Sept. 22, 1963, p. 1.) Then followed a report that Canada wanted to balance its entire current account with the United States, which has lately run at a deficit of about \$1 billion. (The New York Times, Sept. 30, 1963, p. 37.)

⁵ This possibility is recognized on p. 230.

⁶ H. G. Georgiadis in 43d Annual Report of the National Bureau of Economic Research, New York, May 1963, p. 93. Parenthesis added.

Japan as well as a few smaller developed countries). U.S. exports to these areas have behaved quite differently for some years: those to the former have been declining while those to the latter have been rising. (See chart below.) True, this is in good part due to the much larger increase in U.S. foreign aid to all others than to Latin America. But it is at least relevant to pose the question whether or not there could be any underlying reason why all others buying from the United States might not be able to increase much further, while Latin America buying (apart from the loss of sales to Cuba) might remain congenitally weak.



Note: "Asia, Africa, etc.", which is equivalent to the term All Other used in the text, excludes Japan. First quarter of 1963 roughly adjusted for effect of dock strike in January.

Reproduced from "Business Roundup", *Fortune*, August 1963, p. 36

Brookings projects a substantial increase in aid to all underdeveloped regions, with Latin America getting nearly half of the net increase which can be allocated by area, a substantial rise from its present share (table VI-2). Because Agency for International Development aid is projected to rise from \$1.8 billion in 1961 to \$3.9 billion in 1968, the total net aid bill would accordingly rise from \$3.7 to \$5.8 billion (appendix table 10). Although it occurs to the reader that so large a rise might not be forthcoming, only 17 percent of any cut would affect the balance of payments, according to the Brookings analysis. This calculation follows from its assumption that the practice of "tying" aid plus the shift in emphasis to Latin America, with its close trade relations with the United States would mean that \$350 million of the additional \$2.1 billion in aid would eventually "leak" into the reserves of Western Europe. This compares with—and would be in addition to—the estimated 1961 aid leakage to Europe of \$850 million from \$1.8 billion of AID expenditure, or 47 percent (table VI-7). On this basis, the total aid leakage in 1968 would still come to 31 percent.

However, it is conceivable that any changes in the distribution and amount—whether up or down—of aid might have some effect on the structure of world payments, especially in dollars, which is a large and intricate subject in itself.⁷ Brookings never deals with the meaning and future implications of the apparently indirect way in which Western Europe has gained gold and dollars in recent years, although the fact that it has gained them makes Europe the fulcrum of the Brookings analysis. Walther Lederer presents data indicating the “leakage” is much greater than the estimated \$850 million from aid alone⁸ and comments as follows:

Recorded transactions between the United States and Western Europe, Japan, and Canada account for a relatively small part of the adverse balance in U.S. foreign transactions. The much larger part is accounted for by our transactions with other countries, and by unrecorded transactions. Since these countries themselves generally have not accumulated reserves it must be concluded that their dollar earnings from the United States are used to make payments to the industrialized countries, particularly in Western Europe.

The fact that apparently the rise in European gold and dollar holdings is not necessarily due to direct transactions between countries in that area and the United States would imply that an improvement in our foreign balance would require that either our transactions with the less-developed countries be brought into a better balance (by attracting dollars which are now spent by these countries elsewhere) or by achieving a sufficient surplus in our transactions with the industrialized countries.⁹

I have been indicating that, despite the imaginative design and working out of the Brookings study in its opening chapters, and its later meticulous attention to detail,¹⁰ certain investigations of sub-structure were relatively neglected. These might have strengthened or modified the study's general conclusions. In the same way, no cross-checks on the merchandise export and import projections for the United States and other areas, which are so crucial to the conclusions, are presented.¹¹ It would have been reassuring, to say the least, if the results for merchandise trade from the mathematical model had been buttressed, supplemented, or revised by independent projections for major commodities or commodity groups. In this way, some check could have been had on whether foreseeable trends in demand are likely to add up to actual markets as large (or small) as those derived from the overall equations.¹² And some allowance might have emerged for possible changes in the pattern of commodity use, or possible perturbations such as large U.S. purchases of European short-haul and supersonic jets in coming years.

It is apparent to any reader that one of the key elements in the study which wipes out the U.S. deficit by 1968 is the faster rise in European than in U.S. prices. In this connection I have thought

⁷ See Herbert B. Woolley's "Measuring Transactions Between World Areas," to be published by the National Bureau of Economic Research.

⁸ "The Balance of International Payments During the First Quarter 1963," Survey of Current Business, June 1963, table 4 and text table p. 25.

⁹ P. 19, *ibid.*

¹⁰ In respect to the effect of the Common Market, foreign investment, foreign aid, and military expenditures abroad.

¹¹ The introduction says alternate projections were made for travel, transportation and other services, but we are not told what they were, p. XVI.

¹² Hal B. Lary made some judgments on the Brookings projections of U.S. exports to Europe, as well as European buying from third countries in his statement on the Brookings study at the Joint Economic Committee hearings of July 30, 1963.

it useful to assemble, from scattered pages of the volume, the following table:

TABLE 1.—*Annual percent increases*

	Western Europe			United States		
	Real output (GNP)	GNP prices	Export prices	Real output (GNP)	GNP prices	Export prices
1953-60.....	4.7	3.2	0.2	2.5	2.2	1.1
1960-68:						
Initial assumptions.....	4.3	2.75	1.5	4.8	1.5	0.5
Alternate assumptions.....	3.8	1.75	1.0	4.2	1.5	.5

The interrelations are somewhat paradoxical: Slower growth in Europe in coming years than in 1953-60 will bring a slower rise in the GNP prices (i.e., GNP deflators) but, contrarily, a faster rise in export prices; meanwhile faster growth in the United States will not bring a faster, but a slower rise in GNP prices, combined with a slower rise of export prices. Without necessarily subscribing to the detailed figures used, a relative price advantage in favor of the United States should prove to be correct, and already may be in the process of appearing. Still, one may doubt that the disparity would proceed for 5 years without modification, either because the Europeans would not permit it to persist at full tilt or because the U.S. GNP price rise—kept low by hypothesis in the study—will turn out to be higher. It is also important to recognize that the conversions of the respective GNP prices to export prices on pages 81, 83, and 88 are little more than guesses, in default of a better available method. Yet this is a key calculation underlying the final projection.

It should be added that in one respect the course of prices could be more favorable than the study assumes. It believes that prices of primary products that the United States and Europe import from third countries are likely to remain reasonably stable (p. 59). If Brookings is too conservative on this score, and raw material prices actually rise in the event that the United States and other industrial economies do grow rapidly, then there is reason to believe (inferring from p. 60) that the U.S. balance of payments would reap additional benefit from this source.

In the matter of total U.S. net private long-term capital outflows, Brookings projects a decline of \$534 million from the 1961 level by 1968 (table V-10). That is \$691 million less than in 1962 and \$2,113 million less than the fantastic annual rate in the first half of 1963. In fact, more long-term capital than the amount projected went abroad in every year beginning with 1956. The smallest excess over the projected rate was \$223 million in 1959.

One important component, direct investment, is projected at \$850 million for 1968 (p. 148), a considerable reduction from recent rates. It is a little hard to believe that the 1968 figure will turn out to be back at the level of 1955, which amounts to half the 1956-62 average, though some diminution is possible.

For remaining U.S. long-term capital, the study projects an outflow—as I put the figures together—of \$1,225 million. Recent trends and the projection are given in table 2.

TABLE 2.—U.S. private capital outflows, excluding direct investments

[In millions of dollars]

	1959	1960	1961	1962	1963 (first half at annual rates)		1968
					A ¹	B ²	
					Purchases of new issues of foreign securities.....	624		573	523	1,076	2,052	(*)	-----
Purchase of outstanding foreign securities.....	139	177	353	55	200	(*)	-----
Redemptions of foreign securities.....	-95	-100	-123	-170	-166	(*)	-----
Net securities outflow.....	688	650	753	961	2,086	(*)	975
Other long-term, net.....	258	200	258	248	284	(*)	250
Total outflow.....	926	850	1,011	1,209	2,370	2,262	1,225

¹ Unadjusted for seasonal variation.² Seasonally adjusted.³ Not available.

Sources: 1959-62, from table 2 of Secretary Dillon's statement to the House Ways and Means Committee Aug. 20, 1963; 1963, from Survey of Current Business, September 1963, tables 1 and 4; 1968, from Brookings Study, ch. V, text and table V-10, top line.

"Other" net long-term capital outflow (chiefly term bank loans) is not projected to increase above the average rate of 1957-62,¹³ which, however, was about three times as great as in the previous 5 years (p. 137). Given the expanded insurance coverage by the Export-Import Bank and the greater interest of U.S. banks in oversea business (both mentioned on p. 138), it may have been wise to allow for some increase here.

The table shows the now well-publicized acceleration in net U.S. purchases of foreign securities, which rose by nearly one-half from 1960 to 1962, and in the first half of this year were running at a rate triple the 1960 figure. Brookings projects a continuation of the net 1962 rate of about \$1 billion, rather than the early 1963 rate of about \$2.1 billion. The recent rate will doubtless have to be cut back, but Brookings advances no appraisal of the meaning of the early 1963 level or any means of reducing it. (Perhaps this was unavoidable. The developing 1963 situation was only becoming clear as the Brookings study was nearing publication.) Secretary of the Treasury Douglas Dillon, in what must, of course, be recognized as an ex parte statement, has clearly said that without special action (he was advocating the interest equalization tax), the flood of new foreign issues causing the rise in capital outflow would continue.

There are no signs that this flood of new issues will, of its own accord, fall back to the more sustainable levels of earlier years. To the contrary, the information now becoming available points toward the definite possibility that, unless effective action is taken, the tide of foreign sales may rise still further.

Foreign businessmen are becoming much more aware of the efficient facilities and relatively low rates available here, and much more accustomed to their use. At the same time, there are indications that the profit margins of many European business firms have come under increased pressure during recent years, so that their ability to finance their growth almost wholly from retained earnings, the normal practice for many years, is now more limited. This is leading to increased demands for borrowed funds at a time when European capital markets are, by and large, not yet adequately organized to efficiently supply business needs from the growing savings of their own peoples. Somewhat similar forces seem to be at work in the case of many

¹³ The 1957 and 1958 figures are not in the above table. They were inferred from the Brookings statement at the bottom of p. 137.

local government authorities abroad, hard pressed to finance a backlog of local improvements.

These rising demands on our market have a counterpart in the increasing familiarity with, and interest in, foreign securities by U.S. underwriters. At the same time, the appetite of American investors for new foreign issues has been whetted by the huge flow of savings in this country, by the relative shortage of profitable domestic investment outlets, and by the opportunity to earn a higher return on foreign issues. The unfortunate experiences of the twenties and thirties, which long restrained the demand for foreign securities, have now been largely forgotten. Moreover, the fear of difficulties in obtaining prompt payment of income and principal has abated with the ready convertibility of currencies and the growing volume of foreign reserves.

Similar forces could, of course, easily stimulate larger American purchases of outstanding foreign issues, and this possibility would be greatly enlarged if the burgeoning supply of the new issues reaching our market is not successfully curtailed. * * *

American investment advisers and investing institutions, including pension funds, with increasing frequency seem to believe that diversification could be improved by investing a portion of their assets in foreign equities. When one considers the billions of dollars currently invested in stocks by pension funds alone, it is easy to realize that an attempt to place only 5 percent of these assets in foreign securities, as some have recently begun to do, could lead to an outflow of many hundreds of millions of dollars per year, far outpacing our efforts to induce more purchases of American securities by foreigners.¹⁴

Later in the statement Mr. Dillon said he anticipated that the new tax would get new issues back to the \$500-\$700 range of 1959-61, which is even less than seems to be assumed in the study's projection. If the tax is enacted, it is scheduled to expire on December 31, 1965. Thus, assuming Mr. Dillon's hopes for the tax are meanwhile realized, by 1966 other factors such as better developed capital markets abroad and greater investment demand at home would have to substitute for the inhibiting features of the tax, else further special measures could be required.

A striking feature of the Brookings projection is the absence of any speculation about future short-term capital outflow and the behavior of the errors and omissions item in the balance. Without denying that these are extremely difficult if not impossible to predict, some allowance must be made for them, and if Brookings will not make it, then the task falls on others. (Sidestepping this issue made it easier for Brookings to avoid discussion of the effects of monetary and fiscal policy on the payments situation. Advertently or not, this helps the design of eschewing any recommendations for the improvement of the balance.) It is clear that these items can be major factors in the total balance, and it would have been quite useful if sets of alternative estimates as to what the short-term flow might be under varying assumptions (for one thing, of interest rate differentials) had been essayed. In any case, some net outflow of short-term capital is normal as world exports and the need for financing them grow.

The outflow of U.S. short-term capital averaged \$235 million in 1953-59, with no year higher than \$635 million. But in 1960 it reached \$1,348 million and in 1961 \$1,541 million. Last year the flow declined to \$507 million, and was \$1,034 million in the first half of 1963 (annual rate, seasonally adjusted).¹⁵ These are obviously difficult data to deal

¹⁴ Before the House Ways and Means Committee, Aug. 20, 1963.

¹⁵ In recent years, the errors and omissions item has behaved so as to indicate receipts for foreign areas, and hence outflows from the United States. If these are also regarded as short-term outflows (which they are probably not entirely) the totals become: 1960, \$2,031 million; 1961, \$2,446 million; 1962, \$1,532 million.

with sensibly. In the absence of any rigorous attempt at projection, and on the working assumption that errors and omissions in 1968 would be zero, plus the knowledge that some annual short-term outflow is usual, I simply put forward the guess and notion that it would be sensible to set down \$750 million as the net outflow of U.S. short-term capital in 1968.

Altogether, the Brookings position is that from 1961 to 1968, "Our best guess is that the basic deficit will be eliminated" (p. 230). This implies a balance of zero, or an improvement of \$0.85 billion from 1961, as follows:

TABLE 3
[In billions of dollars]

Improvement, 1961 to 1968	Basic deficit, 1961	Basic deficit, 1968
Initial assumptions, +2.71.....	-0.85	+1.85
Alternative assumptions, +.24.....	-.85	-.62
Text, p. 30, +1.85.....	-.85	0

¹ Implied. All other data except the zero, which is taken from p. 30, are from app. table 10.

Several components of the improvement of \$2.7 billion projected for the basic balance on the "initial assumptions" have been discussed here.¹⁶

• It was indicated that the analysis of comparative price trends may have given results on merchandise trade too favorable to the United States. Moreover, Walther Lederer has commented that the equations used by Brookings in any event overstate the effects of relative prices.¹⁷ I am at a loss as to how to correct easily for matters of this kind, so for the purpose of establishing some magnitudes I invoke a rough and ready procedure. That procedure is to ask what a reasonable merchandise trade surplus for 1968 might be.

Apart from the years just following World War II and the unusual year of 1957, the best surplus in recent experience was the \$5.4 billion of 1961, partly, to be sure, because imports were on the low side.¹⁸ By 1968, if things go rather well, perhaps we might be able to improve on the 1961 level by about half a billion—admittedly a sheer guess. But it is important to realize that this would put the surplus at \$5.9 billion, a \$1.6 billion improvement over 1962. On the other hand, it would be \$1.3 billion below that implied on the Brookings initial assumptions. If the trade situation is less favorable, perhaps the surplus would not be more than the \$4.3 billion of 1962. Although this would be \$2.9 billion below that implied on the Brookings initial assumptions, it would be only \$0.2 billion less than that implied on the alternate assumptions.

• If the decline in direct investment to half of the recent average seems too much, it might be feasible to put forward a fall of a quarter, which comes to \$400 million more outflow.

• "Other" net long-term capital could rise, say \$75 million¹⁹ over the \$250 million projected.

¹⁶ In what follows, no judgment of the effects of any possible changes in interarea settlements could be made.

¹⁷ Statement at the Joint Economic Committee hearings of July 30, 1963.

¹⁸ For technical reasons, Brookings uses a \$3.5 billion trade surplus for 1961.

¹⁹ This is rounded to \$50 million in table 4.

- A more pessimistic appraisal of U.S. net purchases of foreign securities might conclude that the United States will not be able to hold the outflow to Secretary Dillon's cutback target, at least after 1965, or the even higher Brookings' figure for 1968. This would suppose that part of the increase in early 1963 is permanent because of the demonstrated foreign hunger for U.S. capital and the ability of the U.S. market—under given conditions, to be sure—to supply it. On this line of reasoning there may be a case for raising the study's \$975 million outflow in 1968 by some amount like \$250 million.

- Perhaps \$750 million needs to be added to the basic deficit to allow for outflow of short-term capital, partly in order to finance exports. In addition, there is now a closer relationship than before to foreign money markets, and possibly some flow which now turns up in "errors and omissions" will later go through more regular channels and so be recorded under short-term capital. Consequently, though the proposed figure is very substantially below the rates of 1960-62, it is a good deal higher than in years prior to then.

- On the other hand, the balance might be \$1 billion more favorable than the study assumes because the investment income projected is too low, as Lary has pointed out.²⁰

- There are several other factors which have not been discussed so far.

- (1) Service transactions with the rest of the world (i.e., outside Western Europe) are not projected (app., table 11), and thereby assumed to be unchanged. The trend for 1959-62, which I computed for purposes of comparison, shows a decline of \$135 million in our net balance. Further, Brookings does not project any portion of our Government miscellaneous services account. The negative balance here increased \$58 million from 1959 to 1962. Unless there are underlying reasons which would halt the trends, these calculations suggest an additional deficit of around \$400 million in 1968 compared to 1961.

- (2) Brookings regards prepayments made on U.S. Government loans abroad as abnormal, and so subtracts them as a credit entry from the 1961 balance. Of the \$668 million of prepayments made in 1961, \$33 million are due in 1968, so Brookings says that, because it took this sum out of the 1961 figure, "logic requires" that it be put back in 1968 (p. 186). While this is correct in theory, it may not be good in practice, for the fact remains that since we took in more in 1961, we will take in less in 1968. And we will probably also take in less from the large prepayments of 1962, and from any made subsequently. The effect will be to put more pressure on the U.S. dollar in foreign exchange markets (and on the actual U.S. balance) than would have existed without prepayments. Moreover, although we are told that the effect of 1961 prepayments on 1968 is \$33 million, we are not told whether this effect is greater or less than that in, say 1967 or 1969 (and the same applies to the prepayments of 1962 and thereafter). Total prepayments totaled \$1,441 million from 1960 through the first half of 1963. If these would otherwise have fallen equally due in the next 5 years (which may be a somewhat inaccurate supposition), then the balance each year would be \$300 million more adverse than if there had been no prepayments.²¹ A further consequence is loss of interest

²⁰ Statement at the Joint Economic Committee hearings on the U.S. Balance of Payments of July 30, 1963.

²¹ This is not meant to be an argument about the wisdom of prepayments. It is merely an attempt to think about their consequences.

in 1968 (or any year thereabouts) on any prepayments which were made prior to then. It is not clear whether Brookings has allowed for this or not. If not, we might be receiving something like \$25 to \$50 million less in interest in the years centering on 1968 than Brookings estimates.

(3) Even though one accepts the Brookings estimate of the foreign aid leakage in 1968, one may still wonder whether a figure that high, \$1.2 billion, will be tolerated. Perhaps attempts would be made to whittle it below \$1 billion.

(4) As mentioned earlier, if prices of raw materials rise, instead of remaining stable as Brookings believes, the U.S. balance will benefit. Just how big the effect would be is impossible to say precisely, and of course in part depends on how much these prices might go up.

Because quantitative estimates for most of the four points just discussed are so hard to make, I make the working assumption that their effects will cancel out. That does not mean to imply, however, that their individual or combined effects are certain to do so in practice, or to be insubstantial. On the contrary. The foregoing has been presented precisely to call attention to them individually.

A further matter to be considered is the positive feedback (or stimulus to U.S. exports) which would result from some of the greater outflow of U.S. dollars on investment and service account that I have put forward. The additional \$1.1 billion, however, is about equal to the posited additional inflow of \$1 billion for investment income. The latter would result in some negative feedback (or depressing effect on U.S. exports), and so perhaps as a first approximation the two effects may be estimated to offset each other.

The foregoing qualifications sum up as follows :

TABLE 4		<i>Billions of dollars</i>
Basic deficit in 1968 on the Brookings initial assumptions.....		+1.85
Less:		
Lower merchandise trade surplus.....	-1.30 to	-2.90
More direct investment.....		-.40
More "other" long-term capital outflow.....		-.05
More securities capital outflow.....		-.25
Total change.....	-2.00 to	-3.60
Plus more investment income.....		+1.00
Equals new basic deficit.....	+.85 to	-.75
Less outflow of short-term capital.....		-.75
Equals total deficit.....	+.10 to	-1.50

It will be noticed that on the "basic deficit," my optimistic estimate is \$1 billion less than that of Brookings, though my alternative \$.75 billion deficit is about the same as that of Brookings (\$.62 billion). In respect to my total deficit, the less favorable one is appreciably lower than the troubling deficits that came after 1957, and is only a little greater than the average experienced during 1951-56. Whether a deficit which inherently tends to be of that magnitude can actually hold there may depend on the behavior of errors and omissions. They were in fact positive during the deficits of the earlier 1950's, which means that the actual deficits of those years would otherwise have been larger. I assumed that errors and omissions would be zero in

1968, but it may be that conditions will then be such that an inherent total deficit of \$1.5 billion would be accompanied by a negative—i.e., an adverse—errors and omissions position.

The actual outcome would naturally be much better than I have indicated if, for example, my somewhat arbitrary modifications of the Brookings figures are too great; or if the errors and omissions item turns in our favor again, as it stood before 1960; or if economic relations with the Soviet bloc are substantially resumed by 1968 and work out so as to benefit our payments balance. The outcome might be worse if, for example, the industrial nations fall short of meeting their full employment goals; or future developments cause U.S. military expenditures abroad to be markedly increased; or if protectionism comes to play a larger role in world trade than at present.

The point of this whole commentary, of course, is not solely to arrive at a set of balances alternate to those of Brookings. Perhaps a more important function is to raise the possibility that the look of the accounts in 1968 may be somewhat different than that visualized by the study. And if that is so, this could affect the choice of any deliberate policies which might be undertaken to assist the U.S. balance-of-payments position.

STATEMENT BY HORST MENDERSHAUSEN ¹

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Writing in 1957, Sir Donald MacDougall, the noted British student of the dollar, held that "the U.S. balance of payments was more likely to improve than it was to worsen, at least over the following couple of decades, though not necessarily at once," ² thus making it possible that a "dollar shortage" might return. In the following 3 years, the U.S. balance of payments registered unprecedentedly large conventional deficits, in excess of \$3.5 billion a year, and an aggregate gold loss of \$5 billion; but writing in 1960, MacDougall cautiously restated his earlier prophecy. He also warned that "the only thing which can be said with certainty about any country's balance of payments is that it changes when one least expects it, and often in the opposite direction * * *. We really do not know how the cat is going to jump."³

The Brookings report of 1963 arrives at expectations of the same kind.⁴ Five years from now, in 1968, Brookings expects the basic elements in the U.S. balance of payments⁵ to be in approximate balance, showing a \$1.9 billion surplus under one set of assumptions and a \$600 million deficit under alternative, less sanguine assumptions. Whether the total balance of payments in 1968 will be in approximate balance likewise—in 1961 and 1962 it still showed conventional deficits in excess of \$2 billion—Brookings leaves an open question. Moreover, the report points to the possibility "that pressures on the dollar (i.e., prevalent foreign efforts to exchange U.S. dollars for U.S. gold) will continue or even increase when the basic U.S. deficit is eliminated."⁶

While more specific than MacDougall with regard to the timing of the improvement process, Brookings is more limited in the substance of its optimistic forecast of the U.S. deficit. The authors reason, and it is hard to disagree with them, that for the items that lie between the basic balance, as they define it, and the entire balance of payments it is quite impossible to say how the cat will jump. Who indeed would have forecast that, beginning in 1960, U.S. short-term capital outflows

¹ This paper was written at the request of the Joint Economic Committee of the U.S. Congress. In accordance with the request, it seeks to provide a critical analysis of "the scope, assumptions, methods, inferences, and findings" of the Brookings report, to help the committee "assess the likelihood that the study's projections will be realized."

Any views expressed in the paper are those of the author. They should not be interpreted as the views of the Rand Corp. or any of its governmental or private research sponsors.

² Donald MacDougall, "The World Dollar Problem," MacMillan, London, 1957. The cited statement appeared in the same author's "The Dollar Problem: A Reappraisal," *Essays in International Finance*, Princeton University, November 1960, p. 3.

³ *Ibid.*, pp. 64-65.

⁴ Walter S. Salant and Emile Despres, Lawrence B. Krause, Alice M. Rivlin, William A. Salant, Lorie Tarshis, "The United States Balance of Payments in 1963," material presented by the Brookings Institution to the Joint Economic Committee, 88th Cong., 1st sess., Washington, D.C., 1963, p. 216. (Henceforth cited as Brookings.)

⁵ I.e., the whole balance of payments, except for movements of U.S. short-term capital, foreign commercial credits, prepayments of Government loans, foreign credits to the U.S. Government and net errors and omissions, on the one hand, and the conventional surplus deficit categories on the other hand. The latter comprise net transactions in U.S. monetary reserve assets (gold, convertible currency holdings of U.S. monetary authorities) and changes in U.S. liquid liabilities to foreign governments, monetary authorities and private citizens of foreign countries.

⁶ Brookings, p. 9.

would spurt to unprecedented levels (at least in 1960 and 1961) and that the opaque item in the accounts, called "Errors and Omissions," would for the first time in postwar history reflect unrecorded net outflows, even to the extent of about \$1 billion a year, 1960 through 1962? But for these two volatile negative components, *certeris paribus*, the conventional total deficit of 1962 would have been a mere \$650 million instead of the shocking actual \$2.2 billion, in other words, about the same as the basic deficit forecast by Brookings for 1968 under the alternative assumptions. It is difficult enough to predict the more transparent, or basic, categories.

THE BASIC BALANCE

At the risk of bypassing the crucial questions, i.e., whether the total deficit will decline and, in particular, whether the net conversions of foreign dollar assets into gold will cease, the Brookings authors ask themselves whether the deficit in the basic balance would vanish by 1968. The authors reason convincingly that an affirmative answer would be the necessary although by no means the sufficient condition for an affirmative answer to the crucial questions; and there they left the matter. They pursued their own question with diligence and great care, but they could not answer even that question without ambiguity. Their two numerical estimates of the trend position for 1968 straddle the balancing point.

This ambiguity in the projection is quite in order. The Brookings authors are perfectly aware that even the basic balance is essentially unpredictable. (Its statistical measure is unpredictable because, besides many other reasons, the other things are unpredictable—e.g., "Errors and Omissions" may originate in basic balance categories.) The only claim that can be made in favor of focusing the study on it rather than on the picture as a whole is that the categories that are grouped in the basic balance are more accessible to macroeconomic simplification and reasoning and to the study of the implications of programs of executive branch agencies. The simplifications may be right or wrong; the reasoning, if correct, may be complete or incomplete; and the programs may be realistic or unrealistic. In any event, the limitation to the basic balance gives the balance-of-payments experts a chance to discuss intelligently important aspects of the development, past and future, as well as serious data deficiencies which constrain our knowledge. The Brookings group has used that chance well. All Brookings should be understood to say is that if the cat is going to jump along a trajectory that appears reasonable to well tempered economists, it will not go off the deep end.

This message is not unhelpful. It can encourage an attitude of confidence which, properly mixed with exertion, might well implement the trend to a lesser imbalance in total payments, and a lessening of the pressure on the dollar. But to be helpful, the message must rest on judicious assumptions and procedures. The purpose of this paper is to examine whether it does.

Before we move on to this matter, however, one blind spot in the Brookings report should be noted. The authors could have returned to the full scope of the balance-of-payments problem by adding to their analysis and their projection of the basic balance a study of the factors determining the readiness of the various foreign central banks to hold

dollar assets. The authors note that there have been dramatic changes in this regard during the past decade. In passing,⁷ they also refer to some reasons for the changes beside the U.S. basic deficits; but they never face this question directly. Their recommendations about international monetary arrangements are not underpinned by an explicit analysis of the political economy of the gold dollar system. A good chapter on this topic could have been very useful in judging the prospects of order and anarchy in the developing international payments situation.

THE 1968 PROJECTIONS

The Brookings projections are summarized in table 1 below. In comparison with 1961, U.S. exports of goods and services, via trade and (nonmilitary) aid, are expected to increase by \$14.3 (or \$10.6) billion, imports of goods and services by \$10.1 (or \$8.9) billion, depending on assumptions. The net outflow of private long-term capital is to diminish by \$600 million, and the net transfers and loans of the U.S. Government are to grow by \$2.1 billion.

TABLE 1.—*Projected 1968 U.S. basic balance of payments under 2 sets of assumptions, and comparison with 1961*

(In billions of dollars)

Item	Actual 1961	1968 projection		Projected change, 1961-68	
		Initial assump- tions	Alterna- tive assump- tions	Initial assump- tions	Alterna- tive assump- tions
Exports of goods and services, total ¹	28.3	42.6	38.9	+14.3	+10.6
Merchandise, adjusted ¹	20.2	31.4	27.8	+11.2	+7.6
Investment income.....	3.8	5.8	5.8	+1.9	+1.9
Other services.....	1.8	2.9	2.9	+1.1	+1.1
Exports not projected ²	2.5	2.5	2.5	0	0
Imports and goods and services, total.....	-23.3	-33.4	-32.2	-10.1	-8.9
Merchandise, adjusted.....	-14.5	-23.3	-22.4	-8.9	-7.9
Military expenditures.....	-2.9	-2.6	-2.4	+4	+5
Other services.....	-2.5	-4.1	-4.0	-1.6	-1.5
Imports not projected ²	-3.4	-3.4	-3.4	0	0
Net exports of goods and services....	5.0	9.1	6.7	+4.2	+1.7
Net private long-term capital.....	-2.1	-1.5	-1.5	+6	+6
Government transfers and loans, net.....	-3.7	-5.8	-5.8	-2.1	-2.1
AID, Public Law 480, and Export- Import Bank.....	-4.0	-6.4	-6.4	-2.4	-2.4
Less repayments.....	.6	.9	.9	+3	+3
Transfers and loans not projected.....	-.2	-.2	-.2	0	0
Basic balance.....	-.8	1.9	.6	+2.7	+1.2

¹ Exports exclude goods and services transferred under military grants, but include goods and services transferred under "Government transfers and loans, net."

² Exports not projected consist mainly of transportation, travel, and other services to non-European countries, but include special category exports. Imports not projected consist mainly of services to non-European countries but include private remittances, most of which go to Western Europe.

Source: Brookings, p. 216.

The two projections differ only in the goods and services accounts. The initial assumptions rest on inputs of the Council of Economic Advisers (U.S. real GNP up 4.8 percent per annum, GNP prices up

⁷ Notably on pp. 257-258.

1.5 percent per annum, and unemployment quickly reduced to 4 percent of the labor force), and on OECD target rates of economic growth for Western European countries (real GNP up 4.2 percent per annum, GNP prices up 2.75 percent per annum). The alternative assumptions derive from the Brookings judgment that actual growth of real GNP in the period may well be slower than the above "capacities" or "targets" indicate—say, only 4.5 percent per annum for the United States, and 3.8 percent for Western Europe—and that the corresponding annual rates of increase of GNP prices would be 1.5 percent for the United States (as above), and 1.75 percent for Western Europe. In both the initial and the alternative cases, Brookings reasoned out the implications of these basic assumptions for productivity, labor cost, income distribution, and export price developments, and with the help of some rough econometric parameters, translated the domestic assumptions into projections of the volume and value of trade in goods and services.

The strategy of presenting two alternative projections is of course debatable. On the one hand, there is a good reason for more than one projection: One can have so little confidence in any set of assumptions. A second set at least helps to show the considerable sensitivity of the results to some variation of the factors; and it does not lead as quickly into vagueness as would a third set or essentially meaningless "confidence intervals" around one set. After all, the report was commissioned to say something about the uncertain future. On the other hand, one may wonder whether the given two sets were the best ones available. In particular, one may wonder what kind of a second set the Brookings authors might have chosen if they had discarded from the start the CEA-OECD "targets" for GNP's which, in their judgment, appear overoptimistic. They might have found a set equally plausible to them as their "alternative" set, and in that case provided a better centered range of projections. This reviewer has no particular candidate in mind, but various critics have come up with suggestions.

QUALITATIVE ASSUMPTIONS

The procedures of the report can be discussed conveniently under the heads of qualitative assumptions, quantitative assumptions, and special subject analyses. The qualitative and quantitative assumptions refer chiefly, but not exclusively, to the projections of merchandise trade and services which form the foundation of the total projection. On this foundation, modifying elements and the remainder of the basic balance of payments were constructed through special analyses of four subjects, viz: Effects of the European Common Market, private foreign investment, foreign economic assistance, and defense transactions, while interactions between the various parts of the structure were taken into account.

This reviewer finds himself in general sympathy with the qualitative assumptions made in projecting the basic balance of payments for 1968; no essentially better or safer ones come to mind. The simplifications that they imply with regard to financial behavior patterns and alternative causes of economic development seem almost inescapable in any effort to make the job of projection manageable and to arrive at results that are at least distinguishable and debatable. It

is worthwhile, however, to comment briefly on some of these assumptions and to point to some troubles that may arise along the way.

One important qualitative assumption divides the world into two camps of different financial posture, one comprising the United States and Western Europe—each capable of running substantial basic deficits or surpluses, or of adding to or subtracting from their foreign exchange reserves in substantial amounts—and the other, the countries of the rest of the world, each held likely to maintain a more or less even balance in its basic accounts and incurring only minor variations in foreign exchange reserves.

As a result of this assumption, after some qualifications and a discussion of Japan as a special case, Brookings postulates a seesaw relation between U.S. and collective Western European basic surpluses and deficits, or of foreign exchange reserves. Thus, as Western Europe moves toward a lesser basic surplus, the United States is expected to move toward a lesser basic deficit, or vice versa, or the same starting from the other end.

I see no good reasons for rejecting the assumption; it seems to fit the recent past well enough. But the sensitivity of the results to it should be stressed. If circumstances should arise that would make say, Japan or Canada turn to an accumulation of foreign exchange reserves, the Brookings expectations for U.S. merchandise and service exports in 1968 would prove too sanguine, everything else remaining the same. These good customers of the United States might take dollar assets or even gold instead of U.S. goods and services. The circumstances might possibly be generated by a failure in meeting the problem of international liquidity, to which the policy recommendations of the report draw attention. The less reliable international system of monetary reserves, the greater the inducement to countries to lay up exchange reserves of their own, notably in the form of gold.

The most important single qualitative assumption of the report seems quite proper, viz; that the growth potential of the United States economy in the next few years is that of an underemployed economy, while that of the Western European economies is one of fully employed economies. This leads easily to the assumption that real output growth in the United States will outdistance that in Western Europe, although nobody, including the Council of Economic Advisers, will affirm that the U.S. potential will be realized.⁸ But assuming with the authors that a differential in growth and tone will materialize, a crucial question for the U.S. balance of payments is whether the export prices of the more strained Western European economies will outpace those of the United States. This appears logical, and indeed likely, but by no means certain. One critic has guessed that European governments, with memories of inflation, will take the necessary measures well before 1968 to prevent a rise in prices greater than that in the United States;⁹ and another critic has warned that it would be inadvisable to rely much on developments which would affect adversely the competitive capabilities of others.¹⁰ A judgment on this matter is unavoidable, and the Brookings judgment is rather persuasive. To be sure, inflation memories exist, and so does

⁸ See letter of Chairman Walter Heller to Senator Jack Miller, hearings on the U.S. Balance of Payments, before the Joint Economic Committee, 88th Cong., 1st sess., pt. 2, July 29 and 30, 1963, p. 335.

⁹ See testimony of Gardner Patterson, *ibid.*, p. 291.

¹⁰ See testimony of Walther Lederer, *ibid.*, p. 235.

the knowledge of instruments to combat price rises, and a number of persons in high places in European countries would be eager to apply some of the instruments; but squeezes on incomes and employment would probably be strongly resisted. One should indeed doubt the political capability of Western European governments in the next few years to conduct counterinflationary price and income policies effective enough to contradict the report's preferred price projections, which are quite moderate. Political constellations in Britain, Germany, and Italy do not favor a suppression of the updrift of prices, and even so authoritarian a regime as the French does not show much effectiveness in this regard at present. To postulate something like an equal, let alone lesser, export price advance in Europe compared with the United States would seem to this reviewer far more daring than the "alternative" Brookings assumption (11 versus 7 percent, 1961 to 1968), and even somewhat more daring than the "initial" one (20 versus 11 percent).

But if prices will rise faster in Europe than here, will not qualitative factors vitiate some of the gain in U.S. competitiveness? Gardner Patterson, of Princeton University, has criticized the report for lacking an appraisal of innovations.¹¹ Hal Lary, of the National Bureau, has warned of the effects of American investment in Europe on the relative pace of technology;¹² and the report itself has pointed to the sad experience of the American automobile industry in the late 1950's. Indeed, the spectacular loss of foreign and domestic market shares by what *Fortune* magazine (in March 1953) still called the "impregnable motor industry," with its strong impact on the merchandise trade balance of the United States, offers an eloquent warning of how our competitive position can be damaged by insensitivity to potential demand and inability to discover and provide what the customer needs. Will it be heeded by our machinery, aircraft, electronics, and other industries—and by the branches of government which influence the initiative of our export industries through administration and legislation? If not, adverse developments could easily occur in some of these branches. Macroeconomic analysis, such as the Brookings report provides, offers no help in evaluating these qualitative aspects of competitiveness, which are so important with manufactured products. The question remains whether, at hopefully reasonable prices, American industry will offer attractive and technically leading products and services in comparison with foreign, especially West European, competition.

Finally, in this area of qualitative assumptions, one must note the expectations regarding trade and payments postures of other countries, including exchange rates, that underlie the projections of the report. The authors assume that these things will continue to 1968 in about the shape they have shown recently, with the major exception of the trade posture of the European Common Market countries, which is expected to evolve unfavorably for U.S. exports. This general assumption may be unavoidable (there is no better one) and even realistic (no great depression, rampant inflation, abandonment of currency convertibility, or widespread adoption of quantitative trade controls are visible on the horizon). Still, this is a turbulent world,

¹¹ *Ibid.*, p. 290.

¹² *Ibid.*, p. 297.

and one can be fairly certain that political crises and economic disarray (even on the other side of the Iron Curtain) and warfare in several parts of the world will influence international trade and payments in the next 5 years. This turbulence may affect the balance of payments in all its parts: trade, returns on investment, and governmental transactions. The impact on surplus and deficit depends on the situation and is unpredictable; e.g., a food shortage in the Soviet Union might work in one way, one in India in another way, and defaults on investments (expropriations) in some trouble areas in still another way. All this does not call for better projections or for greater modesty about present projections—on this score, the Brookings report is beyond blame. It rather serves to emphasize the need for flexibility in the American economic posture toward the outside world and for responsiveness to emerging requirements. A situation might well arise in the next 5 years in which it might appear right to risk an increase in the balance-of-payments deficit. I suspect that here again I find myself in substantial agreement with the authors.

QUANTITATIVE ASSUMPTIONS

The general outlook of the report on the development of merchandise trade and services, supplemented by the special studies, provides the core of the Brookings study. The expectation of a lessening of the deficit in the basic balance in the years ahead flows from this general outlook, notably as developed in the very good chapter on competitiveness. Numerical estimates were necessary to make the various expectations additive and to present a coherent picture. But these estimates also give an unwarranted appearance of precision, and the authors know that and frequently issue warnings about it.

The translation of the general outlook of the study into quantitative projections of trade and services presents very great difficulties. Reliable macroeconomic parameters cannot be found. Whatever was available had to be modified by guesswork to meet some standards of plausibility, and the standards are not clear. The Brookings authors limited themselves to projecting broad aggregates and did not research the outlook for particular groups of products. Hal Lary has criticized this approach and expressed his belief that in this fashion the report arrived at too large an increase in exports of U.S. manufactures to Europe for 1968, under the initial assumptions.¹³ Walther Lederer, Chief of the Balance of Payments Division, Department of Commerce, has pointed to some recent experience that would seem to contradict the strong sensitivity, assumed in the report, of U.S. exports to favorable price differentials.¹⁴ While these criticisms suggest possible overestimates of U.S. exports, at least under the initial assumptions, Lary argues in another observation that the report may have underestimated the growth of U.S. income from foreign investments, and favorable indirect effects on the U.S. balance of payments.

This reviewer is not in a position to evaluate the reliability of the numerical projections. The approach seems to have been judicious and careful, and the authors are fully aware of the great uncertainties besetting the projections. The projections cannot be rejected for reasons of error in the number work; but that does not make them reliable.

¹³ Hearings, p. 296.

¹⁴ *Ibid.*, p. 286.

SPECIAL STUDIES

The study of the effects of the European Common Market on U.S. trade and payments is a fine piece of work. It shows the strongly trade diverting and protectionist potential of the common external tariff and the common agricultural policy of the European organization and maintains that "except for those products in which the United States maintains a clear technological lead, the prospects for increasing, or maintaining, the U.S. share of the EEC market seem remote unless there is a major shift in competitive position or a substantial reduction of EEC tariffs."¹⁵ The report estimates the direct and indirect loss of U.S. exports through this factor at three-fourths of a billion dollars and points out the need for hard bargaining with that difficult partner if a larger loss, or even so large a loss, is to be avoided. The report does not consider in what way U.S. commercial policies may impinge on U.S. imports from the Common Market in the eventuality of a failure of the "Kennedy round." This subject will undoubtedly receive attention in the future.

The Brookings outlook for private foreign investment is one of somewhat lesser outflows of U.S. private capital and somewhat greater inflows of foreign capital. The reasoning is based on the assumed relative improvement of profitability in this country and on other factors. The numbers (reduction of the annual net capital outflow by about \$600 million, 1961 to 1968) are well-considered guesses. As for interest and dividend flows on private and governmental investments, the report projects an increase of the net inflow by about \$2 billion over the timespan—which Hal Lary considers an understatement. In obedience to the assumption that non-European countries cannot run down their reserves, Brookings holds that these changes of capital items in favor of the United States will take about \$700 million out of potential U.S. exports to these countries.

With regard to foreign economic assistance the report follows projections by AID and other executive branch agencies, which appear quite sanguine. The increase in the gross burden to the balance of payments is estimated at \$2.1 billion, 1961 to 1968; but the increase in the net burden is assumed to be almost nil since the more complete tying of U.S. aid to U.S. exports leads to a nearly equal boosting of the study's estimate of merchandise exports. This appears to be a reasonable expectation, regardless of the level of aid, and an automatic corrective of any possible overestimation of the aid flow in 1968. The study took account of the likelihood that some economic assistance exports cut into U.S. commercial exports.

To estimate the effects of defense transactions, Brookings relied on analyses and expectations in the executive branch of the Government. This component of the balance of payments is of special interest since (1) it comprises large U.S. Government expenditures in Western Europe, where dollars have frequently found their way into official reserve accumulations and even gold purchases, rather than U.S. exports, and (2) these expenditures are related to military programs of great political significance. The first circumstance makes this category a convenient target for efforts to make the U.S. balance of payments less deficitary; the second suggests the risk of shooting at the target.

¹⁵ Brookings, p. 104.

The report describes some of the recent efforts to pare certain kinds of expenditures in this category, and to defend the continuation of others by cooperative agreements, notably with Germany, which call for offsetting purchases of U.S. military goods and services by allied countries. Over the years 1961 to 1963 (estimated), U.S. military expenditures abroad have declined little, from \$3.1 to \$3 billion. But sales of military goods and services have increased from \$0.4 to \$1.3 billion, and if these are offset against the expenditures, the "net adverse balance" in the military realm shows a decline from \$2.7 to \$1.7 billion. Projecting to 1968, the authors expect the decline to continue slightly, to \$1.6 billion, owing to a decrease of military assistance expenditures by another \$400 million (expenditures on U.S. forces abroad and their support are expected to decline by less than \$100 million), and a decrease of offsetting U.S. military sales by \$275 million. The implied reduction of U.S. military personnel deployed overseas (from 1962?) to 1968 is by 70,000 men.

The projection reflects a U.S. Government decision to resist strongly the pressure of the balance-of-payments deficit on oversea military programs, and to disappoint the speculations of foreign opponents on a withdrawal of U.S. forces from critical areas. If this decision is adhered to, it will work to hold down the reduction of direct U.S. military expenditures abroad and to stress the military sales, which incidentally serve to strengthen materially some allied forces and their interdependence with ours. The report is rightly concerned with defending these and other substantive interests against headlong sacrifices to "balance-of-payments discipline." There is indeed some danger that the accessibility of this section of the balance of payments to governmental manipulation will lead to a spurious focusing of improvement efforts on it and to a weakening of the decision.

The concept of the net balance on military items, which the Defense Department has developed, is an interesting one. To some extent, it is an administrative fiction. U.S. troop expenditures abroad and sales of military equipment and services abroad, particularly by private industry, do not naturally call for a separate balancing. Some of these sales are as independent of U.S. military expenditures abroad as are sales of breakfast cereals. Certain sections of the U.S. arms industry have enjoyed a competitive advantage internationally and might continue selling abroad even if U.S. military spending overseas fell off. But it is also undeniable that the Defense Department makes a large contribution to U.S. military exports today by its selling efforts and by the comparative efficiency of its logistics services compared with those of other possible providers of such services. In the most important areas, these efforts and comparative advantages would be negated by a withdrawal of U.S. forces. A very real interdependence exists therefore between the elements in the military balance. For this reason, besides others, a dollar of troop spending abroad saved should not be regarded a dollar of U.S. gold saved.

CONCLUSIONS

The principal conclusion of this comprehensive and intelligent study of balance-of-payments prospects for 1968 is expressed in the authors' words: "Our best guess is that the basic deficit will be eli-

minated.”¹⁶ The meaning of this statement is further clarified in the leading recommendation regarding measures to improve the balance of payments, which is negative: “We do not recommend that the Government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves.”¹⁷ The authors argue that the pursuit of basic national objectives, summarized as economic growth and stability at home and abroad, maintenance of free world military strength, and freedom of economically productive transactions in the free world,¹⁸ should not be jeopardized by preoccupation with the balance of payments.

The report is characterized by this outlook. It counsels rejection of some conventional devices to suppress balance-of-payments deficits, such as general credit restriction, currency devaluation, and “beggarmy-neighbor” policies; and it directs attention toward the mobilization of resources for meeting some further deficits as well as efforts to improve the international monetary system. The authors also seem to suggest—their testimony before the Joint Economic Committee is more eloquent on this point than the report itself—that pursuit of vigorous domestic policies favoring economic growth and price stability should be our preferred economic approach to the balance-of-payments problem.

This reviewer sympathizes with these viewpoints, both the negative and the positive ones. He believes that the provocative Kindleberger rule “Don’t just do something, stand there.”—quoted by Emile Despres in testimony before the Joint Committee—should indeed be invoked against many notions of balance-of-payments surgery. But he also believes that much should be done to make the essential domestic developments come about on which the Brookings report bases its optimistic outlook for the balance of payments.

¹⁶ Brookings, p. 230.

¹⁷ *Ibid.*, p. 253.

¹⁸ *Ibid.*, p. 244.

STATEMENT BY RAYMOND F. MIKESELL

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"The U.S. Balance of Payments in 1968" is an ambitious and highly competent attempt to project the changes in the major elements of the U.S. balance of payments between 1961 and 1968. While the authors are fully aware of the difficulties involved in balance-of-payments projections, they have provided the most sophisticated analysis to date of the complex interrelationships among the various elements in the balance of payments which must be taken into account in projections of this nature. Since there is little basis for projecting such highly volatile elements of the balance of payments as short-term capital movements and the relationship between foreign liquid dollar holdings and gold movements, they have concentrated their efforts on "the basic balance" which includes the merchandise and service expenditure and receipt items as usually defined in the balance on current account, plus U.S. Government foreign aid and private long-term capital flows. They emphasize that changes in the "basic balance" may not in the short run, or even over longer periods, be matched by corresponding changes in the strength of the dollar in international markets, or in the amount of official support in the form of gold movements or official short-term borrowing required to maintain the parity of the dollar. Nevertheless, there is a strong relationship between the two and they point out that the United States could not indefinitely endure a substantial deficit in its basic balance while avoiding weakness in the international market position of the dollar. However, the preservation or improvement of the international reserve position of the United States may require more than a surplus in the basic balance.

Since the fundamental task of the authors of this study was the projection of the U.S. balance of payments in 1968, they relied on other agencies for certain basic assumptions regarding key variables. Thus, the Council of Economic Advisers (CEA) supplied the basic assumptions for the level of GNP in the United States for 1968 and the average price of GNP. In addition, they received general guidance from the CEA for assumptions regarding the 1968 GNP of Western Europe, assumptions which were derived from "planned targets" presented by the four major European countries. The authors also relied upon program projections by AID (after revision by the Bureau of the Budget) and the Defense Department for estimating the relevant variables in these areas. In the case of the GNP projections for both the United States and Western Europe, however, the authors employed both the "initial assumptions" given them by the CEA and their own "alternate assumptions" which, in some cases, the authors appear to regard as somewhat more realistic than the "initial assumptions." Thus, the 1968 balance of payments was projected on the basis of each of the two sets of assumptions.

The plan of this paper will be first to comment on the analysis of the U.S. balance of payments to 1961, as presented by the Brookings

study, and then to discuss the projections of each of the major elements in the U.S. balance of payments to 1968. Following this, I shall consider the analytical conclusions for the 1968 basic balance and balance of payments as a whole, followed by a discussion of the implications of these conclusions and of the policy recommendations of the study.

MAJOR FACTORS IN THE DETERIORATION OF THE U.S. BASIC BALANCE
BETWEEN 1953-55 AND 1958-60

It is generally assumed that an analysis of the changes in the U.S. balance of payments during the 1950's and especially since 1953, should provide a ready explanation of the fundamental causes of the weakness in the international position of the dollar, which has been reflected in the more or less steady and rapid outflow of gold beginning in 1958. However, it is abundantly clear that balance-of-payments analysis for the period since 1952 (the end of the Marshall plan) provides no easy and obvious answers. In order to avoid the period of the Suez crisis and for other reasons, the authors of the Brookings study chose to compare the major changes in the U.S. basic and total net balance of payments for 1953-55 (annual average) and 1958-60 (annual average). (See p. 15.) In the latter period, the basic deficit of \$3.4 billion was just double the basic deficit of \$1.7 billion in the 1953-55 period, while the total deficit as measured by the outflow of gold plus increased liquid dollar liabilities to foreigners was \$1.6 billion in 1953-55 and \$3.7 billion in 1958-60. The U.S. gold loss was only \$1.5 billion between the end of 1952 and the end of 1955, while it totaled over \$5 billion between the end of 1957 and the close of 1960. However, if we compare 1953-55 with the more recent period, 1960-62, we find that our basic deficit was \$1.6 billion (annual average) in the 1960-62 period, or slightly less than for the 1953-55 period, but our overall deficit was \$2.8 billion and our gold and official convertible currency loss was nearly \$3.4 billion.

Comparisons between different periods give different results both as regards the basic balance and the relationships among the basic balance, the total deficit, and the gold loss for the periods examined. Even more complex, however, is the assigning of the factors responsible for the changes in the U.S. basic balance or total net balance between given periods. Since the U.S. surplus of merchandise exports over imports has tended to be larger both in the 1958-60 and in the 1960-62 period than in 1953-55, doubts are raised regarding the explanation that the increase in the U.S. overall balance-of-payments deficits has been due to a weakening of our competitive position in merchandise trade with the rest of the world. Moreover, there has been an improvement over the 1953-55 period in our total goods and services current account position, even after the inclusion of oversea military expenditures which have risen somewhat over the earlier period. An easy explanation then would be to point to the increase in U.S. Government foreign assistance and to U.S. private long-term capital outflow as being responsible for either the continued basic balance deficit or the deterioration in the overall net balance. However, such an explanation overlooks the relationship between the increase in foreign aid and private capital outflows on the one hand, and the expansion of U.S. merchandise exports on the other,

as well as a number of other interrelated factors in the balance of payments.

Thus, the history of the U.S. balance of payments over the past 10 years presents at least two fundamental questions: First, what relative weights should be assigned to the causal factors which have produced changes in the basic balance? And second, why have the same or even smaller basic balance deficits in recent years been accompanied by much larger overall deficits and even relatively greater losses of official gold and convertible currency holdings, which reflect the weakness of the dollar in the international exchange market?

THE MERCHANDISE ACCOUNT AND U.S. COMPETITIVENESS, 1953-62

With certain exceptions, mainly in 1958 and 1959, U.S. merchandise exports have been rising relative to imports, so that our merchandise surplus in 1960-62, as well as our overall current account surplus, was significantly larger than in the 1953-55 period. This surplus has not been large enough to eliminate the deficit in the basic balance or to offset the unfavorable short-term movements (including the large deficits in the "unexplained" or "errors and omissions" item) so as to prevent a continued high level of net overall deficits, a substantial proportion of which has taken the form of an outflow of gold. It is easy to argue that our merchandise surplus should have been larger and, in fact, would have been larger, had our competitive position in world markets been greater. Much more questionable, however, is the assertion that our competitive position has deteriorated, especially since we do not know fully the relationship between our foreign aid and private capital exports on the one hand, and the growth of our merchandise exports on the other. And it is even more difficult to pinpoint the causes of a decrease in U.S. competitiveness in world commodity markets if, indeed, in terms of some definitions, one has actually taken place. As the Brookings study points out, the U.S. percentage share of world exports of manufactures has decreased from 26.2 in 1953 to 19.9 in 1962, or to about what it was in the late 1930's. On the other hand, production and exports of such important industrial countries as West Germany and Japan were relatively low at the end of the Marshall plan, so that it was not surprising that their shares of world exports grew from 13.4 and 3.8, respectively in 1953, to 20.1 and 7.5 percent, respectively, in 1962. France's share of world exports of manufactures was approximately the same in both years, while Britain's percentage share which declined from 20.9 in 1953 to 15.2 in 1962, decreased by an even larger percentage than was the case for the United States. (See p. 65.)

Judgments regarding changes in competitiveness in world markets must take into account such important factors as geographical shifts in demand, and changes in the commodity structure of world trade. Generalizations with respect to competitiveness cannot be made without an examination of export performance in individual commodity groups and regional markets in which exporting countries are in competition. An intensive investigation of export market shares for manufactures was made by the Department of Commerce for the period 1954-61. However, in the words of the Brookings study, "the Commerce Department study fails to reveal any general decline in U.S. competitiveness as indicated by shares of individual area prod-

uct markets for manufactured exports." (P. 68.) On the other hand, the United States did suffer substantial losses in market shares for three important commodity groups; namely, motor vehicles, iron and steel, and industrial machinery. However, the factors involved in the losses of market shares for these commodities were both dissimilar and complex. For example, the loss of the U.S. market share for automobiles was mainly a consequence of consumer preference for European-type cars as against U.S. models. On the other hand, U.S. price and cost disadvantages probably played a major role in the loss of our share of the world's export market for steel.

Competitiveness in international as well as in domestic markets has many dimensions, particularly in the area of manufactures, and even in commodity groups and geographical areas where the U.S. competitive position has clearly declined, we are faced with the problem of determining the most significant causal factor or factors. Export prices are certainly an important dimension of the problem, but, owing to the lack of adequate export prices indexes (and the necessity of relying on unit value indexes), the authors of the Brookings study, as well as those of other recent studies,¹ have expressed serious misgivings about assigning a predominant weight to relative price movements in accounting for changes in U.S. competitiveness in world markets, however defined. It is true, of course, that except for the United Kingdom, both wholesale prices and unit value indices of manufactured exports rose more rapidly in the United States than in other industrialized countries over the period 1953-59. On the other hand, the unit value index of U.S. manufactured exports rose much more rapidly than the U.S. wholesale price index over the 1953-59 period, and the unit value index of manufactured exports continued to rise after 1959 even though the wholesale price index has remained stable. This disparity of movements between wholesale prices and the indices of unit values of manufactured exports in the United States, together with a disparity in the opposite direction for a number of other industrialized countries, i.e., wholesale prices have been rising faster than unit value index of manufactured exports, has raised questions regarding the adequacy of the unit value index as an indicator of competitiveness. Moreover, a recent study of changes in competitiveness of the EEC countries in world markets for various commodity groups has indicated several cases in which improvements or losses in export market shares, after adjustments for changes in the commodity and geographical structure of world trade, are not correlated with relative price advantage (compared with the United States) as measured by relative movements in the unit value index of the exports.² It should also be noted that movements in unit labor costs scarcely provide an adequate explanation for changes in export behavior, since for many industries the costs of industrial materials and overhead costs may well overshadow the advantages or disadvantages in labor costs.³

I have dealt at some length with the factors which have been analyzed by the Brookings study and other studies in seeking to explain changes in the competitive position of U.S. exports during the period 1953-62 for two reasons. First, projections of likely changes in rela-

¹ See, for example, Hal B. Lary, "Problems of the United States as World Trader and Banker," National Bureau of Economic Research, 1963, pp. 56-68.

² See Raymond L. Staepelaere and Raymond F. Mikesell, "Common Market Competition in Manufactures," Stanford Research Institute, 1963, pp. 6-10.

³ *Ibid.*

tive prices have occupied a key role in the Brookings study's projections of the U.S. balance of payments for 1968; and second, it seems desirable to emphasize that there are many factors other than relative price movements which determine changes in competitiveness in international markets. It is necessary to keep these facts in mind in evaluating or assigning a degree of confidence to the 1968 projections discussed in the following paragraphs.

THE PROJECTION OF THE U.S. MERCHANDISE TRADE BALANCE FOR 1968

The projection of the U.S. merchandise trade balance for 1968, as undertaken by the Brookings study, involves a combination of methods or models plus a series of steps in which the results are progressively modified by the introduction of additional factors. The approach, or combination of approaches, is simplified by the division of the world into the United States and Western Europe, and by the assumption that since the rest of the world will not change significantly its volume of reserves, purchases by the rest of the world from the United States and Western Europe will depend upon foreign exchange availabilities arising from payments received from the two areas. Thus, while trade with the rest of the world is a part of the overall balance of the United States and of Western Europe, the basic problems of projecting the U.S. merchandise balance boil down to (1) projecting U.S. and Western European imports, and (2) determining how the world export market will be divided between the United States and Western Europe.

The first model or approach employed involves an aggregate output-absorption approach. Given the growth and price assumptions, GNP in 1968 is projected for both the United States and Western Europe along with projections of domestic demand or absorption for both areas, as the major basis for determining both import demand and the current account balance as reflected in the projected surplus or deficit of GNP (output) over domestic expenditure or absorption. This exercise has provided the interesting result that in the case of the United States, the excess of GNP over domestic expenditures will increase from \$4 billion in 1961 to \$4.6 billion in 1968, while in the case of the four major European countries, the modest excess of GNP over domestic expenditures in 1960-61 is projected to shift to a \$17.2 billion excess of domestic expenditures over GNP or output in 1968 (1960 prices). While no attempt was made to derive the current account balance of either the United States or Western Europe directly from the projections of the change in the excess of GNP over domestic expenditures, the results of this approach played a role in the projections of relative price movements between the two areas. Thus, a slight growth in the excess of GNP over domestic expenditures for the United States would, other things being equal, make for relative price stability, while the substantial excess of domestic expenditure or absorption over output for Western Europe, based on the projection of GNP in accordance with planned targets and the projection of domestic expenditures for consumption, capital formation, etc., indicates considerable pressure on prices and costs.

As a first approximation, the projections of United States and Western European GNP and their components are used to estimate the demand for imports and certain other items in the current account such

as transportation and travel and other services (excepting dividends, interest, and Government expenditures abroad). It is worth noting that, on the basis of these initial projections of the current account between 1961 and 1968 for Western Europe and the United States, the consequences of the changes in real income are projected as being unfavorable to the United States, so that U.S. net receipts from these items in the current account would decrease from \$2.5 to \$0.5 billion. Under alternative assumptions which involve a lower rate of growth for both Western Europe and the United States, the U.S. current account for the items included would also deteriorate, but somewhat less drastically. (P. 62.) Thus, the Brookings study concludes that if the results of the primary consequences of the real income changes in the United States and Western Europe between 1961 and 1968 are correct, "a reduction in the U.S. basic deficit with Western Europe will have to come from other factors, such as favorable price developments, a rise in investment income, a significant change on capital account, or from Government transactions." (P. 59.)

CHANGES IN COMPETITION, 1961-68

Under the initial assumptions, the projected improvement in the U.S. merchandise balance from 1961 to 1968 of from \$3.5 to \$5.3 billion, depends entirely upon the expectation of the increased competitive position of the United States relative to Western Europe in world markets. (P. 90.) Moreover, the improved competitive position is predicated mainly on the expected increase in prices in Western Europe relative to those in the United States. Under the alternative assumptions employed by the Brookings study, which involve lower rates of growth in real GNP in both the United States and Western Europe, and a smaller percentage increase of GNP prices in Europe over the 1961-68 period, U.S. merchandise balance is projected to decline from \$3.5 billion in 1961 to \$2.6 billion in 1968, as against a rise to \$5.3 billion projected under the initial assumptions. Thus, under the alternative assumptions, any improvement in the U.S. basic balance by 1968 would depend entirely upon shifts of items in the nonmerchandise balance.

The heavy reliance upon the projected change in relative prices between the United States and Western Europe for the improvement of our competitive position and of the U.S. merchandise balance, is somewhat disturbing in the light of the uncertain role of changes in relative prices for our merchandise exports and imports during the 1953-61 period. Disturbing also is the use of a price elasticity coefficient of 2.5 for determining the increase in the volume of U.S. exports to Western Europe resulting from the change in price relations, and an elasticity of substitution of 2 for calculating the change in the U.S. share of the export markets in the rest of the world. (The single price elasticity coefficient of 2.5 was derived from the Polak-Rhomberg equation which was used in the Brookings study, with certain modifications, to calculate the effect of the change in Western Europe's real GNP on its imports from the United States.) I am not suggesting that these coefficients are either too high or too low. Rather I do question whether their across-the-board application to U.S. exports, the composition and relative prices of which are continually changing, constitute a conceptually valid approach. In fact, the whole concept of elasticity of demand for a country's exports or imports as a whole

has been repeatedly challenged in the literature for nearly two decades. I am sure the authors of the study are fully aware of this point. Moreover, the alternative of trying to estimate the effects of changes in relative prices on a commodity-by-commodity basis is virtually impossible and also open to analytical criticism. A related factor which is also recognized by the authors of the study, concerns the difficulties not only of projecting the relative changes in the general price levels, but of translating these into changes in relative export prices, or of indexes of export prices. This is particularly apparent since the disparities between recent movements of U.S. wholesale prices and the unit values of export commodities have not been satisfactorily explained, and thus the reliability of the export price index is subject to doubt.

In considering possible changes in other dimensions or aspects of the U.S. competitive position in world markets such as officially promoted export drives, export credit competition, technological developments and innovations, and the relative availability of products for which demand is increasing, the Brookings report has some convincing things to say in favor of an improvement of the U.S. competitive position, but the whole picture adds up to little more than an educated guess that under the basic assumptions made with respect to the growth of GNP and of the pattern of domestic demand in the United States and Western Europe, there is a strong possibility that the United States will be in a somewhat more favorable competitive position in international markets in 1968 than it was in 1961.

IMPACT OF THE EUROPEAN ECONOMIC COMMUNITY

The discrimination against U.S. exports and the exports of Latin America and other areas which are important customers of the United States, arising from the European Economic Community, with or without the inclusion of Britain and the other members of the European Free Trade Area (EFTA), is treated as a separate factor in deriving the projected U.S. merchandise balance. The combined unfavorable effects of the EEC on U.S. exports is estimated at \$750 million. It is pointed out, however, that the loss of trade arising from the formation of the EEC may be partially offset by the retardation of the EEC exports to outside the Common Market. In addition, of course, there is the uncertain outlook for reduced discrimination through tariff negotiations and the consequent impact on trade.

THE PROJECTION OF NONMERCHANDISE ITEMS IN THE U.S. BASIC BALANCE

U.S. private foreign investment

The combination of the impact of long-term private capital flows and of interest and dividends flows projected for 1968 constitutes the most important factor making for a surplus in the projected basic balance for 1968 under the initial assumptions of the Brookings study, and the factor which would make the difference between a modest decrease in the basic balance deficit in 1968 over 1961 or an even larger basic balance deficit in 1968 as compared with 1961, under the alternative assumptions. So far as the improvement on interest and dividend account is concerned, the projections are on fairly sound grounds and this improvement accounts for the larger portion of the projected

increase in the basic balance. The arguments for the decline in the net annual outflow of direct private capital to Western Europe and Canada are certainly convincing, but the recent rise in the outflow of portfolio investment which has led to the proposal by the administration to tax private long-term portfolio outflow to the industrialized countries may require a second look at the capital outflow projection. Private capital outflow to the less developed regions tends to be more closely associated with changes in exports to these regions so that, even if this outflow should be larger, a considerable portion of the increased outflow would be compensated by larger merchandise exports.

Foreign economic assistance

The analysis of the balance-of-payments impact of various types of foreign economic assistance which is provided by the Brookings study is by far the best that the writer has seen. Too often the administration has sought to make the case that simply by tying the use of dollars to U.S. exports or by making aid available in agricultural commodities, the balance-of-payments impact will be very small or negligible. While virtually all foreign assistance has a significant adverse balance-of-payments impact the amount of impact accompanying various forms of aid is too complex to determine either on the basis of past experience or on the basis of future projections of aid disbursements. The authors of the study correctly point out that dollar assistance tied to U.S. exports, either by means of irrevocable letters of credit or otherwise, may simply release other dollars available to the recipient country for transfer to third countries, and that even in the case of direct commodity assistance, a considerable proportion represents a substitute for commercially financed exports. Nevertheless, any increase in purchasing power made available to less developed countries gives rise to a feedback in the form of increased imports from the United States. In calculating this feedback, the authors of the study have relied on the matrix of trade relationships among regions in 1960, so that, for example, it is assumed that 55 percent of any amount of untied aid to Latin America would be spent in the United States while only 15 percent of such assistance to Africa would be spent in the United States. These ratios, of course, are subject to change with shifts in the U.S. competitive position. In addition, the pattern of current debt obligations will make a difference in the use of available convertible exchange in the hands of recipient countries. Thus, generous export credits provided by Western European countries for financing exports to Latin America may force these countries to use a higher proportion of their free dollars and other convertible currencies for transfers to Western Europe. Since the report did not go very deeply into the problem of commercial credits, the balance-of-payments effects of export credit competition were perhaps not adequately explored.

Projections of U.S. loan and grant assistance to the less developed countries are based on information provided by the foreign assistance agencies. Expenditures by AID in 1968 are projected to increase by \$2.1 billion over 1961. These projections may very well be on the high side. On the credit side, interest paid to the U.S. Government and repayments of past Government loans, including those of the Export-Import Bank, will constitute a substantial offset to the pro-

jected increase in foreign economic assistance. Another partial offset to the U.S. balance-of-payments costs of foreign assistance may be expected from increased foreign aid spending by Europe and Japan. Thus, the Brookings study projects a net adverse impact on the basic balance arising from the projected increase in U.S. foreign economic assistance of only \$100 million, after taking account of a number of offsetting factors. While in the opinion of the writer, this estimate is probably too low on the basis of the assumed increase in U.S. foreign assistance expenditures, any underestimation may be offset by an overestimation of the actual amount of U.S. foreign assistance in 1968.

Overseas defense transactions

The analysis of the balance-of-payments impact of the flow of defense good and services between the United States and other nations poses some of the same problems and complexities as the analysis of foreign aid and, in addition, the authors of the study were unable to obtain a breakdown of certain categories of transactions which would enable them to analyze the transactions from a balance-of-payments standpoint. Both the total U.S. defense expenditures abroad and the net adverse balance attributed to them have been declining since 1961, and this decline is expected to continue on the basis of present programs and the outlook for the world political and military situation. Obviously, however, the latter cannot be projected, and new Korea or Vietnams might break out at any time. However, on the basis of estimates made available to the authors with respect to our defense expenditures and of their analysis of the balance-of-payments impact, the net adverse balance-of-payments effect of U.S. defense expenditures and receipts entering the balance of payments is projected to decline from \$2,681 million in 1961 to \$1,550 million in 1968, constituting an improvement in our basic balance of about \$1.1 billion.

EVALUATION OF ANALYTICAL CONCLUSIONS

Two major points arise from the analytical conclusions of the authors of the Brookings study (chap. VIII). First is the highly tenuous character of the projections of the U.S. basic balance for 1968 under both the initial and the alternative assumptions. While the initial assumptions were largely given to the authors of the Brookings study, one gets the impression that the alternative assumptions may come somewhat closer to the realistic expectations of the authors. The main difference in balance-of-payments impact between these two sets of assumptions is to be found in the merchandise account, and this difference arises principally from the GNP and relative price movements in Western Europe which, in turn, are calculated by the authors of the Brookings study to affect the competitive position of U.S. exports in world markets. Thus, if the alternative assumptions are closer to being realized than the initial assumptions, the U.S. basic balance will still be in deficit in 1968 with only a slight improvement over the basic balance in 1961. Moreover, the avoidance of a quite substantial increase in the basic balance deficit under the alternative assumptions depends upon an increase in the U.S. competitive position in world markets sufficient to account by itself for a \$2 billion expansion in our exports over 1961 (see p. 90) together with the projected favorable developments on both long-term private capital and

investment income account and the reduction in the adverse balance attributable to our defense expenditures.

The second basic point which emerges from the analytical conclusions is that the projected changes in world trade and payments which tend to favor some improvement in the basic balance so as to eliminate the deficit and possibly provide a small surplus, may well be thwarted if the volume of international reserves fails to expand in a manner which will enable countries, particularly those in Western Europe, to avoid monetary and fiscal restraint, which will in turn limit the expansion of their output. The point is well taken that if there should be a sharp reduction in the official reserves of certain countries, particularly those of Western Europe, they may be led to actions which will restrain increases in output and prices. Moreover, a reduction in Western European official reserves might not necessarily take the form of an increase in U.S. reserves, even though our basic balance were to increase somewhat. Reserves could flow, for a time at least, to Japan and Canada or there could be an expansion of private holdings of international liquidity at the expense of the total volume of official reserves. It further follows, of course, that a projected improvement in the U.S. basic balance is by no means a guarantee of a restoration of the strength of the dollar in international markets, or of the elimination of U.S. gold outflows. These developments again may be determined in part by the adequacy of international reserves and by the nature of the system of international liquidity.

COMMENTS ON THE POLICY RECOMMENDATIONS OF THE BROOKINGS INSTITUTION STUDY

The most interesting and striking characteristic of the policy recommendations of the Brookings study is that they deal almost entirely with the international monetary mechanism, including the means of financing the U.S. deficit and of expanding the volume of international liquidity. Virtually absent are the familiar exhortations for private and public action to expand exports, for fiscal restraints and higher interest rates, or for increased trade restrictions, controls on capital movements, or cuts in U.S. foreign aid and defense spending abroad. In fact, the authors are anxious that the United States, in dealing with its balance-of-payments problem, will not take actions which either affect adversely the growth of the domestic economy or its international responsibilities in the free world. At the same time, the authors are concerned that the continued gold loss and the weakness of the international position of the dollar will force a modification of our basic national and international objectives, or eliminate the strong position of the United States as a world banker, and its currency as an international reserve medium. It is partly for this latter reason that the authors eschew the alternative of devaluing the dollar. Moreover, they do not believe that the United States is in long-term structural disequilibrium. Thus, both because they believe that there are strong tendencies working for an improvement of the U.S. basic balance and because they believe this improvement will be facilitated by an expansion in volume of the world's international reserves, the authors have concentrated their policy recommendations on those which relate to the international monetary mechanism. Further, the authors suggest that "under present international mone-

tary arrangements, a U.S. surplus may be difficult, if not impossible, to attain" (p. 242).

Another conclusion of the authors which needs to be emphasized is that, in their words, "The balance-of-payments deficit itself, however, is not the major source of the international financial problem of the United States. That problem consists of the constraints imposed on the United States in its efforts to attain the more basic objectives of policy" (p. 241). They also point out that, "when a country performs a banking and depository role, the relation between its balance-of-payments position and the strength of its currency is not so direct as is commonly presumed" (p. 241). All of this does not mean that the authors regard the basic balance of the United States as unimportant, since they state that this country could not expect to continue indefinitely with a large basic deficit under any international monetary system which is likely to be acceptable to other countries. But they have ruled out the likelihood of a continued large basic balance deficit in their projections for 1968, provided the favorable tendencies which they foresee are not thwarted by an unsatisfactory international mechanism.

As to their specific recommendations for monetary actions required over the next few years, during which they believe that the U.S. basic and overall net deficit will continue, they recommend that full and unrestricted use be made of the \$15 billion of present monetary gold holdings (which means the abolition of the irrational 25-percent gold reserve against Federal Reserve liabilities); the use of IMF drawing rights; further prepayment by European governments of their long-term debts; and "if necessary, the sale abroad of U.S. securities in exchange for foreign currencies" (p. 252). They also recommend certain measures for improving our basic balance, including voluntary efforts to restrain wage and price increases, the achievement of EEC trade liberalization, etc.

Perhaps the most fundamental policy recommendation of the study is that the U.S. Government work toward the achievement of a new international liquidity system which will both safeguard the international value of the dollar and provide for an adequate expansion of international reserves. While the form which the new system should take is not specifically spelled out, it appears that the authors favor something along the lines of the Triffin plan which would involve the conversion of European dollar holdings into balances with the IMF (see p. 258). However, if an adequate international payments mechanism cannot be obtained, the authors suggest a modified system of flexible exchange rates "consisting of the dollar-sterling bloc and an EEC bloc." There would be relatively fixed rates within each bloc and flexible rates between them. Adoption of this system would imply cutting the tie between gold and the dollar" (p. 259).

A full discussion of the international liquidity problem and the various means of dealing with it was beyond the scope and terms of reference of the Brookings study. On the other hand, I believe they have made some contribution to the liquidity controversy, both in their analysis of the impact of shifts in the structure of the world's balance of payments on international liquidity, and in their showing of how shifts in the balance of payments over the next few years may affect reserve holdings and hence lead the major industrialized countries to adopt short-run monetary and fiscal policies which are in-

imical to both longrun structural adjustments in the world's balance of payments and the domestic and international objectives and responsibilities of the United States and Western Europe. It is not enough to show, either through comparisons with past periods or by some statistical exercise relating likely fluctuations in the payments balances of countries to the volume of world reserves, that there is a sufficient amount of liquidity in the world today.

In advocating a change in the international liquidity mechanism the authors were not unmindful of the recent actions to expand the sources of international liquidity for the United States, including the network of swap arrangements entered into by the U.S. monetary authorities and the expansion of IMF's credit facilities, including the 10-nation accord of October 1962. There also have been discussions regarding a larger use by the U.S. Government of special certificates or bonds which can be issued to foreign central banks accumulating surpluses, as a means of providing medium-term financing for U.S. deficits. However, all of these devices are designed to deal with relatively short-term deficits in the U.S. balance of payments, and involve the creation of liquidity through some form of borrowing by the U.S. Government. Except for short periods, as in the case of swaps, such arrangements cannot be kept secret and they do not provide a satisfactory solution to the problem of deficits of a sizable magnitude which may very well continue for another 5 or 6 years. Moreover they constitute evidence of a reduction of the net international reserve position of the United States and, hence, weaken the market position of the dollar. These conditions will inevitably bring about demands for domestic and international measures which will reduce or eliminate the U.S. basic balance deficit, before the longer run forces foreseen by the authors of the Brookings study can have their effect.

If the United States were willing to use its accumulated gold reserves plus its present borrowing facilities freely in the expectation that the longer range forces making for a shift in our balance of payments will restore equilibrium without special restrictive measures, and if, in addition, world confidence in the dollar remained sufficiently high so that continued deficits, however covered, will not bring about wholesale conversion of dollar assets into gold, then those who argue that the existing sources of international liquidity are sufficient, may be correct. But neither of these conditions is likely to hold true. Moreover, when other countries begin to lose reserves, they are likely to take restrictive measures, even when such measures are not warranted by their basic internal and external position. To quote from the Annual Report of the International Monetary Fund for the year ended April 30, 1963:

On the assumption that liquidity of all kinds is freely used to deal with temporary swings in a country's balance of payments, available liquidity is large; but if a substantial proportion of it is for one reason or another, considered to be available "for emergency use only," then the risk is correspondingly increased, not only of slowing down the world economy but also of being unable smoothly to deal with emergencies (pp. 51-52).

In the case of the United States, and of other major industrial countries as well, the period of balance-of-payments adjustment may be a rather long one; yet the loss of reserves, even when they are considered adequate for a substantial period of deficits, is likely to be a signal for restrictive action. (Indeed the period of adjustment for

Western Europe following World War II was over a decade.) Nor is a rise in a nation's reserves regarded as a signal for internal monetary expansion or more liberal international commercial and financial policies, since such policies are more often dictated by domestic economic conditions and objectives.

Given the unique position of the United States in the world economy and in the free world security system, and given our present relatively high unemployment, unsatisfactory growth rate, and price stability, this country should not be hampered by monetary or fiscal restraints in achieving both our domestic goals and in realizing our international security and economic responsibilities. In order to achieve these objectives, we may very well have to contemplate continuation of our balance-of-payments deficits for the next 3 to 5 years and, under the present system, this could well mean gold outflows of as much as \$10 billion or more. We might be able to borrow under various types of arrangements a large portion of this amount and, thus, avoid some of the gold outflow. On the other hand, we would be faced with the possibility of a large speculative gold drain as a consequence of a weakening of the market position of the dollar. Furthermore, the psychological effect of these deficits, whether covered with gold or deliberate borrowings from the IMF or foreign central banks, would most certainly lead to overwhelming demands for fiscal and monetary restraints, as well as other restrictive actions, which would impair our domestic and foreign objectives.

In the light of the factors cited above, the fundamental question is not whether there is a sufficient volume of international liquidity in the world today, but whether the liquidity mechanism is consistent with world needs and realities. Under present conditions there is substantial evidence that the fundamental economic and security objectives of the free world would be served by having the United States, and perhaps a few other strong industrial countries as well, lend on long term in exchange for short-term liabilities which might well be held and guaranteed by an international institution such as the IMF. This is, of course, exactly what a bank does when it increases its loans and investments in a community, and its own liquidity is secured by the central banking system and the safety of its deposits by the FDIC. Such a system would need to provide safeguards against a large inflationary expansion of liquidity, but a continuation of deficits in the order of \$2 or \$3 billion per year by the United States for the next few years would not appear to pose a threat of inflation either to the United States or to the rest of the world.

It is my personal view that not only are the authors of the Brookings study correct in emphasizing the need for a fundamental change in our international liquidity system, but they might have been even more forthright in criticizing those who have been telling us that the solution to our external deficit problem is to put our monetary and fiscal house in order and stop living beyond our means, much in the same tone as a monetary mission might address a small Latin American country plagued with a chronic balance-of-payments disequilibrium. Such counsel is nonsense for a country like the United States which has tremendous economic power and resources sufficient not only to achieve a high and rising level of living for itself but also to make a major contribution to the economic progress and security of the free world. I fear that most economists, bankers, and statesmen have been

mesmerized by the sanctity of the present international monetary system, and many of them seem willing to sacrifice the truly vital domestic and international objectives of the United States on a somewhat modernized "cross of gold."

The authors of the study are undoubtedly right in expressing reservations regarding the willingness of a number of other countries, particularly those of Western Europe, to go along with a proposal by the United States and Britain for an international monetary mechanism and system of liquidity which would avoid the dilemma of sacrificing our fundamental objectives in order to support the international exchange value of the dollar. However, we may be underestimating the power of the United States in combination with Britain to influence the countries of continental Western Europe in accepting a new international monetary mechanism. Most any of the alternatives available for the United States, including breaking the tie with gold or of substantially reducing our military and foreign aid outlays, or our private capital outflow, would have an economic impact on Western Europe of the most serious proportions. It is my personal view that the United States has refused to use, or even to recognize the full extent of its power on many occasions throughout the postwar period, and that the threat of a highly unpalatable solution would be sufficient to bring most countries around to our way of thinking. It is, of course, true that the countries of continental Western Europe would prefer that the United States come to them hat in hand for financial assistance to enable us to continue programs and policies from which they are major beneficiaries, and which permit them to accumulate international liquidity while following whatever monetary and commercial policies suit their national interests at the time. But neither the U.S. Government nor the American public is likely to accept this solution and so long as we regard the international strength of the dollar as governed by the present system of liquidity to be the major economic problem facing the United States, other far more vital domestic and foreign objectives are likely to be sacrificed.

While I do not believe that it will be necessary to adopt the second best alternative of the authors of the Brookings study, namely, the establishment of a flexible dollar and breaking the tie with gold, I quite agree that it is far preferable to sacrificing our more fundamental objectives. Moreover, I feel that the result of such an action would be more likely to put the bulk of the world's payments on a dollar-sterling exchange standard, while leaving the EEC on a gold island which is likely to sink rather quickly without the support of U.S. balance-of-payments deficits. The United Kingdom was able to maintain the sterling bloc and continue its position as a world banker and holder of international reserves for nearly a decade following the devaluation of sterling in 1931. Moreover, a large proportion of the world's currencies were tied to sterling during this period. A sterling-dollar bloc in which the two currencies were tied together but fluctuated in relation to gold and EEC currencies, would most likely constitute the basis for the world's payments mechanism and far overshadow gold, as both an international standard of value and a system of world liquidity.

In conclusion, the authors of the Brookings study have performed a heroic task in seeking to project our basic balance of payments for

1968, but they have also shown the hazards in any projection of this type, which are not likely to be mitigated by further refinements in the techniques of projection. More importantly, in their analysis of the relationship between the basic balance and the problem of the weakness of the international position of the dollar, they have provided an answer to those who seem willing to sacrifice our more fundamental economic, political, and social objectives to the achievement of a basic balance or surplus, and have put the international financial problem of the United States in its true perspective. The United States as world banker and major contributor to the requirements of the rest of the free world for economic growth and security should not be offered a solution to its balance-of-payments problem comparable to that appropriate for a small country living beyond its means. The problem is not to save the present international monetary mechanism, but rather to make that mechanism our servant in a way which will permit the United States, along with other countries, industrialized and developing alike, to achieve objectives essential to free world economic progress and freedom.

STATEMENT BY HANS NEISSER

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The great number of items in a balance of payments requires an equally great, if not greater, number of projections. For many of these projections the authors of the Brookings study (hereinafter called B-G) had special material at their disposal, which it is difficult for an outsider to evaluate critically. Moreover, the authors were compelled to substitute at many places informed surmises for statistical projections in the narrower sense; in most cases I do not find it possible to modify their work.

The comments here presented, therefore, are limited to exhibiting even more distinctly than the authors did some important assumptions underlying the projections, and if it seems appropriate, to modify the latter. My comments refer primarily to the projections in chapters II and III concerning imports and exports. The committee is probably aware of the fact that the projection of U.S. defense transactions (table VII-4, under (3), "Other Agencies," p. 202) implying a decline of \$230 million, is presented by the B-G without supporting material, for reasons of security.

I. INCOME EFFECTS ON THE U.S. MERCHANDISE IMPORTS

A. A SURVEY OF THE PROBLEMS

The Brookings Group was given by the Council of Economic Advisers a growth estimate for the U.S. economy of 4.8 percent of the GNP; the group also made projections for an alternative rate close to 4.5 percent, and they chose for the West European countries (hereinafter referred to as W-E) rates of growth of 4.2 percent and 3.78 percent, respectively.

The significance of these rates for the balance-of-payments projections lies in the fact that according to the prevailing theory, the higher the GNP the higher the imports, disregarding for the moment the effects of price on the quantum or physical volume of exports and imports. Hence, the higher the growth projection for the U.S. economy the less favorable its balance of trade (merchandise exports minus imports), and vice versa.

For reasons to be discussed later, the B-G study concentrates on the changes in the United States and W-E. In projecting the GNP, however, the B-G uses two different methods. For W-E, the B-G primarily relies on the experience of 1955-60 and, since the increase in the labor force can be projected with high accuracy and full employment has characterized the period and is likely to continue, the B-G deduces from the two rates of growth in GNP and in employment, the third rate, namely the change in output per man-hour. For the United States, on the other hand, the starting point is represented by

the assumption of full employment, *regardless* of experience, and an assumed rate of growth of GNP; from these two rates it derives the corresponding rates of growth of output per man-hour.

An important but doubtful assumption underlies both procedures: that the size of the Government deficit, or surplus, is of no significance for the degree of employment. A special investigation would be necessary to justify this assumption for the countries in W-E. Clearly this assumption does not tally with the experience of the United States, though by making it, an enormous simplification of procedure is obtained. Some comments on this point will be made later on. Here it is enough to remember that in the calendar years 1961 and 1962, the utilization of the capital stock and the labor forces in the United States enjoyed considerable support from Government deficit spending without, however, reaching the level of full utilization; the total cash deficit (Federal plus State and local) amounted to \$7.4 billion and \$7 billion, respectively, surely a substantial sum compared with net private investment of \$24 billion and \$28.6 billion, respectively. In view of the great confidence which the present administration had placed on economic growth for providing the means for the planned additional public expenditure, it is regrettable that for technical reasons the B-G was forced to choose an approach in which this aspect of the future development is neglected.

B. THE PROJECTIONS FOR WESTERN EUROPE

No objections shall be raised here to the B-G's initial projection of growth in W-E, which is slightly below the experience of 1955-60. With the possible exception of the United Kingdom, the W-E economies are in a state of "Americanization" in their methods of production, at least outside of agriculture. In the United States the manufacturing output per man-hour rose from 1921 to 1929 by a rate of about 7 percent, taking into account the price decline in this field. True, manufacturing activity itself amounts to at best 40 percent of the productive activity; but similar progress was made, and is being made, in W-E in a great number of other fields, and together with the projected increase of the labor force of 0.52 percent per annum (appendix table 5, p. 285) the initially projected growth rate of GNP, namely, 4.3 percent per annum, seems acceptable.

Furthermore, in this relatively early state of technological progress there would not be any difficulty of fully employing the slowly growing labor force in W-E; not only the hourly wages but even the efficiency wages—at least outside the United Kingdom—have been relatively low, leaving an ample profit margin and providing both the means for and the inducement to invest; the supply of entrepreneurial activity has been for a century sufficient in Germany and is apparently increasing fast in Italy and France, where so-called anti-inflationary means do not take the form of a deflation but consist in price ceilings. Any deficiency of entrepreneurial activity in the United Kingdom is accounted for by a lower rate of growth in the B-G's initial assumption.

The B-G itself has offered an alternative estimate in which the two variables—output per man-hour and employment, hence GNP—are assumed to grow at the rate of 90 percent of the initial projec-

tion. As stated at the beginning, we are not convinced that this adjustment was necessary.

C. THE PROJECTION OF GNP IN THE UNITED STATES

I look, however, with less confidence at the B-G's projection of growth for the United States, neither at the 4.8-percent rate of the Council of Economic Advisers nor at the alternative of the B-G, close to 4.5 percent per annum since 1962 (p. 60) and 4.2 percent since 1960 (p. 285), though our own consideration will result in an equal rate of growth as an upper limit. The average increase for 1953-60 was only 2.5 percent, although this period did not suffer from severe crises. The projection of the B-G is obtained by projecting the output per man-hour at a rate of 2.9 percent per annum, alternatively of 2.3 percent per annum (compared with 1.5 percent per annum 1953-60); and projecting employment at a rate of 1.9 percent per annum, alternatively 1.87 percent per annum, while the labor force is projected to rise by only 1.71 percent per annum; in other words, assuming a decline in unemployment.

a. Projection of output per man-hour

I am tempted to interpret the B-G's projection in the following way: technological progress comes in waves. The postwar wave of innovations, 1947-52, made use of the experience obtained primarily in war production, and naturally was followed by a much lesser wave of technological progress when these suggestions were exhausted, the utilization of which was considered safe because of the excess purchasing power accumulated during the war. And now, since 1960, or at the latest, 1961, the statistics of output per man-hour indicate the rise of a new wave which apparently is supposed to last close to 1968. I wonder whether more can be learned about this question: in view of the fact that the working out of innovational ideas and programs to execute them precedes their application, it might not be impossible to learn more about the effect of planned investment on productivity.

Before turning to our next principal problem we have to point to a circumstance not explicitly mentioned in the B-G study. The observed increase in output per man-hour refers only to the private sector of the economy and not to Government activities; indeed it would be nonsensical even to ask about productivity changes in the Government sector since here output is measured by input. The B-G could proceed this way because it assumed (p. 40) that Government spending will always be a fixed percentage of total GNP, 19.3 percent (+2.7 percent for investment), so that the private sector and total GNP must develop at the same rate. We have already pointed out that this assumption is doubtful, especially since the figure of 19.3 percent exceeds the actual Government expenditure in 1960 and 1961.

b. The projection of employment in the United States

Whatever our judgment will be about the projected rise in productivity, severe doubts cannot be suppressed concerning the projection of employment. True, a rise in output per man-hour caused by mechanization need not by itself prevent a rise in employment; over

the last 150 years it has not done so, at least not in the long run, and as pointed out, we do not think that it will have this effect in W-E. But there were periods in which both GNP and unemployment increased, almost certainly during the so-called industrial revolution and as late as 1928 in the United States. At present what are the facts from which we can draw conclusions? The decline in unemployment as a percent of the civilian labor force from 1961 to 1962 is of no import in this context because the civilian labor force remained almost constant, while according to the projection of the B-G it will, on the average, over the whole period, show a substantial increase. Since 1962 the unemployment percentage has increased and in 1963 is likely to exceed the level of 1959 and 1960. Even more disquieting is the fact (see U.S. Department of Commerce, "Survey of Current Business," September 1963, series S-12, S-13, S-14) that the absolute increase of employment (employees on the payroll) in manufacturing, mining, contract construction, and transportation has been negligible in the last 12 months; from August 1962 to 1963 it was services, government, and trade, with 360,000, 303,000, and 266,000, respectively, that principally have done the work of absorption of the increasing labor force. Excluding, of course, Government, we find an annual increase in employment of 1.3 percent in these fields, and since mechanization will partly affect at least the field of trade (and finance), we are not inclined to accept a higher rate of increase in employment for the coming years. Together with the increase in output per man-hour this would yield a 4.2-percent rate of increase in the private sector of GNP.

To extend this rate to the economy as a whole (total GNP) is possible only if we assume either that public employment will increase by 4.2 percent per annum, which is obvious nonsense, or that the average pay in government service is so much higher than in the private sector (and will retain its superiority) that a smaller rate of increase in public employment adds 4.2 percent per annum to the public sector of GNP. Even the second alternative, which we have not been able to examine in detail, is improbable.

c. Projection of GNP in the United States: Other evidence

As pointed out, a rising output per man-hour will not reduce employment provided the capital stock is sufficiently augmented by investment, and thus enabled to absorb the workers displaced by mechanization and the natural growth of the labor force. Investment, in turn, must not absorb only the current net saving from a rising income but also the increasing depreciation allowances for capital consumption which very well may be used to replace wornout equipment by something more efficient, especially by equipment which, for every thousand dollars invested, employs less workers than before.

In these respects the development of the last years has not been favorable. The expenditures for plant and equipment in terms of constant prices (President's Economic Report, 1962, table C, 6) were smaller in the year 1962 than in the preceding peak year 1957; at the same time, the capital consumption allowances increased by almost 20 percent, and it is scarcely disputed that at present there is very little demand for outside money by corporations in this field. The growth of the American economy since 1957 has been due to a considerable extent to (a) the still continuing boom in construction, and (b), at

least in the last year, by a slight tendency of the saving ratio to fall. The total new construction rose from 1957 to 1962, in terms of constant prices and after correction for a change in the series from about \$53.7 to \$61.1 billion; both figures exceeded the outlay for plant and expenditure in the same years. Since 1957 this increase in investment and construction was not associated with a noticeable increase in employment; in other words, in the construction industry technological progress also had increased output per man-hour. If ever the investment in this field should cease to increase, a decline in employment would be expected, unless technological progress should stop short at the same time; but if so, the B-G projection of a 2.9-percent increase in output per man-hour could be maintained only by an improbably high speeding up of technological progress in the other fields. An increase in investment so strongly concentrated in construction puts the economy in double jeopardy: (1) \$1 million invested in manufacturing, once the plant starts operating, on the average is able to employ a much larger amount of workers than \$1 million invested in construction, whose employment capacity originates largely in the necessity of maintenance; (2) hence, investment in construction is not self-sustaining: ¹ It is based on the expectation of financiers, builders, and lessors concerning the ability of the latter to pay the rent, i.e., concerning the future of employment; and, as we just saw, the capital represented by the building makes a very small contribution to employment. Thus, if employment outside construction ceases to increase and rising unemployment prevents an increase in real wages, the boom in construction will collapse.

From this angle, our suggestion to reduce the B-G projection of employment in the private sector to 1.3 percent may even appear too optimistic. GNP may continue increasing because output per man-hour increases faster than displacement of labor; hence, trade and services may continue attracting manpower; and employment in education will increase anyway, financed by taxes, simply because the number of children of school age is certain to increase. But against this increase we have to set the possibility of a net decline in manufacturing, mining, et cetera, and then our 1.3 percent per annum projection of the overall increase in employment will prove too high. Unfortunately, it is not possible for me to make even a suggestion how the projection of employment should be modified from this viewpoint.

I have deliberately refrained from relating the investment activity to the level of the activity in industries at the same time. I have assumed—as apparently the B-G did—that the driving force of technological progress is so strong that investment will be continued at a substantial level, even though the existing plant and equipment in manufacturing and related fields is underutilized. As is well known, because of such underutilization net investment was completely discontinued in the years 1932–35, a period, however, which in many respects was basically different from the present times and will be presumably from 1963 to 1968.

That there is underutilization at present seems to be generally agreed. The current statistics collected by the firm of McGraw-Hill, in absence of a well-defined and measurable capacity, probably are

¹ Except at very low and undesirable overall rates of growth, in the neighborhood of 1 percent per annum.

not indicative of the absolute level of utilization. But since the firms furnishing the information are asked to use in their answers the same concept of capacity year by year and quarter by quarter, the statistics give us a hint of the changes in both the degree of utilization and (by making use of the production indexes) of the existing capacity. The following picture develops: The recession of 1954, being unexpectedly short, had influenced the production of equipment goods to a greater extent than that of consumables, a field where primarily the inventories were affected (President's Economic Report, 1962, table C-2). Hence, after 1954, the production of equipment goods rose sharply, to a greater extent than the production of consumables, whether one starts counting in 1954 or 1955; most likely the capacity ran ahead of consumption, a process which found a natural end in the year 1958. At present, consumption does not seem to lag behind the production of equipment goods, and the underutilization observed must be, to a greater extent than in 1957, the consequence of the rising productivity of the new investment once installed. This would be a favorable omen for the prosperity of the coming years. But, of course, that this type of development will prevail cannot be guaranteed, and the Council of Economic Advisers is in a much better position than an individual economist to estimate the effects of the various types of investment.

d. Conclusions

It would be tempting to work out the consequences of a 4.2-percent rate of growth and alternative rates for the trade between the United States and W-E. However, this procedure would require the application of the Polak-Rhomberg model, reproduced in the appendix to chapter 2 of the Brookings study. This proved impossible because the use of this model requires a knowledge of the export prices in W-E and the United States, and no table of the W-E export prices from 1954 to 1960 is given, 1954 being the base year. If, for example, W-E's export prices in 1968 were the same as in 1954, then the U.S. projected imports from Europe, disregarding the price effects in substitution, would be worth \$4.61 billion and not \$7.31 billion as projected by the B-G (p. 57).

II. PRICE EFFECTS ON THE U.S. BALANCE OF TRADE WITH W-E

We see no compelling reasons to modify the B-G's export price projections 1960-68 for W-E and the United States, 11 percent and 4 percent, respectively, and to modify from this angle any projection made for 1968. We wish, however, to make some comment on the B-G's estimation of the substitution effect which is defined as

$$e = \frac{\frac{dq_1/q_2}{q_1/q_2}}{\frac{dp_1/p_2}{p_1/p_2}}$$

The pure number e is called the elasticity of substitution; obviously we expect it to be negative, but from now on we shall omit the minus sign. Most important is the limitation of a study of the substitution

effect to nonstandardized goods, in practice, manufactured goods. In the absence of quantitative trade restrictions we would not observe for standardized goods any relevant price differences, only differences caused by transportation costs and customs duties, which by their very nature cannot cause substitution. The reason is that arbitrage transactions tend to equalize the prices of the standardized goods over the world.²

Technical considerations about the measurement of substitution elasticity

The Polak-Rhomberg model measures the substitution elasticity as an addition to the import propensity of the country, which depends on GNP; although not based on more than 13 annual observations from 1948 to 1960 it obtains much higher values for e than previous investigations which proceeded along the same lines. However, there are various reasons to doubt the validity of the results concerning the e 's. First, as remarked by the B-G itself, the standard error of measurement is uncomfortably large in at least three out of four cases.

Secondly, the model does not break up foreign trade according to the main categories, although the meaning of substitution elasticity is different for manufactured goods and the remainder. Thirdly, the *significance* of the addition of a price variable is not tested at all, neither by examining the significance of the partial correlation coefficients nor by that of an increase in the multiple correlation when the relative price variable is added. For all we know, this price variable may not have any significance whatever. Fourthly, the multiple correlation coefficients are not very high, though, of course, the significance of GNP for imports is beyond doubt. Fifthly, as a minor point, though important in some contexts, we mention that for examining the residuals as to randomness, the Durbin-Watson test was used, which is applicable only in case of a great number of observations in contrast to the Neumann-Hart test (see, e.g., G. Tintner, "*Econometrics*," secs. 10.1.4 and 10.2).

In view of these shortcomings, attention may be drawn to the different and altogether more reliable methods which A. C. Harberger has described ("The Review of Economics and Statistics," supplement, February 1958, p. 123), although in general they measure only the substitution elasticity for "similar" commodities exported from two countries. For more recent times (1946-62) I consulted a not yet published Ph. D. dissertation by E. H. Pegg (graduate faculty, New School for Social Research, New York), which examines the substitution elasticities for 39 similar commodities exported from the United States and United Kingdom, obtaining negative values for 33 items with a simple average of $e=2.5$. This result tallies surprisingly well with the result obtained by GATT for the substitution elasticity for exports from United States and W-E combined to the rest of the world; namely, 2.6.

There remains one important point where we feel compelled to differ from the B-G: what price assortment in the two regions, United States and W-E, decides about substitution? Surely not the GNP prices, though, with misgivings, they are used at least once for

² This does not imply that for nonmanufactured goods substitution is impossible, but to measure its elasticity we would have to measure the response of relative export quantities to a change in relative costs.

this purpose by the B-G (p. 81, bottom, and footnote 16). W-E exports to the United States compete with certain U.S. industries, the so-called import substituting industries, whose price development is not projected separately but may be taken to be close to the export prices projected for the United States. In view of the sharper rise of export prices in W-E, this region will lose in its exports to the United States. I am unable to follow the argument of the B-G (table III-9, p. 89) according to which there is substitution in *both directions*: the volume of United States exports to W-E is supposed to increase because the price relations change and the volume of U.S. imports from W-E is also supposed to change. In other words, U.S. exports are supposed to displace European production in import substituting industries and W-E exports are supposed to displace U.S. production in import substituting industries. It is, of course, possible that both W-E exports to the United States and U.S. exports to W-E increase because the assortments differ. But to obtain the B-G's results we must assume that European export prices rose less than U.S. prices in the relevant substituting industries, *and* that U.S. export prices rose less than the prices in European import substituting industries. While such a development is not impossible, there are no price indexes in the B-G study, or to my knowledge available otherwise which would support this assumption. It seems more reasonable to assume that the prices in import substituting industries change to the same extent as do the prices in the export industries, as we pointed out above. Hence, U.S. imports from W-E will decline under the impact of substitution and W-E imports from the United States will increase somewhat. Since W-E exports of manufactured goods to the United States amounted to 85 percent of W-E total exports (p. 80), and since some substitution is possible also in other categories, we shall use the GATT estimate of the substitution elasticity for manufactured goods as a basis and take 2.4 as the upper limit of the elasticity and 2.2 as the lower limit; the B-G estimate of 2 (p. 86) seems a little low. As to the exports from the United States to W-E, we cannot see any reason why the substitution elasticity for manufactured goods should be different; however, since the U.S. exports of manufactured goods to W-E amounted to less than 60 percent of total exports we can accept the B-G estimate of 1.7, though it is derived in a different way. This yields the following substitution coefficients:

1. Increase of U.S. exports to W-E:
 - a. Upper limit $2.4 (7/104) = 16.1$ percent.
 - b. Lower limit $2.2 (7/104) = 14.7$ percent.
2. Decline of U.S. imports from W-E: $-1.7 (7/104) = -11.4$ percent.

III. CAPITAL MOVEMENTS AND COMMODITY MOVEMENTS

Apart from price effects, the commodity imports of the United States and W-E are assumed to be governed exclusively by GNP. However, at times the capital imports even of industrial countries exercised an influence on commodity imports; for example, in Germany after 1924 (see Neisser-Modigliani, "National Incomes and International Trade," p. 283), and most probably in W-E immediately after the Second World War. In general, of course, these countries used capital imports, apart from strengthening foreign exchange re-

serves, to pay for raw materials and food required during the period of gestation in reconstructing the industrial country in question, since during this period sufficient exports are not available; then the effect of capital movements on commodity imports merges with the effect of the rising GNP on the latter. Very likely the B-G neglected for this reason the capital movement, as far as commodity movements between the United States and W-E were concerned. For the imports of the rest of the world, however, the same is not true, and capital imports will substantially add to the pull of GNP on imports (see "Primaries" N-M, op. cit., p. 294). However, the balance of payments of the United States would not be affected if the capital imports of third countries from the United States equaled the addition to the commodity imports from the United States: in general, this is a questionable assumption because a country borrowing in the United States may spend part of the funds in W-E.

IV. THIRD COUNTRIES

The imports of W-E and the United States from the "Rest of the World" have separate equations in the Polak-Rhomberg model. We refrain from presenting and discussing the ingenious method by which the B-G was able to reduce to zero the influence of these countries on the U.S. trade balance. One of the basic assumptions was criticized in comment III above. In addition, we want to express our regret about another failure of the study; that is, to fully inform the reader about the data on which the projections are based.

The B-G does not indicate the actual value of imports of either the United States or W-E from third countries in 1960, which may very well differ from the level which could be estimated from the model for given GNP.

Even worse, the B-G does not inform us about the level of W-E GNP in any particular year; we are given only the projected rate of increase. To calculate the W-E GNP backward with the help of the model from imports into W-E from the United States, actual imports in 1961, or projected imports for 1968, is hazardous because the computed GNP again need not agree with the actual GNP in any specific year. Two trial computations gave substantially different values. Some materials are available, at least for 1960, in the publications of the OEEC, but they do not include Spain; the translation into prices of 1961 would have created difficulties, and we are not certain to obtain in this way the starting point for the B-G projections. We assume that table II-8 (p. 57), under the heading "Rest of the World Earnings From Exports to Western Europe, Initial Assumption," does not contain any unknown corrections and could be accepted.

V. CONCLUDING REMARKS

In the years 1960-61 and 1962, the U.S. trade balance showed surpluses of \$4.8, \$5.4, \$4.3 billion, respectively. Except for the effect of price changes, these surpluses changed in the B-G projection into deficits of \$2.6 billion and \$2.3 billion, respectively, simply because of the B-G's "involuntary" assumption of a very high rate of growth of the GNP due to full employment and very substantial technological progress.

This picture of the American economy is not in accord with the experience of the last years. Granted that we now experience a new

wave of technological progress, this wave seems to be at least as labor-saving as the earlier ones; hence, while GNP and output per man-hour will increase—at a lesser rate, however, than in the B-G projections—unemployment is likely to be greater, too.

If this picture is correct, then a much more complicated model than that used by the B-G would have to be developed in which the decisive role would be played by the now "classical" forces, namely, domestic investment, budget deficit, the repercussions on GNP of surpluses or deficits in the current balance of trade, unemployment, etc. Such a model does not exist, and to develop it and measure its coefficients probably would have taken the larger part of the time span till 1968.

The lesser the growth rate of U.S. GNP, the more favorable the balance of trade would appear, especially since we do not doubt the GNP projections of the B-G for W-E. Independent of the growth assumptions, the B-G obtains an overall favorable picture by taking account of the projected price changes. In particular, the gain from substituting cheaper U.S. products for more expensive W-E products (in the estimation of which we had to differ from the B-G) is substantial. Apart from some minor corrections, we consider the price projections as well founded, however, we cannot help looking at them with some distrust, since in the past unexpected price reversals have happened. However, for the balance of payments as a whole, as Mr. Hal Lary pointed out in the committee's hearings of July 29 and 30, 1963, the projected increase of interest and dividends received by the United States from abroad may prove to be underestimated. Furthermore, a continuation of the policy of cooperation of the central banks and a supplementary currency legislation as recommended in one form or another by virtually all of the experts, would solve the problem of providing Canada and Japan with higher currency reserves than they now have.³

It seems, therefore, that the recent period of gold loss of the United States was an interlude, in a sense inevitable after the interlude of the European capital flight and gold flight in the 1930's. The Western World becomes Americanized, and if its currency systems should be adapted to the new situation, it could look forward to some years of equilibria all around in balance of payments—at a price, probably, payable by the United States in the form of increasing unemployment.

³ Many of the other objections raised in the hearings affect with much lesser force the lower projections of the U.S. growth rate which we consider appropriate than the B-G projections; as pointed out above, in our case the results for the U.S. balance of trade and balance of payments would even be more favorable than those obtained by the B-G. A comparison of the projections for 1968 with the expansion of 1953-61 is of doubtful value since the B-G approach assumes an economic climate, entirely different from that of the earlier period. Mr. Lary's conjecture of higher imports of W-E from third countries cannot affect a projection based on full employment.

STATEMENT BY JÜRIG NIEHANS

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1. GENERAL IMPRESSION

The general reaction to the Brookings report on the U.S. balance of payments in 1968 is one of admiration for its thoroughness and competence. It is hard to imagine that in so short a time a better assessment of the basic problems and tendencies of the American balance of payments could have been presented. The following comments indeed suggest that in the opinion of this reviewer certain factors should have been given different weights, but such differences of emphasis cannot detract from the high value of the study.

2. CHOICE OF ASSUMPTIONS

It is the central thesis of the report that over the next 5 years the "basic balance" of the United States will have a general tendency to improve. The "initial assumptions" on which it is based seem to be plausible enough. However, one could imagine a variety of other assumptions which are hardly less plausible. Some of them would be more favorable, while others would be less favorable to the U.S. balance of payments. The sensitivity of the projections to variations in the underlying assumptions seems to be considerable. This is illustrated in the report by the projections based on what are called alternative assumptions. Though only moderately different from the initial assumptions, they indicate practically no improvement over 1961. Also one could imagine other sets of plausible assumptions which are even less favorable. To give an example, a serious recession in Europe combined with a resumption of vigorous growth in the United States would probably produce a U.S. balance on current account which would turn out to be less favorable than that to be expected under any alternative considered in the report. (For reasons given below it might nevertheless contribute to the strength rather than the weakness of the dollar.)

3. RELIABILITY OF PROJECTIONS

The report seems to present a well-balanced assessment of the probable implications of the underlying assumptions for the U.S. balance of payments. It is on particularly strong ground when it draws attention to the wide margin of error inevitably attending to projections of this nature. It would be unfair to elaborate on the numerous reasons for this uncertainty, since most of these reasons are so competently discussed in the report. The technical procedures, however, on which the estimates are based are not fully specified. It is thus impossible for a reader to verify many of the results. To give an example, it is difficult to say to what extent estimates of the effects of

price and output changes could have been distorted by the fact that they were determined separately instead of jointly. This is perhaps one of the main limitations of the report from the point of view of economic analysis. The practical usefulness of the report, however, is not seriously impaired. Any doubts that might be raised by a critical reviewer could hardly add significantly to the wide range of uncertainty justly attributed to the projections by their own authors.

4. USEFULNESS OF PROJECTIONS FOR POLICY DECISIONS

In view of the wide range of uncertainty that besets both assumptions and projections, it may be asked to what extent the central thesis of the Brookings report can be used as a basis for policy decisions. I believe the result of the report from this point of view can be summarized by stating negatively that no causes for a dramatic deterioration of what is called the U.S. basic balance could be detected by the best methods available today. This conclusion seems to be sufficiently well-established to be used as a basis for economic policy. Beyond that, however, the conclusions of the report are probably too uncertain to serve as guides to policymakers. This means that no decisions should be taken under the influence of the rather optimistic estimates of the report which could be ill advised in the light of different and perhaps somewhat more pessimistic predictions. Even the more detailed predictions can, however, be turned into a very interesting scientific experiment if, by comparing them with the actual course of events, they are used in the future to assess and, if necessary, to improve the methods used in their preparation. To this extent the report is a basis for further scientific work rather than a basis for political decisions.

5. PRICE AND OUTPUT CHANGES AS AUTOMATIC STABILIZERS OF INTERNATIONAL PAYMENTS

The report considers the assumptions about production and prices in the United States and Western Europe to be independent of the development of international payments. It thus assumes a one-way street of causation leading from production and prices to the balances of payments. It does not consider reverse effects of the balances of payments on production and prices. This simplification may be unrealistic, since, in fact, the development of international payments may be of some importance for the course of prices and perhaps even for the trends in output of the countries concerned. The classical theory of international trade showed how surpluses and deficits in the balance of payments affect price levels. It was later supplemented by an analysis of their effects on output. Today these are standard elements of the theory of international payments. I feel that neither should be neglected in a quantitative appraisal of current balance-of-payments problems.

It would, indeed, be surprising if the divergent movement of prices in the United States and Western Europe during the last few years had not in part been caused by the balance-of-payments situation. As the report points out, American economic policy was probably somewhat less expansionary than it would have been if the dollar had been strong; this fact contributed to the relative stability of prices.

In continental Europe, on the other hand, the balance-of-payments surpluses reinforced the expansionary development which was taking place and thus accelerated the rise in prices. In Switzerland, to give an example, the influx of foreign capital is generally considered to be one of the more important factors contributing to recent price increases, for it largely paralyzed the anti-inflationary efforts of the Government and the central bank. I am inclined to conclude that the very existence of a balance-of-payments disequilibrium would have a tendency to produce divergent movements in prices and perhaps even in output, which, if permitted to work themselves out, would help to eliminate those disequilibriums. Of course, this mechanism does not work perfectly by far; nevertheless, I believe that it still remains a significant part of the picture.

The foregoing considerations seem to give all the more weight to the main thesis of the report that the deficit in the American balance of payments will have a tendency to diminish in the course of time. The reasoning behind this conclusion would now be somewhat different from that of the report, however. In particular, I would tend to emphasize the requirement that economic policies on both sides of the Atlantic be influenced by balance-of-payments considerations to at least the extent they were thus influenced in recent years.

6. THE LIMITED RELEVANCE OF THE "BASIC BALANCE"

The report focuses attention on the "basic balance," consisting mainly of current accounts and long-term capital movements. It points out, however, that restoration of equilibrium of the "basic balance" is not a sufficient condition for a restoration of confidence in the dollar. It may well be that it is not a necessary condition either. If the report had not already done so, I would have pointed out the case of Switzerland which recently had a huge deficit in her "basic accounts" and nevertheless a strong currency. Statistics seem to show that in the United States the main problems are short-term capital movements. It is true that a surplus of the "basic balance" may help to attract short-term capital to the United States. It is equally true, however, that this effect may be too weak to solve the problem of capital movements. For this reason, the importance of the "basic balance" should not be overestimated.

7. A POINT ABOUT SHORT-TERM CAPITAL MOVEMENTS

Short-term capital flows of a given country seem to be strongly influenced by considerations about the risk that this country will follow domestic economic policies detrimental to its exchange position. If the domestic economy is prosperous anyhow, this risk often appears to be quite small. Whatever is done during such times to counterinflationary pressures at home will very likely strengthen the international position rather than weaken it. We thus find that economies which are growing vigorously without assistance from expansionary economic policies often attract foreign capital even if the "basic balance" shows a deficit.

If domestic growth is slowing down, things may be different. Economic policy is then confronted with the dilemma that policies designed to stimulate the domestic economy will often tend to weaken

the international position and vice versa. In this dilemma most governments will be tempted to give the domestic problems a higher priority than to their international position. If the owners of short-term capital at home and abroad feel that the government in question may yield to this temptation, they will be inclined to move their assets elsewhere. These considerations also apply to some extent to long-term capital.

Thus, it is not true that in order to stabilize international capital movements it is best to concentrate on restoring domestic growth by expansionary policies, because these very policies might tend to justify the fears of asset owners at home and abroad. In order to stabilize international capital flows it is essential that a government make it absolutely clear by its actions that it will assign its international position the same weight as it assigns to its domestic economic problems.

8. THE PROBLEM OF INTERNATIONAL LIQUIDITY

While the main body of the report is devoted to the "basic balance" of the United States, surpluses or deficits in this "basic balance" finally turn out to be of secondary importance after all. Instead it is the question of international liquidity, examined briefly in a few pages, which is said to be the key problem. This leads to the somewhat paradoxical situation that the efforts of the authors seem to be concentrated on a problem which, by their own admission, is not the essential one, while the discussion of the really essential problem is not detailed enough to add significantly to our present knowledge. In view of these considerations it would be very valuable if the authors of the report were given the opportunity to examine the problem of international liquidity with the same painstaking care which they devoted to the study of the "basic balance" of the United States.

With respect to international liquidity, the Brookings report presents the conclusion that by 1968 international reserves will be insufficient unless something is done. Insufficient reserves will, in turn, subject the world to long-range deflationary pressures. This conclusion is all the more important as it is largely independent of any particular projection of the "basic balance" of the United States. It only requires that world trade as a whole continues to expand at anything like the projected rate. In fact, from the point of view of economic policy, this prediction seems to be the most important conclusion of the entire report. However, the scant evidence on which it is based and the omission of many important factors affecting international liquidity give the impression that it is far less firmly established than the projections of the U.S. "basic balance." On the whole, the discussion of international reserves still seems to be inconclusive.

9. CRITERIA FOR THE ADEQUACY OF INTERNATIONAL RESERVES

The adequacy of international reserves depends, among other things, on the criteria by which reserve requirements are judged. The report considers reserves as insufficient whenever they induce governments and central banks to adopt policies which from other points of view would be regarded as undesirable. Satisfactory reserves are thus characterized by the fact that they do not compel authorities to adopt policies which they would not have adopted if reserves had been more

ample. I submit that this criterion is inappropriate and that serious efforts to fulfill it would be self-defeating.

The criterion is inappropriate because it is one of the essential features of liquid reserves to place certain restrictions on economic behavior. This is true for the cash holdings of households and business firms in terms of domestic money. Money would not be able to fulfill its economic functions if it were so ample that nobody feels in any way restrained by insufficient cash. The same is true for the liquidity of central banks in terms of international reserves. In fact, the criterion suggested by the report seems to amount to the postulate that for all practical purposes international reserves should be a free good. Such a postulate would make no sense.

In addition, serious efforts to devise an international monetary system satisfying this criterion would be self-defeating, for as soon as governments and central banks made use of their increased freedom to adopt expansionary policies, inflationary pressures in the world economy would increase while deflationary tendencies would be diminished. The result would be an accelerated upward bias in the course of prices. These price increases would in turn increase reserve requirements up to the point where reserves again become insufficient in relation to the requirements of foreign trade. It is one of the basic characteristics of money that in the long run the economy, by bidding up or down the prices of goods and services, itself determines its relative plenty or scarcity, no matter how large or small its absolute amount. This is true for international money, consisting of gold and foreign exchange, as well as for national currencies.

I conclude that it is one of the essential features of a workable monetary system that sometimes the scarcity of reserves forces the authorities to follow a somewhat less expansionary or more restrictive policy than they would otherwise have liked to adopt, while at other times the influx of reserves may induce them to tolerate somewhat larger price increases than they would otherwise have tolerated.

Instead of the one-sided criterion proposed by the report the international monetary system may perhaps be judged by the following criteria: (a) It should not subject the world economy to long-range deflationary pressures. (b) It should not impart to the world economy a long-range inflationary bias. (c) It should not, by some lack of elasticity, aggravate short-term inflationary or deflationary pressures which may develop anywhere in the world economy but rather help to cushion the national economies against violent changes between inflationary and deflationary pressures.

These are basically the same criteria which may be used for national monetary systems. In general, it seems the international monetary system is now faced with about the same basic problems which were largely solved on the national level during the last decades of the last and the first decades of the present century.

10. A COMMENT ON POLICY RECOMMENDATIONS

In view of the predicted shortage of international reserves the report presents two policy alternatives consisting of either a new type of international payments union or flexible exchange rates. The United States, if she followed these recommendations, would thus confront other countries with the choice of either agreeing to a new payments

mechanism or else seeing the United States abandon the system of fixed exchange rates. I believe it would be unwise for the United States to present other countries with this choice. At the present price of gold, an increase in international liquidity requires that in one form or another central banks be prepared to hold each other's money. Regardless of how this is accomplished, central banks will do this only if they have full confidence in the value of their foreign exchange. Successful steps toward an increase of international liquidity at the present price of gold thus require an unequivocal decision to keep exchange rates stable. If a system of flexible exchange rates were constantly pictured as the inevitable alternative to a new international payments union, any efforts to establish a viable payments system at present rates of exchange would be doomed to failure from the start. If I want my neighbor to trust my word, I had better not tell him: "Either you trust my word, or else I shall break it."

Aside from this, both policy alternatives presented by the Brookings report involve rather radical departures from current trends. It is my own tentative impression that international reserves would not necessarily have to increase *pari passu* with the value of world trade, but, if the present price of gold is maintained, reserves would still have to grow faster than the stock of monetary gold. This would imply that an increasing part of reserves will have to consist of foreign exchange in some form or another. After having established fractional-reserve banking systems nationally, we are thus moving toward some kind of fractional-reserve system internationally with gradually diminishing reserve ratios. The basic question seems to be whether in the future as in the past this development should be left to the pragmatic efforts of international bankers or whether a fundamentally new approach is needed. On the basis of recent experience I think that the pragmatic approach has done reasonably well. We seem to need evolution rather than revolution. At the same time it must be recognized that the constructive imagination of international bankers has much profited from criticisms, and from projects and plans coming from the outside, even if at times these might have appeared as "radical," "unbalanced," or "unrealistic." I believe this process of mutual give and take holds out the promise of further progress.

11. FINAL REMARK

In the foregoing comments I emphasized those points on which my views may be somewhat different from those expressed in the Brookings report. In so doing I hope to have followed the spirit in which I was invited to submit these comments. Such differences of opinion notwithstanding, it should not be overlooked that there is a wide area of agreement. Indeed, I have nothing to add to most of what is said in the report and in closing I should like to reaffirm the high respect I have for this very competent appraisal of present balance-of-payments problems.

STATEMENT BY JAMES NORDYKE

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The study by the Brookings Institution of the balance of international payments of the United States in 1968 is, I believe, an excellent one. The authors have performed a difficult task in highly sophisticated fashion. Aside from the general excellence of the study, it has two most striking features. One of these is the conclusion that the American international payments position in 1968 may be one of surplus rather than deficit. The other is the fact that the study's major recommendations for U.S. Government action do not depend upon that conclusion; in fact the authors of the study suggest that Government action should, for the most part, be the same regardless of whether a deficit, a surplus, or a balance is expected in the position for 1968.

The projection of a surplus for 1968 is striking because the position of the present and recent past is and has been one of deficit. It is an unusual feat to extrapolate present circumstances so as to achieve a projection of a character opposite to present circumstances. Such a feat is worthy of investigation as to how it has been achieved. I shall devote the majority of what follows to such an investigation.

Perhaps even more remarkable, however, than the conclusion that a surplus may occur is that having obviously gone to a great deal of trouble to be able to make the conclusion, the makers decide that it is of little significance as a guide to action. The policy which the Brookings authors finally urge upon the American Government is that a vigorous effort be made to secure international agreement for some kind of new or newly enlarged international liquidity-creating arrangement. This policy needs to be pursued, contend the authors, no matter what kind of position the American balance of payments is expected to take in 1968. I shall not comment further on this recommendation nor on what I regard as its somewhat nonsequitur character except to note that this kind of divorce of recommendation from analytical projection has the merit of avoiding a catastrophe which might follow from pursuit of a policy based closely on what could turn out to have been a quite erroneous projection.

How is it possible for the authors of the Brookings study to take a balance-of-payments deficit of \$2,370 million in 1961 and to project therefrom a possible balance-of-payments surplus of \$1,900 million in 1968? Those who make economic projections are sometimes able to suggest that present trends will be reversed sometime in the future by assuming that there are at work what one might call latent reaction factors. The strength of these reaction factors is usually assumed to depend upon present trends. This strength is believed to increase gradually as present trends continue. It increases at first in hidden fashion but ultimately becomes so great that present trends are overwhelmed and reversed. The reaction factors can take a wide variety

of forms. They may be political; persons in power may become increasingly dissatisfied with present trends and increasingly determined to alter them. They may be technological; machines may begin to wear out at an increasingly fast rate as they are used more and more intensively so that ultimately the amount of machine use must decline. They may be "institutional;" as the amount of money expands the reserves upon which the money is by law required to be based decline so that the amount of money must eventually be reduced. Thus it is possible to project a reversal of present trends if one is willing to assume that reaction factors exist.

In what has become the traditional theory of balance-of-payments adjustment mechanisms these reaction factors are several in number. First, a deficit in the international balance of payments is believed in some cases to constitute a loss of income for the entities of the deficit country, and consequently these entities begin to buy less imported goods so that the deficit is reduced or reversed. Second, a deficit is paid for by an outflow of liquid assets and this outflow tends to reduce prices and incomes in the country and to have other damping effects on domestic economic exuberance so that fewer goods are imported and more are available for export. Third, a deficit may be paid for by an outflow of liquid assets; this outflow may cause interest rates to rise within the country; the higher interest rates may attract capital into the country; and this inflow of capital may "solve" the deficit. Fourth, a deficit may cause foreign exchange rates to move in such a way that imports are discouraged and exports encouraged. Fifth, a deficit may cause the government to place restrictions on imports and to encourage exports via subsidies or otherwise so that the deficit is reduced, eliminated, or converted to a surplus.

The Brookings authors do not explicitly use these traditional reaction factors or adjustment mechanisms in a significant way to project the surplus of 1968. It is probably appropriate for them not to have used them. For the traditional adjustment mechanisms, if they are allowed to operate at all, would probably operate over a much shorter period than the 7-year interim between 1961, the base year of the projection, and 1968, the projected year. Since the Brookings authors do not explicitly use reaction factors to project the surplus of 1968, it seems well to review the more important elements which they do use explicitly in their remarkable but perhaps misleading projected reversal of present conditions.

First, much of the deficit of 1961, of 1962, and, one can presume, of 1963 is caused by an outflow of short-term capital from the United States. Much of this outflow and of other transactions related to it are regarded by the authors of the study as speculative, erratic, and likely to fluctuate greatly in direction and volume over time. Therefore, this outflow, they argue, is nonprojectable over a period as long as 6 or 7 years. Consequently they remove this element from both the 1961 balance and that of 1968. When this removal is accomplished, the 1961 deficit is reduced to one-third its former size. If this element had been projected (rather than omitted) in the 1968 figures in an amount equal to that of 1961, the surplus of 1968 would have been reduced by three-fourths from \$1.9 to \$0.4 billion. I do not believe that the most useful assumption is that this short-term capital outflow will be zero in 1968. It seems to me at least as plausible to assume that the outflow will persist and be as large in 1968 as it has been on

the average in the last few years. It seems to me that it will persist for at least a few years in the interim between 1961 and 1968 and that the longer it persists the more likely it is to encourage itself to persist further because the less reassuring will the gold position of the United States become. Hence I regard it as a defect, at least in exposition, to omit the short-term capital item from the projection.

Second, it is projected in the Brookings study that the total merchandise balance of the United States may increase from \$3.5 billion in 1961 to as much as \$5.3 billion in 1968. The primary reason for this improvement seems to be the fact that the average annual rate of change in the general level of prices in the United States is assumed to be only 1.5 percent between 1961 and 1968 whereas the change in Europe is assumed to be about 2.75 percent. A similar difference in the inflation rates of prices of export goods of the two areas is assumed to occur. American goods thus would, by 1968, acquire a competitive position significantly superior to that which they enjoyed in 1961, and the export excess in American merchandise trade would, therefore, be enlarged. The Brookings authors themselves find the assumption of such a large difference in the rates of inflation in the two areas somewhat unrealistic and make an alternate assumption of 1.75 percent as the European rate while continuing to assume 1.5 percent as the rate for the United States. This alternative leads to the conclusions not only that the merchandise export excess of the United States will decline from \$3.5 billion in 1961 to \$2.6 billion in 1968 but also that the entire 1968 U.S. payments position exclusive of short-term capital movements will be one of a small deficit (of \$0.6 billion) rather than one of surplus as first suggested. It seems to me probable that even the alternative assumption is perhaps excessively optimistic regarding the amount of inflation in the United States relative to that in Europe; this is especially true if one also assumes, as the Brookings authors were asked to do by the Council of Economic Advisers, who commissioned the study, that the average annual growth of gross national product in the United States during the period 1961-68 is to be 4.5 percent. It is still true even if the slightly more modest rate of real growth of 4.2 percent is assumed as the Brookings authors do in their alternative set of assumptions. It is true because it seems that any effort by the American Government to encourage economic growth sufficiently to raise the recent average annual rate of 2.3 percent to anything approaching 4.2 or 4.5 percent is almost certain to result in an increased rate of inflation, at least for a time. It seems incorrect to me to assume that the absence of any greater rate of inflation than 1.5 percent in the recent past implies such absence in the future. Even if the Government does not engage in any vigorous effort to get the country moving to a higher rate of growth, it is quite possible that the price stability of the last few years has been merely a pause while the pressures for renewed cost and price increases held themselves in temporary abeyance.

Third, the Brookings authors project that by 1968 the amount of new long-term capital outflow from the United States will be smaller than it was in 1961 and that the amount of investment income flowing into the United States from investment abroad will be considerably greater. This seems the least contestable of the three major projected sources of improvement in the American balance of payments. Even here, however, the Brookings authors may be overly

optimistic. They assume that a rapid rate of economic growth in the United States will provide opportunities for the use of both American and foreign capital in the United States in 1968 superior to those at present. But, as noted above, it is unlikely that the United States will achieve such a high growth rate, 4.5 or 4.2 percent, as is assumed. Hence the relative attraction of the United States for internationally mobile long-term capital is likely to be less than projected and the capital outflow to be more.

In general the assumptions—about real GNP growth rates, about prices, and about productivity—on which the projections of the study are based seem unduly optimistic. Even the more moderate “alternative assumptions” seem so. This does not mean, of course, that a projection based on either set of assumptions has no merit. A projection based on the initial assumptions provided by the Council of Economic Advisers reveals a limit on one side of which subsequent reality can be expected to occur. In other words, the balance of payments of 1968 will, in all probability, be no more favorable than that projected upon the Council’s assumptions. A logical concomitant of a projection of this sort would, it would seem to me, be an attempt to determine the other limit, the pessimistic limit, so that one could say, “On the other hand, in all probability, the balance-of-payments position will be no worse than * * *.” Instead of determining such a pessimistic limit, the Brookings authors chose to make an alternative projection based on what seem to me to be moderate assumptions, ones neither pessimistic nor optimistic, ones which produce a projected balance about which one can say, “Of all possible balance-of-payments positions in 1968, this is the more likely,” or, “It is more likely that the actual balance-of-payments position in 1968 will fall within a given range on either side of this figure than it is of any other.”

Finally, I believe that the study perhaps fails to place sufficient emphasis upon political factors. Of course, it certainly does not ignore them. For example, the authors are careful to point out that the European Economic Community is an economic means to a political end and that some EEC policy which might be most reasonable in its economic consequences might nevertheless not be adopted by EEC because of its incompatibility with the political goal. This and other political factors were introduced into the study. But surely the study does not go far enough in this direction. The strictly economic factors are the place to begin a study of this kind, but they must then be supplemented extensively with political appraisals. Some of the political issues relevant to this study are the probability that the American Government will find it politically feasible to abandon the internal gold reserve requirement, the probability that the American Government will find it politically feasible to maintain or reject the policy of tariff reductions, the probability that the American Government will find it politically expedient to pursue fuller employment by permitting more inflation, the political necessity of reducing American foreign aid, the probability that a Gaullist France will succeed in excluding American products as well as American influence from a united Europe, and finally the effect which a learned study bearing an optimistic projection has upon reducing the political need felt by a government to take action which might correct what is regarded as an undesirable situation.

STATEMENT BY HOWARD S. PIQUET¹

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The authors of the recent Brookings report, "The U.S. Balance of Payments in 1968," have been truly courageous in attempting to project the balance of payments of the United States to 1968. That they have produced the most comprehensive and useful compendium of balance-of-payments data that has thus far appeared is obvious.

It is because of the competency and reputations of the authors, however, that the report can be misleading and potentially dangerous. This is because of the nature of the exercise. In making projections on the basis of a "model" there is the ever-present danger that persons reading them, particularly nontechnicians and, in this case, those responsible for determining national policies, will fail to understand the limitations of the exercise.

NATURE AND LIMITATIONS OF MODELS AND PROJECTIONS BASED UPON THEM

Model building, and projections made on the basis of them, are primarily academic exercises. No model is better than (1) the assumptions upon which it is constructed, and (2) the logic and permanence of the mathematical relationships found, or assumed, to exist within the model itself. If the readers of such reports keep these limitations in mind no great harm is done. But, more frequently than not, the nontechnical reader is impatient with, or does not have the time or the skill, to appreciate the assumptions and logical shortcomings involved, and unwittingly infers that the projections constitute "forecasts." Projections based upon a model in which all but one, or possibly two, of the assumptions are constants often can be useful. However, when the model and the projections are based on assumptions that are themselves variables, they are of doubtful tenability and can be dangerous as guides to action. For every mathematically measurable variable in a model that deals with human behavior there are scores of others which, though conceivable, cannot be measured, and hundreds of others that are not even conceivable. Mathematical models, therefore, are but sketches of the relationships of selected variables, leaving all other variables out of account.

The authors of this report have been careful to point out these shortcomings. On page after page they make it clear that they themselves have little confidence in their own figures, not only as forecasts, but even in terms of the model itself. Some of these qualifications they express as follows:

Factors extraneous to the economic system, such as the Korean war and the Suez crisis; fortuitous economic factors; and differences in cyclical developments inside and outside a country—all these factors can have large effects on the basic balance (p. 12).

¹ The views expressed herein are those of the author and are not to be attributed to the Library of Congress.

It should be emphasized that projections of net balances in international payments, even of net balances in basic transactions, are highly speculative, even more so than economic forecasts in general. Such net balances are the difference between gross payments and gross receipts that are of the same order of magnitude. With the gross international payments and receipts of the United States both running at rates in the neighborhood of over \$30 billion a year in 1961, a deficit of \$3 billion, which is customarily regarded as a substantial one, would represent an excess of payments over receipts of less than 10 percent. Consequently, relatively small errors in the projections of gross receipts or payments would make for large errors in the projection of the net balance (p. 31).

* * * the net balance of goods and services is influenced to an important extent by factors which we cannot take into account. Some of them, such as strikes and crop failures, may have transitory effects; others, such as basic changes in supply and demand conditions for individual commodities important in international trade, may have more lasting and profound effects on international trade. We have had to leave such factors out of account because there is no way of projecting them, or of making quantitative estimates of their effects on trade (p. 34).

* * * these relationships [between real GNP and relative prices, on the one hand, and exports and imports on the other] omit the influence of factors other than the real GNP and relative prices. To the extent that these omitted factors were correlated with either of the two independent variables used in the model, their influence is implicitly, but erroneously, attributed to the independent variables (p. 34).

A further possible source of error arises from the fact that we are using relations derived from the period 1948-60 to make projections for 1968, and these relationships will surely change. Moreover, we not only extrapolate in time. For the GNP, we also extrapolate well beyond the numerical range of the variables on which the equations are based, a procedure which introduces an additional possibility of error (p. 35).

* * * we cannot have much confidence that the relationships derived from econometric studies of the postwar period will hold in the future * * * (p. 56).

Admittedly, it is difficult to feel much confidence in these figures. The period 1948-61 saw so many changes in product availabilities as Western Europe reconstruction proceeded, in tariffs, trade policies, and other moves toward liberalization, such as currency convertibility, and in so many other factors that regression equations which fail to take them into account are subject to deep suspicion as forecasting devices—even when the values computed from the equations correspond closely to the actual values in the period for which they were fitted (p. 58).

The most serious defect of the indexes is that the individual series of which the indexes are composed are not based on price quotations of identical commodities in successive periods, but on unit values of classes of products. The commodity composition of the goods comprising each class may change, and so may the specification of a particular commodity. Changes of either type would cause movements in the unit value series which do not reflect true price changes. A further defect is incomplete coverage (p. 74, regarding prices of exports).

Despite these serious difficulties, we shall discuss the indexes of export unit values for manufactures, partly because they probably have some significance as indicators of relative price changes as between countries, partly because no better indicator is available (p. 75).

* * * we emphasize that the highly conjectural character of both the price assumptions and the elasticity coefficients should be borne in mind, along with the fact that other important, but even less predictable, influences have not been considered (p. 80).

Considering the importance of the U.S. competitive position, the lack of a satisfactory index of export prices is particularly serious. Until the price data are improved, quantitative projections of the competitive position of the United States can be little more than informed guesses—and this warning applies to our projections (p. 91).

* * * it should be emphasized again that an analysis of this kind is necessarily very rough and speculative. Much more work needs to be done before we achieve a clear understanding of the balance-of-payments effect of foreign assistance and related governmental programs (p. 190, relative to foreign economic assistance).

After taking all these limitations into account, one cannot help but wonder whether simple arithmetical projections of individual varia-

bles would be just about as meaningful as projections of an intricate model based upon highly sophisticated, but essentially superficial, observations regarding mathematical correlations.

SIMPLE PROJECTIONS TO 1968

The danger of this type of exercise is brought into focus by reading chapter II of the Brookings report on "Effects of Prospective Changes in Demand and Output" in conjunction with chapter IV on "The European Economic Community and the U.S. Balance of Payments."

Before examining the reasoning in these chapters it is helpful to observe (1) what simple arithmetical projections to 1968 show, on the basis of the assumptions as to economic growth supplied to the Brookings Institution by the Council of Economic Advisers, and (2) what simple arithmetical projections to 1968 show, using past rates of economic growth as guides to future growth and merchandise trade.

The Council of Economic Advisers asked Brookings to assume that the gross national product of the United States will grow by 4.8 percent, per annum, between 1961 and 1968, and that of western Europe by 4.2 percent. Regardless of any assumed achievements by the United States with respect to the alleviation of unemployment and restraint of price increases, simple arithmetical projections of the figures to 1968 would result in an increase in the GNP of the United States from \$518 billion in 1961 to \$719 billion in 1968.

Imports into the United States in 1961 totaled \$14.5 billion. Applying the long-term relationship between imports and the country's GNP (3.1 percent) to the projected GNP in 1968 yields an estimate for imports in that year of \$22.3 billion. The increase in imports between 1961 and 1968 would then be \$7.8 billion. Western Europe's share of these imports, on the basis of past experience, is about 27 percent, or \$4 billion in 1961. On the basis of simple arithmetical projections, application of this ratio indicates that payments for imports from Western Europe in 1968 would total \$6.1 billion.

The GNP of Western Europe, in 1961, was \$331 billion. At a growth rate of 4.2 percent, per annum, it would amount to \$441 billion in 1968. Total imports into Western Europe in 1961 amounted to \$58.9 billion, which was 17.8 percent of the area's GNP. On the basis of this relationship, imports into Western Europe in 1968 would amount to \$78.6 billion, an increase during the period of \$19.7 billion.

The United States share of Western Europe's imports in 1961 was 11.5 percent, or \$6.8 billion. Applying this ratio to the projected GNP for 1968 yields an estimate for imports into the area of \$9 billion.

Thus, with imports into the United States from Western Europe increasing by \$2.1 billion (outpayments) and imports into Western Europe from the United States (flow of funds into the United States) increasing by \$2.2 billion, the effect of the projections on the U.S. balance-of-payments position would be almost neutral (\$100 million on the favorable side).

These simple arithmetical projections are shown in table 1.

TABLE 1.—*Simple arithmetical projections: United States and Western Europe, based on growth assumptions of the Council of Economic Advisers*

[In billions]

	United States (Rate, 4.8 percent per annum)	Western Europe (Rate, 4.2 percent per annum)
Gross national product (1961).....	\$518.2	\$330.9
Gross national product (1968) ¹	719.4	441.4
Imports (1961).....	14.5	58.9
Imports (1968) ¹	22.3	78.6
Increase (1961-68).....	7.8	19.7
Europe's share of imports (1961).....	4.0	.....
Europe's share of imports (1968).....	6.1	.....
Increase (1961-68).....	-2.1	.....
U.S. share of imports (1961).....	.....	6.8
U.S. share of imports (1968).....	.....	9.0
Increase (1961-68).....	.....	+2.2

¹ Projected.

NOTE.—Effect on U.S. balance of payments = +\$100,000,000.

This conclusion emerges because the larger size of the U.S. economy is counterbalanced by the greater importance of imports to the economies of Western Europe than to the U.S. economy.

In chapter II of the Brookings study, however, it is concluded (p. 57) that total U.S. payments for merchandise imports from Western Europe would increase by \$3.33 billion, while receipts arising from exports to Western Europe would increase by only \$1.87 billion, resulting in a \$1.46 billion deterioration in the U.S. balance-of-payments position. On the basis of "alternative assumptions," which are more modest with respect to the anticipated accomplishments of the U.S. economy than those supplied by the Council of Economic Advisers, it is concluded that payments to Western Europe for merchandise imports would increase by \$2.87 billion, while receipts arising from exports to that area would increase by only \$1.59 billion, resulting in a \$1.28 billion deterioration in the U.S. balance-of-payments position.

As far as merchandise trade is concerned, the conclusions of the Brookings study are thus considerably less favorable, from the point of view of the U.S. balance-of-payments position, than simple arithmetic projections would indicate.

CONCEPTUAL LIMITATIONS

The report is subject to a number of broad conceptual limitations. One of the most serious of these is that it analyzes only those balance-of-payments items that are included in the "basis balance," omitting altogether short-term capital movements and the mysterious catchall "errors and omissions." These variables are omitted, the authors admit, because they cannot be forecasted or projected, on the basis of a model. This approach seems to reflect implicit trust in the classical belief that achievements of balance in the basic accounts, somehow or other, will keep short-term outward capital flows in check.

It also seems to be assumed that gold flows result directly from the balance-of-payments deficit. There are good reasons for believing that, during certain periods since 1958, outward gold movements—and to a certain extent, short-term capital outflows (which may or may not be directly related to each other)—have been the result of speculation against the dollar. This speculation appears to have taken the form of purchase of dollars on a margin basis, anticipating that the United States will devalue the dollar in terms of gold. Such speculation, resulting in withdrawals of gold from the free gold market, has had the effect of creating a vacuum which has been filled by withdrawals of gold from the United States by the Bank of England and other central banks against their dollar deposits in U.S. banks.

Withdrawals of gold for this purpose, whether or not accompanied by short-term capital outflow, depend upon a host of considerations that affect confidence in the dollar as the world's key reserve currency. It cannot be denied that the maintenance of balance between international receipts and payments would go a long way toward maintaining international confidence in the dollar. We err, however, when we persist in thinking of it as a direct cause and effect relationship. It is conceivable that the deficit in the balance of payments could be eliminated and that there would still be a lack of confidence in the U.S. dollar as the principal international reserve currency.

The qualifications presented by the authors themselves with respect to their model, and the projections based thereon, together with the considerations just cited, lead to the conclusion that whether balance in the "basic" accounts is achieved in 1966, 1968, or 1970 depends upon how one juggles assumptions which, at best, are subject to wide margins of error, and secondly, that it doesn't make much difference when balance is achieved, if that balance is not the result of major reform in international financial relations among the countries of the free world.

This is not to imply that either the Brookings Institution, or the authors of the report, believe that the classical relationship between balance-of-payments deficits and gold outflows still applies. The observation arises out of the terms of reference laid down by the Council of Economic Advisers. Whether or not there is "basic balance" in the international accounts in 1968 (or any other year) does not go to the heart of the problem. The overall lack of balance in the international accounts during the past few years has been brought about, not so much by failure to achieve "basic balance," as by the outflow of dollars either in the form of short-term capital movements or for the purpose of gambling that the dollar is going to be devalued in terms of gold. It seems like a waste of talent, time, and funds to concentrate so heavily upon mathematical exercises with respect to basic balance, while almost ignoring the fundamental problem of establishing an international monetary system that will maintain equilibrium similar to that which was maintained under the free gold standard. First things should be put first, and certainly projections based upon models and arbitrary assumptions as to rates of growth, et cetera, ought not be highest on the priority list.

The authors do not say it quite so bluntly, but the concluding chapters make clear their belief that attention should be given, in the first instance, to the problem of creating an effective international monetary mechanism. In their own words (pp. 241 and 245):

The balance-of-payments deficit * * * is not the major source of the international financial problem of the United States. That problem consists of the constraints imposed on the United States in its efforts to attain the more basic objectives of policy. It is the changed position of the dollar, the loss of foreigners' desire to continue accumulating dollars, which imposes these constraints. While balance-of-payments deficits have undoubtedly accentuated this change in the last few years, they are not its sole cause, and their elimination would not restore the dollar's position as **virtually the only hard currency in a soft-currency world** * * *. It is clearly in the interest of the United States to make every effort to develop an international monetary mechanism that will permit adjustments to take place without compromising other goals.

This is a realistic and logically satisfying approach. It is to be deplored that the report does not discuss, in detail, the kinds of "adjustments" that will need to take place under an adequate international monetary mechanism.

The report (p. 33) embraces the questionable thesis that the principal factors determining merchandise trade between the United States and Western Europe are the real gross national products of the two areas, considered in the light of relative price levels in the United States and Western Europe. This concept of functional relationships between GNP's and relative price levels, on the one hand, and merchandise trade on the other, does more to obscure economic cause and effect relationships than it does to clarify them. The fact that there happens to be a close correlation between imports and gross national product through a given period of time does not, of itself, prove that either causes the other, or even that they are both results of a common cause. The concept of aggregate demand is vague and rather meaningless as far as economic causation is concerned. The determinants of imports, like the determinants of most other transactions, are individual price relationships (including the prices of cost items as well as the prices of products sold) in a vast sea of changing individual price relationships. The fact that the aggregate, or average, price level of a country is rising does not necessarily imply that all prices are rising, or conversely, a decline in the average or aggregate does not imply that all prices are falling. And, certainly, there is no reason for assuming, when average prices are either rising, or falling, that all prices move at the same rate or that all of them move in the same direction.

On page 34 the authors admit that "the net balance on goods and services is influenced to an important extent by factors that cannot be taken into account. Some of them, such as strikes and crop failures, may have transitory effects; others, *such as basic changes in supply and demand conditions for individual commodities important in international trade may have more lasting and profound effects on international trade.*" [Emphasis supplied.] They admit that they have had to leave such factors out of account "because there is no way of projecting them, or of making quantitative estimates of their effects on trade."

Of equal significance is the fact that the relationships assumed to exist between GNP and prices on the one hand, and trade on the other, are based upon historical data which: (1) Omit the influence of factors other than the real GNP and relative prices, and (2) that the relationships have been derived from the period 1948-60 to make projections for 1968 and that "these relationships will surely change." Furthermore, since the extrapolations extend beyond the numerical range of

the variables upon which the equations are based, they are subject to a high degree of possible error.

The Council of Economic Advisers, in requesting the study, specified not only that the U.S. GNP should be assumed to grow between 1961 and 1968 at 4.8 percent, and that of Western Europe at 4.2 percent, but also that unemployment in the United States will be rapidly reduced to 4 percent of the labor force, and that the Government's long-term growth objectives will be achieved. These assumptions have the effect of raising the 1968 projection of GNP from \$719 billion (based on simple arithmetic projections) to \$743 billion (all expressed in 1961 prices).

The Council also directed that the implicit price deflator for GNP should be assumed to rise by 1.5 percent per year which, according to the authors, "implies that realization of the full employment and growth targets would not entail any significant sacrifice of price stability."

The authors make the following additional assumptions (pp. 40, 41):

- (1) Consumer purchases will be 61.6 percent of GNP in 1968.
- (2) Investment in fixed capital assets required to achieve the assumed growth rate will amount to 13.5 percent of GNP (with the share of the Government coming to 2.7 percent of the total).
- (3) Other Government expenditures for goods and services will be 19.3 percent of GNP compared with 17.2 percent in 1960.
- (4) Residential construction will remain at 4 percent of GNP.
- (5) Inventory accumulation will proceed at the rate of 1 percent of GNP.

On the basis of all these assumptions, the sum of consumption, investment, and Government demand would be \$4.6 billion less than the projected GNP in 1968, which is only slightly larger than in 1960 and 1961. The authors conclude that, unless net exports are substantially higher than this figure, the pressures upon GNP prices stemming from an excess of demand would be negligible.

There are so many other variables in the economic picture—variables that cannot be reduced to mathematically measurable terms—including hundreds of thousands of individual price relationships that, by the time the reader reaches this stage of the reasoning, he has the feeling that he is trying to untangle a large dish of cooked spaghetti.

The assumption that the rate of growth of Western Europe's combined GNP will be less than that of the United States seems unrealistic in view of the fact that the GNP of Western Europe in 1961 was only \$331 billion, compared with \$518 billion for the United States, together with the strong possibility that the tearing down of trade barriers within Europe will have the same kind of expansionary effect on production within Europe that the tearing down of trade barriers among the individual States of the United States had back in 1789. Also, it should not be overlooked that the population of the six countries comprising the EEC, alone, is almost as large as that of the United States.

It is assumed, furthermore, that labor costs per unit of output in the principal Western European countries will rise considerably because of full employment and the likelihood that wages will be allowed to advance more rapidly than productivity. This assumption seems unrealistic in view of recent European successes in restraining wage-price inflation.

On the basis of the assumptions regarding private consumption, capital formation, inventory accumulation, etc. (p. 53), it is concluded

that Western Europe's domestic expenditures will exceed its combined GNP by over \$17 billion in 1968, in contrast to a negligible inflationary pull in the United States. The authors conclude that this demand inflation will express itself in the form of a decreased surplus, or an increased deficit on current account, and partly in the form of rising prices.

The report's conclusion that there would be a "basic balance" of \$1.9 billion in the international accounts of the United States in 1968, on the basis of the stated assumptions, renders it a comforting exercise in deductive logic, but (as far as merchandise trade is concerned) it is not consistent with what seems to be a commonsense view of the growth potentials of the EEC and the EFTA countries.

THE EUROPEAN ECONOMIC COMMUNITY

Although mathematically competent, the treatment of the European Economic Community is not convincing from a commonsense historical and economic point of view. Also, the text is not always internally consistent and, in some instances, it is illogical.

On page 95 the report states "our conclusions indicate that U.S. exports to the member countries should increase substantially." Yet, on page 112 it is stated that "The implication for the U.S. balance of payments of the European Economic Community, as it is now constituted, according to our estimates, is an unfavorable effect of approximately \$750 million", and on page 115 the statement appears that "* * * the European Economic Community is likely to have an adverse impact on the United States if its present policies are continued. * * *"

The report is not always as internally logical as its mathematical form might lead one to expect. Thus, on page 98 it is stated that "the United States is particularly dependent on Europe as a market for its agricultural products." In the table accompanying the text, however, it is shown that 23 percent of total U.S. agricultural exports goes to the EEC countries. The authors are correctly impressed by the fact that agricultural products constitute 34 percent of U.S. exports of all products to the EEC. But, it is a distortion of logic to conclude from these figures that the United States is "particularly dependent" upon Europe as a market for its agricultural products. A more objective observation would be that agricultural products account for 34 percent of U.S. exports of all products to the EEC, but exports of such products to the EEC account for only 23 percent of total U.S. agricultural exports to all countries.

On the same page the authors discover what one would suppose to be the expected fact that expansion of trade among the EEC countries themselves between 1958 and 1962 was much more substantial than imports into the EEC from nonmember countries (97 percent compared with 38 percent). Since the principal reason for eliminating internal trade barriers is to consolidate the economies of the six, the impressive fact is not that imports from nonmember countries increased more slowly than trade among the member countries themselves, but that it was as large as 38 percent.

In this connection it is significant that, whereas total U.S. exports to all countries increased by 22 percent between 1958 and 1962, U.S.

exports to the EEC countries increased 48 percent (compared with an increase of only 11 percent in exports to Canada). It is also significant that, in absolute terms, U.S. exports to the ECC in 1962 totaled \$3.6 billion and were exceeded only by exports to Canada, which amounted to \$3.8 billion. That the formation of the ECC has resulted in considerable trade diversion from nonmember countries to member countries is hardly an outstanding discovery. Rather, it is evidence that the expansionary objectives of the customs union are being achieved.

The report goes on to analyze U.S. exports of various products and groups of products to 1968, on the basis of projections of very recent trends in the model, in what might be called "static" as opposed to "dynamic" projections. They take little, if any, account of changes in comparative advantage and of historical relationships between industrialization and foreign trade.

Notwithstanding the fact that over two-thirds of present agricultural exports to the EEC are not subject to variable levies (including soybeans and cotton) and other protectionist controls, the report is pessimistic with respect to future U.S. agricultural exports. On page 116 the authors contend that "It is doubtful that * * * the EEC agricultural policy, *implying as it does complete protection against imports* [emphasis added] can be moderated through negotiations based on the Trade Expansion Act." It is hardly objective, or even correct, to characterize present EEC agricultural policy as "complete protection against imports." It is just as incorrect as it would be to assert that the United States has a policy of "complete protection" against all nonagricultural raw materials because of its rigid import quotas against lead, zinc, and petroleum. The EEC is pursuing a policy of agricultural protectionism, and so is the United States, along with practically all other economically advanced countries. In most of these countries agricultural producers constitute politically powerful pressure groups. Since this phenomenon is not peculiar to the EEC, it is not logical to conclude that the EEC will necessarily pursue a policy of across-the-board protectionism.

It is concluded (p. 115) that:

While the European Economic Community is likely to have an adverse impact upon the United States if its present policies are continued, the result could be very different if these policies are changed.

Although it is undeniably true that if trade barriers on both sides of the Atlantic are reduced substantially, trade will increase more than it will increase in the absence of such action, it does not follow that, in the absence of trade barrier reductions, trade between the two areas will decline, or even fail to increase. General de Gaulle is very powerful, but he is not powerful enough to repeal the law of comparative advantage and, in his more logical economic moments, he is not disposed to cripple the economic well-being of his own people. Substantial industrial expansion within the EEC, including France, will bring with it substantially increased foreign trade, if history is any guide to the future. In practically all instances, increased industrialization and increased foreign trade accompany each other.

Notwithstanding the pessimism shown in chapter II regarding trading relationships between the United States and the EEC, in

chapter IV (pp. 215-217) the authors draw the more logical and reasonable conclusion that—

* * * under our initial assumptions, prices and costs in Western Europe, primarily on the Continent, will rise substantially relative to prices and costs in the United States. The resulting improvement in the competitive position of the United States, together with the expected rise in Western Europe's real income, will increase the excess of U.S. exports over U.S. imports of goods and services, other than investment income. * * * Even after allowing for the adverse effects of discrimination against the United States and some of its customer countries by the European Economic Community, this increase outweighs the adverse effects of the rise in U.S. imports of goods and services that would accompany the assumed increase in real GNP * * *.

SIMPLE ARITHMETICAL PROJECTIONS OF UNITED STATES-EEC TRADE

Simple arithmetical projections to 1968 (see table 2) based on the assumed rates of growth in GNP's, as suggested by the Council of Economic Advisers (4.8 and 4.2 percent per annum for the United States and the EEC, respectively) show an increase in U.S. outward payments for imports from the EEC of \$1 billion, together with an increase in payments for exports to that area amounting to \$1.1 billion, thus resulting in a net improvement in the balance-of-payments position of the United States of \$100 million.

TABLE 2.—*Simple arithmetical projections: United States and EEC, based on growth assumptions of the Council of Economic Advisers*

[In billions]

	United States (rate 4.8 percent per annum)	EEC (rate 4.2 percent per annum)
Gross national product (1961).....	\$518.2	\$201.0
Gross national product (1968).....	719.4	268.0
Imports (1961).....	14.5	20.4
Imports (1968).....	21.6	26.8
Increase (1961-68).....	7.1	6.4
EEC share of imports (1961).....	2.2	-----
EEC share of imports (1968).....	3.2	-----
Increase (1961-68).....	1.0	-----
U.S. share of imports (1961).....	-----	3.5
U.S. share of imports (1968).....	-----	4.6
Increase (1961-68).....	-----	1.1

NOTE.—Effect on U.S. balance of payments, = +\$100 million.

However, if past performance is taken as the basis for the simple arithmetical projection (18.8 and 44.9 percent for the 7-year period, 1953-60, for the United States and the EEC, respectively) the increase in U.S. outpayments would be \$0.6 billion, while the increase in receipts arising from exports would be \$1.4 billion, thus resulting in a net improvement in the balance-of-payments position of the United States of \$0.8 billion.

TABLE 3.—*Simple arithmetical projections: United States and EEC.*
Based on growth 1953-60

[In billions]

	United States (18.8 percent)	European Economic Community (44.9 percent)
Gross national product (1961).....	\$518.2	\$201.0
Gross national product (1968).....	615.6	291.2
Imports (1961).....	14.5	20.4
Imports (1968).....	18.5	29.1
Increase (1961-68).....	4.0	8.7
EEC share of imports (1961).....	2.2	-----
EEC share of imports (1968).....	2.8	-----
Increase (1961-68).....	.6	-----
U.S. share of imports (1961).....	-----	3.5
U.S. share of imports (1968).....	-----	4.9
Increase (1961-68).....	-----	1.4

NOTE.—Effect on U.S. balance of payments, +\$0.8 billion.

To repeat, all of these are aggregate projections that do not take into account thousands of variables that prevail in the real world. Under the circumstances, it seems not unreasonable to believe that complicated projections, based upon selected factors which appeal to an individual analyst, and which happen to be statistically measurable, are not much better, by themselves, than simple arithmetical projections. Commonsense, a genuine understanding of the principle of comparative advantage, combined with a keen sense of elementary logic, all considered in the light of economic history, are more convincing than mechanical extrapolations made on the basis of a static model which projects existing relationships—many of them assumed—into the future.

Of course, there will be serious strains on certain U.S. exports because there will be increasing competition in certain sectors of the manufacturing economy, as well as in certain sectors of agriculture, where displacement of exports caused by discriminatory tariff treatment by the EEC will occur. The problem confronting the United States, however, is not that its total exports (or even its total agricultural exports) will decrease, but that the composition of its exports will change in an environment of overall expansion.

As stated so aptly in a recent "Report on Western Europe" by the Chase Manhattan Bank (July 1962) "the competitive outlook varies widely from industry to industry, from product to product, from company to company. * * * U.S. producers compete most successfully in industries where innovation, engineering, and design are most important. This is partly explained by America's concentration on research and development. Britain's National Institute of Economic and Social Research found that U.S. industry employed some 2½ times as many qualified scientists and engineers per 1,000 employees as British industry did; and ploughed about 4 percent of net output into research and development, compared to 2 percent in Britain. There seems to be a tie between research and competitiveness by industry." The report goes on to say that aircraft, electrical apparatus,

automobiles, industrial machinery, and some chemicals are the lines in which research expenditures are high.

Yet, in the Brookings report (p. 93) it is stated that in the projections no account has been taken of expenditures for research and development.

The Chase Manhattan report adds that "The principle of comparative advantage, applied to a world where trade barriers are coming down, does not mean that Europe will produce all the machinery and the United States will revert to a raw material producer. * * * U.S. industry is competitive, but not always in the same products. * * * The U.S. economy—probably the world's most competitive internally—is now adjusting to a new competitive situation. How successfully the economy as a whole is to compete in the 1960's will depend very largely upon how successful we are in holding down the overall level of prices and keeping wage increases in line with productivity gains."

Generally speaking, the outlook for U.S. exports is not dim and, as far as the U.S. balance of payments is concerned, formation of the European Economic Community, in spite of General de Gaulle, should have a favorable, rather than an unfavorable, effect upon the U.S. economy as a whole.

CONCLUSION

We are prone to concentrate too exclusively upon the numbers in the balance of payments, as such, than upon the international equilibrating process. We fail to recognize that the difficulties to which we refer as our "balance-of-payments problem" arise from abandonment of the free gold standard (and its discipline) which prevailed prior to World War I. Since World War II the nexus between gold reserves and prices has been severed, so that international gold flows now have little, if any, effect upon price levels and, therefore, upon international financial equilibrium.

Immediately following World War II the world was greatly worried over "dollar shortage." In 1958 this worry gave way to worry over "dollar surplus," which had begun to appear as early as 1950 and which continues to this day.

The balance-of-payments problem is only superficially a problem of attaining "balance" between debits and credits in the international accounts. Even if, by strenuous effort, the United States were to attain such balance there is no assurance that it would be maintained. It might—and it probably would—simply mark the transformation from an extended period of dollar surplus into another extended period of dollar shortage.

The balance-of-payments problem is the problem of creating an international payments and adjustment mechanism to take the place of the gold standard. As long as we conceive of the problem as one primarily of increasing "liquidity" we shall fail to find a real solution. There appears to be a "need" for increased liquidity only because the international adjustment mechanism no longer functions. If it still functioned the way that it did prior to World War I there would be no such problem. The move for liquidity arises because, in the absence of an equilibrating mechanism, it becomes necessary to finance international trade and other international monetary outflows by increasing the short-term indebtedness of the country, or countries,

that are in a deficit position. Under a sensitive balancing mechanism the world could (as it used to) get along quite well with only a small quantity of gold. The answer to the apparent need for liquidity is the creation, not of more debt, but of a mechanism that will make it possible for national economies to adjust to each other.

“Adjustment” means willingness to accept international economic interdependence in fact, as well as in word. It means willingness to allow wages and prices to adjust to wages and prices in other countries.

Maintenance of international financial equilibrium would bring with it temporary dislocations within national economies. If we and other countries pursue policies of full employment, at all cost, we shall have to abandon the idea of restoring a viable, self-adjusting free world economy. The dilemma cannot be avoided.

In the absence of willingness to restore a free gold standard, or a system of flexible exchange rates, the liberalization of international trade becomes increasingly important. If the countries of the free world were willing to admit freely the competitive imports from each other, some adjustment would occur. Adjustment, it should be emphasized, means not only short-run adjustment of the prices of commodities, but adaptation of the prices of the factors of production, that is, the wages of labor and the returns to capital. As long as we concentrate upon increasing liquidity and ignore almost completely the problems of international adjustment, we are behaving like the occupants of a ship that is leaking, who are so busy concentrating upon buckets to bail out the water that they fail to try to stop the leak.

We should concentrate more upon the failure of the international financial mechanism to equilibrate and less upon the need for increasing liquidity, which is a device for delaying adjustment. This is not to say that we should not try to evolve ways to increase liquidity while basic adjustments are being made. Up to now, however, we have been content to talk about “adjustment” without doing much about it.

STATEMENT BY JUDD POLK

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The Brookings report makes two quite different types of contribution to the analysis of the U.S. balance of payments. One is to provide further comment on what the Joint Economic Committee has been calling "factors affecting the U.S. balance of payments." The other is to offer a pair of projections illustrating what sort of numerical balance the evaluation of major accounts might imply for 1968—in short, what sort of shape the balance of payments will be in at that time.

The forecasting of a net international payment position is subject to prohibitive error. In the field of international economics this is perhaps the most familiar fact of all, and the Brookings authors have duly cautioned users of their projections. In their general approach they sought, I gather, to focus attention on some of the major accounts which are bound to affect the balance of payments critically at any time, and then to consider some of the major demands of these accounts.

In this approach, some concept of a fundamental balance isolated from casual shifts becomes necessary as a norm. The authors chose a concept, "basic balance," which they felt might be considered largely free of "transitory" effects (notably short-term capital movement). They make it clear that this basic balance is not an ideal conception: not all transitory effects can be removed, and there are any number of other statistical difficulties (an area in which they are considerably expert).

As a comprehensive and thoughtful essay on factors affecting the balance of payments, the report is outstanding, and the projections themselves are certainly useful for discussion purposes. For example, the basic balance emphasizes the major components of international earnings and expenditures, namely exports, imports, defense, aid, and private investment. As an approach, this analysis abstracts the basic balance from problems of financing. From the authors' policy recommendations it may be inferred that they by no means discount the importance of the financial implications of any given state of the basic balance. In fact they come to argue that under existing international financial arrangements it is hard to conceive of any state of balance or imbalance in accounts of the United States that would be free of disturbing repercussions here or abroad, or both. However, it is my feeling that the possibility of truly correct "payment" inferences has been greatly prejudiced by the nature of the analysis.

Forgetting for the moment all the relevant qualifications in the report, and all the careful and often fresh comments on the important trends, we have roughly this sort of picture:

1. Over any considerable period of time a country's international accounts must be brought into basic balance.

2. Broadly, this means that net U.S. expenditures on defense, aid, and investment must be covered by current earnings.

3. The projections (table VIII-2, p. 216) illustrate the following potential improvements in major accounts compared to 1961:

	Billions of dollars	
	Initial assumption	Alternative assumption
Exports minus imports.....	2.3	-0.3
Investment income.....	1.9	1.9
Reduced investment outflow.....	.6	.6
Military expenditures.....	.4	.5
Other services.....	-.5	-.4
Government transfers and loans.....	-2.1	-2.1
Improvement in basic balance.....	12.7	.2

¹ Involves slight rounding discrepancy.

4. The short-term financing of a basic deficit has very limited effectiveness and, if relied on excessively, will entail sacrifice of vital objectives of employment, economic growth and stability.

The effect of the exercise, for better or worse, is to suggest that broad underlying economic factors are likely to lessen, slightly or materially, the present balance-of-payments pressures on the United States, as seen from the point of view of a conceptual norm or basic balance. Whatever case may be made for the internal logic of the approach, I find it hard to relate to realistic discussion of the outlook for our balance of payments. It may be helpful at this point to introduce the thought that the state of major U.S. international accounts in 1968 or any other time is dependent on the financing availability, and that it is fundamentally improper to distinguish between basic balance and short-term capital movements.

WHAT IS A TENABLE POSITION?

The notion that it is analytically interesting to group together the more important accounts affecting the balance of payments, as the report does in establishing the concept of basic balance, is acceptable, but when that particular balance is suggested as the norm for a tenable international position, it loses realism for me. For example, the report states (p. 9) that "a substantial basic deficit cannot be sustained indefinitely," after having provided a useful summary statement (table I-1, p. 6) of the course of the U.S. basic balance in the period 1947-62, during which "basic deficit" was the continuing condition.

Omitting 1947 (incidentally a \$3.8 billion surplus year), this summary might be further summarized at convenient 5-year periods as shown in the table on page 391.

Basic and total net balance of U.S. international payments taken from table I-1 of the Brookings report, p. 6

Period	Basic balance			Total	Short-term capital	Total net balance
	Net goods and services	Long-term capital and aid				
		Private net	Government net			
1948-52.....	17.8	-4.2	-20.2	-6.6	2.9	-3.7
1953-57.....	11.4	-6.6	-11.5	-6.6	1.4	-5.1
1958-62.....	13.9	-10.9	-16.0	-13.2	-2.6	-15.1
1948-62.....	43.1	-21.7	-47.7	-26.4	1.7	-24.5

The picture is one of almost uninterrupted deficit in basic balance amounting cumulatively to \$26 billion. Whether such a position could be sustained through 1968, or even "indefinitely" depends on the willingness of the rest of the world to enlarge the dollar component in their financial habits.

Recalling our general knowledge of world economic development in the period covered by these figures, it seems clear that the accounts must be describing something other than a \$26 billion derangement of a tenable position. Broadly, it must describe the economic response of the United States to the growth of world production and trade, moving from the early phase of war-disrupted production in Europe to unprecedented productive levels in the latter phase, to a global broadening of the Western defense bases, and to new apparent gains in the economic development of the nonindustrialized countries. The entire period has been one of growing freedom in trade and stability of exchange rates. In the course of these developments gold reserves have been redistributed, involving movement of \$7 billion in gold from the United States, largely to Europe, and roughly in accordance with the magnitude of redistribution considered by most financial observers earlier in the period to be a desirable correction of unhealthy concentration of gold in the United States.

In the course of this net \$26 billion outpouring of dollars occasioned by defense, aid, and investment commitments, there has occurred a growth of foreign dollar holdings in the United States from \$8 billion at the end of 1947 to \$27 billion at the end of 1962.

This change in foreign liquid holdings is, of course, an international balance-sheet item, not covered by the income-type accounting reflected in the balance-of-payments statements, but nonetheless of fundamental significance in the interpretations of the course of the "deficit."

Similarly, outside the scope of balance-of-payments accounting is the massive change in the investment position of the United States. The investment outflow from year to year, together with earnings retained abroad, have built up the U.S. private stake abroad from \$15 billion in 1947 to \$60 billion in 1962. If Government investment is added, the total U.S. investment abroad at the end of 1962 amounted to \$80 billion. The broad details of the growth of our investment abroad since 1950 are illustrated in the accompanying diagram and table prepared by the National Industrial Conference Board.

A concept of basic deficit which fails to allow for a growth of foreign claims against the United States resulting from its role as the major world banker and supplier of capital is inadequate and I believe misleading. It is hard to quantify just how rapid a growth of foreign dollar claims might be considered essential to this formative and formidable period of international financial development. A satisfactory expansion of the U.S. capital market and of banking facilities for world use could not have been achieved if dollar credit had been geared merely to the rate of expansion of world trade or even to the volume of estimated international settlement. Even such a standard of a normal volume of expanding foreign claims against us would fail to take adequate account of the structural significance of the United States as a capital center and of the increased use of the U.S. dollar for international reserves and for settlement purposes. But the fact that "normal" expansion of foreign claims is hard to quantify is no reason for ruling it out of a calculation of tenable position. However normal the basic balance of Brookings' analysis might be considered for other countries, it misses the economic centrality of the U.S. role in international finance.

Nor can these international functions be relegated by some arbitrary redefinition of responsibilities to international institutions alone. The distinctiveness of a dollar claim, or for that matter a claim designated in any currency, is that it is legally and economically recognized in the issuing country as a claim against production. In a world of national sovereignties, there is no direct link between intergovernmental authority and production. It should be observed, also, at this point, that the credit instruments of international institutions face formidable barriers in gaining market acceptance.

THE SHORT-TERM PRESSURES

A considerable growth in short-term claims by foreigners against the United States over the last several years would be a normal accompaniment of the growth of the U.S. credit to foreigners. To a large extent such claims reflect merely a translation of that credit into usable funds, as any bank loan is likely to take initially the form of a demand deposit. However, the rate of growth has clearly been more rapid than foreign central banking authorities would have chosen. The restiveness of these and other demand claimants cannot be dispelled by lectures on the economic validity of the claims against us. The pressure is real and stems from the fact that more dollar claims find their way into the hands of central banking channels than the responsible foreign authorities like. There can be little doubt either that U.S. authorities must grow tired of having their plea for short-term accommodation occupy a regularly high position on the agenda of the international financial discussions. The implied position of dollar weakness itself becomes a disturbing factor in the markets, and prejudices the needed growth of dollar-holding habits.

It has been observed by many financial commentators that whatever may be in store for longrun financial considerations, the United States must put its current payments situation in better shape as a simple act of reassurance to foreign dollar holders. Agreement on the sensibility of this observation must be general. However, after the United States has done all that reasonably can be done to reassure

foreign claimants by reduction of the current shortfall of foreign exchange to cover the flow of foreign expenditures, there still remains the fact that an economically appropriate level of foreign dollar claims is likely to be higher than some claimants would choose. It is difficult to imagine an adequate orderly expansion of the international capital market or national payments procedures without a continuing growth in international habituation to the dollar.

THE DEFICIT AS A FACTOR AFFECTING PROJECTIONS

In the context of these somewhat more flexible, but I think realistic, notions of what a tenable basic position is for the United States, it is appropriate to speculate, as the Brookings authors have done, on how some of our major national accounts may develop. In such an exercise the term "balance of payments" may itself prejudice discussion because of a possible implication that any excess of foreign claims must be liquidated in terms other than the dollar banking credits which would be normal in interregional balances encountered domestically. Moreover, a series of projections can hardly take into account the ways in which the state of the balance of payments at any time in the course of the period covered by the projection may itself affect the course of the account—in short, how the adjustment mechanism may alter the course of given accounts.

The intricacies of the internal relationship among balance-of-payments accounts, and the sensitivity of any given major account to the financial limitations implied by the state of the deficit at any given moment need reemphasis. For example, the projection of exports from a level of \$20.2 billion in 1961 to \$31.4 billion (initial assumptions) in 1968 is essentially an illustration of what happens to exports if they develop in accordance with a currently familiar relationship to price and production trends and in accordance with given assumptions about the growth of production and the level of exports prices in relation to competitive production abroad. There are difficulties enough in the assumptions about these general conditions, as the authors recognize. Not so readily recognized, however, is the sensitivity of export growth to the availability of financing. The latter is affected by the net availability of dollars in the hands of foreigners from earnings and through U.S. credit facilities, by the extent to which aid is tied, and by the important residual factor of competitiveness of export prices.

Given a favorable trend in the availability of credit, which in turn depends most importantly on how rapidly the dollar grows as an element of international finance, the sustainable level of exports could conceivably be considerably higher—or, of course, lower. On the whole I would think that foreign population trends in relation to food production suggest very considerable enlargement of our food exports, with financing again being the important limitation.

The export account is an example of a major international income source which is particularly sensitive to the state of the balance-of-payments deficit and its financing. The Brookings projection is interesting primarily as an illustration of a possible trend, provided a continuing current deficit placing net dollars at the disposal of foreigners proves feasible.

The projection of income from foreign investments probably is somewhat less dependent on the state of the deficit, although it does depend on influences that are extremely hard to predict. These include the factors which influence owners of foreign assets in the choice between repatriating income and reinvesting it, and this choice in turn is influenced among other things, by foreign government policy.

INVESTMENT POSITION

The history of the private investment account over the last 10 years exhibits considerable regularity in the outflow of new private direct investment, the growth in the value of U.S. investment abroad, and the flow of repatriated income from it. These trends appear in an accompanying graph. A simple projection of the total investment trends would account in 1968 for a net yield of income (\$6 billion) over new investment outflow (\$3.2 billion) amounting to \$2.8 billion in 1968. The Brookings projections may considerably understate the growth of income from foreign—and particularly recent—investment abroad. Mr. Hal Lary suggested to the committee that the understatement might be in the order of a billion dollars.

It has come to be generally recognized that the factors affecting our foreign investment relationships call for much deeper study than they have as yet received. The National Industrial Conference Board is now in the early phase of a major review of these factors with the cooperation of the investing business communities. These labors will, it is hoped, throw more light on the critical significance of private investment for the balance of payments. But even before having the advantage of this more careful evaluation of the investment process, the broad facts suggest a substantial growth in receipts from the United States' huge stake in foreign production. The heavy investment response of the United States to the rapid advances in foreign—especially European—productive potential since 1957 may imply a marked enlargement of earnings for the country in the period immediately ahead.

Looking again at the tremendous growth in the international position of the United States since 1950 (see summary chart and figures), we find that in the short space of 12 years:

1. U.S. foreign assets have grown from \$31 billion to \$80 billion (long term from \$28 billion to \$69 billion, short term from \$3 billion to \$11 billion).

2. U.S. assets held by foreigners have grown from \$18 billion to \$47 billion (long term from \$8 billion to \$20 billion, short term from \$10 billion to \$27 billion).

3. The net investment position of the United States consequently has grown from \$13 billion to \$33 billion (long term from \$20 billion to \$49 billion against a growth in short-term liabilities from \$7 billion to \$16 billion).

The comment is frequently made, particularly by foreign colleagues, that these broad figures obscure the nature of a shift, unfavorable to the United States, away from "liquidity," and that what really has happened is that the United States has been borrowing short while lending long. On net short-term account the U.S. liability appears from reported figures to have increased from about \$7 billion to \$16

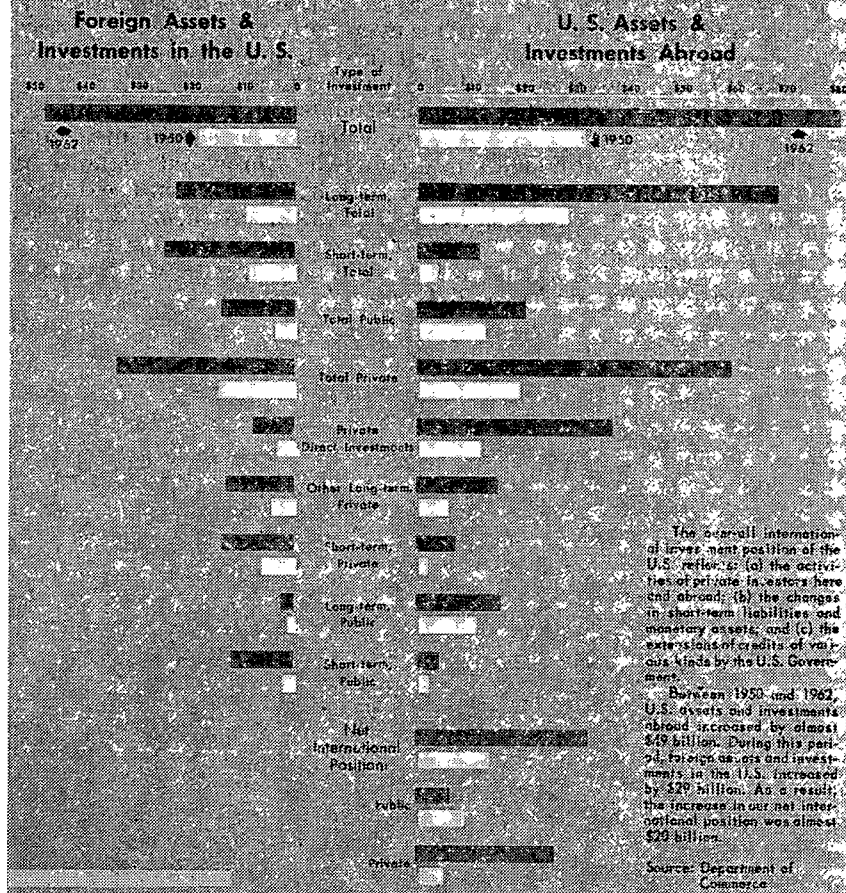
billion. On the face of it this liability does not appear excessive in relationship to the size of the economy (\$600 billion plus) against which it ultimately represents a claim, or more particularly against the investment income stream from abroad (some \$4 billion in 1962) or in terms of the general international banking position of the country.

As has been noted, no amount of argument can dispel the fact that important foreign holders of dollars are reluctant to see their holdings enlarged. But if the U.S. investment and trading position is fundamentally sound, then the most rewarding line of policy is to promote conditions under which dollars are more likely to be held than presented for conversion into something other than production. Current efforts to achieve a better balance in Government accounts should directly reduce the pressure through central banking channels. Foreign liberalization of capital markets and trade policies would contribute a markedly better environment for dollar holding.

There is room to hope that financial trends and the present lines of policy will shortly relieve the pressure which now seems so intractably implied by the current deficit and even by the "improved" balance-of-payments contours projected in the Brookings study. In these terms the Brookings projections suggest not so much a solution to the immediate financial problem or even to the problem that may be presented in the year 1968, but rather a rough program which greater international confidence in the dollar would support.

International Investment Position of the U.S.

Billions of Dollars



The overall international investment position of the U.S. reflects: (a) the activities of private investors here and abroad; (b) the changes in short-term liabilities and monetary assets; and (c) the extensions of credits of various kinds by the U.S. Government.

Between 1950 and 1962, U.S. assets and investments abroad increased by almost \$49 billion. During this period, foreign assets and investments in the U.S. increased by \$29 billion. As a result, the increase in our net international position was almost \$20 billion.

Source: Department of Commerce

International investment position of the United States

[In millions of dollars]

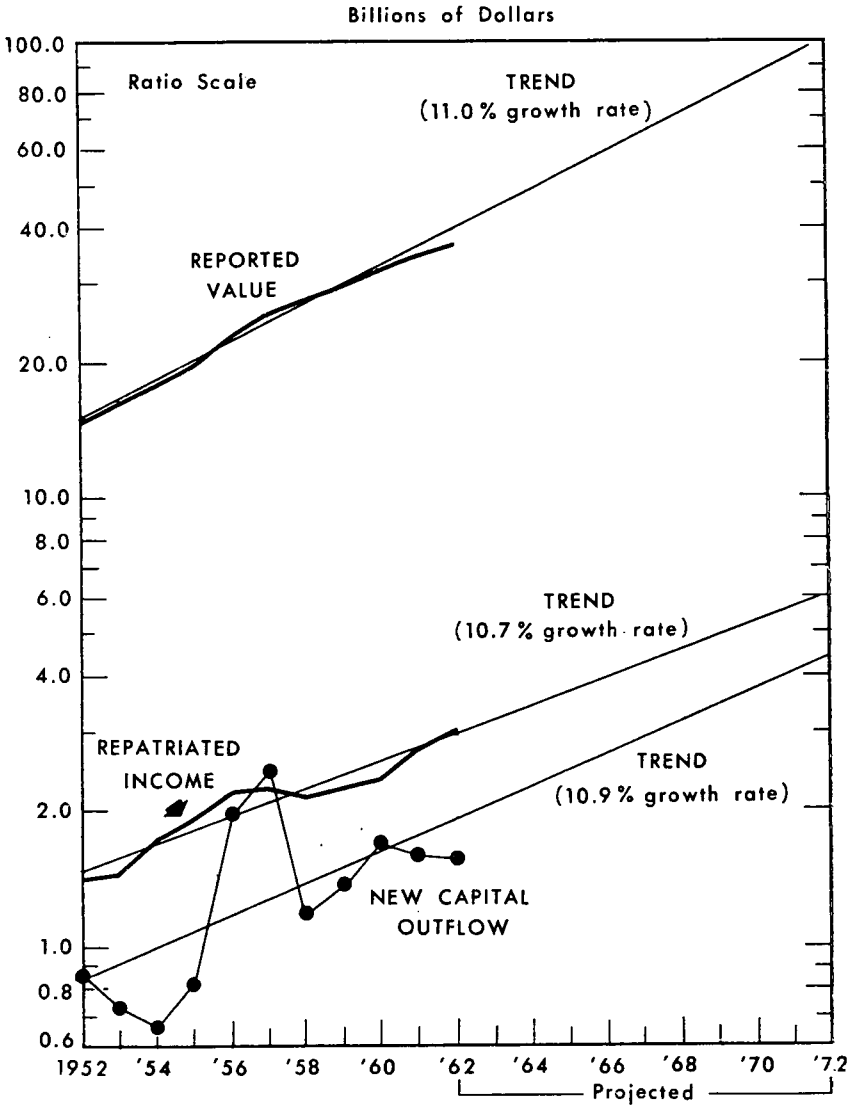
Type of investment	1950	1962 ^{1 2}
U.S. assets and investments abroad, total.....	\$31,539	\$80,126
Private investments.....	19,004	59,810
Long term.....	17,488	52,576
Direct.....	11,788	37,145
Foreign dollar bonds.....	1,692	6,373
Other foreign securities ³	2,641	5,429
Other.....	1,367	3,629
Short-term assets and claims.....	1,516	7,234
Denominated in dollars.....	1,174	6,322
Denominated in foreign currencies.....	342	912
U.S. Government credits and claims.....	12,535	⁴ 20,316
Long term.....	10,768	⁴ 16,040
Foreign currencies and short-term claims.....	322	3,113
International Monetary Fund position and monetary authorities holdings of convertible currencies.....	1,445	1,163
Foreign assets and investments in the United States, total.....	18,407	47,368
Long term.....	7,997	20,201
Direct.....	3,391	7,597
Corporate stocks.....	2,925	10,336
Corporate, State, and municipal bonds.....	181	657
Other.....	1,500	1,611
Short-term assets and U.S. Government obligations.....	10,410	27,167
Private obligations.....	6,477	13,340
U.S. Government obligations.....	3,933	13,827
Long-term marketable issues.....	1,470	2,061
Nonmarketable, medium-term nonconvertible securities.....	-----	251
Short term.....	2,463	11,515
Change in net international position.....	13,132	32,758
Public.....	8,602	6,489
Private.....	4,530	26,269

¹ Preliminary.² Data for Cuba omitted effective 1961.³ Consists primarily of securities payable in foreign currencies, but includes some dollar obligations, including participation in loan made by the International Bank for Reconstruction and Development.⁴ Outstanding amount of U. S. Government long-term credits is raised by \$490 million in 1962 on account of the settlement of postwar aid to Japan, and reduced by \$50 million for other miscellaneous adjustments.

NOTE.—U.S. gold stock, end of 1950, \$22,820 million; end of 1962, \$16,057 million.

Source: Department of Commerce.

U. S. DIRECT INVESTMENTS ABROAD, 1952 - 1962



STATEMENT BY GERALD A. POLLACK

International Economist, Joint Economic Committee,¹ Congress of the United States

I. INTRODUCTION

This statement is addressed exclusively to the Brookings study's analysis of the impact of the European Economic Community (EEC) on U.S. exports of manufactured goods. It examines the argument that the protectiveness of the EEC's common external tariff is measured, not by comparing it with the previous tariffs of the four constituent tariff areas, but by the amount of protection it affords to the dominant low-cost suppliers within the community. Applying this argument, the Brookings study found that "the protective tariff on 75 percent of all manufactured products will be raised by large amounts." And pursuing the argument further, the study concluded that in 1968 U.S. exports of manufactured goods will probably be roughly \$200 million below the level they might have reached in the absence of the tariff changes resulting from the formation of the EEC.

The main question that will be investigated is whether the method used in the Brookings study, or any other manipulation of tariff data, can correctly measure to what extent, if any, the EEC's common external tariff is more protective than the four previous tariffs of the constituent territories.

II. SUMMARY

The discussion concludes that the impact of tariff changes cannot be determined or inferred from the magnitude of such changes taken by themselves. Conditions of supply and demand in each trading country affected must also be taken into account. The impact of the Common Market is thus determined by the interaction of many variables, not just by the tariff changes emphasized in the Brookings study.

The method adopted in the Brookings study especially fails to emphasize the relevant variables. Of the national tariffs which might have been selected for comparison with the common external tariff, surely a poor choice was made—the tariff of the leading EEC exporting country. This tariff is unlikely to have had much economic significance. Only if a tariff keeps out some or all imports can it bring about changes in internal costs, prices, output, employment, consumption, and international trade. But the leading exporting country is so efficient, by definition, that it overcame other country's tariffs and sold in their markets. Under such circumstances, the exporting country would probably not import appreciable amounts of the products it exported even if it had no tariffs. When a country is a leading exporter of a product, it is sheltered against imports of that product primarily by its relatively low costs, not by its tariffs.

¹ This statement reflects the personal views of the author, and not necessarily those of the committee or its individual members.

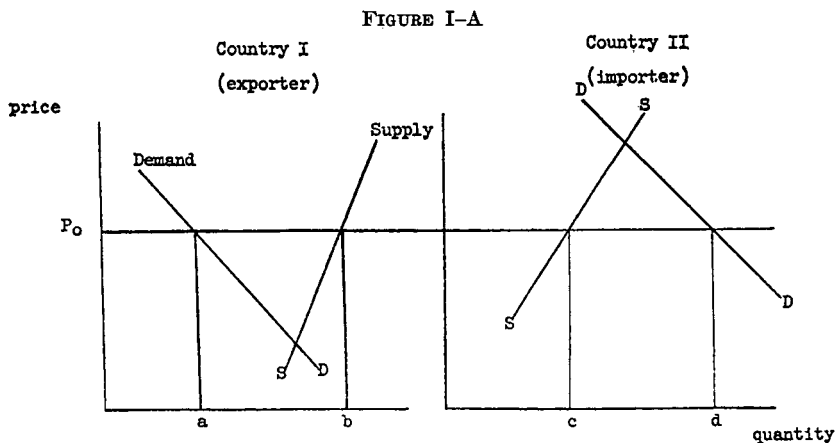
The consequences for the United States of the Common Market may be favorable or unfavorable, depending on supply and demand conditions and tariff levels in every country concerned. If the Common Market, as a whole, is a net exporter to the world at large of products which the United States also exports, the United States will generally benefit in terms of output, employment, and exports, and will rarely, if ever, suffer from the creation of the customs union. But if the Common Market is a net importer of products exported by the United States, its creation may harm or benefit the United States. These alternatives for the United States are consistent in every case with the achievement of substantial benefits from economic integration by the leading exporting country among the EEC members.

In view of these considerations, the Brookings study probably exaggerated the adverse impact of tariff changes resulting from the formation of the Common Market on U.S. exports of manufactured products.

III. THE ECONOMIC CONSEQUENCES OF TARIFFS—TOOLS OF ANALYSIS

Partial equilibrium analysis will help to explore the problem in a systematic, logical way.² The principal elements of such an analysis are best highlighted by considering a two-country case and one product, and abstracting from transportation costs. Our basic assumption is that price increases in each country stimulate production but discourage consumption.

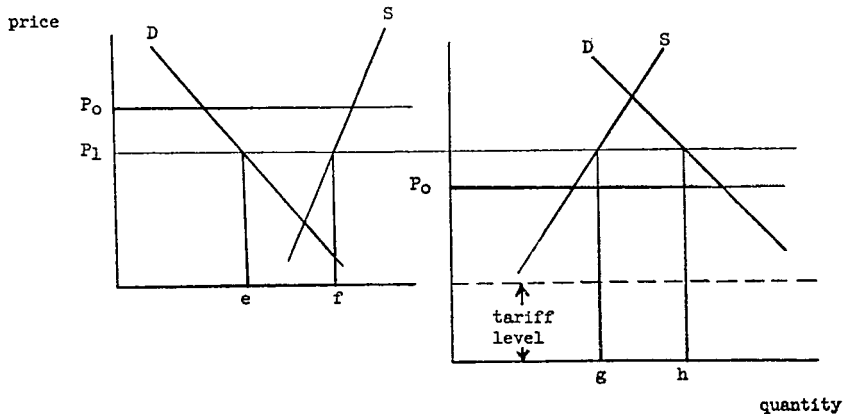
If the international trade in a particular product is considered without duties, the equilibrium position for the two nations is illustrated in figure I-A. At P_0 , total demand equals total supply of the product. In terms of the two national markets, the excess demand of the importing country is exactly counterbalanced by the excess supply of the exporting country. Country I is a net exporter of the quantity ab , and country II is a net importer of the quantity cd . Equilibrium requires that $ab = cd$.



²This discussion is indebted to Gottfried von Haberler, "The Theory of International Trade," (London: William Hodge & Co., Ltd., 1956), pp. 227-234.

The imposition of a duty alters the equilibrium. The new situation may be represented as a shift upward of the system of functions of the exporting country relative to that of the importing country (see figure I-B). The duty raises the apparent level of prices in the exporting country as seen by the importing country, but

FIGURE I-B



does not alter the relation between supply and demand functions in the exporting country. After a tariff is imposed by the importing country, a new equilibrium is reached when, once again, imports equal exports, i.e., $ef = gh$. Under the new circumstances, however, the volume of trade is less, and prices differ in the importing and exporting countries by exactly the amount of the duty; the new price is P_1 in country I and P_1 plus the tariff in country II. As is shown by the diagram, the new equilibrium is also characterized by lower prices and production, and higher consumption in the exporting country than before, and by opposite changes in the importing country. When duties are eliminated or reduced, the effects in the two countries are, of course, the opposite of those which occur when duties are imposed or increased.

The Brookings study refers to levels of protection in its discussion and uses this concept as a measure of injury to non-EEC exporting countries. We can see in figure I-B that the country imposing the tariff enjoys, at the new equilibrium, a level of protection equal to the tariff rate. But this in itself is not particularly useful economic information. Unless a tariff is prohibitive, the price of a product must differ in the importing and exporting countries by the amount of the tariff—abstracting for present purposes from transportation costs and other expenses peculiar to international trade. It is more important to observe that the disparity in prices in the two countries resulting from the imposition of a tariff is the joint result of a price increase in the importing country and a price decline in the exporting country. Depending on the slopes of the supply and demand functions, the price decline in the exporting country will range from zero to the full amount of the tariff, and will usually be at some intermediate level.

In general, when the importing country imposes or increases its

tariff on a product, other things being equal, the exporting country's price will fall more, output, exports, and employment will fall less, and domestic consumption will expand more, the steeper the slope of its supply function; and, other things being equal, the exporting country's price, output, exports, and employment will fall more, and domestic consumption increase less, the steeper the slope of its demand function. These conclusions follow directly from the conditions of equilibrium, that prices in the two countries must differ by the amount of the tariff, and that the new level of imports must equal the new level of exports.

These observations are useful because they illustrate that a given amount of protection in the importing country is consistent with a broad range of consequences in the exporting country. If the slopes of the demand and supply functions in the exporting country approach the horizontal and vertical, respectively, the tendency for that country's price to fall, after the other country's imposition of a duty, will greatly stimulate domestic consumption, which will cushion the price decline, and significant cutbacks in domestic output and employment will be prevented. In this case, protection to the importing country would not be particularly injurious to the exporting country. On the other hand, if the slopes of the demand and supply functions of the exporting country approach the vertical and horizontal, respectively, the domestic price will not fall significantly, but output, exports, and employment will be severely curtailed, while consumption will not be appreciably stimulated. In this case, the importing country's imposition of a tariff will have seriously injurious consequences for its trading partner. These considerations point to the need, when evaluating the effects of tariffs, of going beyond the level of protection to the consequences of that protection on prices, output, employment, consumption, and exports.

IV. LIMITATIONS OF PARTIAL EQUILIBRIUM ANALYSIS

Before proceeding further with the application of partial equilibrium analysis to the problem of the United States vis-a-vis the Common Market, certain limitations of such analysis should be pointed out. First, the analysis assumes perfect competition. In the absence of such competition, individual producers could affect the market price by increasing or decreasing their output, and would take this market power into account in deciding on their scale of operations. Supply would then be a function of demand, and it would not be possible to draw a supply function showing simply the relation between quantities offered and market prices. Second, the analysis assumes that supply and demand curves are independent of each other, and functions only of price. Actually these curves are also functions of income and wealth, and the distribution of these variables in the community. Changes in tariffs are likely to bring about changes in these and other relevant variables, through their effects on the Government and private sectors, which may cause the supply and demand functions to shift in relation to each other and to the axes. This consideration is particularly important in analyzing the consequences of the formation of customs unions, where large and widespread tariff adjustments are made.

Third, the analysis suggests that countries either import or export a given product, but do not do both. This follows from the observa-

tion that the importing country's price exceeds the exporting country's price by the amount of the tariff. The protected producers in the importing country could therefore not find buyers in the exporting country at prices as high as those prevailing in the importing country. But this abstracts from transportation costs, spatial considerations, and time. When trading nations have contiguous boundaries, residents in the net exporting country living close to a common boundary might find it cheaper to buy from close-by foreign suppliers than more-distant domestic sources, despite a tariff, even if the domestic sources quoted lower f.o.b. prices. And seasonal factors may cause a country to import agricultural products during certain times of the year although, during the course of an entire year, that country might be a net exporter of the particular products. While partial equilibrium analysis suggests that a country's tariff on a product has no consequences of any sort if it is a net exporter of that product, these considerations indicate that such a tariff may have some effects on domestic prices, production, employment, imports, and consumption. Of course, it remains true as a general proposition that tariffs which raise a country's prices above world levels make it more difficult for that country to sell abroad.

Despite these qualifications, partial equilibrium analysis offers a useful tool of analysis for the problem at hand. Speaking of partial equilibrium analysis in another connection, Professor Viner noted:

* * * it rests on assumptions of the *caeteris paribus* order which posit independence where in fact there is some degree of dependence. For such logically invalid assumptions there is the pragmatic defense that they permit a more detailed analysis of certain phases of economic interdependence than would be possible in their absence, and that to the extent that they are fictions uncompensated by counterbalancing fictions, it is reasonable to believe that the errors in the results obtained will be almost invariably quantitative rather than qualitative in character, and will generally be even quantitatively of minor importance.³

V. THE UNITED STATES AND THE COMMON MARKET

We turn now to the situation of the United States vis-a-vis the Common Market. The outcome for the United States with respect to any product we export will depend largely on whether or not the EEC, after the full consequences of union have been realized, is a net importer or exporter of the product concerned. These two alternative situations will be discussed separately.

A. The effects of the Common Market on the United States if the Market is a net importer

We will consider four different cost situations under this heading.

1. Increasing costs in all countries considered as output expands—with the United States harmed by the emergence of a common external tariff;
2. Increasing costs in all countries considered as output expands—with the United States benefiting from the emergence of the common external tariff;
3. Constant costs in the dominant EEC exporting country; and
4. Declining costs in the dominant EEC exporting country.

³Jacob Viner, "The Long View and the Short," (Glencoe, Ill.: The Free Press, 1958), p. 51.

The Brookings study addressed itself exclusively to the third of these situations. But it is probably more typical for costs to rise as output expands than for them to remain constant.⁴

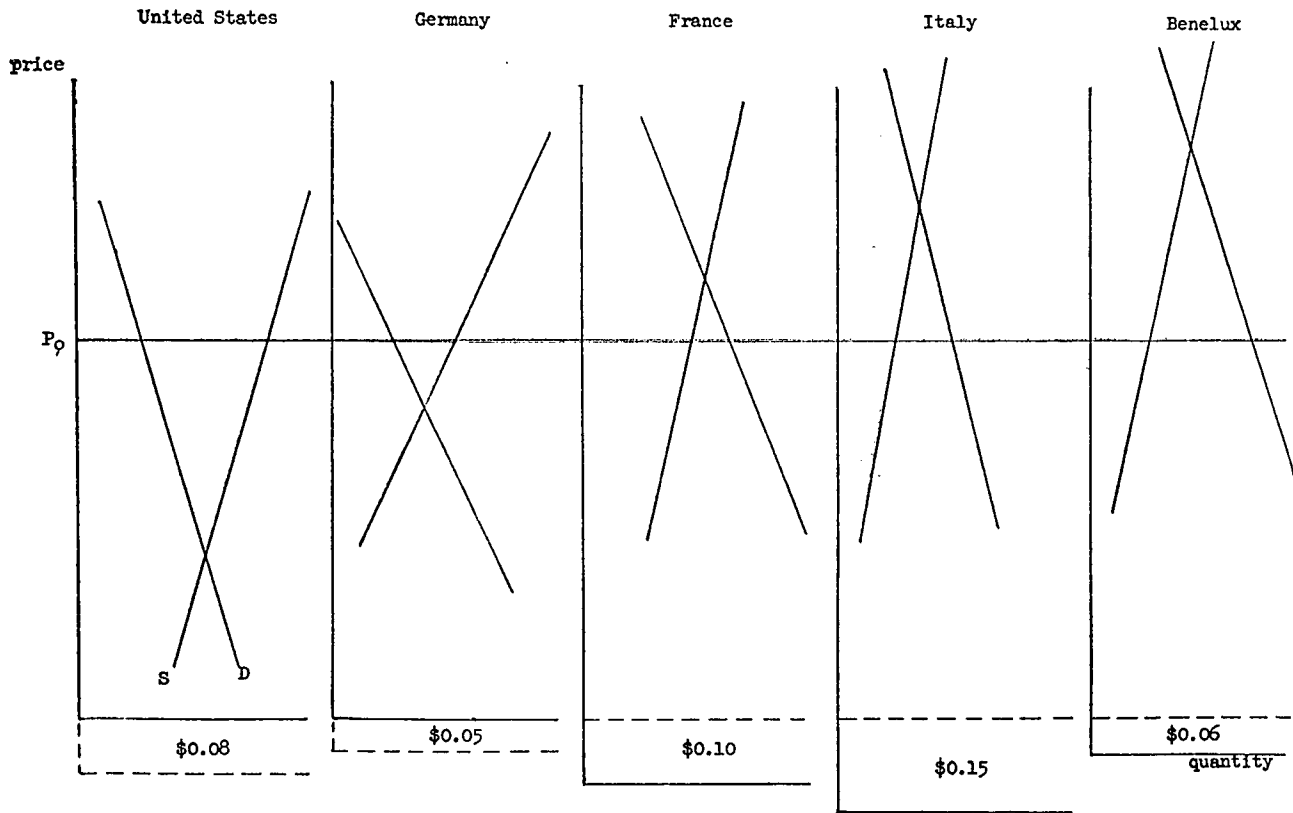
In each case, we assume, in addition to the general assumptions already described, that: (1) production takes place in each of the constituent territories, at least initially; thus all tariffs are protective and none serve exclusively to generate revenues; (2) Germany is the dominant low-cost supplier of the EEC; (3) only the United States and Germany are net exporters to the other countries; and (4) the entire trading world consists of the United States and the EEC countries; this assumption is helpful in preventing an analysis which is already complicated from becoming even more so. But the assumption has substantive consequences which should be recognized at the outset. If the EEC is a net importer, inclusion in the analysis of trading countries other than those considered would require us to modify our conclusions only as to the degree of change in the relevant variables, not as to the direction or kind of change. But if the EEC is a net exporter, the existence of additional non-EEC importing countries introduces qualitative as well as quantitative complications which will be examined later. Our assumption that the United States is the only non-EEC exporting country requires no important change in our conclusions. All non-EEC exporting countries will be affected in the same general manner by the EEC's discrimination. Additional exporting countries can be accommodated in the analytical framework of this paper by grouping them with the United States, and reading "United States and other exporters" wherever "United States" is used in the text. Conclusions for the United States then apply to all exporters.

1. *Increasing costs in all countries considered as output expands—With the United States harmed by the emergence of a common external tariff.*—Suppose that the national tariffs of the various countries with respect to a certain product are as follows: United States, 8 cents; Germany, 5 cents; France, 10 cents; Italy, 15 cents; and Benelux, 6 cents.

The situation before the move to a common external tariff is shown in figure II-A. Domestic prices in the importing areas, France, Italy, and Benelux, are measured relative to the horizontal axes applicable to each. In figure II-A, these axes are appropriately displaced to reflect the tariffs in each area, as is indicated by the vertical difference between the level of the importing countries' horizontal axes and the dashed line indicating the reference level determined by the exporting countries. Figure II-A thus shows that prices in the importing areas differ from those in the exporting countries by the amounts of their respective tariffs. The tariffs of the United States and Germany in this example do not affect costs, production, and prices in these countries, since neither imports the product under consideration, and each must surmount, on an equal footing, the tariffs of the importing areas. Domestic prices in the United States and Germany of the product traded are consequently identical, despite different tariffs in the two countries on the product in question. That the exporting countries' tariffs lack economic significance is indicated

⁴ See Professor Viner's "Supplementary Note to 'Cost Curves and Supply Curves,'" *ibid.*, pp. 79-84 and the discussion in his "The Customs Union Issue," (New York: Carnegie Endowment for International Peace, 1950), pp. 46-47.

FIGURE II-A



in figure II-A by showing the existence of these tariffs with dashed lines.

The situation after the move to a common external tariff is shown in figure II-B. The common external tariff is the unweighted average of the rates previously existing in the four tariff areas, or \$0.09.⁵ The axes of all four Common Market areas are displaced vertically relative to those of the United States by the amount of the new tariff. German producers are now on an equal footing with producers in the other three EEC countries, with internal tariffs eliminated in the entire Common Market area, and the United States, alone, remains at a tariff disadvantage. At the new equilibrium, United States and German exports to France, Italy, and the Benelux countries equal the imports of the latter, and domestic prices are equal in all Common Market areas and higher than the U.S. price by the amount of the tariff. In the particular case under review, the move to a common tariff results, as compared with the initial situation, in higher prices in Germany and the Benelux countries, and lower prices in the United States, France, and Italy; German exports are higher and U.S. exports lower than before, while imports by France and Italy are higher and imports by the Benelux countries are lower.

While Germany has been the principal beneficiary of the change in terms of higher prices, output, employment, and exports, the burden of adjustment has not fallen exclusively on the United States. In our example, France and Italy are also worse off than before.

The outcome in our example depended on the shapes of the 5 pairs of supply and demand functions, and on the relationships between the separate national tariffs of the EEC countries, on the one hand, and the common external tariff which supplanted them, on the other. Different solutions would result if these variables were changed.

2. *Increasing costs in all countries considered as output expands—with the United States benefiting from the emergence of the common external tariff.*—In this case, the national tariffs of the respective countries applying to a particular product are assumed to be—United States, 6 cents; Germany, 4 cents; France, 10 cents; Italy, 20 cents; and Benelux, 14 cents.

Figure III-A shows the situation before the move to a common external tariff, and figure III-B, the situation after, when the common external tariff is \$0.12 per unit. Here Germany is again the principal beneficiary of the change, but the United States also benefits. Our producers receive higher prices, and enjoy higher levels of production and exports than before. This situation results, essentially, from a decrease in the tariffs of the importing countries which brings about large net increases in demand and decreases in domestic production in these countries, while Germany's surplus of domestic production over consumption expands relatively slowly with rising prices. Thus the new equilibrium requires higher U.S. exports and prices. The particularly noteworthy aspect of this situation is that the leading EEC exporting country enjoys a price increase greater

⁵ We are abstracting in this example, and in the ones that follow, from the fact that the EEC countries are moving their national tariffs applicable to imports from non-EEC sources on most manufactured goods not to the unweighted average of duties existing on Jan. 1, 1957, but to this average less 20 percent.

FIGURE II-B

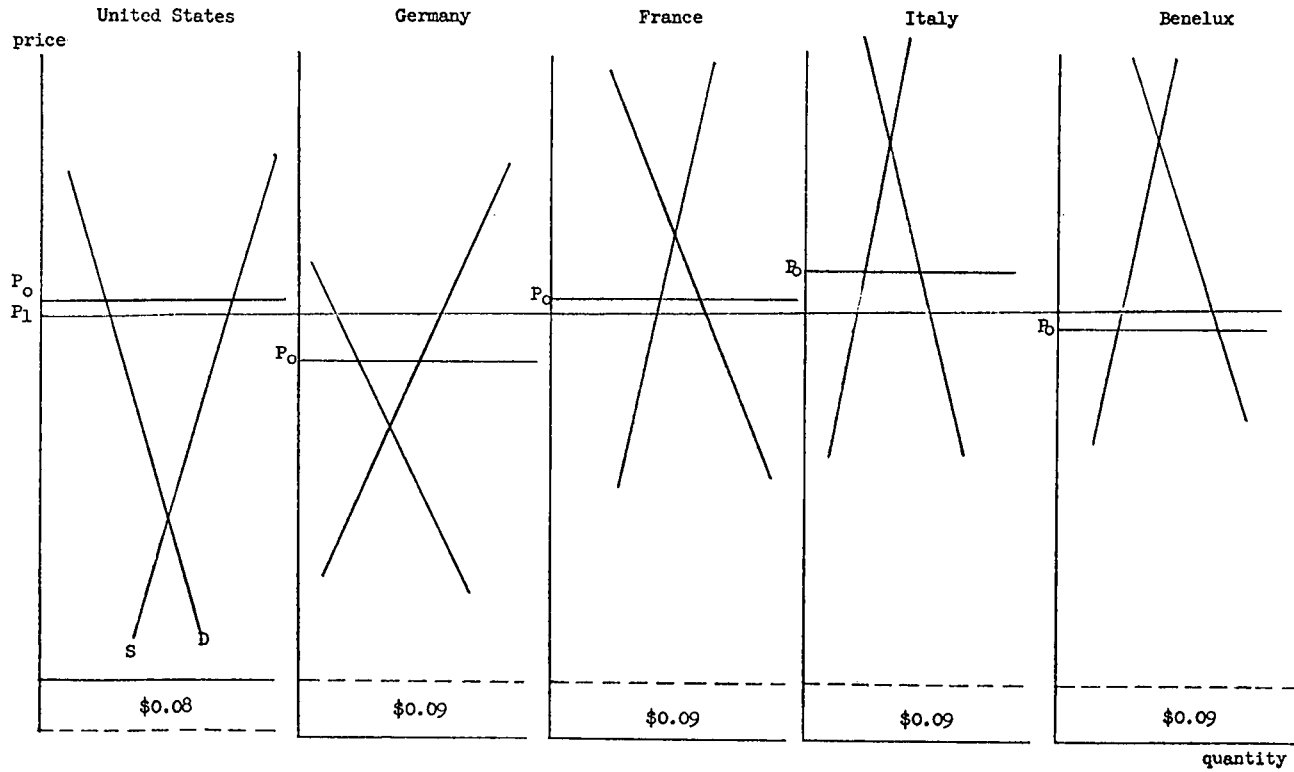


FIGURE III-A

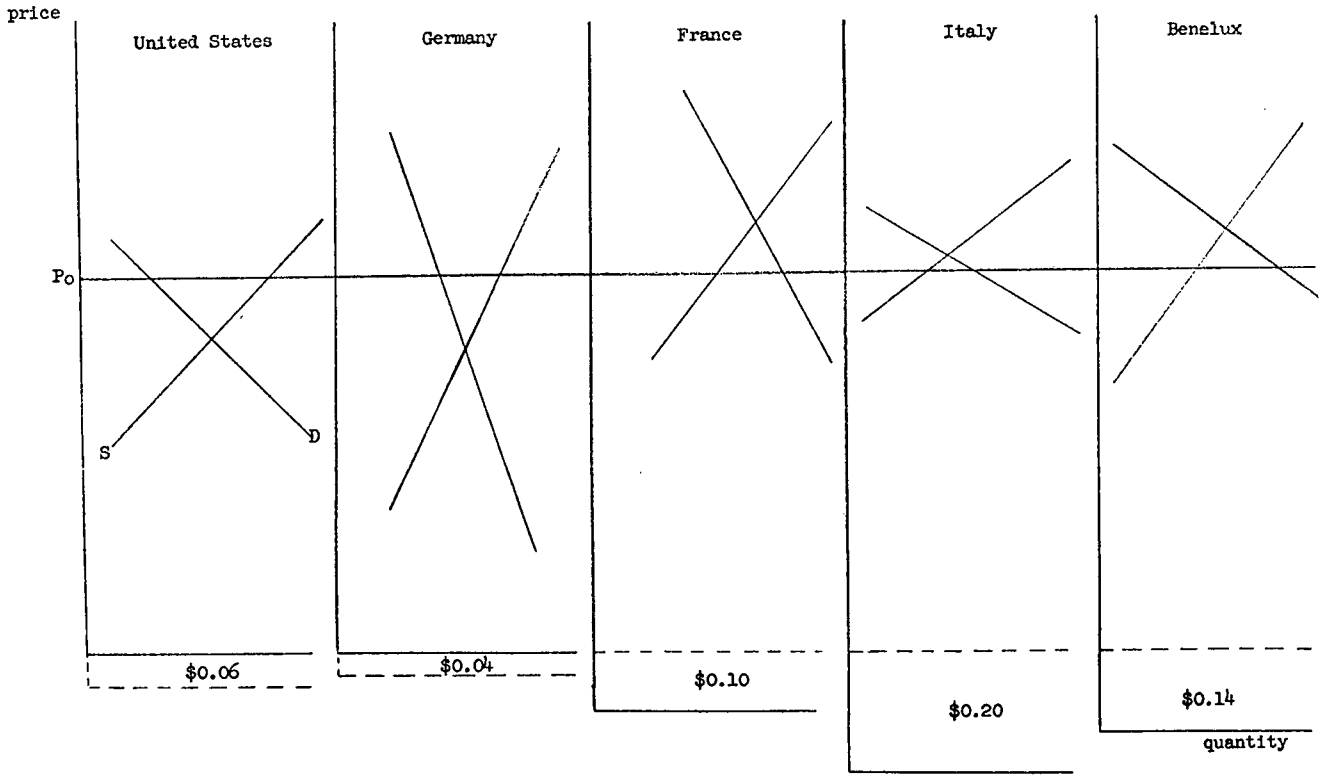
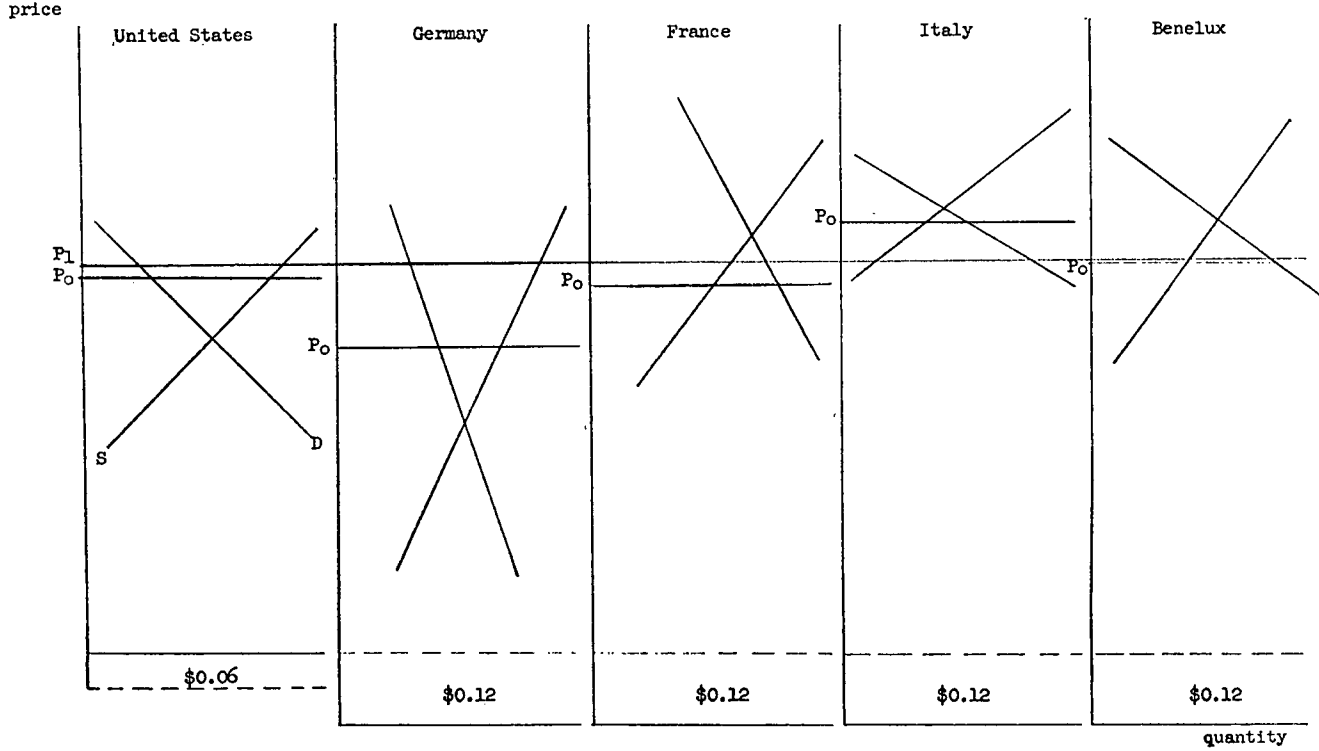


FIGURE III-B



than the amount of the common external tariff. It gains protection substantially exceeding the measure suggested by the Brookings study—the difference between its former national tariff and the new common external tariff. Yet the United States also enjoys an increase in prices, output, employment, and exports.

Further consideration of the circumstances which permit the United States to gain from the Common Market reveals that such gain requires, with respect to tariff changes, only that the new common tariff be below the former national tariff of one of the constituent territories. So long as even one country must lower its tariff to adjust to the new common tariff, the possibility exists that the tendency of prices to fall in that country as its tariff is reduced will lead to such increases in its consumption and decreases in its production as require higher output and exports by the United States, if a new world equilibrium is to be reached. In this situation, the requirement that the tariff of at least one country fall is, of course, a necessary but not sufficient condition for the United States to gain from the establishment of the common external tariff.

This possibility indicates that the United States could gain, in some circumstances, even if the new common external tariff were higher than the unweighted average of the tariffs of the four constituent EEC territories. Indeed, the possibility of gain for the United States would exist even if the new tariff were set at a level nearly as high as the highest national tariff among the EEC members. Under such circumstances, of course, gain for the United States, while possible in theory, would be improbable in practice. In general, gains to the United States are greater, and losses smaller, the lower the new common external tariff.

Under increasing cost conditions, which situation is more likely to be typical—a gain or loss for the United States? We have no way of being certain. The analysis in this memorandum identifies the relevant variables—the supply and demand functions of the various countries and their respective tariff levels. It suggests that our situation would have to be examined with respect to individual commodities before we could determine the balance of advantage or loss as a result of the Common Market's formation.

3. *Constant costs in the dominant EEC exporting country.*—This is the special case discussed in the Brookings study. In the illustrative example used below, the following initial national tariff rates are assumed: United States, 8 cents; Germany, 4 cents; France, 12 cents; Italy, 14 cents; and Benelux, 6 cents.

The pre-EEC situation is depicted in figure IV-A, and the situation resulting from the adoption of a common external tariff of \$0.09 is shown in figure IV-B.

Unlike the other cases discussed earlier, there is in these circumstances no possibility for the United States to gain when a common external tariff is adopted. Germany receives no price advantage from being included in the common tariff area, but its output, employment, and exports increase substantially. In the United States, if exports are to continue, the price must fall by the entire amount of the common tariff. This will generally entail declines in output, employ-

ment, and exports. It might be, however, as is shown in figures IV-A and IV-B, that domestic supply and demand conditions in the United States would be such as to keep the domestic price from falling by the full amount of the tariff. If that were the case, the United States would cease to be an exporter of the particular product concerned.

The Brookings study did not recognize that the existence of constant costs in the leading EEC exporting country generally rules out any increase, as a result of tariff changes occurring during economic integration, in the price, including the tariff, of U.S. exports within the Common Market. If U.S. exports to the EEC are to continue, such constant cost conditions usually require the domestic U.S. price to fall by the full amount of the common external tariff. Given its assumption of constant costs in the leading EEC exporting country, the Brookings study erred in assuming that the U.S. price in the EEC would rise, and that this price increase would be the cause of reduced U.S. exports. Indeed, the Brookings study based its estimates of reduced U.S. exports on the assumption, stated on page 104 of the study, that U.S. export prices would rise by the full amount of the "effective tariff increase (if applicable)"—the quotation apparently referring to the difference between the leading EEC exporting country's former national tariff and the new common external tariff.

While the Brookings study explicitly assumed constant costs only for the dominant EEC exporting country, the analysis can accommodate constant costs in one or more of the other countries. If constant costs prevail everywhere and domestic production occurs in each territory before the move to a common tariff, the level of international trade is not defined by the partial equilibrium analysis being used, without further assumptions. The United States and Germany must initially have identical costs if they are to compete in the markets of the others. Costs in the importing countries will be higher than those in the exporting countries by the amounts of the importing countries' respective tariffs. Since, by definition, constant cost industries are capable of supplying an unlimited quantity at the same price, and we are abstracting from transportation costs, it is not clear how much of the importing countries' consumption is supplied through imports instead of domestic production, or how much of total exports is supplied by each of the exporting countries.

But when the EEC countries adopt a common tariff, the United States must lose its entire export market, and the domestic producers in each of the importing countries will all be forced out of business. Germany, now included in the duty-free internal EEC market, can undersell the producers of the other EEC countries at all levels of output; and the United States cannot compete for export sales because its products, which cost as much as Germany's to produce, must pay a tariff from which German production is exempt.

Regardless of the behavior of costs in the importing countries as output expands, if the United States and Germany had constant costs and both exported to the others before the common external tariff was adopted, the creation of a duty-free internal EEC market would result in the complete, or nearly complete, loss of whatever American sales previously took place. Moreover, the United States could prevent this development only by bargaining down the common external tariff to

FIGURE IV-A

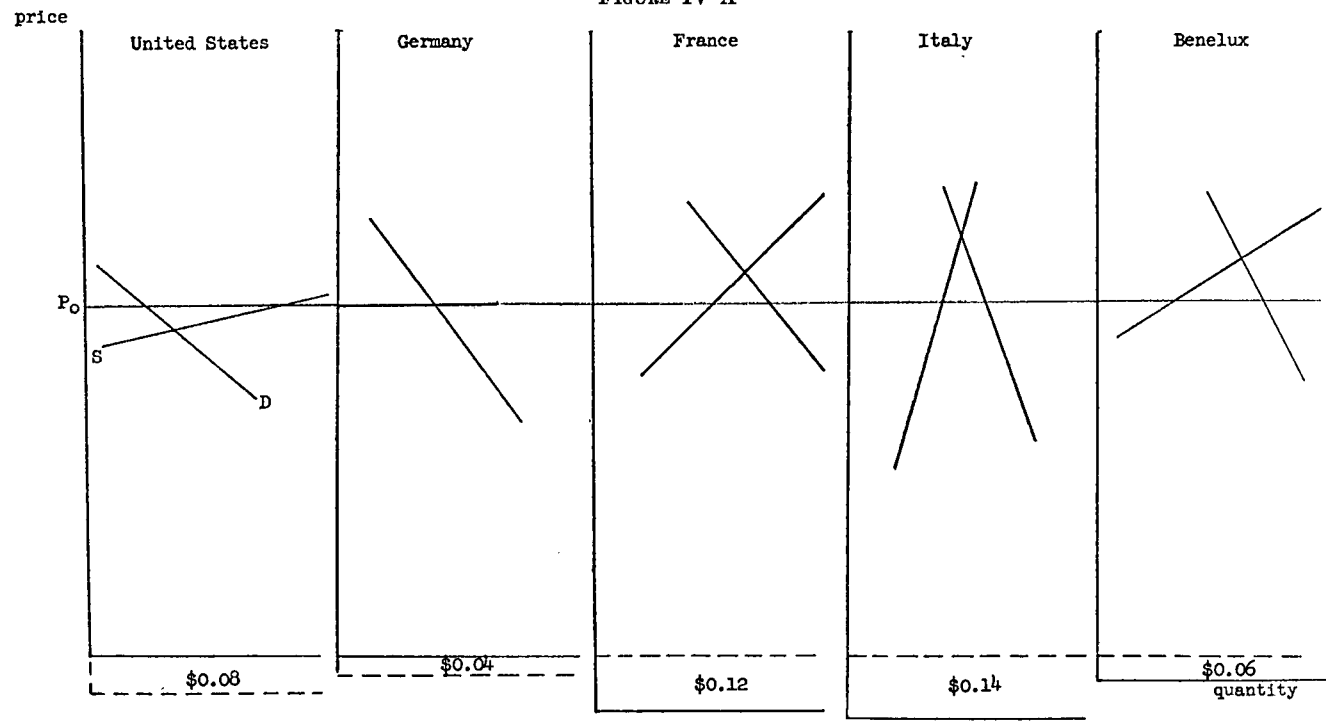
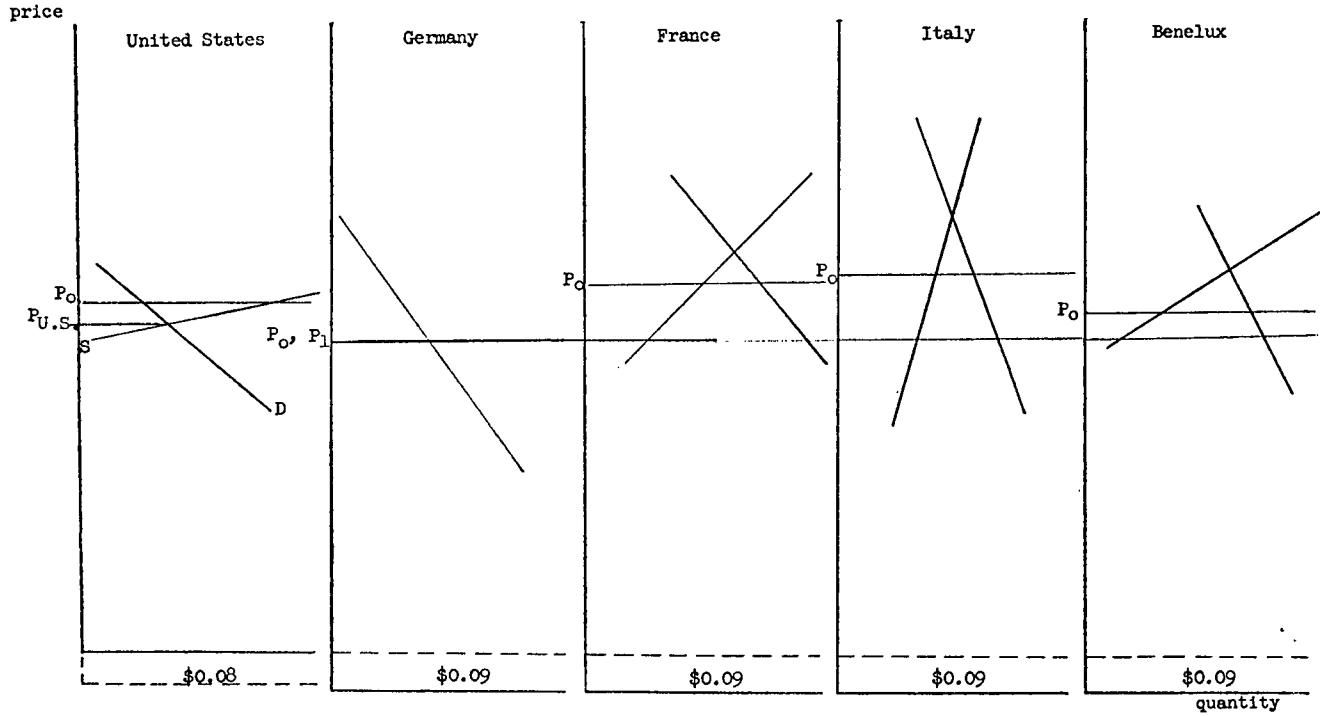


FIGURE IV-B



zero, because, so long as any duties at all remained from which German goods were exempt, such goods would enjoy a cost advantage within the Common Market over the comparable U.S. products.

4. *Declining costs in the dominant EEC exporting country.*⁶—It would be interesting to go beyond the Brookings study's analysis to consider the consequences if the dominant EEC exporting country enjoyed declining average costs as output expanded. Partial equilibrium analysis suggests that such cost conditions would not be consistent with the achievement of a new equilibrium, at least within the EEC. To fit within the framework of our analysis, declining long-run average costs as output expanded would have to be based on net external rather than internal economies of scale; otherwise individual firms would grow so large that competition would be impaired. If this occurred, the supply functions necessary for the analysis could no longer be derived, since they assume that no single producer's output is large enough relative to the entire market to affect the price.

When the common external tariff became effective, the dominant EEC exporting country would experience an increase in the demand for its products. Its firms would enjoy increased profits, and new firms would be attracted into the industries affected. The growth of such industries through enlargement of the number of firms would, if there were net external economies of size, result in lower costs for each firm. The accompanying industrial growth would put downward pressure on prices. But as prices fell within the Common Market, consumers would expand their purchases, while producers in the other EEC countries, by assumption not enjoying decreasing cost conditions, would curtail their output. As a consequence of these developments, the amount demanded as prices declined would increase more rapidly than output in the falling-cost country, thus further increasing the profitability of existing firms and intensifying the incentives for new firms to enter the industry. This process would feed on itself, accentuating the disequilibrium, until at some point costs in the declining-cost country ceased to fall further and turned up.

In this situation, given our assumption that the trading world is limited to the United States and the EEC, the United States would cease to be an exporter to the EEC, and the domestic price would fall to a level that could be sustained by domestic demand alone.

B. The effects of the Common Market on the United States if the market is a net exporter to the rest of the world

The preceding analysis has shown that, where the Common Market is a net importer of a product which the U.S. exports, the United States may either gain or lose as a result of the Common Market. Where the Common Market is a net exporter, the United States will almost always gain, and will rarely, if ever, suffer.

Suppose that, as in our former illustrations, Germany is a net exporter and France, Italy, and the Benelux countries are net importers. Suppose further that Germany's net exports before the customs union exceeded the net imports of the other EEC countries, and that Germany and the United States were net exporters to the rest of the world. With the elimination of internal tariffs within the customs

⁶ I have benefited, in preparing this section, from conversations with Mr. Sterie T. Beza of the International Monetary Fund.

union, the EEC's demand for Germany's product would rise, thus tending to raise Germany's price level. This would result, as was shown in the earlier illustrations, from the tendency of prices to fall in the importing EEC countries when their internal tariffs were eliminated; this price decline would discourage production, stimulate consumption, and thus increase the demand for Germany's goods.

If Germany wished to supply not only the entire import requirements of the Common Market countries but also some of the import needs of the rest of the world, her products could not sell at higher prices in the markets of the rest of the world than were being charged for the same goods of the United States and other exporting countries. Therefore, as a result of competition, and assuming the absence of domestic subsidies, transportation costs, etc., the internal price level for the relevant products within the EEC would be the same as in the non-EEC exporting countries. Consequently, where the Common Market as a whole is a net exporter of a product, its new tariff applicable to that product has little or no economic significance, and the individual EEC members who are net importers lose the benefit of whatever protection they enjoyed before the union. However, a general increase in world prices would be likely if Germany remained a world exporter, because the expansion of intra-EEC demand for Germany's products, resulting from the elimination of internal duties, would cause total world demand for the affected products to increase relative to supply. Unless German producers operated under constant cost conditions, the new equilibrium would have the following characteristics:

(1) Prices would be lower than before in France, Italy, and the Benelux countries, and higher in the United States, Germany, and the rest of the world.

(2) Domestic prices of the products concerned would be identical in the United States and all Common Market countries: but the United States could not sell to the EEC because its products would have to pay a tariff from which Germany is exempt.

(3) In industries producing the relevant products, output and employment would decrease in France, Italy, and the Benelux countries, and increase in the United States, Germany, and the rest of the world.

(4) U.S. exports would increase in absolute terms and as a percentage of world markets outside the EEC.

If German producers operated under constant cost conditions and exported to the rest of the world, and increasing cost conditions prevailed in the other countries concerned, the creation of the EEC would have no effect on output, employment, prices, and the volume of international trade outside the Common Market. In this case, the United States would receive no benefit, but it would be no worse off than before.

VI. CONCLUSIONS

Examination of tariff changes alone can never provide an adequate basis for judging the economic consequences of such changes. To be sure, there is a presumption that tariff reductions by importing countries benefit exporting countries, and conversely. But a given tariff change will have different effects on output, employment, prices,

consumption, and international trade in the importing and exporting countries depending on supply and demand conditions in all countries concerned. The effects of the multiple tariff changes associated with the formation of a customs union are particularly complicated. There is no ready short-cut or rule-of-thumb method for measuring them. The impact of the EEC on the United States cannot be evaluated unless supply and demand conditions in the various countries affected, as well as the changes in tariffs, are taken into account.

The analysis has shown that, depending on supply and demand conditions, the United States may gain or lose as a result of the Common Market's move toward a common external tariff and its elimination of internal duties. If the leading EEC exporting country enjoys constant costs when output increases, as is assumed in the Brookings study, the United States will generally be injured as a result of the Common Market. However, the nature and extent of such injury is not correctly described in the Brookings study. Moreover, constant cost conditions are probably not typical for the Common Market countries, or for the leading EEC exporting country. Increasing cost conditions, which must be supposed to prevail at least to some degree, offer the United States the possibility of expanding exports to the Common Market, despite tariff discrimination. Failure to recognize this possibility and to offset estimated export gains against losses resulted in a downward bias in the Brookings study projection of U.S. exports. On the other hand, errors of conception in estimating export losses may have resulted either in an upward or a downward bias in the export projection. We could not say with certainty whether, as a result of these considerations, upward or downward biases predominated. But if increasing cost conditions exist to an appreciable extent, the Brookings study probably took an overly pessimistic view of the effect on prospective U.S. exports of manufactured products of tariff changes resulting from the formation of the Common Market.

STATEMENT BY JACK C. ROTHWELL

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The task assigned the Brookings group was that of projecting the U.S. balance of payments to the year 1968. The difficulty of such a charge is, of course, substantial. It is hard enough to predict the course of our own economy (one remembers the sanguine forecasts of the soaring sixties) much less the future of our economy, those of the other principal industrial nations of the world, and the international trade and financial transactions that will result from and interact with the course of domestic events.

In spite of the inherent difficulties, the Brookings group forged ahead to give us an educated guess of what the surplus or deficit will be in 1968 and what forces will propel it there. The group chose to project the "basic deficit," thus excluding a forecast of flows of private short-term capital, commercial credits, and errors and omissions. The result ranged from a projected surplus of \$1.9 billion to a deficit of \$600 million.

The Brookings projections are, of course, no better than the assumptions and statistical methods underlying them. I shall direct my comments, as requested, primarily at these considerations rather than at the policy recommendations of the study.

DETERIORATION IN WESTERN EUROPE'S COMPETITIVE POSITION

The major reason for the projected improvement in the basic balance of payments of the United States is a substantial increase in our export surplus on goods and services account (an increase of \$4.1 billion under the initial set of assumptions and \$1.7 billion under the alternative assumptions). The principal reason for the projected increase in our export surplus is an improvement in our competitive position vis-a-vis Western Europe as noted in the table below.

Projected changes in selected price indices, 1961-62

[In percent]

ASSUMPTION NO. 1		
	Western Europe	United States
GNP deflator.....	+20	+11
Export prices.....	+11	+4
ASSUMPTION NO. 2		
	Western Europe	United States
GNP deflator.....	+11	+11
Export prices.....	+7	+4

¹ The views expressed herein are those of the author. They do not necessarily represent the thinking of officials within the Federal Reserve Bank of Philadelphia.

The improvement in our competitive position is expected to occur primarily because of differences in the growth of the labor supply in the United States and Western Europe. The growth of the labor force is expected to decline in Western Europe and the workweek is expected to fall. In the United States, the labor force is underemployed to begin with and growth in the labor force is likely to accelerate.

The Brookings report assumes that the tight labor market in Western Europe will cause a substantial increase in wages and in labor costs per unit of output, more than double the average annual rise in the United States. Combined with substantial aggregate demand, this cost pressure is expected to result in a substantial rise in prices.

The report assumes that Western European governments will allow price increases to occur because "political pressures and strong commitments to full employment policies will prevent Western European governments from making significant sacrifices in the form of unemployment to avoid increases in the general price level."

This price-trade assumption is perhaps the most heroic and certainly the most crucial one in the Brookings report. As such, it deserves special attention.

I would certainly agree with the authors that the tinder for an inflationary wage-price spiral is present in Western Europe. Limited growth in the labor force and demands for a shorter workweek should exert upward pressures on costs. I would also agree that pressure for higher money wages is likely to come from both labor and management, labor hoping to gain a greater share of the national income and management finding it necessary to bid for a limited supply of workers during a period of rising aggregate demand. I would agree, finally, that governmental measures to control wage hikes might be circumvented in part by upgrading of job classifications and the like.

Yet for several reasons I should be surprised to see these cost pressures affect prices and trade to the extent suggested in the Brookings report. First of all, the political leadership within West Germany, France, and many other Western European nations appears to be sufficiently established to withstand much of the pressure for wage increases in excess of increases in productivity. Furthermore, policy-makers need not necessarily make "sacrifices in the form of unemployment to avoid increases in the general price level." The nations of Western Europe historically have been less reluctant than the United States to use direct controls. By combining these controls with traditional measures to deal with aggregate demand, it may be possible to moderate price pressures without strangling effective demand. Moreover, given the traditional European fear of inflation and the relatively large proportion of exports and imports to gross national product, Europeans would probably be more inclined to go along with "austerity measures" for balance-of-payments reasons if such measures indeed became necessary.

Finally, even if efforts to control price inflation should meet with indifferent success it is not at all certain that the deteriorating competitive position of Western Europe vis-a-vis the United States would carry through to the projected increase in the U.S. exports. A developing tendency toward current account deficit might well result in imposition of trade controls and/or currency restrictions, tools with which Western European nations are not at all unfamiliar.

PURPOSE OF THE STUDY

The Brookings study was undertaken at the request of the Council of Economic Advisers for the purpose of finding out (as stated on page 40 of the study) "how the balance of payments in 1960 would be affected if unemployment were rapidly reduced to 4 percent of the labor force and the Government's long-term growth objectives were achieved." In accordance with this request, the Council provided the Brookings group certain basic assumptions: an average annual growth rate of real GNP in this country of 4.8 percent, an increase in the implicit GNP price deflator of 1.5 percent a year, an average annual growth rate of real GNP for the major European economies of about 4.2 percent a year (the latter in accordance with the "plan target" submitted by each to the OECD).

The Brookings group went on to make additional assumptions as to GNP and export price increases in Western Europe. These further assumptions render the study less valuable for the purpose originally intended, i.e., ascertaining the effect of rapid economic growth on the balance of payments.

The GNP deflator in Western Europe was assumed to increase by 20 percent and export prices by 11 percent in the initial assumption, compared to 11 and 4 percent, respectively, in the United States. This means that, though growth in real income is projected for both Western Europe and the United States, Western European purchasing power is significantly larger in terms of U.S. goods, tending to inflate U.S. exports to Europe. The steepness of the increase in European prices, especially in the initial assumption, tends to obscure the phenomenon which was singled out for special study and indeed which was the apparent purpose of the study.

To serve more adequately this original purpose, the Brookings group might have made additional assumptions in which relative price changes were accorded a position of less importance than that in the initial or alternative assumptions.

MAGNITUDE OF U.S. EXPORTS

The magnitude of the projected increase in U.S. exports is subject to question. Under the initial assumption the Brookings report projects an increase in our nonmilitary exports of goods and services of \$14.3 billion or over 50 percent. The alternative assumptions produce a projection of \$10.6 billion or around 37 percent. During the period 1956-62, by way of contrast, U.S. exports increased by \$6.4 billion or 27 percent. And from 1946 through 1951 (the latter year representing the largest export figure in the early fifties) exports rose by only 27 percent. In other words, the projected increase in exports seems large in terms of recent experience.

Since a very large proportion of the projected increase in exports is expected to go to Western Europe (in response to the improvement of our competitive position) it is necessary to examine the types of goods exported from the United States to Western Europe in order further to assess the credibility of the export projection. As noted in the report (p. 98), about half of our exports to the United Kingdom and EEC are agricultural products and nonagricultural raw materials. The other half is composed of manufactured goods. Since

industrial materials and agricultural products would probably be less sensitive to the assumed change in prices (price elasticities of demand are lower, trade controls are stronger, and Europe produces only a small volume of commodities such as cotton) exports of manufactured goods would have to expand very significantly if the projected increase in exports to Western Europe were to be realized. Indeed, the projections imply as much as a 100-percent increase in exports of manufactures to Western Europe, given the makeup of present exports. This figure would seem a bit on the high side.

PRIVATE FOREIGN INVESTMENT

The assumptions and conclusions with respect to the investment projections are also subject to question. If demand pressures do indeed push against the limits of capacity in Western Europe the assumption that "the level of long-term interest rates in the United States and Western Europe * * * would not differ greatly from the current structure except for the possibility of a narrowing of the spread between countries" may be a bit off base. In a rapidly growing Western Europe the demand for savings would probably rise at a more rapid rate than supply. The monetary authorities in turn might be reluctant to provide the additional funds necessary to keep rates from rising in view of the threat of inflation. Hence there is some reason to expect an upward bias in the structure of European interest rates.

An important reason given for the improvement in our balance of payments on private capital account is the projected expansion in the U.S. rate of economic growth relative to that of Western Europe and a relative improvement of profits in this country. In fact, little empirical work has been done on the responsiveness of capital flows to changes in rates of economic growth. Indeed, one might argue that an increase in our relative rate of economic growth would actually give rise to greater outflows of direct and portfolio capital to foreign countries. The reasoning would be that improved growth and profits in this country create an environment favorable to investment. Given this environment, businessmen and others might increase investment both at home and abroad rather than raise domestic at the expense of foreign investment; e.g., "Profits look good so let's expand in Cincinnati, and while we're at it we might reconsider the subsidiary in Milan," or, "things look good the world over so let's stretch out for an extra 1 percent on a Canadian issue."

Technical caveats

In assessing the likelihood that the Brookings projections will be realized, particular attention should be paid to the technical caveats cited by the authors. Of special significance, projections of net balances in international payments are, as the authors mention, "highly speculative." For example, if U.S. imports of goods and services should be 2 percent greater than projected and exports 2 percent less, the projected surplus under the initial assumptions would deteriorate by \$1.5 billion and the deficit under the alternative assumptions would increase by \$1.4 billion. It cannot be emphasized strongly enough that the projections are of value primarily in illustrating the types of influence which will bear upon our payments position (given the assumptions). The actual quantitative projections are of only limited significance.

A second technical point concerns the data and techniques used to project U.S. exports and imports of goods and services. The projections were made on the basis of the revised Polak-Chambers model which attempts to explain imports and exports of goods and services during the period 1948-60, using real gross national product, consumption, and relative prices as the principal independent variables. As the authors note, the functional relationship thus derived (even if we abstract from the problems of serial correlation, autocorrelation, and specifications of variables) may not continue into the future. Indeed, Mr. Walther Lederer in recent testimony before the Joint Economic Committee² indicated that relative prices may already have become a less important variable influencing U.S. exports to Western Europe.

Finally, many events could occur in the future which would have an important impact on our balance of payments but which the authors could not or did not attempt to quantify. The passage of the President's "interest equalization tax" could have important implications for capital flows. A thawing of the cold war could affect profoundly the pattern of our export trade and our oversea military commitments (as could an intensification of tension). A major breakthrough on any number of rapidly developing technological fronts could give us new products to export or provide new import competition. Export stimulation drives could pay off in expanded oversea sales. Tax cuts could have unanticipated impacts upon our balance of payments.

"BASIC" VERSUS "TOTAL" DEFICIT AND THE JOB OF THE POLICYMAKER

The Brookings report projects our basic balance of payments in 1968 and then on the basis of this projection, states that, "we do not recommend that the Government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves."

While it is certainly desirable to look over a longer span of time and consider more fundamental determinants of the balance of payments, the policy recommendations emanating from such a "looking down from the mountaintop" may be of little use to the policymaker beyond a broad guideline. The policymaker must deal with our total, not our basic balance of payments, and he must do so now, in 1964, in 1965, and each day of each year through 1968 and beyond. Indeed, it is possible that reservation in the short run of measures which may be undesirable in themselves could lead to a situation in the long run in which it would be impossible to avoid even more drastic measures of an undesirable nature.

I am not saying that domestic demand should be sacrificed to balance-of-payments objectives. I am saying that plans such as the President's "interest equalization tax," though perhaps distasteful in and of themselves, may be measures of practical necessity to avoid even more distasteful measures at some future date. The Fed's action in putting upward pressure on short-term interest rates is another case in point.

Granted such measures might be unnecessary in a world where the institutions of international finance were altered significantly. But

² Joint Economic Committee, "Outlook for United States Balance of Payments" (Washington: U.S. Government Printing Office, 1963), pt. 2, pp. 281-289.

the fact is such institutions are not altered and it may take some time to accomplish changes.

CONCLUSIONS

In quest for balance-of-payments equilibrium one might ask if the Brookings policy recommendations are in keeping with the mainstream of thinking in the world today, and if not, how this bodes for the national welfare. As already noted, the Brookings report calls upon American policymakers to do nothing which is not desirable in and of itself to solve our balance-of-payments problems. This position would include a recommendation against the President's interest equalization proposal, as noted in the hearings before the Joint Economic Committee on the Outlook for the U.S. Balance of Payments.³ Simultaneously, the report calls on this country to push for new institutional arrangements to permit an expansion in international liquidity.

Such a course of action would indeed seem laudable from a longer term point of view. And it is certainly in keeping with U.S. policy since World War II, a policy which has met with some success in pressing toward a goal of free multilateral trade and payments.

But in the shorter run the Brookings proposals might be criticized as representing a noninterventionist philosophy in an interventionist world. One might argue that the Brookings recommendations call upon this country to play the rules of the free market game in solving its payments problems in an environment in which other nations feel less so compelled. Moreover, one might say that we are called upon to play these rules even though much of our deficit stems from non-marketplace type of transactions—military aid and the like, capital outflows not so much because capital is cheaper here as because other capital markets of the world are restricted as to entry and underdeveloped in depth and breadth. The price we are asked to pay for this adherence to free market rules is a continued drain of gold and increase in foreign-held, short-term dollar liabilities. The market force which is supposed to restore equilibrium results not so much from our own efforts as from failure on the part of our competitors to keep their own prices down, a market force of debatable probability.

In short, one might say that longer run goals of free multilateral trade and payments must be pursued with relentless vigor. But it may be desirable to keep a sharp eye on the game as it is being played by other nations in the world during the transition to the longer run goal. With an eye only on the horizon one may stumble over the smallest pebble in the path.

³ *Ibid.*, p. 256.

STATEMENT BY VIRGIL SALERA

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Hayward, Calif.

The present writer is wholly unpersuaded by the Brookings guesses concerning the state of our balance of payments in 1968. Briefly, their guesses understate the balance-of-payments problem which we face, while their prescription with respect to a newfangled liquidity scheme is little more than another attempt to defend the increasingly shaky orthodoxy regarding mere demand stimulation via Government spending. The authors of the Brookings study admittedly are good tool users, as all in the profession know, and whatever else may be said the work surely is not unsophisticated. But this magnifies the problem facing the Member of Congress seeking counsel, to say nothing of the interested layman who, if he has the patience to wade through the analysis, is likely to be impressed most of all with the "sweet reasonableness" of the lengthy message. As usual, the story stands or falls on its assumptions, stated and implied; as we shall see, the authors ventilate the wrong assumptions.

Stripped of detail and voluminous "iffy" reasoning, the authors' case rests overwhelmingly on the juxtaposition of two simple "trends": slackness permitting relatively cost-stable expansion in the United States versus tightness and associated relative cost-raising forces on the European Continent, rightly perceived to be the only region of the world (along with Japan) worth worrying about from a balance-of-payments angle for the near-term future. Time is thus claimed to be on our side, even if we proceed about as we have been doing with respect to domestic and foreign spending policies. Economists in or close to our Government for some time have been emphasizing developments along the lines of those spelled out in the Brookings study, so that it is not surprising that the writers on Massachusetts Avenue have proceeded along a similar route.

Both slackness and tightness are deceptively simple and misleading explanations, however. Consider first the Council of Economic Advisers concept of slackness, which the Brookings group accept as a datum. This notion, as most people now know, is based mainly on the belief that considerable labor is unused, allegedly because of a deficiency of aggregate demand, and that aggressive Government spending will enable the economy to reemploy much of the Nation's estimated unemployed, thus permitting the addition of a claimed \$30 to \$40 billion to the country's annual output. If all this is granted, clearly the American external economic outlook appears good or even quite favorable. Given the assumed condition for relatively cost-stable expansion (and, among other things, the crazy quilt of currency swap and other special international financial arrangements now in being), the Brookings group naturally plead for a virtually do-nothing program in relation to the drift of domestic and foreign spending by our National Govern-

ment, arguing instead for time (foreign patience) to allow the (claimed) favorable forces to assert themselves.

Should the continental Europeans be faced not with the same but with a more or less opposite pattern of developments, the outlook for the United States would be rosy indeed. This, not surprisingly, is what the Brookings study predicts—admittedly, not a difficult feat in the light of well-known wage, cost, and price pressures which have attained prominence in recent years as the continental Europeans have been riding their galloping economies. For years, more specifically, most of the continentals have been experiencing job vacancies in excess of gross unemployment despite heavy external recruitment; even Italy seeks skilled labor outside her borders, mostly among nationals at work north of the Alps. The European gallop is now slowing down, however, as “initial” positions become established and the many long-term economies and product possibilities inherent in the new regional arrangements beckon competing managements in the world’s oldest developed area to effect more general economies and innovations in production and international marketing.

In a basic sense, Washington (and hence Brookings) is the victim of admittedly sophisticated illusions concerning the meaning of our statistical abundance. On top of this, the woods of Washington are full of respectable slaves—the slaves of aggregates. Because the United States has the best and (of course) the most economic statistics in the world, Washington kids itself into believing that they are really good statistics for other than rough informational purposes. “Facts don’t lie.” More specifically, viewed in major policymaking terms, our employment and unemployment statistics are positively the worst.¹ Yet these are the main data on which rest claims of slackness from the White House on down—claims which get all the play in domestic and foreign newspapers and TV which modern centralized government affords.

If appropriate recognition is accorded (1) the increasingly dynamic nature of the American private economy; (2) the wage and “fringe” benefit “reservation prices” to which even the underskilled have become accustomed; (3) (of course) the official estimating procedure; and (4) the need to segregate the frictionally unemployed on technical grounds, a good case can be made for the proposition that a large number of those officially classified as unemployed are virtually unemployable. To make such a statement is in no way to reflect upon the human beings involved, who are essentially and mostly innocent victims of institutional and political arrangements which date mainly from the depressed thirties—for example, the inadequate performance of our vocational schools (and the associated overemphasis on a routine college education for nearly all), discrimination practiced by many trade unions, undue delay in appreciating the extent of skill adjustment required in a dynamic business economy (perhaps largely because of indentured servitude to the conventions of macroeconomics and obsession with such intellectual toys as the multiplier), and the still inadequately understood phenomenon of “Joe Public’s” role as a maximizer in playing the unemployment compensation game.³

¹ This statement is believed to be consistent with most of the Gordon report of 1962.

² To cite one illustration from among too many, in the present writer’s county there are numerous unskilled unemployed within less than half an hour’s freeway ride of truck crop operations which rely on braceros—a phenomenon which shows up as a double “liability” according to our reporting conventions.

³ Some food for thought is provided by some members of the League of Women Voters who have suggested to the present writer, in the light of their experience, that women who are not heads of households be denied eligibility for unemployment compensation.

Russia, of course, takes the prize for claiming the most from the easily quantifiable,⁴ to be sure in the realm of gross product and thus the thoroughly muddled world of "growth."⁵ But we are in danger of competing with that nation in the wrong way; that is, of giving the Russians a run for their money—certainly if allowance is made for the technical superiority (or at least potentiality) of the American information complex. And the claims now made for the informational base of employment policy expose the incredible extent to which we rely on the easy way statistically: We know that the total of job vacancies is large, if not huge (though official spokesmen try to minimize the matter by asserting that the pace of technological change, as if it were readily quantifiable, has remained stable⁶); yet we treat the reported unemployment figure for all practical purposes as if it were an accurate net item, a homogeneous aggregate with essentially frozen properties that only needs to be melted by the heat of expanded aggregate demand.

If we are to speak in terms of "slack," a good job vacancy series would be far superior in principle to an aggregate which indicated, only roughly, an economy's capacity to expand largely unwanted output (unwanted either because of physical type or real cost). Putting the matter this way reveals, it is submitted, how wide of the mark is the current orthodoxy with respect to our leading policy guideline. Yet we are years away from a truly accurate and meaningful vacancy series, not only because centralized government has been negligent in emphasizing the positive in this sphere. Our highly inaccurate and misleading unemployment data present piddling conceptual problems by comparison, and they reflect an effort unilaterally conducted by central government. A little imagination will reveal, by way of contrast, something of the technical and administrative task involved in perfecting a really good—yes, honest—vacancy series.⁷

The upshot of this discussion is that, contrary to the Brookings group (and the Council of Economic Advisers), we probably have little if any cost-stable short-run slack in labor force terms. Putting on the Government expenditure heat in an effort to increase output supposedly by absorbing economically meaningful idle labor, therefore, would run the serious risk of inflating unit labor costs to the marked further disadvantage of the American balance of payments. The administration appears to be so committed in principle to the expenditure heat approach, however, that we seem almost certain to be headed for trouble, unless the Continental Europeans—General de Gaulle and all—come to our rescue roughly along the lines of the Brookings prediction.

⁴ Members of Congress might well reflect upon the following: "In a highly centralized economy, the way to make headway quickly is to concentrate on the easy tasks and neglect the difficult ones." G. W. Nutter, "Economic Trends and Prospects in the U.S.S.R. and Eastern Europe," *American Economic Review*, May 1963, p. 572. This simple matter has been disregarded over and over again by those who have boasted of Soviet accomplishments.

⁵ Those who like the easy GNP concept of growth should also take a look at California, where performance in conventional growth terms has been so great that some are now thinking of "deflators" to account for such growth-connected pathology as jammed freeways (where people spend so much of their "leisure"), lower quality education, and abundant smog.

⁶ For example, G. Ackley, "The Federal Budget and a Dynamic Economy," *Michigan Business Review*, July 1963, p. 14. A good popular treatment of the vacancy problem is Congressman Tom Curtis' "87 Million Jobs," New York, 1962.

⁷ Ideas expressed in this paragraph are in part deductions from the highly significant paper by Arthur F. Burns, the distinguished Chairman of the Council of Economic Advisers in the previous administration, "Economics and Our Public Policy of Full Employment," *Morgan Guaranty Survey*, July 1963. The overtime problem to which Burns refers is also relevant to the general vacancy question.

Unfortunately, the Brookings group appear to have misread the underlying trend of European economic affairs almost as much as they have misunderstood the domestic employment situation. As has already been indicated, the Brookings study takes comfort in the marked rise of Continental European costs in recent years. A similar movement adverse to Europe and favorable to us, is predicted at least to 1968. Though the study considers a number of factors bearing on Europe's competitiveness, it has little to say about the crucial matter of the favorable impact on costs and innovations⁸ of regionwide specialization which is bound to proceed apace as complete internal free trade is attained. The Continentals, as is well known, are now approaching this stage, when the full force of the market will discipline all in the economic sphere in a regional context in which, moreover, deep-seated nationalistic drives serve to add a further stimulus to innovation and a spirit of rivalry that should keep the whole area on its economic toes. The United States, by way of contrast, is likely to remain a Washington-centered monolith in the face particularly of urban problems with unknown but probably unfavorable impact on U.S. costs—perhaps the more unfavorable the more we rely on a centralized approach to the problems. Hence, the years ahead are critical, since the Europeans have something economically big going for them while we have mounting new problems and little if anything in reserve—at least that Washington can do much about, save encouraging enterprise by giving truly long-term assurances that the National Government will not interfere with the market mechanism as it tried to do in steel in 1962 with such bad results,⁹ will not hog most of the Nation's research talent for Government projects by overplaying glamour,¹⁰ and will move—in general—to decentralize the role of Government as far as it affects the economic process, thus lightening tax burdens and, more importantly, strengthening the forces of freedom in our society.

As far as the balance of payments in 1968 is concerned, the outlook does not appear good to the present writer unless (1) domestically, spending is subordinated mainly to a decentralized upgrading of the work force, (2) foreign economic aid is curtailed (and all the anti-free-trade tying arrangements that go with it) mainly for the reason that the American record is encouraging (as Bronfenbrenner has pointed out¹¹) only in the case of nations that were already substantially developed, and (3) military aid is provided more selectively in the light mainly of growing doubts concerning the political reliability of some parts of the present so-called alliance system.¹²

⁸ In this connection, the writer suspects that Washington is off the beam on two counts: First, it probably underestimates the extent to which resources will be released from agriculture (especially in Germany), and secondly, it seems to continue to pay excessive attention in theorizing about policy to influential British opinion and periodicals, which speak persuasively but superficially about the role of mere demand stimulation in the context of a not very dynamic economy.

⁹ Is it not a sad commentary on the state of American democracy that the President's popularity hit a peak on the occasion of intervention in steel, despite the fact that under our system he had no right to force his own economic views on an unwilling industry without legislation? Besides, his advisers confused the exception with the rule when they laid down the so-called guidelines in the January 1962 Economic Report, pp. 185-190.

¹⁰ Contacts with people in some of the major universities reveal disquieting evidence that NASA is even paying for questionable opinion-directing studies in the social sciences. Some institutions have gone so far as to terminate contracts with the agency.

¹¹ On the general question of Government and research, Members of Congress might want to consult Yale Brozen, "The Role of Government in Research and Development," the American Behavioral Scientist, December 1962.

¹² M. Bronfenbrenner, "Second Thoughts on Confiscation," Economic Development and Cultural Change, July 1963, p. 370.

¹³ The present writer almost agrees with those who argue that others will assume a fair share of the defense burden only when the United States stops picking up their part of the tab.

The reader will note with respect to the foregoing that the exchange rate question is conspicuous by its absence. Without going into the array of permutations involved in this complex question, the present writer may perhaps be allowed to state that (1) he supports free pricing in the foreign exchange market as a matter of principle, and (2) agrees with those who take the position that a fixed rate places too much of the burden of adjustment on internal product and factor prices (given the other elements involved). But Members of Congress have reason to be wary of the expert when they see the learned professors disagree so much on this question. If the matter involved only the relation between United States and foreign costs, if officially reported unemployment really reflected in any meaningful sense an inability to compete in world markets, and if foreigners had not been induced—to what extent by undisclosed pressure in the sphere of necessarily secretive defense policy perhaps may never be known—to hold so many billions of dollars in lieu of taking our gold on our promises to end our balance-of-payments deficits, the present writer would also urge devaluation or, more precisely, a switch to a floating rate. But the traditional (or modern) theory of the subject really does not take account in any systematic way of the autonomous role of National Government in committing itself to huge foreign spending more or less regardless of the market portion of the balance of payments.¹³ We thus find ourselves in some kind of poorly defined “interim situation” between a balance-of-payments-with-fixed-rate case and a floating rate situation proper. Abstracting from what Washington does—all in the name of goals supposedly superior to that of balance-of-payments equilibrium—and thinking in fixed-rate terms for the time being, the present writer believes that our balance of payments is essentially in manageable shape. He would urge that we clean house first, and wait—perhaps some time—until we are sure that the level of foreign-held dollars reflects only voluntary decisions before taking the exchange rate plunge.¹⁴ This will admittedly make life in Washington a lot more difficult than it has been for top policy-makers.

There remains the question of international liquidity (in the fixed-rate context), which the Brookings study claims to be the real problem. But is not this a diversionary tactic? If the United States would assign top priority to the balance-of-payments problem, as the American Bankers Association among others has urged,¹⁵ rather than subordinating it to nearly all other objectives of (spending) policy as the Brookings group would have it, international liquidity is likely to prove adequate though the United States would have to get used to a somewhat limited liquidity cushion and the real discipline of the

¹³ One should also be wary of arbitrary rearrangements to show what is called a “basic” balance of payments. Once ground is given on this score, we will doubtless find rationalizations for breaking out many other categories for reasons of “nonessentiality,” and the like. Would we have a “super basic” balance if we broke out payments for such “trivia” as Scotch whisky, visits to the Vatican Museum, and the like? If we carried that sort of thing far enough, we might find that it was in the “national interest” to have Washington pay for gold-plating all the window trimmings on all of the Government buildings in, say, Brasilia.

¹⁴ Stopgap measures, such as the poorly thought out steep cut in duty-free treatment of tourist imports (our advisers apparently made the sophomoric mistake of equating reduced spending on foreign goods with reduced spending abroad), and the recent hastily drawn proposal to tax foreign securities, are unworthy of so inherently strong an export economy as that of the United States. They are also unnecessarily embarrassing in the light of our record of official preachment in the general area of international adjustment.

¹⁵ “Statement on the Balance of Payments,” 1963.

balance of payments. Moreover, Continental European reserves are already excessive. On this subject, the present writer shares the view of Dr. Furth of the Board of Governors: "an increase in world liquidity is the last thing the present international payments system needs."¹⁶

The free spenders at the political center, aided first by depression (now nearly a generation behind us), then by the soothing lyrics of chronic dollar shortage (which the present writer feels did more than any other single force to promote the easy-spending habit), and now by rationalizations of blank-check relief from balance of payments constraints in the name of "time" to effect international adjustment perhaps after every pet domestic and foreign scheme is financed in easy-going fashion, have got to be brought down from cloud 9 and the exaggerated concepts of aggregative economics which dominate the scene in those heavens. Perhaps we could afford the intellectual and policy luxury of disregarding microfactors¹⁷ in deep depression; to do so any longer risks serious loss of economic position and worse in a world with vigorous rivals who are a match in terms of sophisticated labor and tested privately managed enterprises of all types, with perhaps a historical long-term marketing edge in many if not most of the world's third markets.

¹⁶ J. Herbert Furth, "Discussion," *American Economic Review*, May 1963, p. 145.

¹⁷ Not surprisingly to those who know Washington, analysts with the Board of Governors appear to be doing some of the best probing in this area; this, at any rate, is illustrated by Clayton Gehman's "Measuring and Analyzing Economic Growth," *Federal Reserve Bulletin*, August 1963, pp. 1046-1060. Those who are concerned about the excessive claims which are regularly made for aggregate measures will do well to consult Gehman's article.

STATEMENT BY EUGENE R. SCHLESINGER

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The Brookings balance of payments study¹ constitutes a dual landmark for international economic forecasting in the United States: Not only must the report be considered the most ambitious, most comprehensive, and most technically proficient projection of the U.S. balance of payments yet made, but its publication represents the first occasion on which the standard methods of balance-of-payments forecasting have been made subject to widespread public scrutiny and debate. This creates somewhat of a dilemma for the balance-of-payments technician. Should he concentrate on an analysis of the underlying assumptions and techniques used by the Brookings staff, or should he content himself with trying to explain the implications of the projection to the nontechnical public? This evaluation attempts to accomplish both these objectives simultaneously.

I. CRITERIA FOR EVALUATION

A realistic assessment of any balance-of-payments forecast must involve judgment as to its reliability, its usefulness, and the delicate interrelationships which exist between these two criteria. For this reason the reliability of the Brookings projection cannot be determined independently of the specific types of analytical conclusions which it is used to support. Similarly the usefulness of the Brookings projection as a guide to public policy cannot be evaluated without simultaneously considering its reliability.

The Brookings study reaches one fundamental analytical conclusion, from which two major corollaries are drawn. The fundamental conclusion is that the basic deficit in the U.S. balance of payments "will be eliminated" by 1968 (p. 230) through the normal operation of the basic economic trends which are most likely to take place in the intervening period. The first major corollary is that, in the light of this, there is no pressing need "to take any steps to improve the balance of payments other than measures which seem desirable in themselves" (p. 253). The second major corollary is that the normal growth in international trade that can be expected between 1961 and 1968 will be of sufficient magnitude to cause concern about the adequacy of international liquidity arrangements toward the end of the period (p. 239).

NOTE.—This evaluation forms part of a series of interrelated studies on the general theme of "Comparative Economic Structure and the International Payments Framework," undertaken with the assistance of a grant from the fund for summer research projects of the Graduate School of Business Administration of New York University.

¹"The U.S. Balance of Payments in 1968," materials presented by the Brookings Institution to the Joint Economic Committee, 1963. All reference to page numbers given in the text below refer to this edition of the Brookings study.

Is the Brookings projection sufficiently reliable to support these general analytical conclusions? This is the critical question which must be answered. In attempting to do so, it seems wise to restrict the discussion to an analysis of the reliability of the merchandise balance projection. For one thing the specific estimates for foreign aid, defense transactions, and private foreign investment involve so much specialized institutional knowledge on the part of the Brookings authors and their collaborators that it would be presumptuous for an individual to try to match it. But of perhaps greater significance is the consideration that the statistical forecast underlying the general analytical conclusions is in the form of a range, rather than specific, forecast: What the Brookings authors have actually done is to project an improvement of between \$200 million and \$2,700 million in the basic balance between 1961 and 1968, and virtually all of the critical difference of \$2,500 million can be accounted for by the range to be found in the merchandise balance projection itself (p. 216).

In evaluating the reliability of trade or merchandise balance forecasts, it is useful to distinguish between (a) forecasting vision and (b) forecasting techniques.² These terms can be defined as follows:

Forecasting vision.—The ability to predict changes in “independent” economic variables (e.g., gross national product, labor force, population, relative costs).

Forecasting techniques.—The ability to predict changes in economic parameters or the relationships between “dependent” and independent variables (e.g., the ratio between imports and gross national product, the degree of responsiveness of exports to changes in relative prices).

Any international trade forecast may prove to be erroneous because of inadequate forecasting vision, inadequate forecasting techniques, or a combination of the two. The Brookings study’s projection of American exports to Western Europe, for example, could turn out to be wrong either because the ratio of U.S. export prices to European gross national product prices (p. 82) would decline more or less than 13 percent (inadequate forecasting vision) or because the price elasticity of European demand for American imports would be greater or smaller than -2.5 (inadequate forecasting techniques).³

The evaluations of the Brookings study which have appeared to date have been almost exclusively concerned with its forecasting vision rather than its forecasting techniques. There has been considerable discussion of the reasonableness of the study’s fundamental assumptions as to the behavior of independent economic variables, but virtually no analysis of the validity of the underlying statistical methods. In the present evaluation the author attempts to redress this

² Some of the concepts and arguments used in the present evaluation are based on chapters I and III of part II of “Draft Report on Trade-Cargo Forecasting,” which the author prepared for the Maritime Administration of the U.S. Department of Commerce while serving as a consultant to Arthur D. Little, Inc. This report, which was submitted under contract MA-2451, is still “administratively restricted.”

³ Alternatively, for example, the Brookings forecast of U.S. imports from Western Europe could prove to be erroneous either because American gross national product would rise more or less (p. 41) than 43.3 percent (inadequate forecasting vision) or because the income elasticity of American import demand for European goods is greater or less than 1.933 (inadequate forecasting techniques).

imbalance by focusing attention on the Brookings study's forecasting techniques. It is, moreover, within this technical area that the real shortcomings and inadequacies of the Brookings balance-of-payments projection are to be found.

II. THE ESSENTIALS OF THE BROOKINGS STUDY'S TRADE FORECASTING TECHNIQUES

Stripped of technical vocabulary and unimportant qualifications, the trade forecasting methods employed in the Brookings study can be boiled down to three essentials. The net merchandise position of the United States in her balance of payments will improve more (less):

(1) The smaller (greater) the rise in U.S. gross national product:

(2) The greater (smaller) the increase in Western European gross national product; and

(3) The larger the improvement (deterioration) of the competitive price position of U.S. foreign-trade products (i.e., exports and import-competing products) vis-a-vis those of Western Europe.

The relative simplicity of this economic model is readily apparent. Nevertheless, it is important to recognize that, except for certain minor improvements, this represents the epitome of the science of longrun foreign trade forecasting as it has been developed to date. Direct emphasis is placed exclusively on demand factors: supply considerations are treated indirectly and only to the extent that they influence relative price changes.

The true test of a scientific hypothesis, however, is its operational validity, not its completeness. How well does it actually work in practice? In the case of the Brookings forecasting model, a meaningful operational test can be performed for the years 1960-63, which fall outside of the statistical base period (1948-60) used to construct the underlying forecasting equations. Since 1960 the rate of increase in U.S. gross national product has been significantly below that projected by the Brookings study for the years 1961-68, while the rate of increase in Western European gross national product has been slightly higher than that projected. On income account alone, therefore, the Brookings forecasting model would have predicted a substantially greater relative improvement in the U.S. merchandise balance since 1960 than the Brookings staff itself projected in the years to 1968. Furthermore, since the relative price position of the United States vis-a-vis Western Europe has also been improving, the competitive factors stressed in the Brookings model would have also been working in the direction of improving the U.S. merchandise balance.

The actual developments in U.S. foreign trade during this period have not, however, conformed to these predictions. As is clearly demonstrated by the data in the accompanying table, not only has there been no improvement in the balance on trade account, but a significant amount of deterioration has actually taken place. How can this serious discrepancy between expectation and fact be explained?

U.S. merchandise balance on private account, 1960-63¹

	[In millions of dollars]	<i>Balance</i>
Annual data :		
1960-----		2, 817
1961-----		3, 179
1962-----		1, 989
Quarterly data : ²		
1962 :		
I-----		485
II-----		658
III-----		558
IV-----		288
1963 :		
I-----		420
II-----		502

¹ Balance on trade account, excluding exports financed by Government grants and capital.

² Seasonally adjusted.

Source : U.S. Department of Commerce, "Survey of Current Business," September 1963.

The standard answer given by balance-of-payments technicians (and the one which would presumably be used by the Brookings staff) is that the forecasting equations did not yield valid results for the years 1960-63 because of the presence of unforeseen structural changes (i.e., shifts in sources of supply and the relative demand for individual products) which took place.⁴ But what guarantee is there that similar or different types of structural changes will not be operative throughout the 1960's? Looking back from the vantage point of 1968, might not the Brookings authors once again have to point to the presence of unforeseen structural changes to explain why their projection had turned out to be either too favorable or unfavorable?

There is also a standard answer which can be given to this question : Since the true function of a forecast is to obtain future perspective on what is most likely to happen on the basis of the best presently available information, and since it is impossible to predict most structural changes in international trade with any reasonable degree of accuracy, a more useful and valid forecast can be obtained by completely ignoring the possibility of such changes. This argument has a certain amount of appeal, and the present writer himself has made use of it on occasion.⁵ However, for reasons outlined below, he now believes it to be both invalid and question begging. At the very least, the assuming away of the importance of structural changes may lead a forecaster to ignore those structural changes which may have been present during his base period and which may have exercised thereby a significant influence on the validity of his forecasting equations and parameters.

⁴ From the standpoint of commodity and product composition, the modified Polak-Rhombert model used in the Brookings study continues to treat trade on a completely aggregated basis. Ideally, if given more time, the Brookings staff would probably have preferred to construct separate forecasting equations and parameters for the major economic classes of exports and imports. This procedure would have undoubtedly pointed up some of the structural shifts which occur among the major economic classes of trade. However, as is discussed in some detail below, technical improvements of this nature would not be sufficient to detect the most troublesome and important of the changes which occur in international economic structure—namely, those which take place within and among subclasses of finished manufactures.

⁵ Mainly in unpublished memoranda; see, however, E. R. Schlesinger, "The Long-Run Outlook for U.S. Merchandise Imports," International Monetary Fund Staff Papers, February 1954, pp. 387-415.

III. STRUCTURAL CHANGES AND THE VALIDITY OF THE FORECASTING EQUATIONS AND PARAMETERS

That important structural changes took place during the years 1948-60 is amply demonstrated by those historical-empirical studies of trends in international trade which break down such trends into "structural effects" and "competitive price effects."⁶ In fact, the historical-empirical studies which cover the 1950's definitely conclude that the "structural effects," and not the "competitive price effects," were the predominant factors operating during this period. This is the case whether the focus of attention is on shifts of relative market shares in world exports of manufactures⁷ or on comparative analysis of changes in U.S. imports and exports.⁸

In the light of the predominance of structural changes during the base period used in the Brookings projection, the forecasting equations obtained could yield only what can be termed "interaction" parameters. Since such parameters reflect the combined interplay of (a) supply and demand and (b) autonomous and induced price changes, extreme care should have been exercised to avoid giving them any definite theoretical economic meaning. But this is precisely the interpretation employed by the Brookings authors.⁹ If they had rigidly treated the parameters in interaction terms, the degree of improvement projected for the U.S. merchandise balance would have been considerably greater.

A far more serious problem can arise if the pattern of "structural effects" in the period covered by the forecasting horizon should turn out to differ markedly from that in the base period. The possibility of this happening has been brought home personally to the present writer by the results of a projection of U.S. imports which he undertook some 10 years ago: While comfortably accurate in terms of total imports of nonmanufactures and of imports from such regions as Canada and Latin America, the forecast was off considerably in terms of total imports of finished manufactures and of imports from Western Europe.¹⁰ The usual explanation for this forecasting failure

⁶ In contrast, as the exposition of the Brookings trade forecasting model has already shown, forecasting equations analyze trade trends in terms of "income effects" and "competitive price effects."

⁷ See, for example, Bureau of Foreign Commerce, "Analysis of Changes in United States Shares of Export Markets for Manufactures, 1954-58," Washington: U.S. Department of Commerce, 1959; or A. Romanis, "Relative Growth of Exports of Manufactures of the United States and Other Industrial Countries," International Monetary Fund Staff Papers, May 1961, pp. 241-273.

⁸ See H. B. Lary, "Disturbances and Adjustments in Recent U.S. Balance-of-Payments Experience," American Economic Review, May 1961, pp. 417-429.

⁹ See, in particular, the treatment of the price-interaction parameter of Western European imports from the United States as a price-elasticity of demand and the consequent reduction in size from -4.0 to -2.5 (p. 82). The question of whether the Polak-Rhomberg equations yield demand elasticities or interaction parameters is not germane for the purposes for which the model was originally designed—namely, tracing the effects of a single assumed autonomous change through the international economic system. (See J. J. Polak and R. R. Rhomberg, "Economic Instability in an International Setting," American Economic Review, May 1962, pp. 110-118.) The problem arises only in cases (e.g., the Brookings study) where two or more autonomous changes are introduced simultaneously. Nevertheless, for reasons given later in the present section, it seems quite unlikely that the Polak-Rhomberg trade equations would yield even interaction parameters that would be valid for the 1960's if the particular growth rates in gross national product for the United States and Western Europe that are projected in the Brookings study are actually realized.

¹⁰ See Schlesinger, *op. cit.* It should be pointed out, however, that the forecasting error involved here was one of magnitude rather than direction. The principal conclusion reached in the paper—and this was a factor not widely appreciated at the time—was that increasing American imports of finished manufactures would be the major factor working to improve the rest of the world's balance of payments with the United States.

would be that U.S. import demand for finished manufactures had changed between the interwar and postwar years. But could it not also be argued that there had been a change in interaction parameters because the pattern of structural changes in the interwar period was different from that in the postwar era?

This second interpretation appears to be borne out by the factual evidence. Historical-empirical studies of trends in international trade for the years before World War II provide a convincing demonstration that the direction of structural changes in this earlier period was definitely favorable for the U.S. balance of payments.¹¹ In contrast, the pattern of structural changes in the postwar years was biased in the opposite direction and definitely unfavorable to the U.S. balance of payments.

What underlying economic causes can explain this sharp contrast in experience? Comparative examination of statistics reveals one other striking contrast between the two periods—namely, that in the prewar years the comparative rate of economic growth in the United States was generally higher than that in other industrial countries, while in the postwar years the reverse was true. Yet the Brookings study, while utilizing postwar data for its estimating equations, specifically projects an international economic environment in which the U.S. growth rate exceeds that of Western Europe. Perhaps, under these circumstances, it would have been more appropriate for the authors to have employed parameters based on equations taken from the interwar period?¹²

IV. COMPARATIVE GROWTH RATES AND THE DIRECTION OF CHANGES IN INTERNATIONAL ECONOMIC STRUCTURE

The shifts in the patterns of structural changes which have taken place during this century can be used in a positive, constructive fashion. The historical experience strongly suggests the validity of the following major hypothesis concerning U.S. merchandise trade:

Changes in the direction of international economic structure are the direct result of the comparative rate of growth of the U.S. economy; with the American growth rate high relative to that in the rest of the industrialized world, structural changes are biased in favor of the U.S. merchandise balance, but with a lagging American growth rate, the structural changes which occur are unfavorable to the U.S. merchandise balance.¹³

¹¹ See R. W. Baldwin, "The Commodity Composition of Trade: Selected Industrial Countries, 1900-1954" *Review of Economics and Statistics*, February 1958 (supplement), pp. 50-71; or H. Tyszniski, "World Trade in Manufactured Commodities, 1899-1950," *Manchester School*, September 1951, pp. 272-304.

¹² The application of interwar parameters to the Brookings study's forecasts of changes in independent variables would, from the import side, produce a greater improvement in the U.S. merchandise balance than was actually projected. The income-interaction parameter for U.S. imports from Western Europe obtained from interwar data is significantly smaller than that of the Polak-Rhomberg model, while the price-interaction parameter is slightly larger. See J. H. Adler, E. R. Schlesinger, and E. Van Westerborg, "The Pattern of United States Import Trade Since 1923," New York: Federal Reserve Bank of New York, 1952.

¹³ "Changes in international economic structure" are broadly defined to include not only the "structural effects" of the historical-empirical literature, but also those important changes in the pattern of trade that cannot be explained by either "structural effects" or "competitive price effects." For this reason the hypothesis can serve to explain such phenomena as the rise of Canada and Japan as important industrial exporters. See Baldwin, *op. cit.*

This hypothesis is supported inductively by the empirical evidence and has the additional merit of focusing attention on those factors which have historically been most important in determining international economic change (rather than abstracting from them as is usually done). The conclusion that the direction of changes in international economic structure is not random might appear to conflict with a considerable body of theoretical literature; it is frequently argued there that the structural changes associated with differential rates of growth are equally likely to lead to an improvement or a deterioration of a country's balance of payments.¹⁴ However, this conflict is purely one of semantics. The arguments of the theoretical literature are based on a relatively narrow definition of "structural" changes, which limits them, in effect, to productivity changes. In the broader definition which is found in the historical-empirical literature, such productivity changes appear as "competitive price effects" rather than "structural effects."

The validity of the hypothesis can also be supported deductively if the nature of the existing body of international economic theory is explicitly recognized. Our aggregative theory of the balance of payments is largely an equilibrium, not a disequilibrium, doctrine; it explains how balances of payments adjust to assumed autonomous changes or to maladjustments which have already taken place, but is comparatively inadequate for predicting the probable sources, direction, magnitude, or persistence of future autonomous changes. Similarly, our present theory of international economic structure is entirely static and *ex post*; the principle of comparative advantage is an effective tool for analyzing the pattern of trade which exists, but can explain neither why this pattern emerged nor how it can be expected to change in the future.

This is scarcely an appropriate occasion for the formal development of a disequilibrium theory of international economic structure. However, the principal constituent elements of such a theory, in comparative static terms, might be tentatively set forth as follows:

(a) The technological interdependence of methods and products places certain definite international constraints on the choice of productive methods, with the result that lower wage industrial economies continuously find themselves in a position that would be comparable to one of incomplete specialization under the static equilibrium conditions assumed by the theory of comparative advantage.

(b) The subsequent growth in productive resources in these lower wage industrial economies will enable them to capitalize on the profit opportunities and quasi-rents arising from a situation in which productive capacity in certain industries has been too small to supply all that is demanded at home and abroad.

(c) The resulting additions to productive capacity in these industries will automatically lead to changes in international economic structure, the direction of which is definitely unfavorable to the balances of payments of higher wage industrial economies and the magnitude of which is dependent on the rates of growth achieved by the lower wage industrial economies.

¹⁴ See, for example, F. Machlup, "Dollar Shortage and Disparities in the Growth of Productivity," *Scottish Journal of Political Economy*, vol. I (1954), pp. 250-267.

(d) Such changes in international economic structure will be the predominant ones unless they are counteracted by changes in the other direction caused (1) by shifts in demand in the higher wage industrial economies away from the kinds of products presently produced abroad and (2) by the introduction of new types of export products from the higher wage industrial economies.

The magnitude of these countervailing shifts is, in turn, a function of the rates of growth achieved in the higher wage industrial economies. Hence, the critical importance of comparative growth rates.

V. THE RELIABILITY AND USEFULNESS OF THE BROOKINGS STUDY'S ANALYTICAL CONCLUSIONS

The analysis of the three immediately preceding sections has revealed a significant number of historical, statistical, and theoretical reasons for believing that the Brookings study's forecasting techniques are internally inconsistent. It is quite unlikely, therefore, that the study's trade and gross national product projections will ever be realized simultaneously. Such inconsistency in the merchandise balance forecast must, in turn, cast considerable doubt on the reasonableness of the Brookings projection of the overall basic balance.

If the rate of growth which the Brookings study projects for the United States should be attained, the improvement in the merchandise balance will obviously be much greater than forecast. However, a lower rate of American economic growth seems far more likely. In this case, the results in balance of payments terms are problematic. A rate of growth as high as that which prevailed in the early 1950's, on the one hand, when coupled with the expected slowing down of Western European growth, might bring about the elimination of the basic deficit. On the other hand, continuation of the low growth rate of recent years would seem to indicate the persistence of the deficit.

Paradoxically, however, the internal inconsistency of the Brookings basic balance projection does not necessarily vitiate either the reliability or usefulness of the study's other general analytical conclusions or corollaries. Considerations of the direction and quality of the inherent biases are also involved. The authors' belief in the need for new international liquidity arrangements, for example, is based largely on their projection of gross trade flows, but the evidence of internal inconsistency pertains primarily to net trade flows.¹⁵ Moreover, the Brookings staff also stresses (pp. 237-238) that primarily as a result of structural changes "future annual imbalances will be larger, relative to total international transactions, than they have been in the past, and that they will also be more persistent." The tentative disequilibrium theory of international economic structure advanced here only serves to formalize and strengthen this important conclusion.

The adequacy of existing international liquidity arrangements is essentially a function of the stability of the reserve-currency system.

¹⁵ Statistical data which have recently become available lend support, however, to the additional hypothesis, that for the United States, declines in the trade-output ratio occur during periods of rapid economic growth relative to the rest of the world, while increases in this ratio take place when the comparative American growth rate is low. See R. E. Lipsey, "Price and Quantity Trends in the Foreign Trade of the United States," Princeton: Princeton University Press, 1963, ch. 2.

Several important attributes of a properly functioning reserve-currency have recently been set forth.¹⁶ In this list, our analysis strongly suggests, there should be included a major, and perhaps fundamental, addition:

The rate of growth of a reserve-currency country must bear a definite relationship to that in other countries; if it is too high, a shortage of international liquidity will ultimately emerge, and if it is too low, concern about the stability of the currency as a reserve-medium will eventually develop and grow.

Given the present rudimentary state of our knowledge of the true determinants of economic growth, this comparative growth rate requirement may appear to some to be a rather flimsy peg on which to construct a viable international payments framework.

The conclusion, furthermore, that the direction of future changes in international economic structure is a function of comparative growth rates would seem to imply that the existing international economic structure may in itself be an important determinant of comparative growth rates. To the extent that this is true, the responsibility of being a reserve-currency country would tend to place intolerable strains on a very high-wage economy and make it increasingly difficult for the country to accomplish important domestic policy objectives.

VI. COMPARATIVE GROWTH RATES AND THE "DISCIPLINE" OF THE BALANCE OF PAYMENTS

The realization that the U.S. balance-of-payments problem is far more intractable than visualized in the Brookings projection might appear, at first glance, to cast considerable doubt on its authors' conclusion that there is no pressing need to take any fundamental policy action. It has, in fact, become quite fashionable in banking and other financial circles to speak of the "discipline" which our balance-of-payments position must place on American policies and actions. But as the analysis of the present evaluation has clearly demonstrated, much of our balance-of-payments problem is the result of unfavorable changes in international economic structure which arise because of the comparative stagnation of the American economy. In this context the persistence of the deficit reflects, not monetary and financial excesses, but the simple fact that the rate of growth of the United States has been too low relative to that in the other industrial countries of the world. It becomes reasonable therefore to talk not so much in terms of the "discipline" of the balance of payments as in terms of the "spur" or "incentive" of the balance of payments.

The idea of balance-of-payments discipline does, of course, have obvious and intrinsic merit in the case of international flows of short-term capital. However, as the Brookings study so ably shows, it is in the basic rather than the total deficit that the solution to the American balance-of-payments problem must ultimately be found. And to

¹⁶ These are: (1) That the reserve-currency country have a key currency widely used in international trade; (2) that the reserve-currency be a long-term foreign investor so that it can run a continuing payments deficit without becoming a net debtor; and (3) that the reserve-currency country have a large short-term public debt and a well-developed money market. See P. B. Kenen, "Reserve-Asset Preferences of Central Banks and Stability of the Gold-Exchange Standard," Princeton: International Finance Section, 1963, p. 68.

the extent that measures of financial constraint reduce or otherwise hamper our rate of economic growth, they should prove to be self-defeating insofar as the improvement of this basic external balance is concerned. A policy of discipline, it is true, can be quite effective in bringing about the necessary adjustments to those external imbalances which already exist. At the same time, however, the low rate of economic growth that is associated with such a policy of constraint would permit the continual emergence and creation of new external imbalances. It is this pattern of interaction between "adjustment to the old" and "emergence of the new" which seems to offer the most realistic and convincing explanation of the conflicting trends that have characterized U.S. merchandise trade over the last 5 or 6 years.

Turning to the idea of the spur or incentive of the balance of payments, it would be comforting if one could reverse the argument and point unequivocally to the desirability of a policy of domestic expansion rather than of constraint. However, expansionary measures can lead to an improvement of our basic international balance:

(1) Only to the extent that they take a form that will induce an expansion of actual physical production rather than mere money values; and

(2) Only if this rate of expansion is sufficiently great to ameliorate or reverse the direction of present and recent changes in international economic structure.

If either or both of these conditions are not fulfilled, there is a considerable likelihood that expansionary policies will create not an improvement but a worsening of the U.S. basic international balance. For this reason a calculated policy of domestic economic expansion would necessarily involve certain definite international financial risks.

In the opinion of this observer, however, these are risks which are well worth incurring. Indeed, the American Government and American people do not really seem to have very much of a choice in the matter. The only realistic alternative to vigorous domestic expansionary measures would be the continuing acceptance of the persistent domestic stagnation and the chronic passiveness of the balance of payments that have plagued the U.S. economy in recent years.

STATEMENT BY TIBOR SCITOVSKY

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The authors of the Brookings report were commissioned to estimate not what the U.S. balance of payments is most likely to be 5 years from now, but what it would be if the development goals set by the President's Council of Economic Advisers for the United States and by the Organization of Economic Cooperation and Development for Western Europe were fully realized. Since, with the passage of time, these goals appeared more and more unattainable and the projections based on them more and more unrealistic, the authors have also provided an alternative projection based on more modest though possibly still overoptimistic assumptions concerning growth rates in the American and Western European economies. The first projection, based on the assumptions prescribed, shows a \$1.9 billion basic payments surplus in 1968; the second projection, based on the more realistic alternative assumptions, shows a \$600 million deficit—hardly smaller than the \$800 million deficit of the base year, 1961.

I will not attempt and am not competent to criticize the approach and its technical details which have led to these predictions. Indeed, I should like to congratulate the authors on their ingenuity in presenting a very complex problem in manageable, even readable, form; and on their public spiritedness in attempting a task which must have seemed impossible beforehand and which their work has proved, in a sense, to be impossible. The latter I regard as the authors' main contribution; but before discussing this further I should like to raise a few minor points.

While the Council prescribed the assumptions concerning future growth rates, U.S. employment, and the course of U.S. prices, the authors were free to make the assumptions most realistic or most in keeping with those prescribed for all the other variables. One can find fault with and wish to modify quite a few of these assumptions, but only two of my objections are important enough to be mentioned here.

(1) The authors divide the free world into the United States, Western Europe, and the rest of the world; they assume that this last consists of countries that neither wish to accumulate nor can afford to draw down external reserves and can be trusted, therefore, always to equate their external expenditures to their external receipts. This assumption greatly simplifies the analysis, but it is not quite realistic. Although the combined reserves of the rest of the world remained remarkably stable during the 1950's,¹ this was the result of offsetting changes between, rather than of stability in, the national reserves of the individual countries. The rise in Japan's reserves from \$0.8 billion to \$1.8 billion over the past decade and Canada's adoption of fixed

¹ For a convenient table (though excluding Canada), see p. 180, "Factors Affecting the United States Balance of Payments," Joint Economic Committee, 87th Cong., 2d sess.

exchange rates (coupled with a \$0.7 billion addition to her previously stable \$1.9 billion reserves) strongly suggest that these two countries at least wish to accumulate reserves and adopt reserve policies similar to those of other industrial countries. The same may be true of several other members of this group as well. If this is so, it would probably render our future payments balance worse than the authors anticipate.

(2) Of the many factors influencing the U.S. balance of payments and considered by the authors, one appears dominant: America's competitive position in world markets as determined by the ratio of Western European to U.S. prices. The assumptions made concerning this factor are, therefore, of crucial importance, and here two points can be made. First, the authors may well have exaggerated the expected improvement in America's competitive position when they assumed Western European GNP prices to rise almost twice (and export prices three times) as fast as American ones. Their justification for the assumed rise in Western European prices is convincing enough when viewed against the background of past experience, but they fail to take into account a new factor: the price stabilizing influence of integration within the European Economic Community. When the Community's common agricultural price policy comes into effect it is likely to put a damper on the future rise in European farm prices, and the fast-increasing volume of intramember trade can be expected to slow the rise in European wages by increasing producers' dependence on export markets within the Community and thereby strengthening their resistance to wage demands. On the other hand, membership in the Community will probably deprive France of her traditional competitive weapon, devaluation. On balance, however, further progress of the Community is likely to slow the rise in European prices. If this argument is correct, and if Western European prices rise more slowly than forecast by the authors, then also on this count our payments balance will be worse than they predict.

A further point concerning America's competitive position is not a criticism of the authors but a warning to the reader. The authors assume that our imports respond to changes in price ratios with an elasticity of 1.7, our exports to Western Europe with an elasticity of 2.5, to the rest of the world with an elasticity of 2. The first and third of these elasticities were derived from empirical studies; the second was assumed by the authors because the empirically derived value of "more than 4 * * * seems too high to be plausible."² In view of the notoriously great difficulty and wide margin of error with which such elasticities are estimated, I have no quarrel with the authors' procedure; but it is worth asking what difference a small change in this purely arbitrary assumption would make. An elasticity of 2 or of 3 is hardly less plausible than the 2.5 the authors assumed. The first would change the two projections to a \$1.2 billion surplus and a \$900 million deficit, the second to a \$2.6 billion surplus and a \$300 million deficit respectively. These are very big changes to result from small revisions of a single arbitrary assumption, and they make one wonder how much confidence to attach to the forecasts contained in the report.

This brings me to my main point, the impossibility of the task the authors were set. Reading their report, analyzing their assumptions,

² Cf. pp. 82, 86, and 88 of the report.

and tracing the consequences of slight changes in these assumptions make one realize that neither their projections nor any conceivable improvements upon them could possibly be reliable enough to serve as a basis for national policy. The reason is no fault of the authors or their approach but a characteristic of the payments balance. The balance of payments is the relatively small difference between the very much larger amounts on the two sides of the international accounts, and this is why it fluctuates so greatly in response even to small percentage changes in the items of which it is the difference. It may be likened to the pointer of an old-fashioned balance, which describes a great arc in response to the tiniest change in the weights placed on one of the scales. This great sensitivity of the payments balance to slight changes in economic conditions is matched, of course, by an equally great sensitivity in the estimates of the future payments balance to slight errors in estimation or changes in assumed conditions. How great this sensitivity is was illustrated in the previous paragraph, and I should like to draw attention to yet another and even more striking illustration of it in the very great difference between the two projections presented in the report.

It will be recalled that the alternative projection assumes a U.S. growth rate of $4\frac{1}{2}$ percent lower and a Western European growth rate 10 percent lower than the growth rates underlying the first projection. These are small changes in assumptions. Moreover, they are mutually offsetting, since slower U.S. growth tends to improve, and slower Western European growth tends to worsen, the U.S. balance of payments.³ And yet, these two changes in assumptions, mutually offsetting and each of them small, change the projected U.S. payments balance from a comfortable \$1.9 billion surplus to a sizable \$600 million deficit by \$2.5 billion—a difference as great as our average basic payments deficit over the past 4 years (1959–62). That such small changes in assumptions—or conditions—can have so large an effect on our balance of payments is in my opinion the main lesson to be learned from the Brookings report. It shows not only the virtual impossibility of making long-term balance-of-payments forecasts and basing policy on such forecasts, but it also brings home the great variability of the balance of payments and its great sensitivity to relatively small changes in economic conditions at home and abroad. A best guess estimate of the U.S. balance of payments 5 years hence would almost certainly be less favorable than the authors' first projection, but even the most reliable and sophisticated forecast would be subject to a margin of error so wide as to be virtually useless as a basis for policy.

This conclusion carries an important implication: it reinforces the authors' policy recommendations. We have a balance-of-payments problem which needs solving, and the message of the Brookings report is that we should solve it not by any of the familiar emergency methods but by reforming the free world's system of international payments and establishing international machinery that would enable individual

³ It is true that these changes in assumptions, while small, are cumulative, since slower growth is assumed for not 1 but 7 years. On the other hand, such cumulation is characteristic of most economic changes. It is also true that the reason why a 10-percent lower European growth rate has so great an impact on the payments balance is that it is assumed to reduce by almost one-half the rise in European prices; but this again is a reasonable assumption.

countries to deal with their payments deficits as a matter of routine, without sacrificing domestic prosperity and without the stigma of economic bankruptcy.

The authors advocate such a reform because one of their findings, which I fully accept, is their prediction of an increasingly severe shortage of the world's international liquid reserves which would render balance-of-payments crises progressively more frequent and harder to deal with. The case for reform, however, is much stronger than they make out, because it rests not only on this finding of the authors but as much or more on the unreliability of their projections and the wide margin of error to which they are subject. The difficulty of predicting the payments balance, which their report so strikingly illustrates, implies that a policy of balance-of-payments adjustment cannot be planned in anticipation of future trends on the basis of long-run projections; it must await and follow the events with whose consequences it is designed to deal. If this is so, we need prompter and less painful means of adjustment or a longer period of grace during which adjustment policies can exert their influence. Either of these would be provided by the kind of reform the authors advocate.

I should like to endorse, therefore, the authors' recommendation for a reform of our system of international payments. I do not share the optimism implied in their first projection and believe that our payments deficit needs attending to. But this should be done as part of the kind of reform they contemplate. Any attempt to eliminate our payments deficit without such reform would almost certainly deal a further blow to the payments mechanism by implying an admission of our inability to abide by its rules.

STATEMENT BY ARTHUR SMITHIES

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The Brookings study, which projects the U.S. balance of payments in 1968, is a remarkable statistical undertaking, reflecting the ingenuity, perception, and experience of the authors. They are not only imaginative with use of their methods, but are also acutely aware that they have undertaken as difficult a task of projection as can be found. In an open economy such as the United States the balance-of-payments surplus or deficit results from the operations of its entire economy, and of the economies with which it trades. A projection of the balance of payments 5 years in advance is even more difficult than a projection of the surplus or deficit in the Federal budget. Both are affected by many of the same factors, but the balance of payments is materially influenced by capital flows which may not alter the budget estimates.

The study does not even purport to be a forecast of the future. The authors were instructed to make an estimate of the payments implications of the pursuit of domestic growth objectives announced as desirable (and feasible) by the Council of Economic Advisers in the United States and by the Governments of OECD countries. Such a study is necessary since the balance-of-payments consequences are highly relevant to the feasibility of the growth targets themselves. The Brookings estimates indicate that vigorous pursuit of domestic objectives in the United States and Europe will in fact change the international situation by converting the basic deficit of United States into a basic surplus, and the surplus of Europe into a deficit. That will be welcome news in the United States; whether it will be equally welcome in Europe is open to question.

The authors received their instructions early in 1962. Since then, the pursuit of the stated goals has been neither active nor successful enough to justify the initial hopes. Since there can be little expectation that the goals can be reached by 1968, the Brookings authors have produced an alternative estimate, with lower growth rates for the United States and Europe. These estimates yield approximate balance in the basic accounts of both Europe and the United States, which may be less comfortable for the United States but more so for Europe.

The report is not simply an analysis of payments relation between the United States and continental Europe. It makes, however, the simplifying assumption that the rest of the world, including the sterling area and Japan, will neither accumulate nor decumulate reserves over the 5-year period. Consequently persistent surpluses or deficits are confined to the United States and Western Europe. These can arise from their direct trading and financial relations, and also from changes in their relations with the rest of the world. I am not sure that the rest of the world is quite as passive as the report assumes,

but there is no doubt that, in making their simplification, the authors have directed attention to the most critical area.

The authors provide no payments estimates for the intervening 5 years up to 1968. But the implication is clear that U.S. basic deficits will continue for the first part of the period. If these can be accommodated there will be a happy end of the story. The essence of the matter is that Europe will inflate more rapidly and grow less rapidly than the United States. The more rapid rate of inflation in Europe will improve the relative trading position of the United States. The more rapid rate of growth in the United States will improve the relative profitability of investment in the United States and hence reverse the outflow of private capital, which has been an embarrassing negative item in the U.S. accounts in recent years.

Whether the statistical estimates are right, given the assumptions that underlie them, I am quite unable to say; even though, in direction, they conform to my own preconceptions. As one of the authors of the report stated in informal discussion, the methods produce a mixture of econometrics and horsesense. This remark points up the projector's dilemma. If he predicts the future in a changing world on the basis of statistical formulas derived from the past, he knows that the errors of his estimates of a small item like the balance-of-payments deficit or surplus can be as great as the estimate itself. The additional application of horsesense may contain elements of bias and wishful thinking. On one occasion in the report, however, the horsesense adjustment was applied to avoid results that would seem too good to be true.

The estimates, whether right or wrong from a statistical standpoint, are based on certain important propositions concerning the policy and behavior of the United States and Europe:

(a) That Western Europe will be prepared to lend substantial amounts to the United States over the next few years in order to permit it to run continuing deficits without a loss of gold beyond the limits of its tolerance.

(b) That Europe will be prepared to inflate to an extent that it will find domestically disagreeable in order to play its part in converting its present surplus into a deficit.

(c) That the pursuit by the United States of its major domestic objectives—full employment and a satisfactory rate of growth—will by itself contribute to elimination of the balance-of-payments deficit. These propositions must be critically examined in assessing the validity of the projections.

The present balance-of-payments difficulties of the United States result in large measure from the fact that other countries are not willing to lend to us on the terms at which we are prepared to borrow. Instead of holding the proceeds of their surpluses in the form of U.S. Treasury bills or deposits with U.S. banks, European countries have preferred to buy gold with the consequent drain on the U.S. gold reserves. If they preferred U.S. deposits or Treasury bills to gold no one would be worrying about the balance-of-payments deficit today.

The report, in effect, assumes that by the creation of new institutions or in other ways European attitudes toward lending to the United States, presumably on the same terms as before, will change in favor of the United States. During the past 2 years the Treasury has made

valiant efforts to persuade European central banks to alter their attitudes, with only qualified success. There is considerable question in my mind whether those attitudes can be changed with the future unless the United States is prepared to increase substantially the attractiveness of the terms on which it is prepared to borrow, by raising interest rates, offering exchange guarantees, and so forth.

The next question is whether, as assumed in the report, Europe will be prepared to inflate at the rate of 2.75 percent a year and hence help convert its surplus into a deficit. It is possible that the continued accumulation of banking reserves, combined with a tight labor market will make the desired degree of inflation in Europe inevitable. But this outcome should not be regarded as certain. With their great dependence on exports, the European countries are deeply conscious of the damaging effects of cost inflation, and may be expected to take strenuous domestic measures to curb it. However if inflation does occur, they may not readily acquiesce in the increased flow of U.S. exports that the report hopes for. Instead they may respond to pressures from domestic producers threatened with increased import competition and attempt to prevent the increase by raising the Common Market tariff or other forms of import restriction. Thus the second basic assumption of the report cannot be accepted without question.

The third assumption is also open to question. The report assumes that for the next 5 years the United States can grow at 4.8 percent per year, with general price increases limited to 1.5 percent annually. This projected rate of price increase is substantially lower than those experienced during the periods of expansion of the 1950's and lower than the rate of increase for postwar period as a whole. The assumption implies that new measures have been taken or will be taken to contain wage-price inflation in the interests of domestic stability. The relative stability that has occurred for the past year is not a sufficient basis for such an assumption. With the present degree of unemployment and excess capacity, one would expect relative price stability. On the other hand, the various actions by the administration urging or encouraging wage-price restraint may have made a permanent difference in the behavior of business and labor. My own inclination is to assume that future periods of expansion will follow the same price pattern as previous ones, until the contrary is proved.

A major contention of the report, concerning the United States, is that expansion here will increase profitable domestic investment opportunities, and hence limit private capital outflow. This view rests basically on the general assumption that capital will tend to flow from less rapidly growing economies to more rapidly growing ones—and hence, incidentally contribute to disparities among international rates of growth. It seems to me that attention should be directed primarily to the yields on investment rather than to aggregate rates of growth. It is quite possible that the more rapidly growing economy may be operating at lower profit rates and lower interest rates than the more slowly growing one. In that event the effects of differentials in growth rates would be the opposite to those anticipated in the report.

The authors argue that profit rates will tend to be lower in Europe than in the United States, because of an increasing labor shortage in the former. However, they also assume that to achieve growth ob-

jectives, interest rates will need to be lower in the United States than in Europe. That seems to imply that they expect profit rates to be lower in the United States.

With respect to current balance-of-payment items, the report argues that deficits will have a natural tendency to correct themselves, and that the provision of credit will not, therefore, remove incentives for the country to correct the deficit. The authors argue (p. 250) that if a country loses export markets, business firms will have incentives to seek new export markets to replace the old ones. This argument is highly questionable, and the world is full of counterexamples. Whether businesses will seek new export markets to replace old ones will depend heavily on the domestic fiscal and monetary policies of the Government. If full-employment policies are literally followed, regardless of the balance of payments, that means that losses of export markets will be compensated for by the creation of new domestic markets. In that event, the incentive to find new export markets to replace old ones may disappear entirely.

The three basic assumptions underlying the report's estimates are thus open to question. Other countries may not provide credit on the terms desired by the United States; European countries may not inflate to the extent desired, and, if they do, may nullify their action through import restrictions; and, finally, normal pursuit of its domestic objectives may not be sufficient action on the part of the United States. But if the assumptions are all wrong, the consequences are indeed alarming.

If an international system based on fixed exchange is to work satisfactorily countries must be prepared to extend credit to each other, and they must be prepared to allow relative price changes to occur: surplus countries must inflate more than deficit countries. If credit is not available, and surplus countries refuse to inflate, the burden of adjustment must be borne entirely by income deflation in the deficit countries. There is some evidence that Europe, partly as a result of education by the U.S. Treasury, now believes it has an interest in making the present system work. While it has withdrawn gold, it could have withdrawn much more, and probably could have forced a devaluation of the dollar. In the last year or two Europe has inflated more than the United States, but whether inflation has been permitted, to any extent, for the sake of international adjustment I am unable to say. But the European countries clearly have not gone far enough in either of these directions to remove the difficulties now facing the United States.

In the light of their analysis the authors reach their conclusions that "we do not recommend that the Government at this time take any steps to improve the balance of payments other than measures that seem desirable in themselves" (p. 253) and "we have stressed that measures which might endanger U.S. economic growth, and the restoration of high employment levels should not be adopted for balance-of-payments reasons. This means that it is inadvisable to raise interest rates in an attempt to affect international flows of capital unless, as seems unlikely at present, the adverse domestic effects of higher interest rates can be fully offset by fiscal expansion." (Ibid.). In the international field the United States should demonstrate that it is prepared to make bold use of its existing reserves and drawing rights,

seek additional credits, and negotiate for removal of European discrimination against it.

When they read these recommendations, citizens of other countries may be tempted to remark that the report claims for the United States immunity from the rules of international conduct that it does not hesitate to recommend to other countries. During the Marshall plan, we insisted that European countries increase exports and replace imports demand even though such measures might have impeded economic growth. We urged devaluation of sterling in 1949. We give stern deflationary advice to the countries of Latin America. But whatever foreigners think of it, the report may still be right.

One possible course of action is for the United States to design its domestic policies with domestic objectives alone in view and to let the balance of payments take its course. Other countries would then be compelled to decide whether their interests required that they provide credit to the United States, or inflate or reduce tariff barriers. If they followed that course they would, in effect, validate the assumptions of the report. Or they could decide that devaluation of the dollar was in their best interest, and thereby spare the United States a decision that it would be reluctant to take deliberately.

The other approach is to attempt to devise policies that will both serve domestic objectives and contribute positively to balance-of-payments equilibrium. Such policies would include measures to increase the relative attractiveness of the United States as a financial center for the holding of assets by foreigners and Americans and measures to improve the competitive trading position of the United States. Other less attractive measures would involve direct controls of capital or commodity movements.

The most direct approach to the capital side of the problem is to raise the general level of interest rates in the United States. But if such a move is to be consistent with domestic policy objectives, the profitability of investment in the United States must be increased correspondingly. In other words, both interest rates and the marginal efficiency of investment need to be increased. The increase in the marginal efficiency can be brought about by reduction in profits taxation generally, special investment allowance and so forth. This is the course of action that the authors of the report reject on grounds of political feasibility. In this respect the authors have gone too far in accepting irrational prejudice as a barrier to rational economic policy. However, interest rates will be higher than they otherwise would be, if the proposed general tax reduction is enacted.

If a general increase in interest rates is not feasible the United States must resort to various practical measures to offset the effects of continuing discrepancies between interest rates at home and abroad. One such measure is the proposed interest equalization tax which would lower the rate of return that Americans can obtain by investing in foreign securities.

Another possibility is that the U.S. Government should engage in long-term borrowing in foreign currencies. Already the Treasury has broken with tradition by undertaking short-term borrowing, and I see no valid reason why it should not sell long-term obligations to foreigners. So long as private capital export amounts to about \$2.5 billion a year, Government borrowing up to this amount can be under-

taken without impairing the net asset position of the country. Objection to this suggestion will be raised on the ground that the United States will have to pay higher interest rates abroad than it does at home. This objection should not be decisive. The question to ask is whether it is worth paying a price, and if so how much, for the ability of the country to be a large-scale private capital exporter. A further objection is that public issues abroad would attract private American capital, which would be attracted by the higher interest rates. It may not be possible to meet this objection entirely. But a simple requirement that the nominal subscribers should be foreigners should be enough to deter the large institutional investors in Government bonds. Another possibility is that American subscribers should be subject to the interest equalization tax.

Part of our difficulties stem from the fact that we want other countries to extend us credit on the terms that prevail in the U.S. domestic financial markets. If we need credit why should we not obtain it at the rates that prevail in foreign markets? Otherwise we seem to be inviting other countries to provide us with economic assistance. A policy of increased borrowing abroad would have the advantage that it would require minimum readjustment of domestic policies.

If adequate measures are taken on the capital side, can trade be left to itself, or must domestic policies be designed with due regard for the international competitive position of the United States? As I have indicated, I do not share the view, expressed in the report, that the international situation should not be taken into account. We should pay more attention to the wage-price question than we would for purely domestic reasons. Furthermore, the U.S. Government should not take the view that it is somehow exempt from the international adjustments that other countries have to make. Rather, it should warn the country that if inflation gets out of hand, compromises must be found between national and international objectives.

Such compromises, however, should not involve prolonged periods of unemployment in the United States. If that seems to be the only possibility with fixed exchange rates, devaluation is a clearly preferable alternative. But I share the report's view that primary attention should be directed toward making the fixed rate system work.

The remaining category of available measures consists of direct controls of capital and commodity movements. Most foreign governments have capital issues committees that limit foreign borrowing in their financial markets. The United States could follow their example. But such a move would presumably encourage other countries to strengthen their own restrictions. Whether the world should move in the direction of increasing impediments to the international mobility of long-term capital is open to question. With respect to the use of direct controls on U.S. imports, I have few doubts. Resort to them by the United States would destroy the painstaking efforts it has been making to achieve a multilateral world trading system, on which the welfare of much of the world depends.

I have discussed so far the problems of the U.S. balance of payments during the next few years. There remains the support given by the report to proposals that international reserves should be held increasingly in international institutions rather than in particular coun-

tries. The report points clearly to the modern dilemma of a reserve currency country. To play that role in an expanding world, a country, like a commercial bank must be prepared to borrow short and lend long, and its liabilities to its depositors increase in relation to its own reserves. In other words, it must run a persistent basic deficit. But the United States has found that a persistent basic deficit diminishes confidence in its currency. The reason is that other countries rightly believe that the United States will not impose severe deflation on its economy, if that becomes necessary to meet its obligations as a banker. That is what Britain was prepared to do until 1931. On the other hand, measures to reduce the basic deficit prevent the country from playing its part as a banker. Increased reliance on the International Monetary Fund or the creation of new international institutions may be the only satisfactory way of reconciling international reserve requirements with the freedom of internal action that modern countries choose to exercise.

STATEMENT BY D. A. SNIDER

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The study by Walter Salant and colleagues on the U.S. Balance of Payments in 1968, is a very competent, professionally done piece of research. Yet I have serious reservations on many of its principal conclusions and implications, and it is to these that I shall mainly direct my remarks.

SUMMARY OF RESERVATIONS

Before examining in some detail the reasons for them, I shall first briefly summarize the reservations I have on the conclusions and implications of the study.

The principal conclusion of the study is that the basic deficit in the U.S. balance of payments will be eliminated by 1968, with a definite possibility that a surplus will develop. An important qualification of this conclusion is that inadequate international reserves may lead to actions on the part of other countries which would prevent, or make more difficult, improvement in the U.S. balance of payments.

A second major conclusion of the study, related to the above qualification of the first conclusion, is that the balance-of-payments deficit is not the primary problem: "More fundamentally, the problem is the basic inadequacy of the international monetary mechanism in relation to requirements of the free world" (p. 243).

My chief criticism relates to the conclusion that our balance-of-payments deficit will probably disappear over the course of the next 5 years, and to the related conclusion that it is not now necessary to take any special measure to reduce the deficit. Implicit in this criticism is another, bearing on the second major conclusion of the report. While I thoroughly agree that the present international monetary system is seriously defective and in urgent need of basic reform, I cannot agree that this has a priority as a problem for the United States. In my judgment, we have two distinct, even though related, problems. The first is the deficit in our balance of payments; the second is reform of the international monetary system. A final solution to the first problem may indeed require a solution to the second, but solving the second problem cannot be a substitute for a direct attack on the first.

In short, I feel that the study is too optimistic in its conclusions on the future balance of payments of the United States, and consequently places too little emphasis on our balance-of-payments problem in comparison to its emphasis on the defects on the international monetary system.

I wish to emphasize, however, that I have no basis for reaching conclusions opposite to those of the study. The study's optimistic projection of our balance of payments may well turn out to be accurate. *The point is, the bases upon which the projection is made are inadequate to yield conclusions in which we can afford to place confidence*

for policymaking purposes. If the chances of the study's projections being seriously wrong are significantly large, to base policies upon them is to run dangerous risks. For reasons to be developed below, I feel that the chances of the projections being wrong are great enough to warrant extreme caution.

THE STUDY'S FRAME OF REFERENCE

Preliminary to an examination of my reasons for questioning the projections of the study, a brief comment on its frame of reference is in order.

The authors are very careful in pointing out the limitations of their model and the tentative character of their conclusions. They state that their projections are not unconditional forecasts but "estimates of what the assumptions imply, *made without assessing the probability that these assumptions will be realized.*" (P. 35, italic supplied.)

While the authors cannot therefore be criticized for making wild and irresponsible forecasts, it is clear that their report is more than an academic exercise in the manipulation of an economic model. Presumably they were assigned the task of making the study to serve as a guide in policy formation. It seems fairly clear that the authors have not intended to bypass this purpose. Thus, despite numerous caveats and disclaimers, they state conclusions which can only be interpreted as representing their best judgment as to actually what will happen to our balance of payments over the next several years.

That this is the correct interpretation of the report is evidenced in several ways. In the first place, presumably in an effort to be more realistic, an alternate set of assumptions as to the GNP and price levels in the United States and Western Europe—less favorable to our balance of payments than the initial assumption, assigned by the Council of Economic Advisers—was used in the study. Secondly, in their "analytical conclusions," the authors state, "Our best guess is that the basic deficit (in the U.S. balance of payments) will be eliminated" (p. 230). The use of the word "guess" indicates a high degree of modesty and considerable uncertainty, but does not destroy the predictive character of the statement. Finally, the authors' recommendation that the Government not take any steps at this time to improve our balance of payments, "other than measures which seem desirable in themselves" (p. 253), would be difficult to justify if they did not believe there is a reasonably good chance that the deficit will disappear "on its own" within the next few years.

I find it difficult to accept these conclusions as a basis for policymaking, because I have even less confidence than do the authors in the projections their model yields. In my view, the projections are too uncertain to form the basis of policy, for two kinds of reasons: (1) those relating to weaknesses in the theoretical model itself, and (2) those relating to the specific assumed values of the variables included in the model. I shall now briefly discuss each of these in turn.

WEAKNESSES OF THE THEORETICAL MODEL

The disequilibrium in our balance of payments is now conventionally described as an imbalance between (a) the net export of goods and services, and (b) the sum of net autonomous unilateral transfers,

foreign military expenditure, and capital outflows. The excess of (b) over (a) is identified as the deficit, and is matched by (c) the creation of short-term foreign liabilities and the export of gold (plus or minus errors and omissions). Elimination of the deficit therefore requires that (a) increase relative to (b).

To forecast the future balance of payments involves estimating the future volume and prices of exports and imports of goods and services, the amount of unilateral transfers and foreign military expenditure, and the volume of autonomous capital flows into and out of the country. The Brookings study logically considers each of these major elements and the interrelationships among them.

An important distinction can be drawn between those components of the balance of payments largely determined by market forces, and those determined by governmental decision on the basis of nonmarket criteria. In the case of the U.S. balance of payments since the end of World War II, the latter category has been unusually important, and includes large unilateral transfers in the form of economic and military aid, that part of capital outflow in the form of Government loans to foreign countries, and oversea military expenditure. The export and import of goods and services (excluding military) and the flow of private capital remain essentially market phenomena.

I have no serious criticism of the study's projection of nonmarket transactions and their impact on the balance of payments. But I do question the projection of market transactions, in particular the export and import of goods and services.

The exports and imports of a country are dependent upon numerous forces. A list of the most important of these forces would include the level of real income, relative prices—at given exchange rates—the tastes of consumers, the kinds of products and services traded, the state of technology, institutional ties, market structures and practices, and commercial and financial policies. In all cases, it is a question of the relationship between these variables at home and abroad.

The authors of the Brookings study are certainly quite aware that all the above factors—as well as others not mentioned—enter into the determination of a country's trade balance. Nevertheless, for very understandable reasons, they have employed a theoretical model which excludes all the relevant variables except for two; namely, real income—or gross national product—and relative prices.¹ These two variables are assumed to be the "principal factors which determine United States and Western European imports of goods and services" (p. 33). The reasons for this choice are clear: real incomes and relative prices are indeed "principal factors," and in any event they are the only ones that can be quantified. As the authors state, other variables are excluded not because they are unimportant, but because they are not susceptible of quantification or projection.

What the procedure amounts to, then, is the assumption, for purposes of the analysis, that all relevant variables other than real income and prices remain unchanged over the period to 1968. It is doubtful whether anyone—least of all the authors of the study—believes such will actually be the case. But different observers are likely to have different opinions on the extent to which projections based on ignor-

¹ Their conclusions are later modified, however, by the anticipated effects of developments in the European Common Market.

ing other variables are thereby weakened. It is possible that the ignored factors will turn out to have exerted only a negligible influence, either because of small changes or because of offsetting changes.

In my opinion, however, it would be extremely unwise to expect this to happen. As the report itself explicitly recognizes, widespread structural changes have been occurring in the world economy—especially in the economies of Western Europe and Japan—and can be expected to continue to occur in the years ahead. “The prospect of changes in the relationships between the economic structures of the United States and Western Europe emerged clearly from our studies” (p. 237).

If such changes do in fact occur, the function employed in the study to project our balance of trade is likely to yield false results. Specifically, the parameters of the regression equation based on relationships for the period 1948–60 will not be relevant for the period under consideration. Moreover, relatively small differences in the parameters could make a large difference in the results.

ASSUMED VALUES OF VARIABLES INCLUDED IN THE MODEL

Even though I have little confidence in projections based on a model which assumes no significant changes in structural relationships that prevailed in the past, for the sake of argument let us assume that the function used in the study relating imports and exports to real gross national products and relative prices continues to be valid during the period 1961–68. In this case there emerges a second kind of criticism of the projections—namely, the doubtful validity of assumed values for the independent variables included in the function.

Given the function employed in the study, the future trade balance of the United States depends upon future levels of real gross national product and prices in the United States and Western Europe. I find it very difficult to accept as within the realm of reasonable probability the values assumed for these variables.

Growth rates

First, as to the values assumed for real income changes, I feel that the relative rise in the real GNP of the United States is unrealistically high, if regarded as a forecast. While it is reasonable to expect the growth rate of Western Europe to decline somewhat from its recent extraordinary level, it does not seem probable that such a sharp reversal as projected in the study in the relative growth rates of Western Europe and the United States of recent years will occur for a sustained period in the near future.

I shall not, however, press this point, for one of the most important aspects of our balance-of-payments problems lies in the implications of a marked increase in our rate of economic growth. There can be no doubt that a persistent balance-of-payments deficit imposes constraints upon vigorous expansionary policies for the domestic economy. Since achieving a more rapid rate of growth than realized in the recent past is perhaps our chief domestic economic goal, the projected effects on the balance of payments of success in achieving this goal are of prime interest. Hence, even though the assumed annual growth rate in the United States of 4.8 percent—or, under the alternative assump-

tion, of 4.5 percent—may strike one as unrealistically high, it is not unreasonable as representing a limit that might conceivably be reached if we are successful in our domestic policies.

If we proceed from this base, however, a second question of a quite different order arises—namely, is the assumed value of the other independent variable in the model—relative prices—consistent with the assumed growth rate? This is a critical question, for the rather optimistic conclusions of the study rest importantly upon the answer arrived at by the authors.

Relative price changes

In the model used in the study, relative price changes determine—given changes in the GNP—the trade balance. The quantitative balance-of-trade effects of relative prices changes is dependent upon (1) the direction and magnitude of price changes, in conjunction with (2) the price elasticity of the demand for imports. The report arrives at favorably price effects for the U.S. balance of trade because it projects a significant decline in our prices as compared to prices in Western Europe, and, secondly, because it assumes a price elasticity of foreign demand considerably in excess of unity—2.5 for Western Europe's demand for U.S. exports. If either relative prices in the United States should fall less than projected, or the assumed foreign price elasticity of demand for our exports should prove to be lower, the result for our balance of payments would be less favorable.

It should be noted that the report's optimistic projection of the U.S. balance of trade is heavily dependent upon its forecast of favorable price effects. A high growth rate in the United States, plus a slowdown in the growth rate of Western Europe, would certainly, in the absence of any other changes, cause a deterioration in the U.S. trade balance. Under initially assumed real income changes, the report estimates the deterioration of the U.S. merchandise trade balance with Western Europe because of real income changes alone to be \$1.5 billion by 1968 (table III-10, p. 90). Yet, despite these adverse income effects, the trade balance is shown to improve significantly because of favorable price effects. The report estimates that the improved competitive position of the United States would account for a favorable increase in our net trade balance with Western Europe of \$3.5 billion—offsetting by more than double the deterioration caused by income effects alone.

Clearly, therefore, the projection of relative price movements, together with the assumed elasticity coefficient, are largely responsible in the report for any improvement in the U.S. trade balance, and, pro tanto, in the basic balance of payments.²

There are grounds for questioning the predominant role assigned by the study to price effects as compared to income effects in projecting the balance of trade—an emphasis implicit in the assumed relative price elasticity of demand for U.S. exports. I shall not pursue this possible weakness in the model, but instead concentrate on the projected magnitude of relative price changes.

There can be little doubt that the international competitive position of the United States deteriorated during the years immediately pre-

² The importance attached to price effects is further pointed up by the report's estimate of the much less favorable impact on the balance of payments if relative prices behave according to the alternative set of assumptions.

ceding 1959, and that the deterioration was, to a significant degree, caused by the greater degree of price increases for manufactured export goods in the United States than in most of our leading competitors. The relative inflation of U.S. prices was in turn largely the consequence of lagging rates of increase in man-hour productivity, in relation to the movement of wage rates, compared to other industrial countries. Neither can there be much doubt that the competitive position of the United States—to the extent that it depends upon price comparisons—has markedly improved since 1959, both because of the leveling off of prices in this country and the emergence of inflationary pressures in Western Europe.

The key question, however, is whether this improvement can reasonably be expected to continue over the next several years, *given the large increase in the average rate of growth assumed* in the study. The conclusion of the authors that an average annual growth rate of 4.8 percent and average general price increase of 1.5 percent a year are consistent is based primarily upon assumptions as to labor productivity and wage changes. Specifically, output per man-hour is assumed to increase at an annual rate of 2.9 percent, while wage rates increase by 4.4 percent, resulting in labor costs per unit of output rising by 1.5 percent. Only this relatively mild "cost push" inflation is admitted; "demand pull" inflation is regarded as improbable.

Before examining the realism of the conclusions, the methodology involved should be noted. The procedure employed in the study is as follows: first, a growth rate of 4.8 percent per annum is assumed; second, a price increase of 1.5 percent a year is assumed; third, given a projection of changes in the labor force employed, and further assuming no changes in the wage share in the national income, the conclusion is reached that man-hour productivity will rise by 2.9 percent a year and wage rates by 4.4 percent a year; lastly, on the basis of assumed expenditure functions, it is concluded aggregate demand will not likely exceed assumed real output, so that demand inflation is improbable.

One cannot criticize the authors for making assumptions they were assigned by the Council of Economic Advisers. But one must be careful in interpreting the significance of conclusions reached on the basis of such assumptions. The assigned assumptions as to growth rates and price changes limit the degree of freedom of the analysis. The assigned assumptions imply certain others. For example, a growth rate of x percent implies, given projections of the labor force, a certain rate of increase in man-hour productivity, and this in turn implies—given assumed price-level movements—maximum rates of increase in money wages. Such implied assumptions should not be confused with estimates of the variables independently arrived at on the basis of analysis of the forces directly determining the variables.

In order to stay within the limits imposed by the assigned assumptions, and at the same time keep as close as possible to realistic estimates of related variables, the authors of the study were virtually compelled to project an image of the American economy that one might guess is quite different from that which would emerge from an analysis less burdened with initial assumptions. It is an almost ideal economy, achieving simultaneously the goals of above-average growth and reasonable price stability, while moving toward balance-of-payments equilibrium.

One may seriously question, however, the realism of this ideal model. Specifically, one may be skeptical about the probability of realizing the postulated growth rate of 4.8 percent, or even the alternative rate of 4.5 percent, while keeping the price level within the bounds of 1.5-percent increase. In order to accomplish such a feat, there are two critical requirements to be fulfilled: (1) Wage increases must be restrained to the maximum anticipated in the study of 4.4 percent a year, and (2) aggregate demand must stay within the limits of real output. The two requirements are closely related, for it is highly doubtful that wage increases would be this moderate if demand-pull inflation were to occur.

The study's conclusion that demand inflation is not to be expected is not very convincing. It is arrived at by estimating the various components of domestic demand to be expected in 1968, on the assumption that gross output has reached the assumed level of \$743 billion (in 1961 prices). The sum of these sectors' estimated demand is less than output by \$4.6 billion. It is then concluded that only if net foreign demand (net exports of goods and services) exceeds \$4.6 billion will demand pressure on prices be present.

An interesting question is through what process the GNP is to grow at an annual rate of 4.8 (or 4.5) percent if aggregate demand barely manages to keep pace with rising production. One should think that starting from a period of excess capacity and high unemployment in the economy—with these still present even after, in 1963, more than 2½ years of cyclical recovery—continued high growth rates would require the inducement of constant pressure from the side of demand. The study apparently anticipates a "supply led" rise in the GNP; i.e., one "pushed" along by increases in productivity. Such increases in productivity must, indeed, occur if the projected growth rate is to be realized. But increased productivity is not sufficient if aggregate demand fails to expand enough to provide employment opportunities for growing supplies of labor and capital. In short, in our economy rapid growth may require that it be "demand pulled." If this is so, the growth rate projected in the study is not likely to be consistent with the projected rate of price-level increases.

Even greater exception must be taken to the study's assumption that export prices will rise by markedly less than the general level of domestic prices—0.5 percent a year, compared to 1.5 percent. Since it is only export prices that are relevant to our international competitive position, this becomes a crucial factor in the study's conclusions.

The study gives no convincing reason for expecting export prices to rise less than the general level of prices. U.S. exports are heavily weighted with manufactured goods, among which the major items are produced in oligopolistic industries with administered prices. During periods of slack demand and excess capacity, stable or only gently rising oligopolistic prices may be expected, but during a period of above average growth in the GNP and elimination of excess capacity—such as projected in the study—all past experience points to the probability of an upward "ratcheting" of prices.

A slower rise in export prices than in the general level of prices might be reasonably expected in those cases where industries are "export oriented" and depend on export markets for a significant proportion of total sales. However, typically this is not the case in the

United States. Conceivably, through a strong propaganda campaign by the Government, American firms may be converted in their outlook and practices with respect to exporting to something like those of their European counterparts, but it would be unwise to count upon this happening, especially during a period of vigorous domestic demand.

Finally, since it is U.S. prices in relation to European prices that are relevant for the balance of trade, a brief comment on the study's projection of European prices is in order. While I agree that market inflationary pressures will probably be much greater in Europe than in the United States over the next few years, I think it would be a mistake to discount the possibility that effective governmental measures will be taken to restrain these pressures in Europe. If Europe is as successful in this respect as it has been in maintaining full employment and rapid economic growth, one of the chief props of an optimistic outlook for the U.S. balance of payments is destroyed.

POLICY CONCLUSIONS

I must repeat that my criticism of the report's projections does not imply that I would project a continuation of the deficit in our balance of payments. I believe the Brookings' report has correctly identified some current and future probable developments that will contribute within the next few years to an easing of our balance-of-payments problem. I do not believe, however, that we have sufficient evidence to justify any projection in which we can place enough confidence to serve as a basis for policymaking.

Even though I agree with the report that we are not yet in a critical balance-of-payments situation, I believe it would be a mistake to rely upon market forces so to improve the situation in the near future that we refrain from considering positive measures to reduce the deficit. It is a formidable task to discover what these measures should be. It is important, therefore, not to be too hasty in dismissing from consideration any potentially effective action, even one as drastic as devaluation. Hopefully, such extreme action can be averted, but the chances of doing so might well be diminished if the recommendation of the report that we do nothing now is followed.

On the other hand, I heartily concur with the authors that we should not continue to adopt the kind of piecemeal measures we have taken in the last few years, which do not significantly reduce our payments deficit but which do have other undesirable effects and compromise other goals. While it is fatuous to seek means of correcting our deficit that will be burdenless and without some necessary adjustments in the economy, an effort should be made to find those measures which, while effective in reducing the deficit, involve the least cost and disturbance, both domestically and internationally. Exchange controls on current account transactions, and internal deflation, are examples of possible measures that belong at the bottom of the list. What possible measures belong near the top of the list is a matter deserving more intensive investigation than it apparently has received.

STATEMENT BY EGON SOHMEN

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I. THE UNITED STATES AND WORLD PAYMENTS

The Brookings study is most valuable as an analysis of developments in the U.S. balance of payments over the past few years and the present situation. Considerably less significance can be attached to the projections attempted in the study for the period up to 1968. Although the authors' conclusions are always stated with all due caution, it pays to emphasize once again that, no matter how carefully and expertly they are prepared, balance-of-payments projections over a timespan of 5 years cannot serve as an even vaguely reliable guide for policymakers. It is not impossible that the projected values of the different variables will be approximately realized, but this is hardly any more probable than the possibility that the United States will have a potential surplus or deficit of \$5, \$10, or \$20 billion in its basic balance by 1968.¹ The reasons for this agnostic conclusion should become apparent in the sequel.

The Brookings authors begin with a discussion of various definitions of "balance-of-payments deficits." Their own emphasis rests on the concept of "basic balance" (roughly, the combined balance of the current account, including unilateral transfers, plus long-term capital movements). To the extent that any conclusions are to be drawn at all for a country's international monetary position from its balance of payments, this concept indeed appears to be the most relevant one.

This differs from the official definition of balance-of-payments deficits practiced by the United States (the Brookings authors' concept of "net total balance"). According to this official definition, the "deficit" includes, apart from any reduction of official reserves, the gross increase in U.S. short-term liabilities to foreigners (in other words, additions to short-term U.S. claims on foreigners that may simultaneously have accrued are not netted out). As the Brookings study points out, deficits of all countries, if they were defined everywhere in this manner, would not add to zero.

The reason usually given for the U.S. practice is that the position of the United States as a "world banker" makes it necessary to follow closely any additions to potential claims against U.S. monetary reserves, irrespective of simultaneous increases in U.S. claims on the rest of the world. A sudden demand for the simultaneous conversion into gold of all liquid claims of foreign governments and central banks, a demand to which they are formally entitled, would confront the U.S. authorities with a most embarrassing dilemma.

¹ The adjective "potential" is meant to remind the reader that continuing imbalances of this magnitude may not become effective because they will have to be checked by trade and payments controls or by policies resulting in large-scale unemployment either in the United States or elsewhere.

It is not sufficiently appreciated, however, that even deposits held by U.S. residents with banks in the United States (and not only short-term dollar assets of foreigners) may, at a moment's notice, become additional claims on the U.S. gold reserve under a regime of full currency convertibility. As long as the dollar remains a convertible currency, the maximum potential claim against American monetary reserves is consequently not the value of foreign short-term claims. Rather, it equals the total money supply in the United States, including all demand deposits held with American banks by foreigners and domestic residents alike.

When the authors mention "the irrational requirement of a 25 percent gold reserve against Federal Reserve notes" (p. 252), one can agree with them for two radically different and contradictory reasons. The one they have in mind (which is also the one almost universally shared by economists) is that the appropriate monetary policy in the United States might be made impossible, to the detriment of the American economy, as a result of unpredictable movements in the American balance of payments.

Another reason for considering the 25 percent gold reserve requirement irrational is, from a purely formal point of view, equally convincing. It follows easily from our previous considerations. In view of the fact that the upper limit for the potential claims against the U.S. gold reserve is the total money supply in the United States, logic and safety would require not a 25, but a 100 percent gold reserve not only against Federal Reserve notes and Federal Reserve deposit liabilities, but against the total money supply in the United States. Such a requirement, it is true, would be even more dangerous and, for lack of a sufficient worldwide gold stock, even be physically impossible to maintain. It is a logically compelling conclusion, however, if the reasons advanced for choosing the official American definition of balance-of-payments deficits are taken seriously at all.

II. THE EFFECT OF PROSPECTIVE CHANGES IN DEMAND AND OUTPUT

III. COMPETITIVENESS AND THE U.S. BALANCE OF PAYMENTS

For purposes of prediction, the Brookings authors consider separately the effects of changes in real output on the one hand and of changes in relative prices on the other. It is also useful and reasonably realistic to stress the difference in the balance-of-payments behavior of the industrialized countries of Western Europe and of the rest of the world (outside the United States). Only the former area is assumed to experience significant changes in its foreign exchange reserves. For the purpose of prediction, I am somewhat skeptical about the legitimacy of including Japan and Canada in the latter group. Especially for the case of Canada, the constancy of monetary reserves from 1950 to 1961 was merely a consequence of the fact that the Canadian dollar was a freely fluctuating currency during that period. Canadian exchange reserves have undergone rather significant changes since the abandonment of that system.

The Brookings authors present two alternative sets of forecasts for the U.S. balance of payments to which we shall refer as projections A and B. The bases for projection A are estimates of real national incomes and price levels in the United States and Western Europe

by the Council of Economic Advisers and the Organization for Economic Cooperation and Development. One cannot help feeling that these estimates contain a significant element of wishful optimism. The average growth rate of the real gross national product of the United States between 1960 and 1968 is expected to be 4.8 percent (p. 40) against the OECD estimate for Western Europe of 4.2 percent (p. 43). In itself, the assumed U.S. growth rate would certainly be physically feasible if the administration succeeds, as assumed, in reducing the level of unemployment to 4 percent of the labor force. It is most doubtful, however, whether the degree of price stability which underlies the projections can be maintained under these circumstances. This holds especially for the sectors whose prices are most important for the competitiveness of U.S. exports on the world markets. As is sufficiently well known and also shown in chapter 3 of the study, upward pressure of prices has consistently been strongest in these sectors (especially in the steel, machinery and transport equipment industries). If unemployment falls from the 1958-62 average of 6 to 4 percent, it is unlikely that the development of export prices will be more favorable in the United States than in Western Europe.

The assumptions underlying projections B of the Brookings study are slightly, but not, in my view, sufficiently more realistic than those of the Council of Economic Advisers. In both cases, the experience of a comparatively brief period during which price increases have been rather marked in West Germany, in particular, has been merely extrapolated. It must be remembered that this was typically a time of "imported" inflation during which brisk world demand pulled up the prices of Europe's industrial exports to the (generally) higher levels of American export prices. In my judgment, the forces making for "sellers' inflation" continue to be stronger in the United States than in Europe. Price stability at a satisfactorily high level of employment will be more difficult to realize in this country if this judgment proves to be correct.

Table 1 summarizes the assumptions underlying projections A and B.

TABLE 1.—*Assumed average annual increases of price indexes in the United States and Western Europe, 1961-68*

	<i>Percent</i>
Implicit GNP price deflators:	
United States-----	1.5
Western Europe:	
Assumption A-----	3.0
Assumption B-----	1.5
Export prices of manufactures:	
United States-----	0.5
Western Europe:	
Assumption A-----	1.5
Assumption B-----	1.0

In preparing their estimates, the Brookings group relied on the result of a detailed econometric model constructed by Jacques J. Polak and Rudolf R. Rhomberg of the International Monetary Fund.²

² A general description of the model was given in "Economic Instability in an International Setting," *American Economic Review*, vol. 52 (May 1962), pp. 110-118.

The revision of the Polak-Rhornberg equations yielded a price elasticity of more than 4 for U.S. exports to Western Europe. In appraising the future competitiveness of American industry, the Brookings authors apply an elasticity coefficient of 2.5 instead. The explanation given for this change is that a value of 4 "seems too high to be plausible" (p. 82). It is evident that the final conclusions may be drastically changed by this rather arbitrary modification. Use of the higher elasticity would yield results more favorable for U.S. exports on the basis of a comparatively higher rate of increase of European export prices, but less favorable if the relative movement of export prices should turn out to be the opposite, as it might well be.

The Brookings authors emphasize the noticeably different behavior of U.S. export prices as compared to general price indexes such as the implicit GNP price deflator or cost-of-living indexes. On the basis of comparisons of such aggregate price indexes, it has often been believed that the U.S. balance-of-payments problem could not possibly have been caused by a comparatively greater increase of American prices. A comparison of unit value indexes of manufactured exports indicates that the rate of inflation in this crucial sector has been higher in the United States than in all of its principal competitors (table III-6, p. 75). Even without looking at price indexes, an undeniable deterioration of the American competitive position can be easily inferred from the continued fall in the share of the United States in the aggregate exports of manufactures by the 12 leading industrialized countries over the past decade (19.9 percent in 1962 against 26.2 percent in 1953; cf. table III-1, p. 65). Such a deterioration could, to be sure, also have been caused by production bottlenecks as a consequence of a pronounced boom in the American economy. The prolonged underutilization of capacity precisely in American export industries is sufficient evidence that such bottlenecks cannot have been the cause of America's difficulties.

It is regrettable, on the other hand, that the Brookings study considers only movements of price indexes rather than absolute prices. In general, comparisons of absolute prices are rather hazardous. A few industrial commodities are sufficiently homogeneous, however, to make such comparisons possible. Table 2 shows the development of export prices of rolling mill products in the United States and Western Europe. It is seen that U.S. prices in this sector have always been substantially higher and nevertheless continue to rise slowly while export prices in Europe have been falling in recent years. Even a relatively more moderate rate of increase in the United States over the next few years is not likely to make American exports in these lines more competitive than Europe's. In view of the fact that steel is such an important raw material for many other export industries, the outlook for the future of American exports as a whole may be considerably less reassuring than what can be deduced from mere comparisons of the evolution of price indexes.

TABLE 2.—*Export prices of steel products*

[Dollars per metric ton f.o.b. port of shipment]

	European Coal and Steel Community countries				United States			
	February 1958	January 1960	January 1962	January 1963	February 1958	January 1960	January 1962	January 1963
Reinforcing bars.....	81-84	105-110	77-84	70-73	129.40	127.00	127.00	127.00
Merchant bars.....	97-101	110-114	94-96	77-79	130.00	133.00	130.30	130.30
Joists.....	98-103	101-102	94-95	77-78	128.10	131.85	126.30	128.30
Wire rod.....	103-105	132-140	88-90	80-83	140.20	146.15	146.15	146.15
Hoop and strip.....	110-113	110-112	92-94	88-93	119.25	117.95	114.65	114.65
Plate.....	118-122	106-112	89-92	85-88	123.25	126.75	118.60	118.60
Hot-rolled sheet.....	150.50	158-163	106-115	107-108	140.85	141.75	141.75	141.75
Cold-rolled sheet.....	170.00	Up to 225	116-121	111-113	159.60	156.75	156.75	156.75

Source: European Coal and Steel Community, "11th General Report on the Activities of the Community," Luxembourg, 1963.

Prices are those of basic Bessemer (Thomas) quality for the Community, and of basic open-hearth steel for the United States. An allowance of approximately 5 percent should be made in the prices listed to take account of the higher quality of American open-hearth steel.

IV. THE EUROPEAN ECONOMIC COMMUNITY AND THE U.S. BALANCE OF PAYMENTS

The chapter on the Common Market is a concise yet penetrating appraisal of the economic consequences of the Treaty of Rome. Enthusiasm over the political significance of European integration—in itself a positive and reassuring development—has for a long time made people overlook some of the less desirable policies pursued under the aegis of the European Economic Community. In particular, its rather protectionist disposition has only recently caught the attention of a wider public. It has been rather widely believed that the common external tariffs of the union were true averages of the national tariffs actually applied by the four customs areas before the formation of the union. Also, it is frequently thought that there cannot be any legitimate grounds for complaint by outsiders as long as the common tariff does not exceed this average.

Neither the first nor the second view is correct, as the Brookings study points out. A mere reading of the Rome Treaty must convince anyone that there is practically no single commodity for which the eventual EEC tariff would be a true average of the previous national tariffs.³

Chapter IV also deals effectively with the notion that no burden would be imposed on the outside world if only the EEC tariff were the correct average of previous national tariffs. According to the Brookings authors, the degree of protectiveness is to be judged by whether or not the common tariff protects producers in the country that happens to be the lowest cost source for each individual commodity (p. 101). This latter inference can only be accepted with reservations since it rests on the assumption of constant costs of production in all sectors. Increasing costs must generally be taken to be more typical for the majority of industries. Nevertheless, the Brookings conjecture is undoubtedly closer to the truth than the naive view that a correct averaging of national tariffs would leave the degree of protection unchanged. Any simple arithmetic average is bound always to increase

³ See especially arts. 19 and 20 and lists A to G of the Treaty of Rome.

the degree of protection. Table IV-4 (p. 103) attempts to give a rough idea as to the excess of individual EEC tariffs over a level that would be required in order to leave protection unchanged. The evaluation of the possible reduction of U.S. exports of manufacturers to Europe (on the basis of an assumed elasticity of demand of 2; see p. 104) is, if anything, likely to be too cautious.

Truly alarming prospects for the future of world trade are raised by the agricultural protectionism of the community (pp. 106ff.). According to President de Gaulle, "the system of the Six * * * incorporates the requirement for each participating country fully to indemnify the Community for any savings realized by importing foodstuffs from outside instead of consuming the products of the Common Market."⁴ This is only the personal interpretation of one head of state among the Six, but it reflects the intentions of a powerful group of vested interests within the Common Market.

The U.S. Government is well advised to exercise the strongest possible pressure to forestall the realization of this scheme. This ought to be done not so much in order to improve the U.S. balance of payments, for which the consequences would perhaps not be overly crucial, but above all to prevent the misallocation of resources that would be brought about by agricultural self-sufficiency of one of the world's most densely populated areas. Especially the millions of European city dwellers in the lower income brackets, for whom artificially high food prices represent a serious drag on their living standard, will have reason to be grateful for any American initiative in this direction. The same holds for many of the less-developed countries outside the EEC orbit, for which exports of agricultural commodities to Europe have traditionally been a vital means of financing desperately needed imports of manufactures.

V. PRIVATE FOREIGN INVESTMENT

Not only laymen, but also most experts have for a long time pointed to private foreign investment, foreign aid and military expenditure abroad as the true reasons for America's balance-of-payments troubles. The information presented in chapters V-VII therefore deserves the most careful study.

As far as long-term private foreign investment is concerned, the gist of the story is told in table 3 below which summarizes the data presented in tables V-1 and V-3 of the Brookings study (pp. 126 and 128).

TABLE 3
[In millions of dollars]

	1950-55 average	1956	1957	1958	1959	1960	1961	1962
Receipts of dividends and interest from U.S. foreign investments minus payments of dividends and interest to foreign investors in the United States.....	1,396	2,054	2,174	2,008	2,147	2,266	2,860	3,194
New outflow of long-term capital from the United States.....	-733	-1,961	-2,902	-2,552	-1,589	-2,114	-2,143	-2,495
Excess of net U.S. earnings on foreign investments over net outflow of long-term capital...	663	93	-728	-544	558	152	717	699

⁴ Press conference of Jan. 14, 1963.

This table shows that U.S. private investors have, with the exception of 2 years (1957 and 1958), not even fully reinvested their earnings from foreign holdings. The excess of net earnings over net outflows of long-term capital has, in fact, increased during the past 5 years. The activities of private investors can therefore hardly be blamed for the continuing deficits, and the decision of the U.S. Government of July 18, 1963, to discourage private foreign investment by the imposition of an "interest equalization tax" must be judged to be rather ill advised. The conclusion seems inescapable that, far from investing too much, American individuals and businesses have been investing abroad far too little. A sustained flow of private capital in large volume from the regions most abundantly equipped with capital to the rest of the world would obviously only follow the rules of efficient resource allocation.

VI. FOREIGN ECONOMIC ASSISTANCE

Similar remarks apply to the issue of U.S. foreign aid. When outlays for foreign aid in 1961 are expressed as a percentage of their gross national products (the only relevant comparison of relative burdens), a ranking of developed countries shows the United States comfortably in center position, by no means in the vanguard (see table 4, taken from the table on p. 187 of the Brookings study). As the authors point out, "the United States has had some difficulty maintaining that it was carrying too heavy a share of the common burden" (p. 187).

TABLE 4.—*Foreign aid as percent of GNP at factor cost in 1961*

France.....	1.82	United Kingdom.....	0.67
Portugal.....	1.44	Netherlands.....	.62
Belgium.....	.92	Japan.....	.58
Germany.....	.86	Italy.....	.23
United States.....	.72	Canada.....	.19

It is common knowledge that foreign aid does not put a burden on the balance-of-payments equal to the amount of grants and loans since part of these funds is used for additional purchases in the United States. The Brookings study also emphasizes the fact that the United States has over the last few years increasingly tied its economic aid to purchases of American goods. This reinforces the effect noted in the preceding sentence, of course. The current percentage of tied aid is estimated to be about 80 percent of the total.

What has to my knowledge never been pointed out is that a foreign aid program may conceivably even benefit the transferring country's balance of payments. This possibility may be demonstrated easily by means of a hypothetical example.

Let us assume that \$1 billion of aid is given and that 80 percent of this aid is tied. Suppose that at the same time \$600 million of interest and repayments of loans granted in the past are received.

Not all of the \$800 million of imports from the United States required under the tying provision will be a genuine addition to American exports. Some of these commodities would have been bought from American suppliers in any case out of the general foreign exchange receipts of the countries receiving aid. Let us assume that this holds

for 30 percent of the tied purchases, or \$240 million. The net increase in direct exports to the receiving countries is therefore only \$560 million.

In our hypothetical example, let us also follow the Brookings assumption that all foreign exchange receipts of underdeveloped countries are immediately spent on additional imports whereas all foreign exchange newly acquired by Western European countries is hoarded. This would imply that the remainder of the \$1 billion of American aid that is not used to finance a net increase of direct U.S. exports to the recipient countries, \$440 million, serves as a means of purchasing additional imports from countries outside the United States. Let us assume that half of this figure is used on imports from Western Europe and the other half for imports from sources other than the United States and Western Europe.

Whereas the \$220 million of new foreign exchange receipts of Western Europe disappear among the reserves of central banks, the other \$220 million constitute new earnings of foreign exchange of other developing regions. It is only natural to assume that these funds, which can be used freely for imports from all over the world, are spent in roughly the same way among different countries as any other new accruals of foreign exchange to less developed countries. Suppose that the expenditure of these funds eventually leads to an increase of American exports by 30 percent of the funds spent (including both direct purchases in the United States as well as the repercussions of purchases in other countries; see appendix to ch. VI, pp. 275-277). This raises American exports by another \$66 million.

Together with the direct net increase of U.S. exports of \$560 million, we thus arrive at a total increase of American exports of \$626 million as a consequence of new foreign aid of \$1 billion. The immediate burden on the U.S. balance of payments, the difference between these two figures, amounts to \$374 million.

We have also postulated that repayments and interest on earlier development loans amount to \$600 million. Again, the U.S. balance-of-payments benefits by less than this figure. The transfer reduces the foreign exchange reserves of developing countries by an equivalent amount and this must be assumed to entail a decrease of their imports. In agreement with our previous assumptions, the eventual (direct and indirect) effect on U.S. exports is taken to be a decrease by 30 percent of the transfer, or \$180 million. The net benefit of the receipts of \$600 million for the U.S. balance of payments amounts to \$420 million.

The combined effect of the new development grants and loans of \$1 billion and the receipts from repayments and interest on previous aid of \$600 million is thus found to be an improvement of the U.S. balance of payments by \$46 million (\$420 million minus \$374 million). The assumptions concerning the expenditure patterns of the three groups of countries in our hypothetical example were chosen in approximate conformity with the estimates presented in the Brookings study (p. 171). The only contrast to present conditions is to be found in our assumption of a relatively high ratio of repayments and interest to new aid disbursements. We had chosen a ratio of 60 percent, as compared to the 1961 ratio of approximately 25 percent (or, if unscheduled prepayments of former aid are taken into account, 40 percent).

It should not be concluded from our analysis, of course, that abrupt cuts in private foreign lending or foreign aid would not temporarily help the American foreign accounts. Since the credit entries in the balance of payments that are associated with earlier loans and investments would remain unaffected in the short run, the immediate results of cuts in the debit items would obviously be favorable. We have endeavored to emphasize two important points. The first, and rather obvious one, is that a reduction of U.S. investment or lending abroad (be it private or official) will necessarily increase U.S. balance-of-payments difficulties in the future. Our numerical example has shown, moreover, that the practice of tying aid may, when a sufficiently high percentage of the aid consists of loans (60 percent in our example), even cause a net benefit for the donor country's balance of payments.

The most important conclusion is that the true reason for America's difficulties must be put squarely on the failure of the American economy to generate a sufficiently large export surplus. This deficiency can, in turn, only be attributed to the unsatisfactory competitive position of American industries on the world markets. The surpluses on current account which the United States has been able to achieve have for years led many observers to conclude that the origin of the trouble cannot, or not primarily, be sought in too high a level of American export prices. These surpluses dwindle to insignificance, however, once their components are carefully analyzed.

Let us take the surplus on current account of \$5 billion in 1961, the highest since 1957. There were \$4 billion of new foreign aid, 80 percent of it tied to purchases in the United States, and receipts of interest and repayments (including prepayments) of approximately \$1.7 billion. Most of the latter came from European countries whose imports are unlikely to be reduced because of this. A reasonable estimate would be that the aid program has induced a net increase of American exports by about \$2 billion. Without any foreign aid, the surplus on current account would consequently not have been more than \$3 billion. The balance on current account also includes net dividend and interest earnings from foreign investments of \$2.9 billion. Earnings on foreign investments cannot be included in any figure purporting to show a satisfactory competitive position of American industries on the world markets. Without them and without foreign aid, the U.S. balance on current account would barely have been equilibrated at all.

VII. THE EFFECTS OF DEFENSE TRANSACTIONS

U.S. defense transactions with the rest of the world gave rise to a demand for foreign exchange of slightly over \$3 billion in 1961. This is obviously an important debit item in the U.S. foreign accounts. Oversea defense activities are considered so vital to the United States, however, that few people would seriously propose major cuts in this program. Attempts to redirect expenditure from foreign to U.S. sources of supply, as prescribed by a number of regulations in the past few years, benefit the balance of payments, but only, let it be remembered, at the cost of an increase (possibly substantial) in the cost of any given level of foreign military operations to U.S. taxpayers. Also, any cut in military expenditure abroad will, owing to the repercussions of reduced foreign-exchange earnings of underdeveloped countries on U.S. exports, only benefit the U.S. balance of payments less than proportionately.

VIII AND IX. ANALYTICAL CONCLUSIONS AND POLICY RECOMMENDATIONS

Table VIII-2 (p. 216) summarizes the results of the Brookings projections for 1968. Under assumptions A, the U.S. basic balance is estimated to reach a surplus of \$1.9 billion; under assumptions B, the Brookings authors forecast a deficit of \$0.6 billion. This compares with deficits of \$0.9 billion in 1961 and \$2.1 billion in 1962. These conclusions are not very encouraging, especially if one shares the view that the underlying assumptions are unrealistically optimistic.

The Brookings authors rightly stress that the balance-of-payments difficulties of the United States are a matter of grave concern primarily because of the constraints they impose on the country's employment policies. It is somewhat surprising, however, to see that most American economists nowadays appear to be resigned to a level of 4-percent unemployed as the best that can be hoped for. This level is still a considerable distance away from full employment.

The study might have made even clearer that both the balance-of-payments deficits and the unsatisfactory level of business activity have one principal common cause whose diagnosis is unusually clear and unambiguous: the incessant upward movement of prices in a few major industries in which the monopoly power of both labor unions and of a few leading producers is particularly high. Prices and wages in these sectors have for years been pushed upward in spite of excess capacity. The fact that these same industries are also very important for America's exports is the basic cause of the adverse balance of payments. The natural remedy for both the external accounts and the domestic employment situation would appear to be determined measures to strengthen competition in these few highly concentrated industries in order to make it more difficult for sellers (of commodities as well as of labor services) to raise prices and wages above a level that would permit reasonably full utilization of available capacities. It is regrettable that these issues are treated so timidly by the Brookings authors, apart from very few and very vague recommendations of "international cooperation regarding cost and price policies" (p. 248) or "wage and price restraint during the course of recovery to high employment" (pp. 253-254). It is not indicated in any way what policies could lend substance to these fond hopes. Besides the strengthening of competition through determined antitrust and de-concentration measures as well as the revision of collective bargaining legislation, there is really only one other alternative: comprehensive price and wage controls. Policies designed to strengthen competition are frequently rejected as "politically unfeasible" and therefore hardly worth advocating. This would imply nothing less than that a workable and fully employed market economy is politically unfeasible. Apart from the question of desirability, it would appear to be politically just as difficult to introduce wage and price controls in the American economy in times of peace.

The principal policy recommendation of the Brookings authors is a plea for increasing international liquidity. Superficially, it would indeed seem as if most of the difficulties that have arisen in recent years could be elegantly overcome by providing means of easier financing of balance-of-payments disequilibria. On closer inspection, the experience of the United States itself is rather persuasive evidence,

however, that this is not the easy way to escape present difficulties as which it appears at first sight. There has not been a single year since 1948 in which the United States basic balance would not have shown a deficit (p. 6). These deficits would presumably have been much larger during the last few years if the deepening stagnation of the American economy had not somewhat reduced the upward pressure on export prices. Proposals for increasing international liquidity, on the other hand, are meant to bridge temporary imbalances alternating between surpluses and deficits over reasonably short periods.

Attempts to overcome the specific difficulties of the United States in this manner would, moreover, enable the world's richest country to borrow continuously and at low cost from the poorer and much less capital-rich countries in the rest of the world. The basic objection to these plans must consequently rest in the deterioration of allocative efficiency that would be brought about by a reversal of the direction in which capital normally ought to flow.

The almost complete neglect of short-term capital movements in the Brookings study is regrettable. Even a system that could successfully cope with disequilibria of the basic balance might on occasion be too weak to withstand a sudden large flight movement of short-term capital. Such movements cannot be ruled out in a system of convertible currencies in which par-value changes can happen. Only a myopic observer can fail to realize that such adjustments will forever remain a possibility as long as independent economic policies can be pursued in different currency areas. There is an easy test to find out whether or not governments are prepared to conform to the severe constraints of a system of eternally immutable currency parities. One merely has to ask them whether they would be prepared to establish one single monetary standard for the world as a whole and to subject their economies to the monetary policies of a single central bank that is entirely independent of the governments of all countries. There is no doubt as to what the almost universal answer would be. As long as we do not have a single world currency and a single central bank, we will have to live with expectations of occasional par-value adjustments and the associated possibility of large-scale speculative movements.

A misunderstanding that can be frequently encountered may be pointed out in this connection. On page 234, the Brookings authors correctly state that a need for international liquidity arises only out of the imbalances of world payments. Many people appear to believe instead that whatever is defined as "international liquidity" has to rise approximately in proportion to the absolute value of world payments. A little reflection shows that all payments occasioned by international trade and capital movements are made in national currencies and that, under a regime of full convertibility and irrespective of the volume of world trade, private banks can always create whatever accounts in other countries they may need to ensure a smooth working of the international payments system. Discrepancies between the aggregate demand and the aggregate supply of individual currencies, the only phenomenon that creates a need for central banks to hold monetary reserves, arises only if central banks are required to stabilize exchange rates artificially by purchases and sales of foreign exchange while general economic policies in different countries violate the rules

that could insure long-run stability of exchange rates in free exchange markets.

If the creation of a system of freer international borrowing should prove impossible or insufficient, the Brookings authors recommend, albeit somewhat hesitatingly, the introduction of a "modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc." There would be "relatively fixed rates within each bloc and flexible rates between them" (p. 259).

It is somewhat unclear what prompts the authors to recommend this particular division of the world into currency blocs. A new international monetary system obviously ought to be a permanent institution and should not be designed to relieve the momentary difficulties of specific countries. Only 5 or 6 years ago, nobody would have thought of proposing this particular grouping of countries. Who can guarantee that the balance-of-payments constellation 5 years hence will not be closer to what it was 5 years ago than to what it is now?

There is also some ambiguity about what exactly the authors have in mind when they recommend a system of flexible exchange rates. On page 124, it is stated that "for several years, Canada had a nominally flexible rate, although the degree of flexibility in practice is a matter of dispute" (n. 4). By definition, exchange rates are flexible if they are not pegged by the monetary authorities through purchases and sales of foreign exchange. What the passage quoted above apparently wants to say is that exchange rates for the Canadian dollar have not been highly unstable.

Should it be inferred from this that the authors want to recommend unstable exchange rates between the dollar-sterling bloc and the EEC bloc? If the principal intention in recommending a system of flexible rates is to facilitate policies resulting in a definitely higher rate of inflation by comparison with the rest of the world, there is not much hope for a resounding success. This is not to deny, of course, that a system of pegged rates would not work at all under these circumstances. For the disease of sellers' inflation, there is, unfortunately, no easier cure than a strong deconcentration policy directed against the monopoly power of businesses as well as labor unions. The decisive, but virtually unknown argument in favor of flexible rates is that monetary policy will only become a truly powerful instrument if exchange rates are flexible, though highly stable over the long run.

STATEMENT BY HERBERT STEIN

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In response to the Joint Economic Committee's request, I present here some comments on the Brookings Institution study, "The United States Balance of Payments in 1968." I should emphasize that these are personal comments, not claiming to represent the views of the Committee for Economic Development. Also I have followed your instruction to concentrate on the estimates in the study, rather than on the policy recommendations contained in the last chapter of the study.

1. The assignment undertaken by the authors of the study was an exceedingly difficult one. In attempting to answer their question, the authors applied the available information with logic and sophistication. This does not mean that they obtained a good answer, in the sense that the final outcome in 1968 will be close to it. However, I don't know of any alternative method that would probably give a better answer 5 years in advance.

2. It should be noted that the study forecasts the U.S. balance of payments in 1968 on the assumption that the United States continue certain policies that have been adopted, largely, to deal with an excessive deficit. The most important of these are the tying of foreign aid and the determination of the location of military expenditures by the standard of minimum foreign exchange cost rather than minimum dollar cost. Even if it is judged that we would have eliminated the balance-of-payments deficit by 1968 on this assumption it should not be concluded that we would have reached a satisfactory situation. We would still have some way to go before we were able to balance our accounts without policies that are, in general, inefficient and undesirable.

3. The study assumes throughout that the rest of the world, except for Western Europe, does not try to increase reserves. This may be a realistic assumption up to 1968. Nevertheless, it may understate the problem. The underdeveloped countries and Japan are able to get along with low reserves because they use controls to keep their payments in close balance. Probably we and they would prefer that they should own more reserves. Some may try to acquire them, although possibly not before 1968. When they do, this will affect the problem of the United States in trying to regain balance, and also will affect the world's need for liquidity.

4. The study's estimates imply a slowing down of the rate at which Western Europe acquires reserves. It also seems to be assumed that Western Europe will respond passively to this. Such a development is possible, but nevertheless rather hazardous to predict. The European reaction will presumably depend, in part, on their interpretation of the causes and durability of the change in their balance-of-payments position. If the United States achieves a surplus by 1968 as a

result of a steady excess of European price increases over U.S. price increases, as the study assumes, would there be any reason for the Europeans to expect this process soon to stop or be reversed? If not, won't they feel obliged to take steps to stop their inflation or at least offset its balance-of-payments consequences? And won't they take these steps before 1968?

The European reaction would probably depend upon the distribution of the balance-of-payments effects among countries. If each country continued to run a surplus, although a diminishing one, there would be less reaction than if some countries encountered deficits while others still had surpluses.

5. The study's estimates of improvement in the U.S. balance of payments depend critically on estimates of relative price movements in the United States and in Europe, and on estimates of the consequences of these movements. The study clearly indicates the speculative character of these estimates, and it is no criticism of the report to emphasize this again for those who may only see the results without having read the whole study. A few points may be repeated or added on this subject.

(a) The estimates of price movements in the United States and in Europe are based on projections of institutional, price-and-wage-administering behavior. They are not estimates of wages and prices determined by supply and demand. Such institutional behavior is not well understood and forecasts of it are unreliable, especially when they imply rates of change markedly different from the recent past.

(b) It is assumed that the European countries will not take sufficiently restrictive monetary and fiscal action to restrain inflation because they will be afraid of causing unemployment. This implies that they will not try to control wages and prices directly, or, if they try, will not succeed.

(c) The econometric study on which many of the estimates are based yielded a price elasticity of 4.0 for U.S. exports to Western Europe. This means that if the relevant U.S. prices decline in comparison with European prices by 1 percent, U.S. exports to Europe will rise by 4 percent. The authors decided that this elasticity was too high to be plausible, and instead used an elasticity of 2.5. This change from 4.0 to 2.5 reduced estimated U.S. exports to Western Europe by about \$2 billion. In view of the large size of this number, some explanation for the choice of 2.5 would have been useful.

(d) This elasticity of 2.5 seems to be used as if it is a measure of the instantaneous response of exports to relative prices. That is, if, in 1968, U.S. prices decline 1 percent relative to European prices, U.S. exports in 1968 will be 2.5 percent higher than if there had been no relative price change. However, it seems reasonable to believe that there is some lag, and that 1968 exports will be determined by 1967 and 1966 prices more than by 1968 prices. If so, and since the spread between U.S. and European prices is assumed to be rising, U.S. exports to Europe would be lower in 1968 than the study estimates.

6. As a forecast, the study's estimate of a large increase in U.S. foreign aid expenditures seems to me unrealistic, when placed along-

side the apparent trend in the willingness of Congress to appropriate funds for this purpose. However, with substantial tying, even a large reduction in this estimate would have only a small effect on the balance-of-payments estimates.

7. The main thing the study demonstrates, in my opinion, is the impossibility of making a reliable forecast of the U.S. balance of payments 5 years ahead within a useful range. Of course, we can say with some confidence that the balance in 1968 will be within the range from a \$10 billion surplus to a \$10 billion deficit. But if it makes a substantial difference whether the trend value, aside from random fluctuations, is plus \$1 billion or minus \$1 billion, we can't give a useful forecast with confidence. The range of estimates resulting from alternative, possible, assumptions made in the study is large. Moreover, this range does not embrace all the reasonable possibilities, as the study clearly states at many points.

I think that readers of the report have paid inadequate attention to the policy implications of the great uncertainty revealed in the forecast of the balance of payments. What kinds of policy instruments do we need to achieve balance when the future course of the balance is so unpredictable? What kinds of credit arrangements would the uncertainty require? What would be the results if each country based its policy on the most conservative (i.e., pessimistic) of the possible forecasts of its own balance of payments?

STATEMENT BY JEROME L. STEIN

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There is nothing like a difficult policy problem to evaluate the state of economic knowledge. The Brookings report is a thoughtful and imaginative study of the balance of payments which not only applies the existing techniques of economic analysis but also develops them in a masterful manner. Undoubtedly this report will be studied carefully by economists and students and will serve as a guide for further research. What emerges from this report, however, is a picture of the unbalanced development of international economics. Our powers of deductive reasoning, embodied in theoretical models of the world economy, far surpass our ability to apply these models as instruments of prediction.

There is a wider consensus of opinion on the theoretical level than there is on the level of application. Alternative methods of applying a commonly accepted theory are possible because (i) the published statistics often represent an attempt to measure concepts which are different from those postulated in the theory and (ii) the theory is generally not sufficiently precise in specifying the form and content of the behavioral relationships.

Although the reader cannot fail to admire the skill of the authors, it is difficult to have confidence in their quantitative conclusions. This lack of confidence is often expressed by the authors themselves (e.g., pp. 38, 91) ; and the report admits that

* * * the value of the projection lies less in its quantitative result than in the process of obtaining the result, for that process identified the kinds and directions of influences that will determine the future development of the basic balance-of-payments position of the United States (p. 31).

The aim of the report is to predict the magnitude of the 1968 basic balance of payments, given the knowledge available in 1963. A succinct statement of the weakness of the projection method employed is contained in chapter II.

A further possible source of error arises from the fact that we are using relations derived from the period 1948-60 to make projections for 1968, and these relationships will surely change. Moreover, we not only extrapolate in time * * * we also extrapolate well beyond the numerical range of the variables on which the equations are based, a procedure which introduces an additional possibility of error. Finally * * * the percentage effect of a given error in projecting receipts and payments is greatly magnified in the projection of the net balance * * * (p. 35).

In view of (i) and (ii) and the paragraph above, a study containing projections should contain a comparison of the predictive power of alternative forecasting methods. To use any predictive method of forecasting the 1968 basic balance of payments with confidence, one should know how accurately it was able to predict, in 1958, the 1963 value of the basic balance. Unfortunately, the Brookings report neglected to include such a comparison. As a result, it is difficult to attach a high degree of confidence to their quantitative estimates.

How could we experiment with alternative predictive methods to evaluate their efficiencies? Using the data through 1957 exclusively, the 1962 basic balance could have been predicted. Since the Council of Economic Advisers furnished the Brookings study with the assumptions concerning the 1968 income and prices, the actual 1962 values of income and prices could be taken as independent variables in predicting the 1962 basic balance. Similarly, using the data through year T exclusively, the basic balance in year $T+5$ could have been predicted. Year T could run from 1957 back to (say) 1952. If a given predictive method proves to be most efficient in these experiments (there would be six experiments if $T=1952$ * * *, 1957), then we would have confidence in it as a predictor of the 1968 basic balance. We would also know the magnitude of the forecasting error. The study, however, did not demonstrate the predictive power of its forecasting methods.¹

A comparison of predictive methods solely on the basis of (R^2) the ratio of "explained" to the total sum of squares, derived from a given set of observations (e.g.) 1950-62, is misleading. We are not interested in how assiduous the researcher was in finding statistical series to absorb residual from a regression. What we want to know is: How well does a method predict magnitudes of variables 5 years hence? Conceivably, my subsequent criticisms are not correct, and the predictive techniques used in the study are the most efficient ones known. However, it would have been desirable had the authors demonstrated the predictive power of their techniques.

The general conclusions of the report are that:

Taking the period between 1961 and 1968 as a whole, the projections indicate an improvement in the basic balance of the United States, although the degree of the improvement must be regarded as uncertain. Our best guess is that the basic deficit will be eliminated. If the initial assumptions come close to being realized, there is a definite possibility that a significant basic surplus will develop (p. 230).

Although the components of the balance of payments are functionally related, the statistical sources of the projected improvement in the balance of payments² are (a) the rise in the net exports of goods and services from 5.0 (1961) to 9.1 (1968) and (b) the decline in the outflow of long-term private capital from 2.1 (1961) to 1.5 (1968). The substance of my review is devoted to a critique of these quantitative conclusions, for they are the crucial elements in the report. I claim that (a) is not likely and that (b) is not based upon a logically defensible quantitative analysis.

I. THE NET MERCHANDISE BALANCE

Two sets of assumptions were used to predict the 1968 net merchandise exports. If the initial assumptions are accepted, the basic balance rises from -0.8 (1961) to 1.9 (1968). On the other hand, if the alternative assumptions are accepted, the basic balance rises to -0.6 (1968): a negligible change in view of the margin of error. A crucial question is: Which set of assumptions should be used?

¹ An experiment with alternative forecasting methods is found in G. H. Borts and J. L. Stein. "Investment Return as a Measure of Comparative Regional Economic Advantage," in W. Hochwald (ed.), *Design of Regional Accounts (Resources for the Future)*: Johns Hopkins Press, 1961, pp. 89-95.

² Government transfers and loans, net, are projected to worsen the balance by \$2.1 billion.

The 1968 merchandise balance, in 1968 prices, was predicted in the following way. Let X_0 be the 1961 value of U.S. exports, and let $100y'$ be the percent change in the quantity of U.S. exports demanded by foreigners as a result of the projected rise in their incomes. Thus $X_0(1+y')$ is the projected 1968 value of U.S. exports, in 1961 prices, that would occur if only foreign real incomes changed. Let $100wn$ be the percent change in the quantity of U.S. exports, in 1961 prices, that results from a change in relative prices. Variable $100w$ is the percent change in relative price³ and n is the foreign price elasticity of demand.⁴ Hence, $X_0(1+y')(1+wn)$ is the value of U.S. exports in 1961 prices, that would occur if foreign income rose and relative prices changed. To convert the value of exports into 1968 prices, multiply the value in 1961 prices by $(1+v)$, where $(1+v)$ is the index of export prices in 1968 relative to those prevailing in 1961.

Similarly, let M_0 be U.S. imports in 1961 and $M_0(1+y)$ the value of U.S. imports, in 1961 prices, that would occur as a result of the projected rise in U.S. real income. If e is the U.S. price elasticity of demand, then $M_0(1+y)(1-we)$ is the projected quantity of imports, in 1961 prices, that would result if U.S. incomes and relative prices changed. To convert imports into 1968 prices, multiply the above by $(1+v')$: the index of foreign export prices in 1968 on a 1961 base.

The Council of Economic Advisers, seeking to discover the effects of a full employment policy upon the balance of payments, provided an estimate of the growth of real income from 1960-68 of 4.8 percent per annum. The Brookings report also considered a growth rate of 4.2 percent per annum during this period. Based largely upon target rates of growth submitted to the OECD, the European growth rate⁵ was assumed to be 4.3 percent from 1960-68. An alternative growth rate was 3.8 percent during this period.

The value of $X_0(1+y') - M_0(1+y)$ represents the income effect on the merchandise balance. It made very little difference which set of assumptions about the growth of income were chosen. In one case our merchandise balance (in 1961 prices) would decline by \$2.6 billion, and, with the alternative set of assumptions, it would decline by \$2.3 billion (table III-10).

If our merchandise balance were to increase, then the relative price effect would have to more than offset the income effect which is between \$2.3 and \$2.6 billion. What would the change in relative prices have to be, given the Brookings' estimates of the price elasticity of demand, such that the negative income effects are offset? I show that, using their upward biased elasticity figures, the European price of exports would have to rise at least three times as rapidly as the U.S. price of exports to offset the negative income effect. Then I suggest why this is not very likely.

First, consider the merchandise balance with Europe, B_1 . This is

$$(1) \quad B_1 = p_1 X - r p_1 M$$

where p_1 is the U.S. export price, and $r p_1$ is the European export price.⁶ The ratio of European to U.S. export prices is r . X is the

³ This is the ratio of foreign to U.S. prices.

⁴ Define the elasticities to be positive.

⁵ This rate is for the United Kingdom, West Germany, France, and Italy.

⁶ The price $r p_1$ is measured in dollars, given the exchange rate.

U.S. quantity of exports to Europe, and M is the quantity of U.S. imports from Europe.⁷

The change in the merchandise balance with Europe, resulting from a change in relative price (Δr) is $(\partial B_1/\partial r) \Delta r = \Delta B_1$.

$$(2) \quad \Delta B_1 = (p_1 X n + p_1 r M e - p_1 r M) (\Delta r/r).$$

The value of U.S. exports to Europe in 1968, measured in 1961 prices, as a result of the income effect, is $P_1 X$ is \$8.9 billion (initial assumption). The value of U.S. imports from Europe in 1968, measured in 1961 prices, as a result of the income effect is $p_1 r M$ is \$7.3 billion. (See pp. 80 and 82.) Initially, let us accept their estimates of the price elasticities.

The European price elasticity $n=2.5$ (p. 82) and the U.S. price elasticity $e=1.7$ (p. 88). Then

$$(2) \quad \Delta B_1 = [(8.9(2.5) + (7.3)(1.7) - (7.3)) (\Delta r/r) = (27.3)R,$$

$$\frac{R = \Delta r}{r}$$

is the predicted change in the merchandise balance with Europe in billions of 1961 dollars that results solely from a change in relative prices.

Second, consider the merchandise balance with the rest of the world (B_2). The rest of the world imports the full value of its foreign exchange receipts, projected at \$38.8 billion in 1968. The United States is projected to account for \$15.2 billion of imports from the rest of the world (table III-7). U.S. exports are expected to account for 37.8 percent of the rest of the world's imports, on the basis of the income effects alone (p. 87). These income effects arise because of the geographical pattern of imports: Canada, Latin America, and Japan trade primarily with the United States while the remainder of the rest of the world trades mainly with Western Europe.

Brookings uses a coefficient $\sigma=2$, showing the elasticity of the U.S. share of an unchanged value of the rest of the world's imports from the United States and Western Europe combined, with respect to a change in the ratio of United States to Western European export prices. Coefficient $\sigma=2$ is an elasticity of substitution.

As a result of changes in relative price (R), the U.S. share of the rest of the world's imports will be $(1+2R) 0.378$. With imports of \$38.8 billion the projected U.S. exports to the rest of the world as a result of changes in relative price is $(1+2R) (14.6)$ billion.⁸ The U.S. balance with the rest of the world, in 1961 prices, resulting from relative price changes is

$$(2) \quad B_2 = (1+2R) (14.6) - 15.2.$$

In 1961 the balance with the rest of the world was \$0.5. Hence the change in the balance with the rest of the world ΔB_2 is

$$(3) \quad \Delta B_2 = (1+2R) (14.6) - 15.7.$$

⁷ The income effect is already assumed to have occurred.

⁸ \$14.6 billion is the income effect upon U.S. exports to the rest of the world (excluding Europe).

The total income effect could be estimated at about \$2.5 billion: an average of \$2.6 (initial assumption) and \$2.3 (alternative assumption).

The critical value of the change in relative price is the value of R such that $\Delta B_1 + \Delta B_2 = 2.5$. That is

$$(4) \quad (27.3)R + (1 + 2R) (14.6) - 15.7 = 2.5.$$

Since the trade balance rises when foreign prices rise relative to U.S. prices,⁹ any value of R greater than the one which satisfies equation (4) will certainly increase the net merchandise balance. Solving equation (4), we obtain

$$(5) \quad R = 0.064.$$

If U.S. export prices are 104 in 1968 (table VIII-1), then European export prices must be at least $104 (1.064) = 111$. The rate of growth of the export price in the United States is projected at 0.5 percent per year, from 1961 to 1968, to produce a value of 104. To produce a value of 111, the European export prices would have to rise by 1.5 percent per year.

So far, I have shown that European export prices would have to grow by at least three times as much as U.S. export prices to offset the effects of the rising incomes upon the trade balance in goods.

As the key relative price variable, I followed traditional theory and used the ratio of foreign export prices to U.S. export prices. The elasticities n and e are the percentage change in the excess demand for goods with respect to a percentage change in relative export prices.

Following the empirical studies of Rhomberg and Polak,¹⁰ the Brookings report used a different relative price variable and a different concept of elasticity. Their relative price was the GNP deflator in country i divided by the export price of country j . Their estimate of the elasticity was the percentage change in the deflated value of imports divided by the percentage change in their measure of relative price.

The Brookings report clearly questioned the wisdom of using their measure of relative prices, but relegated this objection to a footnote (p. 81, note 16). We know from experience that the GNP deflator may rise as a result of an increase in the prices of services at the same time that the wholesale price index is falling. In such a situation, given European export prices, the Brookings study would predict that Americans would substitute foreign for domestic goods. This would be strange since our wholesale prices are falling relative to their prices.

Their estimates of elasticity may be biased because they used an inappropriate measure of relative prices. U.S. deflated imports rose from 1953 to 1961; and so did the ratio of U.S. GNP price deflator to foreign wholesale prices. Consequently, it was possible to obtain a high elasticity figure. But the ratio of United States to foreign wholesale prices rose with respect to France and Italy, and declined with respect to Germany and the United Kingdom.¹¹ A poor relation

⁹ $\Delta B_1 / \Delta R$ is positive.

¹⁰ R. Rhomberg, "A Three-Region World Trade and Income Model, 1948-60," paper delivered to the Econometric Society, Sept. 9-11, 1962; J. Polak and R. Rhomberg, "Economic Instability in an International Setting," *American Economic Review* (May 1962).

¹¹ See table III-5.

between U.S. imports and relative wholesale prices would have been found, and, perhaps, that was the reason why relative prices were measured as the GNP deflator of country *i* to the export price of country *j*. Nevertheless this method imparted an upward bias to the elasticity figure.

A recalculation of the price elasticities, when the price ratio is measured as the ratio of export prices (properly defined),¹² might raise the critical value of *R* considerably. European export prices might have to rise by more than three times the rate at which U.S. export prices are projected to rise, if the relative price effect is to offset the income effect.

How were the 1968 export prices predicted? Given their measures of the price elasticities, the European export price index in 1968 must be at least 111, to the U.S. index of 104, if the net merchandise balance is to increase. The reason that the merchandise balance rises by \$1.8 billion, under their "initial assumptions," is that the foreign to U.S. export price index is 111 to 104; and they used an exaggerated ratio of relative prices,¹³ 120 to 104, in determining the quantity of U.S. exports demanded by Europeans. Under the alternative set of assumptions, the merchandise balance declines by \$0.9 billion. This occurs primarily because the assumed ratio of foreign to U.S. export prices is 107 to 104, below the critical ratio.

The U.S. wholesale price index has been stable from 1959 to 1962, and the authors assume that it will rise by very little, 0.5 percent per annum, from 1961 to 1968 (p. 81). The European export price index is expected to rise (to the critical level) by 1.5 percent per annum, a bit more than half of the increase in their GNP prices. How did the authors arrive at this figure?

During the 1950's, wholesale prices lagged far behind the rise in GNP prices in Western Europe. * * * There is reason to believe that during this period the export industries enjoyed a more rapid growth in productivity than industry in general and the economy as a whole, and that their costs consequently rose less than costs in other sectors of the economy. It seems unlikely that this favorable experience will be repeated in the next few years. The advantage of the export industries in productivity growth is likely to diminish if not disappear, partly because investment will shift away from them, for reasons stated in chapter II. The tightness that may be expected in the labor supply will probably have its most pronounced effects on costs in manufacturing (p. 83).

The projected rise in export prices is qualified in other parts of chapters II and III. "No tested hypothesis exists as to what determines the relationship between the general price level and export prices" (p. 91). Moreover, there are several reasons for doubting that European export prices will rise three times as rapidly as U.S. export prices.

First, the export sector in Europe is a high wage sector, and there is a large fraction of the labor force employed in low wage sectors, e.g., agriculture and retail trade. By contrast, much greater intersectoral wage equalization exists in the United States. For this reason, there should be a greater longrun elasticity of supply in the European

¹² As was pointed out in ch. III, the export unit value index is misleading. The more appropriate measure of export prices is the wholesale prices with export value weights.

¹³ 120 is the West Europe GNP deflator, and 104 is the U.S. export price index. In calculating the U.S. import demand, the U.S. GNP deflator of 111 just canceled out the foreign export price index of 111. But the European demand elasticity of 2.5 exceeds the U.S. demand elasticity of 1.7.

export industries, which can attract labor from the low wage sectors, than exists in their U.S. counterparts.

A substantive theoretical contribution of this report is the proposition that the net balance of goods and services depends upon both aggregate demand and potential output.

A rise in the rest of the world's domestic demand relative to its productive potential increases the net U.S. export balance of goods and services, but a rise in the rest of the world's productive potential relative to its domestic demand tends to reduce the U.S. export balance (p. 20).

What I claim is that the potential output of the European export industries will grow at a greater rate than our own export industries, and thereby the longrun European export supply is more elastic. There is strong empirical support for this claim on the basis of the U.S. interstate growth experience from 1880-1950. The rate of growth of personal income per capita in a State, from one decade to the next, was shown to be positively related to the extent of the misallocation of resources existing in the initial period. States with high fractions of their labor force in the low wage sector (agriculture) experienced higher rates of growth of per capita income, and of manufacturing employment, than did States with better allocations during the initial period.¹⁴ Consequently the longrun growth of capacity output in the export sector (relative to the whole economy) should be greater in Europe than in the United States.

Second, the projected growth in GNP prices is subject to question. Essentially, the projection is done by projecting: labor costs per unit of output and the share of output going to labor (ch. II). U.S. money wages are predicted to rise by 4.4 percent per annum, and European wages are predicted to rise by 7.9 percent per annum. The justification for these figures is not clear, but they are consistent with (a) a world Phillips curve derived from table II-5 and (b) the assumption that 4 percent unemployment exists in the United States and 1.5 percent unemployment exists in Europe. The lower growth of money wages in the United States, in recent years, can be accounted for by the higher unemployment rates.

As both the United States and Europe tend to have full employment, they will tend to have smaller discrepancies between the rates of growth of their money wages.

Third, the projected growth in European productivity may have been underestimated. There is a backlog of technology that Europe can adopt from the United States. Other things equal, this will produce a greater rate of technological change in Europe than in the United States. In addition, there is a greater potential for increasing real income through a more efficient allocation of resources within Europe than exists within the United States. Thereby, aggregate output per unit of aggregate input can be expected to rise faster in Europe.

As a result of the greater rate of technological change and improved allocations of resources in Europe and the reduction of the differential in rates of growth of money wages, I would expect a smaller rate of growth of European prices than of U.S. prices.

¹⁴ See G. H. Borts and J. L. Stein, "Economic Growth and the Allocation of Resources Among Regions" (New York: Columbia University Press, forthcoming, spring 1964), ch. 2; and J. L. Stein, "A Theory of Interstate Differences in the Rate of Growth of Manufacturing Employment in a Free Market Area," *International Economic Review* (1960).

Fourth, under full-employment conditions the price level bears a closer relationship to the money supply than it does when there are idle resources. Consequently, by reducing the rate of growth of the money supply, the European countries can reduce the rate of growth of the GNP deflator to its target rate. This target rate may be a magnitude no greater than the U.S. rate of growth of price. Since I would expect export prices to grow at a slower rate, relative to GNP prices, in Europe than in the United States (for the reasons cited above). I expect the relative price effect to worsen our net merchandise balance. Although chapters II and III are two of the most impressive empirical studies in international trade, I cannot accept their quantitative conclusions concerning the relative price effects.

II. PRIVATE FOREIGN INVESTMENT

The conclusion, in chapter V, that the rate of long-term private capital outflow will decrease by \$0.6 billion from 1961 to 1968 represents a leap from literary economics to quantitative conclusions. The careful bridge between theory and quantitative conclusions, which was developed in chapter III, is absent here.

There is an interesting discussion of the forces affecting bond flows on pages 133-134. Then, the report writes:

The expected future developments in bond flows discussed above were used to make a quantitative estimate for 1968 of the net flow of capital through long-term bonds (p. 134).

Taking all areas together, a net outflow from the United States of \$675 million through bond dealing is estimated (p. 135).

The report fails to tell the reader how this particular number was obtained. Then some comments are made on the prospects for equity securities. This informal section concludes with:

A quantitative evaluation of the various factors influencing future equity flows leads to our estimate that purchases of European securities by Americans will be \$150 million in 1968 and that European purchases of American securities will be \$300 million (p. 137).

No quantitative estimation methods were developed to justify these figures. They are just presented as assertions. In view of the rising importance of portfolio investment (it was 28 percent of direct investment in 1950-55 and 75 percent of direct investment in 1962), a careful econometric analysis is required to justify a projected rate of portfolio investment.

The volume of direct investment was projected in a more explicit manner, but the method is arbitrary and does not seem to have any predictive accuracy. Essentially the method is based upon the view that (A) expenditures by American business abroad for investments in property, plant, and equipment are equal to (B) retained earnings, (C) depreciation and depletion allowances and (D) funds from the United States (direct investment), while investment in working capital is financed abroad (pp. 141-142, appendix to ch. V).

By projecting (A), (B), and (C), item (D) direct investment is forecast. Item (A) was estimated from historical data through trend extrapolation. Not only is this an indefensible method in theory, but it leads to egregious errors in practice. Here is a simple test of this

method. Take an issue of Business Cycle Developments¹⁵ and try to see if any simple trend method can predict business expenditures for new plant and equipment from one business cycle to the next. I could not find anything to recommend this as a predictive method. To predict (B), retained earnings, a profit rate was obtained "from historical data." This note was applied to U.S. equity at the beginning of the year to obtain total earnings. Then a repatriation rate, also obtained from historical data, was used to determine dividends and its complement: retained earnings.

If the profit rate increased, for a given rate of investment in plant and equipment, retained earnings would rise. The authors would predict a decline in direct investment: i.e., given (A), a rise in (B) implies a lower (D). Ordinarily, we would expect a rise in the profit rate to induce a larger capital outflow.

Not only is such an analysis misleading, but what is the reliability of a profit rate derived from historical data as a projection device? If the report tested the predictive accuracy of their projection techniques in the manner suggested in the first few pages of my analysis, the strengths and weaknesses would be quite evident. Unfortunately, this was not done. For this reason, and for the criticisms raised above, no confidence can be attached to their quantitative estimates of the 1968 capital outflow.

Interestingly, however, a fruitful analysis of how to predict the long-term capital outflow is developed in chapter I, but it was not used in the remainder of the study. A statistical hypothesis, subject to test, can be derived from this fruitful theory of capital movements (pp. 21-23).

Let F be the net long-term private capital outflow from the United States, and let M be the rate of return on capital. Equation (6) claims that the long-term private capital outflow is determined by the rate of return on capital in the United State (M_1) and in the rest of the world (M_2), where the rate of return is discounted by a risk factor (c_i). Moreover, F will be affected by the savings (S_i) available in each region. Given M_1 and M_2 , the rate of capital outflow can be expected to vary as the total funds available for investment increases. To keep the statistical equations simple, write the long-term net private capital outflow as

$$(6) \quad F = c_2 M - c_1 M_1 + S_1 - S_2$$

Two influences upon M , the marginal rate of return, are considered in the Brookings Report. First, there is the marginal product of capital. This is a longrun concept determined by the ratio of labor to capital, the level of technology and the tariff structure.¹⁶ Denote the marginal product of capital by m_i , where the subscript refers to the region. Second, there is a short-run (cyclical) influence which is determined by the rate of capacity utilization ($A - y$): the difference between absorption (A) and potential output (y). High utilization rates mean high quasi-rents received by the owners of capital

¹⁵ This is published by the U.S. Department of Commerce, Bureau of the Census. Look at chart 1, item 61.

¹⁶ The tariff structure will affect the ratio of output prices to the prices of capital good inputs in Europe.

goods. Thereby, further capital growth is induced. The determinants of the marginal rate of return are summarized in equation (7).

$$(7) \quad M_i = m_i + n_i(A - y)_i \quad i = 1, 2$$

and

$$0 \geq (A - y)_i \geq -y_i$$

The net long-term capital outflow from the United States is obtained by substituting (7) into (6). This is done in equation (8).

$$(8) \quad F = [c_2 m_2 - c_1 m_1] + [c_2 n_2 (A - y)_2 - c_1 n_1 (A - y)_1 + (S_1 - S_2)]$$

The first term in brackets represents the secular forces; the second term in brackets represents the cyclical forces. A high rate of capital outflow is produced by a (relatively) high marginal product of capital abroad, a (relatively) low rate of capacity utilization in the United States and a (relatively) high rate of savings in the United States.

In 1968, given the assumptions of chapter II, the cyclical forces should reduce the rate of capital outflow. But what will happen to the relative marginal products of capital? With the backlog of technology and the misallocation of resources between sectors, I would expect the secular forces to increase the rate of capital outflow. Which effect will predominate? A necessary, but hardly a sufficient, condition for a satisfactory answer is a sophisticated econometric analysis using equation (8) above. The Brookings study will certainly be a guide for future research, although its quantitative conclusions are in doubt.

STATEMENT BY ROBERT M. STERN

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I am not at all confident of the Brookings projections that by 1968 the United States will have realized a sizable basic balance-of-payments surplus or a greatly reduced deficit. My skepticism concerning these projections stems primarily from the assumptions made in the Brookings study about the rates of economic growth and inflation in the United States and Western Europe between 1960 and 1968. While it is not to be denied that there are underlying factors at work making for improvement of the U.S. basic balance, these factors may not be sufficiently powerful in themselves to effect the projected improvement. This will be the case especially if the rates of growth and inflation are less favorable than assumed for the United States. It would be unwise, therefore, to place too great reliance upon the specific projections in this study as a basis for the adoption of particular measures of economic policy.

In order to trace out the path by which my conclusion was reached, I will divide my discussion into the major points touched upon in the report and under each point will offer some critical remarks. I will then consider the report as a whole in my concluding remarks and examine only very briefly its policy implications.

I. THE SCOPE AND METHOD OF ANALYSIS

The choice of growth rates

The choice made of growth rates is of crucial importance in evaluating the 1968 projections. Since the study was commissioned by the Council of Economic Advisers, it was perfectly legitimate to adopt as a frame of reference the 4.8 percent growth rate of real GNP which the Council hoped would be implemented between 1960 and 1968. It was similarly legitimate to adopt the 4.2 mean growth rate targeted for Western Europe by the OECD. Since these rates might be difficult to attain, lower alternatives were felt by the authors to be worth investigating. The U.S. growth rate scaled down accordingly to 4.2 percent and the West European rate to 3.8 percent.

How do these assumed rates compare with the actual rates experienced in the 1950's? For the United States, GNP in constant prices rose by 2.5 percent a year from 1953 to 1960. The real GNP of Western Europe, in contrast, increased by about 4.7 percent per year in the same period (p. 38). The Brookings assumptions imply, consequently, that the U.S. rate of growth between 1960 and 1968 would be nearly double or at least two-thirds greater than the rate during 1953 to 1960. Whether increases of such magnitude can actually be achieved is never really discussed. The report gives the impression, then, that it would not be particularly difficult to obtain increases of such magnitude in just a few years' time. This I doubt. Rather, un-

fortunate as it may be, to add a few tenths of a percentage point to the growth rate over time in the United States might prove to be extraordinarily difficult, as Edward F. Denison has shown in his remarkable book, "The Sources of Economic Growth in the United States and the Alternatives Before Us" (Committee for Economic Development, 1962).

In contrast to the very sizable increases in the rates of U.S. growth, the West European rates for 1960 to 1968 are assumed to be 11 and 19 percent below those realized during 1953 to 1960. Declines of this order of magnitude clearly are possible in view of the unusually favorable growth conditions in Western Europe in the 1950's. But it should be pointed out that the United Kingdom and other relatively slowly growing countries in Western Europe were lumped together with France, West Germany, and Italy in computing the rates for the two periods. Taking only the latter three countries, their annual rate of growth averaged about 5.4 percent for 1955 to 1960 and was projected at 4.9 percent for 1960 to 1968 (p. 43). If the United Kingdom was included, the rates would be lowered to 4.7 percent for 1955 to 1960 and 4.5 percent for the 1960 to 1968 projection. Since France, West Germany, and Italy have been the fastest growing and the most persistent surplus countries in Western Europe, they might properly have been isolated from the United Kingdom and from the other continental countries for special consideration viz-a-viz the United States.

In view of the foregoing remarks, it is not clear why the authors chose only two sets of growth rates. This is especially the case inasmuch as both sets are very favorable compared to recent full employment rates in this country. In my judgment, the failure to investigate other alternative sets, in particular those less favorable to the United States and more favorable to Western Europe, detracts greatly from the scientific objectivity of the study. This would admittedly have made the research more cumbersome, expensive, and difficult to present. But at the same time, interested readers and policymakers would have had impressed upon them (p. 31) the "sensitivity of projections of net balances of international payments," and that the value of projection "lies less in its quantitative result than in the process of obtaining the result."

The authors apparently did not fully appreciate the significance of their own warnings about the speculative nature of the projections. For otherwise they might have been less sanguine about the continuance of a sizable American basic balance-of-payments deficit, more concerned about possible measures for correction of this deficit, and consequently less preoccupied with the reform of the international monetary system.

The extent of inflation

It was assumed in both of the 1968 projections for the United States (p. 40) "that the implicit price deflator for GNP would rise by 1.5 percent per year, which implies that realization of the full employment and growth targets would not entail any significant sacrifice of price stability." It was demonstrated (p. 41) that with particular proportions of total GNP assigned for 1968 to the individual expenditure sectors, there was an implied absence of demand pressures.

With such relatively high growth rates, how likely is a 1.5 percent rate of increase in GNP prices? The precarious nature of the invest-

ment relationship used (pp. 263-264) certainly does not inspire great confidence in the GNP shares. Moreover, inadequate attention was given to whether an annual 1.5-percent price increase was consistent or feasible in the light of recent U.S. experience. For example, the average annual increase in the GNP price deflator between 1953 and 1960 was 2.2 percent. And this was, it will be remembered, a period of 2.5 percent per annum growth in the United States.

The initial projection for Western Europe implied that GNP prices would rise by 3 percent a year in France, Italy, and West Germany (pp. 47-50, 283), and by about 2.75 percent a year if the United Kingdom was included with these countries. Such a relatively high rate of price increase was conditioned by the combination of a slackening in the rate of growth of production and productivity, a tightening of the labor market, and only moderate shifts in the distribution of income between labor and capital. It was further assumed (p. 60) in the initial projection that "to avoid sacrificing a high rate of growth, fiscal and monetary restraints on demand in Western Europe will not be exercised vigorously enough to restrict price rises very much." While such an assumption has considerable heuristic value, it seems unlikely that the authorities in Western Europe would deliberately expose their economies to inflation. Accordingly, a somewhat restrictive monetary and fiscal policy was assumed in the alternative projection. The consequent lowering of the rate of growth and thus of labor earnings implied a reduction of the annual rises in GNP prices from 3 to 2.1 percent in France, Italy, and West Germany and from 2.75 to 1.75 percent if the United Kingdom is included (pp. 283, 285).

Relatively substantial inflationary pressures have been clearly evident in Western Europe since 1960. This has not brought immediate relief to the American balance-of-payments position, however, because European exporters may have absorbed higher money costs by letting their profits be squeezed. But there are surely limits to this. The United States will stand to gain, therefore, if it can restrain its own rate of price increase relative to the increase in Western Europe.

I am in agreement with the authors that strong inflationary tendencies are likely to persist in Western Europe in the next few years. But should these tendencies increase to proportions which seriously threaten internal stability and the balance of payments, the willingness and ability of the authorities to impose restrictive policies should not be underestimated. The inflations of the 1920's and 1940's are undoubtedly still vivid enough in Western Europe so as to call forth strong and effective action should the occasion arise. There is no guarantee, therefore, that West European inflation will bail the United States out of its balance-of-payments difficulties. Moreover, should the United States actually experience a lower rate of growth and a higher rate of inflation than the Brookings projections imply, the intractability of our balance of payments could well continue and maybe even worsen.

Export prices and competitiveness

Under the initial and alternative assumptions made in the report, U.S. exports to Western Europe were projected to rise by \$5.7 or \$3.4 billion (in 1961 prices) from the \$7 billion level recorded in 1961. Of the \$5.7 billion rise under the initial assumptions, \$3.5 billion was

ascribable to an improvement in the U.S. competitive position relative to Western Europe. Of the \$3.4 billion rise under the alternative assumptions, \$1.5 billion was due to an improvement of competitive position (p. 90). The income projections were thus \$2.2 and \$1.9 billion, respectively. American imports from Western Europe were projected to rise (in 1961 prices) by \$4.1 and \$3.9 billion over 1961, with at most a \$0.5 billion competitive impact under the alternative assumptions. The sensitivity of the merchandise trade balance (p. 89) "both to the assumptions about the size of relative price changes and to the assumptions about the response of trade to given changes in relative prices" is therefore very clear.

It should be evident from the foregoing remarks that the authors were forced to project not only the changes in GNP prices in the United States and Western Europe, but had, in addition, to project the associated changes in the export prices of the two regions. The precarious reliability of these estimates can best be appreciated from the authors' own words (p. 91) :

* * * no firm basis exists for projecting changes in export prices, even if our assumptions about changes in GNP prices are correct. No tested hypothesis exists as to what determines the relationship between the general price level and export prices. What is of greater relevance * * *, however, is that the data needed to test hypotheses about the determinants of export prices are not available; we do not even have reliable information about export prices in the past, either for the United States or Western Europe.

Until the price data are improved, quantitative projections of the competitive position of the United States can be little more than informed guesses * * *.

The inadequacy of the basic data is a very serious handicap to the statistical estimation of the relationships between exports and relative prices. Lacking other alternatives, the authors were forced to rely upon the price elasticities of demand for American and West European exports to each other's markets and to third markets on the basis of computations made in studies by Polak and Rhomberg using data for 1947-60. There are two major difficulties that should be mentioned about the use of these estimates for the purposes of projection.

First, there is some doubt about whether the regression equations based upon the historical data will hold for projections. The actual values of future exports may therefore show considerable divergence from the projected values because of changes in the magnitudes of the historical income and price coefficients.

The second difficulty stems from estimating an elasticity of demand for all merchandise exports, thus lumping together exports of raw materials, foodstuffs, and manufactured goods. Now in 1961, over one-half of U.S. exports to Western Europe consisted of nonagricultural raw materials and agricultural products. Some of these goods do not compete seriously or at all with European output (e.g., cotton). Others (e.g., foodstuffs) are in more direct competition and may thus be vulnerable to restrictive commercial policy. Sizable increases in the exports of these goods to Western Europe are therefore unlikely. The burden of the increase in exports would consequently fall to a very large extent upon exports of manufactures, which, in order for the projections to be realized, might have to be increased by more than \$1 to \$3 billion. In view especially of the uncertainty which surrounds the height of the Common Market tariff, such a large increase in the exports of manufactured goods to Western Europe might be difficult to achieve.

Investment and growth

Although not developed at length, the significance of export-stimulating and import-replacing investment in the West European growth process is emphasized in the study a few times (pp. 29, 54). It is questioned, however, whether the investment mix will continue as in the past to favor the foreign trade sector. Instead, more investment may be channeled or diverted into the domestic sector and particularly into industries with relatively higher capital-output ratios (pp. 54, 219).

Whether such a restructuring of investment will occur on an important scale by 1968 is an open question in my judgment. We need more than casual empiricism to determine whether the changing demand pattern in Western Europe will divert investment in ways inimical to the balance of payments. It should be recognized, moreover, that investment policy might just as well continue to favor the foreign trade sector, especially if high social priority is attached to a strong external account position.

There is in addition to the foregoing questions the important relationship between investment and technological change. The evidence covering the 1950's should amply demonstrate that the United States does not enjoy unrivaled leadership in manufacturing production and productivity. Western Europe may well be able to continue its impressive strides in the growth process, especially if technological change there is accelerated and leaves important U.S. industries behind. Neither the authors nor myself can pretend to know the answer to this question. But it may well develop that the incremental gains in comparative advantage, especially in manufacturing, may not be in favor of the United States.

Lagging American productivity could well materialize if the favorable rates of investment and of economic growth in the United States are not accomplished. In such an event, the likelihood of a continued outflow of private capital for direct foreign investment purposes would be enhanced. Conditions might be created, therefore, which would result in a substantial displacement of American exports both in Western Europe and in third markets.

A three-country model of trade and payments

A unique feature of the Brookings report is the development of a model of trade and payments which pairs off the United States with Western Europe as the only regions which can run continuous balance-of-payments deficits or surpluses. The rest of the world, correspondingly, is assumed to spend all of its foreign earnings upon imports. While extremely useful as an analytical model, there is some question, as the authors themselves recognize, about whether the rest of the world, in particular Japan and Canada, will, in fact, behave as the model suggests.

While it is broadly correct to state that these two countries were not able in the postwar period to generate continuous balance-of-payments surpluses, this is a condition that could be altered in the future. Japan's reserve experience during the 1950's may have been unusually conditioned by the Korean war and the subsequent decline in earnings from U.S. offshore military purchases. In the absence of stress in the coming years, the Japanese might be more successful, if they wished, in building up their reserve position. The same could be true of Canada, particularly since its adoption of a fixed exchange rate.

As the authors point out, it need not of course follow that an increase in Japanese and Canadian reserves will affect the United States adversely. This is because of the relatively high feedback ratios which characterize the relations of these economies to the United States. But it should also be remembered, and this is a point which the authors do not take into account in their calculations, that the size and reliability of the feedback could be affected adversely if the growth and competitive position of the United States are not sufficiently improved.

Exchange rates, the balance of payments, and liquidity

The authors are very clearly in favor of a system of fixed exchange rates because of the certainty which such rates provide for the expansion of world trade and payments and the associated maximization of economic welfare (p. 245). In their view, the main disadvantage of this system in its present form "is that it requires countries whose payments are not in balance to restore balance more rapidly than may be consistent with important domestic and international objectives." This disadvantage is felt particularly with reference to imbalances created by structural changes which (p. 246) "require time, not drastic action aimed at achieving an immediate result." The authors believe that the best way to buy time is to create and provide more convenient access to greater international liquidity.

Another way of buying time under a fixed exchange rate system is of course through changing the exchange rate. However, as the authors point out (p. 247), because considerable uncertainty is pervasive when there is a likelihood of devaluation, speculation against the faltering currency may be substantial. If a devaluation is then implemented, it may, in the desire to generate confidence in the new rate, overshoot the mark required to attain a new equilibrium.

Then, there is the alternative of flexible exchange rates. This alternative is judged implicitly by the authors to be inferior to a fixed rate system. It is suggested, however, that in the event international liquidity cannot be increased sufficiently, consideration might be given to the creation of a dollar-sterling currency bloc and a European Economic Community currency bloc (pp. 259-262). While exchange rates would be fixed within each bloc, they would be free to vary between the blocs.

Even assuming that the international monetary system is to be altered in favor of greater exchange rate flexibility, the need for forming two new currency blocs to obtain the consequent advantages is not at all clear. An individual country or all countries could just as well have a flexible rate system which would do away altogether or at least in great part with the need to hold international reserves for balance-of-payments purposes. Flexible rates would, moreover, permit individual country objectives to be pursued without undue concern for the balance of payments, particularly if monetary policy was used effectively to keep domestic prices relatively stable.

It should be clear that the balance-of-payments adjustment process under a fixed rate system depends upon internal readjustment of domestic prices and costs in the face of a structural disequilibrium. To work effectively, sizable and mobile international reserves are needed, and there must be complete confidence in the established exchange rates. This is just what the pre-1914 international gold standard was like. There was an inner logic in the system which found expression

through the responses of the monetary authorities to changes in their gold reserve to liabilities ratio, particularly by means of altering the discount rate and thereby affecting the cost and availability of borrowing.

In today's pegged exchange rate system, we are lacking the inner logic of the gold standard mechanism of adjustment. Countries undergoing balance-of-payments deficits often wish to avoid the painful domestic readjustments which may be required to restore equilibrium. Reliance is placed therefore upon the use of international reserves to finance balance-of-payments deficits, and particularly if deficits are structurally caused, to use reserves to buy time until the ad hoc policies implemented to suit the occasion have the desired effect upon the imbalance. The difficulty with this system, and therefore with the authors' judgment concerning the expanded need for international reserves, is that it implies that the existing rates of exchange are proper and that all balance-of-payments deficits should be financed irrespective of the size of the deficit and the length of time necessary to restore equilibrium. There is a real danger, consequently, in overstressing the need for more liquidity in a system which lacks the inner logic and discipline of the gold standard. It would be much simpler indeed to have a flexible exchange rate system.

II. CONCLUSION AND POLICY IMPLICATIONS

Lest my foregoing remarks be misconstrued, I should like to make it clear that I consider this study to be a work of great importance. It should be commended as a model of analytic clarity to all serious students of international economics. Unfortunately, its impact is marred by unwarranted optimism and misplaced concreteness.

I do not share the authors' optimism concerning the projected rates of economic growth and of price inflation in the United States between now and 1968, although I agree with them that Western Europe will continue to be beset by serious inflationary pressures. There is no reason to believe, however, that the authorities in Western Europe will stand by and permit inflation to degenerate their international competitive position in order to help the United States to reduce its balance-of-payments deficit. It is misplaced concreteness, therefore, to argue, as the authors do, that the really fundamental problem is the adequacy of international reserves and not the magnitude and intractability of the unfavorable American balance-of-payments position.

I agree completely with the view expressed in the study that the United States should not let its balance of payments interfere with the attainment of important domestic and international objectives. We should willingly relinquish our position as world banker if the price for this position is the underemployment of our national resources. My own inclination would be to stimulate the American economy by vigorous application of fiscal and monetary policy. Should our balance of payments worsen in the interim, we could exercise more fully our drawing rights with the International Monetary Fund and seek further monetary cooperation with Western Europe. At the same time, we should seek to reform the international monetary system in ways that will not interfere with the maintenance of full employment and price stability in the world economy.

STATEMENT BY ERIK THORBECKE

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I. This critical evaluation of the Brookings study consists of three parts. The first part is devoted to some introductory comments about the timing of, and the overall procedure used in preparing the report. The second part consists of a general appraisal and critique of the scope and the underlying methodology of the study, whereas the final section concentrates on a specific examination—chapter by chapter—of the basis upon which the projections were arrived at.

II. At the outset it should be mentioned that the Brookings study is a careful and rigorous analysis of the state of the U.S. balance of payments in 1968, within the delineations which the authors selected and granted the assumptions and tools used by them. In fairness to the Brookings group, it should be pointed out that it was operating under some directives, guidelines, and assumptions which were set forth by the Council of Economics Advisers. In this sense the group was subjected to a set of constraints imposed from outside which limited somewhat its range of "free inquiry," and which, as will be argued subsequently, may have been responsible for certain weaknesses in the study.

It is, also, necessary to remember—before starting a critique of the report—that the study was, for all practical purposes, completed within a period of 8 months. (The contract between the Council of Economic Advisers and the Brookings Institution was signed in May of 1962 and the report submitted to the Council in January of 1963.) Given the time limitation, it proved very difficult—if not impossible—for the authors to formulate and derive new quantitative relationships, explaining changes in the various balance-of-payments transactions. Therefore, the analysis is based—practically throughout the report—on quantitative and conceptual sources already in existence at the time the report was being prepared. The main disadvantage of this procedure is reflected by a less than perfect "fit" between the conceptual part of the study, as formulated by the authors, and the already available and independently derived quantitative relationships used as the backbone of the conceptual framework. The image which results is sometimes slightly blurred, as when a lens is out of focus, and in some instances one almost gets the impression that the conceptual framework is dictated by, and forced into a mold to correspond to, the existing set of quantitative studies, rather than the other way around. It is true that a few econometric relationships were recomputed on the basis of the conceptual breakdown chosen by the authors,¹ but this is as far as they appear to have gone in deriving their own independent econometric relationships.

¹ A few of the equations of the Polak-Rhomberg world trade model were altered and reestimated so as to conform to the geographical breakdown selected by the Brookings group.

A final introductory observation which should be kept in mind in evaluating the report is that it was produced by a team of experts rather than by one authority. The division of labor among experts took place essentially along chapters lines.² One consequence of this approach is that the study as a whole suffers somewhat from a lack of continuity. The various chapters and parts have been developed in cognizance of the findings of the other coauthors but, nevertheless, mostly independently. The feeling this reviewer was left with after reading through the report was that, obviously, the authors started—*ex ante*—with a given common methodology, given directives and a set of underlying assumptions, but that the internal consistency was only achieved *ex post*, by revising the individual contributions to eliminate conflicting evidence or conclusions in the separate parts. Each author was, more or less, forced to follow a “partial equilibrium” approach, concentrating on his (or her) specific question assuming almost everything else constant. The *ceteris paribus* assumption in each part, makes for a fairly intractable whole. The pieces of the puzzle seem to fit together very well within a section (or chapter) but not as well between sections or chapters. It should, of course, be recognized that the above criticism may be unfair in view of (A) the tremendous difficulty inherent to any attempt at a “general equilibrium” approach to forecast the state of the balance of payments in the future, and (B) the time which might be necessary to complete such a project. A recognition of the extent of the problems involved in an alternative approach (to the one followed by the Brookings Institution) increases ones admiration for the quality of the Brookings study but should not preclude a critical evaluation of its absolute as well as its relative limitations and shortcomings.

III. The basic approach followed by the Brookings group is that of conditional forecasts. In other words, the projections of the U.S. balance of payments for 1968 would be accurate if (A) the assumptions concerning the changes in the explanatory variables, affecting the balance of payments; that is, rates of growth of GNP, domestic and export prices, level of employment, productivity, et cetera are accurately forecast for 1968, (B) the structural and quantitative relationships used to explain the changes in the various components of the balance of payments are correctly specified. This means that the actual observed changes in the (dependent) balance-of-payments transactions are completely explained by the explanatory variables over the period used to estimate the coefficients. Since the econometric and other quantitative relations were estimated with respect to the past (the Polak-Rhomberg model covered the period 1948-60) even a coefficient of correlation of unity would not guarantee that the past and prevailing structure will be maintained in the future. This is particularly true when the changes in the explanatory variables are outside the range of observations covered by the equations. Given the anticipated values of the explanatory variables in 1968, it is almost a foregone conclusion that extrapolation of the relationships is necessary, (C) the error term is zero in the structural relations. In fact this is almost

² Walter Salant wrote chs. I and VIII, in addition to providing the bulk of the integration and coordination among the various parts. Lorie Tarshis did the basic work on ch. II. William Salant contributed ch. III, Lawrence Krause chs. IV and V, and Alice Rivlin ch. VI. Emile Despres helped formulate the basic method of analysis and contributed on specific issues.

never the case, so that given the joint probability distribution of the random disturbances the changes in the dependent (balance-of-payments components) can be stated only in probabilistic terms, even when the coefficients are perfectly specified and errors of measurement are absent, (*D*) the least squares conditions are met whenever applicable and, more specifically, that no intercorrelation between the explanatory variables exists.

It is, of course, obvious that these conditions are so strict that it would be highly unreasonable to expect them to be met in reality. This is typical of all econometric relationships and the Brookings study makes these qualifications quite explicit throughout the analysis.

It appears desirable nevertheless to explore the extent to which the above conditions are met in the report under consideration, primary emphasis being placed on the selection process of the key explanatory variables affecting the balance of payments (condition (*A*) above).

Two sets of assumptions were used with respect to the levels of GNP: prices and employment which would prevail in the United States and in Western Europe in 1968. No independent forecasts of the changes in these variables were required for the rest of the world since it was assumed that third countries (developed as well as developing) do not accumulate reserves and will essentially adjust their payments patterns for goods and services to the level of their receipts from exports and capital inflows.³ The first set—referred to as “initial assumptions” in the study—were provided by the Council of Economic Advisers (CEA) in the forms, “either of specific figures or general guides.” The second set—called “alternative assumptions”—were chosen by the Brookings group and suppose a slightly lower rate of growth in both the United States and Western Europe, and a smaller price rise in Western Europe than do the initial assumptions.

With respect to the United States the initial assumptions call for a 4.8-percent average (annual) growth rate of real GNP between 1960 and 1968, an annual increase in the labor force of 1.7 percent (consistent with a rapid reduction of unemployment to 4 percent of the labor force), and a rise in the implicit GNP price deflator of 1.5 percent per year. For Western Europe, the corresponding rates are 4.2 percent for the growth in GNP, 0.5 percent annual rise in the labor force, and a 2.75 increase in the price level per year.

The rationale behind these figures is not stated in any details. No justification for the selection of these magnitudes is given in the study, although the CEA undoubtedly must have arrived at these figures on the basis of some model. In a sense, the viewpoint which is taken by the group is that of the “onlooker,” presuming a given set of predetermined policies which presumably affects key variables such as GNP and prices, but not explicitly analyzing the alternative effects of different policies on these basic variables.

The lack of an explicit policy model relating policy means to the above economic variables is the greatest weakness of the Brookings study in the opinion of this reviewer. The nature of the problem assigned to the group falls clearly within the scope of what is called—following Tinbergen’s terminology—the theory of economic policy.

³ The United States and Western Europe are the only regions which are assumed to grow, as it were, autonomously. The balance-of-payments developments of the rest of the world being induced by changes occurring in the former regions.

The Government wants to achieve certain economic objectives, i.e., full employment, relative price stability, economic growth, and balance-of-payments equilibrium. The quantitative determination of these so-called target variables, as well as the rates of substitution between them, depends on the preferences of the people, expressed through the Government, for, i.e., high employment as opposed to price stability, growth as opposed to external balance, and so on. These target variables can be influenced by changes in policy means—the instrument variables (as for instance tax rates, open market operations and other means available to the Federal Reserve System; and the rate of exchange). The instrument variables are means over which the Government exercises some degree of control. In addition to instrument variables there is a class of variables over which the Government has no control—the “other data”—which are exogenously determined. In the methodology of the theory of economic policy a model is formulated relating the target variables to the instrument variables and the other data. The essence of the approach is then, to follow through the consequences of changes in the instrument variables on the target variables, in the light of the predicted values of the “other data.” In so doing, a policymaker can be made aware of the complete set of effects resulting from any set of policy measures. Likewise, given the desired state of affairs expressed in terms of the target variables, the system can be solved—under certain conditions—for the set of instrument variables satisfying the predetermined values of the targets. In this sense the “initial assumptions” as well as the “alternative assumptions” with respect to the variables affecting the balance of payments, presuppose specific sets of policy measures (values of instrument variables) consistent with the given magnitudes of the former. These sets are conspicuously absent from the study and, consequently, they have to be guessed at.

In the above context one is reminded of a statement by Professor Frisch, one of the foremost econometricians of our time and a major force in the systematic development of the theory of economic policy—

During the last generation the shift from the onlooker viewpoint to the decision viewpoint has become more and more prevalent in economic thinking all over the world * * *. In most countries this shift in viewpoint is, however, based on a sort of half logic which I have never been able to understand and which, I think, will never be able to yield fundamental solutions. On one hand, one still retains the onlooker viewpoint, and tries to make projections on this basis (growth models of the current types). And on the other hand one will afterward try to use such projections as a basis for decisions. How can it be possible to make a projection without knowing the decisions that will basically influence the course of affairs? It is as if the policymaker would say to the economic expert: “Now you expert try to guess what I am going to do, and make your estimate accordingly. On the basis of the factual information thus received I will then decide what to do.” The shift from the onlooker viewpoint to the decision viewpoint must be founded on a much more coherent form of logic. It must be based on a decision model, i.e., a model where the possible decisions are built in explicitly as essential variables.⁴

At least two extenuating circumstances can be offered in defense of the “onlookers” approach followed by the Brookings group: First, the CEA provided—as mentioned previously—the “initial assumptions,” and, thereby, it may have tied the hands of the group, at least par-

⁴ Ragnar Frisch, “A Survey of Types of Economic Forecasting and Programing and a Brief Description of the Oslo Channel Model.” Memorandum from the Institute of Economics, Oslo, May 1961, p. 4.

tially; secondly, it is extremely difficult to formulate and to specify quantitatively a policy model of the Tinbergen type for an economy as complex as that of the United States. Parenthetically, it is even doubtful that the new SSRC econometric model of the United States which is presently being prepared by a distinguished group of econometricians will be capable of providing a detailed picture of the alternative effects of various policy measures on the basic target variables.

Nevertheless, it can be argued that, to the extent that the 1968 forecasts of the target variables in the initial assumptions reflected the analytical views of the Council with respect to the most desirable and feasible policies (in terms of given quantitative values of instrument variables), the relationships connecting the targets to the instrument variables should have been explicitly stated and contained in the report. The desirability of expressing the underlying policy model—even if it were of a very rough nature—would have been further enhanced in view of the fact that the Brookings group adopted a set of alternative assumptions. The formulation and the inclusion of such a policy model in the report, even in a sketchy and incomplete form, would have brought out the evaluation of the CEA and Brookings with respect to the sensitivity of the target variables to different monetary fiscal and other policy measures.⁵

It is true, in this connection, that the selection of an alternative set of assumptions by the group was meant to, and did permit an analysis of the sensitivity of the balance-of-payments transactions to different levels of GNP and other target variables. But what the study lacks is an attempt at going one step further and analyzing, with the help of a policy model, the sensitivity of the balance of payments to changes in policy means.

The extreme difficulty which governments throughout the world face in achieving simultaneously internal and external balance makes it imperative to follow through the consequences of monetary, fiscal and trade policies on the domestic goals (high employment level, relative price stability, and growth) and on the external goal of balance-of-payments equilibrium. Given the conflicting impact of almost any policy measure on these objectives—in the sense that the level of attainment of one of the goals is aided by the measure but at the expense of reducing the level of attainment of one or more other goals—it would have been highly desirable to have added one chapter discussing the implicit policy measures underlying, and consistent with, the assumed values of the key variables. In this fashion the domestic as well as the balance-of-payments impact of these measures could have been ascertained.

A second general criticism of the Brookings study is the highly aggregative nature of the analysis in terms of the geographical breakdown as well as the commodity composition of imports and exports. In contrast, the study presents a detailed and well-organized analysis of the various components of the balance of payments.

For all practical purposes the world is divided into (a) the United States; (b) Western Europe—which are assumed to be the only dynamic regions in the system from the balance-of-payments standpoint;

⁵ The sensitivity of changes in the rate of growth of GNP, the price level, the level of employment, and the balance of payments to changes in policy instruments could easily be derived from this type of model since the relationships between the various types of variables are expressed in a functional form within a set of simultaneous equations.

(c) the countries whose trade and payments patterns are closely tied to the United States: Canada, Latin America, and Japan; and (d) the rest of the world which is closely linked to Western Europe. These last two regions—as was pointed out before—are supposed to play only a passive role in the system since the hypothesis is made that they do not accumulate reserves. They adjust the level of their international payments to the level of their international receipts. This geographical division can be defended as a first approximation and so can the adaptive nature of the balance of payments of the countries outside the United States and Western Europe—at least with respect to the developing countries.

On the other hand the lack of even a very broad commodity breakdown into a few major classes, appears to be a fairly serious defect. Given the relative importance of merchandise trade on both the credit and debit sides of the balance of payments—accounting as it does, for as much as two-thirds of overall receipts from abroad and payments to foreign residents—and given the substantial differences which exist in the magnitudes of the income, price, and substitution elasticities for different classes of goods, a commodity breakdown would seem to have been warranted. It would, in any case, have added much to the degree of confidence to be placed on the resulting projections.

The justification for not using a commodity breakdown may derive from the following considerations: (1) the Polak-Rhomberg model provided econometric relationships only for aggregate imports into the United States from Western Europe and the rest of the world, and into Western Europe from the other two regions, expressed as a function of real GNP of the importing country and relative prices, (2) a major problem in any attempt at commodity disaggregation is to specify homogenous classes and to construct reliable price deflators corresponding to these classes. It appears that the Brookings group made an effort to estimate disaggregated import and export demand equations but decided not to use them in their available form.

The present reviewer would attach a very high priority to the construction of econometric relationships by commodity groups superimposed on regional breakdown by sources of imports and destination of exports. It is to be hoped that in the near future a world trade model, along matrix lines, might be developed, containing the two types of breakdown mentioned above.

IV. This last part of the evaluation of the Brookings study deals with specific issues and points which are taken up in the order they appear in the report.

The decision to use the "basic balance" as opposed to the "net balance" for analytical purposes, appears sound. It is a well-known fact that short-term capital movements do not necessarily take place in response to economic forces per se, so that abstracting from them permits the analysis to proceed along more structural and fundamental lines. At the same time, a still more adequate definition of the relevant balance would result if it were possible to distinguish between autonomous short-term capital movements (responding to interest rate differentials) and the essentially induced capital movements for reserve purposes (the derived changes in the liabilities of U.S. residents to foreign residents). At this time it appears very difficult to make this distinction because of data limitations and even if a

statistical breakdown existed the Brookings definition could still be strongly defended on conceptual grounds.

One interesting concept which the study attempted to make operational, and expressed in quantitative terms, is that of the feedback ratio; i.e., estimates of the proportion of U.S. expenditures abroad that are ultimately respent in the United States. It is clear that a number of feedback ratios can be distinguished on the basis of the type of U.S. expenditure (merchandise imports as opposed to capital outflow, for example). In order to arrive at the quantitative estimates of the feedback ratios, the group drew on analyses prepared for the CEA and AID. These ratios were developed on the assumptions that: (1) as seen previously—only the United States and Western Europe accumulate reserves, (2) all other regions spend receipts in proportion to their existing trade patterns in 1960. Given the trade matrix it is, then, possible to compute the percentages cumulative returns, to the United States of dollars spent in various regions, at the end of any round of expenditures. The feedback concept is very useful in, and highly relevant to any attempt at making projections of the balance of payments and the Brookings group should be praised for its efforts in this direction. At the same time, the underlying assumptions—mentioned above—used to derive feedback ratios lead to the following defects: First—as the study itself pointed out—the use of trade matrix to estimate feedback ratios corresponding to a payments matrix introduces errors in the estimates. It is likely that the feedback ratios applying to investment or aid receipts are different from those applying to export receipts, at least for some regions. A second defect is that timelags between receipts and expenditures are ignored. This is a minor criticism since, as long as the timelags are short, differences in lags will not effect the basic position of the U.S. balance of payments. Nevertheless, cyclical or temporary disequilibriums could result from given time patterns of U.S. payments. A knowledge of these timelags could be useful in rearranging the pattern and timing of U.S. payments (whenever feasible) to counteract short-term pressures on the balance of payments, resulting from changes in the domestic economic conditions, for example.

A last defect which might be mentioned is the hypothesis that there is no direct relationship between U.S. expenditures in Western Europe and the latter's payments to the United States. There appears to be some evidence that U.S. imports from Western Europe are responsive to changes in the value of U.S. exports to Western Europe. A "reflection elasticity" of close to 1 was found by one econometric study of the determinants of U.S. imports from Western Europe (implying that a 1 percent change in U.S. exports of goods to Western Europe is accompanied on the average by a 1-percent change in U.S. imports from the latter region).⁶ It appears likely that some (quantifiable) relationship exists between U.S. imports from, and exports to Western Europe as well as, in a more general sense, between these regions payments and receipts from one another.

The direction of the causality may be fairly involved, so that only an interdependent system of equations might yield an estimate of the feedback ratios. Given the importance of Western Europe in the

⁶ See Irma Adelman "An Econometric Analysis of U.S. Foreign Trade," Statistical Appendix; Provisional Draft, August 1962.

world payments network it is to be hoped that further research will be done along the above lines.

The changes in the trade in goods and services resulting from changes in real income (output) are analyzed in chapter 11. The analysis is very thorough and the implications of the two sets of assumptions—initial (given by the CEA) and alternative—are carefully examined with respect to labor productivity, capacity, investment, and other variables. An attempt is made at justifying the choice of the assumptions—at least the alternative assumptions—on the basis of past and probable future trends. The internal consistency of the various components of GNP is checked against the background of the assumed rates of growth of output and price developments in the United States and Western Europe. It would have been desirable, as was pointed out previously, to have analyzed the set of policy measures (such as, for instance, President Kennedy's tax program) which would have permitted the attainment of the magnitudes of the explanatory variables predicted to prevail in 1968.

Under the initial assumptions it was supposed that between the period 1960-68 the rate of growth of output would increase by 4.8 percent per year in the United States and 4.3 percent in Western Europe, while the GNP price deflator would rise by 1.5 and 2.75 percent, respectively, in the two regions. The alternative assumptions postulate lower growth rates (4.2 and 3.8 percent, respectively) and a more moderate price rise in Western Europe (1.75 percent annually). These values were then plugged into the Polak-Rhomberg equations to derive conditional forecasts of the impact on U.S. imports and exports of goods and services. Concerning the choice of growth rates, one is tempted to express some skepticism about the expected U.S. rates. A shift from an average of 2.5 percent annual rate between 1953-60 to either 4.8 or 4.2 percent appears considerable. In contrast, the assumed slowing down of the Western European growth rate from 4.7 percent, in 1953-60, to the lower levels appears reasonable. In any case it is interesting to note that the net impact of the real income effect comes out to be almost similar under the two sets of assumptions, which would tend to increase the degree of confidence to be placed on the projections. The main reason for this close correspondence appears to be that, from the standpoint of Western Europe, the U.S. balance on current account is subjected to two opposite forces. A higher rate of growth in Europe generates larger U.S. exports but, to the extent that it is accompanied by a higher GNP price rise, it reduces the flow of U.S. imports, and vice versa.

Chapter III examines the impact of competitiveness on the U.S. balance of payments, and more specifically the anticipated effects of changes in the prices of exports in both the United States and Western Europe. Here again the study was hampered by the lack of disaggregated data on the changes in the pattern of world trade. In order to appraise whether the United States underwent a loss in its competitive position, use is made of a Department of Commerce study which scrutinizes the changes in the U.S. shares of individual regional product markets. In this respect, a clear distinction between the structural and competitive changes would have added to the analysis. The structural changes in world trade would result from the changes in the relative importance of commodity groups and of regions in

world trade. The competitive effects could be measured both with reference to a change in the U.S. export shares of regional markets, and commodity groups, respectively. An examination of the changes in the U.S. export shares of regional markets per se includes the simultaneous effects of both structural changes in the regional distribution and the commodity composition of world trade. Given the raw data, presently available, a more refined study of the competitive position of the United States—pinpointing specifically the shifts by regions and by commodity classes—is possible.

However, when it comes to an appraisal of the role played by price changes on the competitive position of the United States, the problem becomes almost impossible in view of the extremely limited information available on export prices broken down by commodity groups. Consequently the Brookings analysis is forced to make "guestimates" which are sometimes contrary to the skimpy quantitative evidence. An illustration of this type of necessary taxonomy is to be found in the following quotation from page 81 in the study:

The behavior of the series for unit value of exports as a whole and exports of manufactures, which have continued to advance during the period of stability in wholesale prices that began in 1959, already has been discussed. The conclusion was that this rather puzzling rise in the export indexes is probably caused by deficiencies in the indexes, rather than actual price changes. We, therefore, attribute little importance to the rise in assessing the prospects for export prices in 1968. Thus, we allow for a small increase in export prices, at an annual rate of just over 0.5 percent, or by 4 percent in the period 1961-68.

The rise in the aggregate price levels of exports which is, ultimately, postulated for Western Europe amounts to 11 percent under the initial assumptions and 7 percent under the alternative assumptions, during the period 1960-68. For the United States a rise of 4 percent is expected under both sets of assumptions. These figures are intended to be consistent with the real income and GNP price deflators forecasts. Here again, in order to derive conditional forecasts for 1968, these values were plugged into the Polak-Rhomberg model to estimate the impact of a change in the ratio of United States to Western European export prices on the current account. The resulting projections are extremely sensitive to assumptions concerning export and GNP price changes. Under the initial set of assumptions the current account of the balance of payments would improve by \$4.8 billion between 1960-68, exclusively as a result of changes in the competitive position; whereas under the alternative assumptions the improvement is only of the order of \$1.5 billion.

In addition, it appears that the projections are also highly dependent on the value placed on the elasticity of substitution. The study used a coefficient of 2.5 essentially on a priori grounds.

In view of (a) the completely aggregative nature of the Polak-Rhomberg model; (b) the high sensitivity of the current account to small differences, with respect to export prices and the elasticity of substitution; (c) the relatively high intercollinearity between the explanatory variables in the model, and, finally, (d) the very tentative nature of the forecast for export prices, the confidence to be placed on the estimates of the effects of the changes in the competitive position of the United States should be quite limited.

Chapter IV evaluates the impact of the EEC on the U.S. balance of payments. The present reviewer would agree with a large part of

the analysis, with the following qualifications: (1) The impression is left that the EEC will have a detrimental effect on the U.S. balance of payments. The justification for this statement can only be made after comparing the anticipated effects on the U.S. balance of payments in the presence of economic integration (within the context of ECC) as opposed to what would have happened in the absence of integration. It appears likely that the static effects of the EEC will be negative in terms of discriminating against U.S. exports but that the dynamic effects will be favorable to the U.S. balance of payments by generating a higher growth rate in the Six (not all economists would agree with this contention) and a consequent rise in prices. The dynamic effects of the EEC are already included in the estimates of growth rates and price levels made in chapter II so that chapter IV essentially emphasizes the discriminatory, "static effects" of the EEC; (2) the greater relative rise in intratrade within the Community, as opposed to and between the Community and the rest of the world, is given as suggestive evidence of trade diversion. Given the lack of quantitative evidence to support this contention the alternative explanation of trade creation; i.e., a substitution of sources of imports within member countries for previously (protected) domestic sources, cannot be rejected, (3) no allowance is made for capacity limitations which could result from the expected very large relative increase in intratrade. If the common external tariff rates on manufactured goods are not increased—and there is absolutely no evidence that they will be raised—the increases in the cost of production resulting from capacity limitations within the Six, would reduce the discrimination faced by U.S. exports and the aggregate estimate of the U.S. balance of payments loss resulting from the EEC.

The analysis in the chapters on investment, foreign economic assistance and military aid is thorough, given the limitations inherent to this type of projections. The two main comments which came to mind after reading through these pages were, first, that to a large extent the U.S. flow of direct investment to the rest of the world, and particularly to Western Europe, may be a substitute for merchandise exports. Industry studies might be undertaken to find out the estimates of companies within industries of that part of investment which is indeed a substitute for merchandise exports and of future prospects. The guess of this reviewer is that the future flow of U.S. foreign direct investment might have been underestimated. Secondly, the feedback ratios used in these three chapters are based on the trade matrix and not on the payments matrix and are, therefore, more likely than in the earlier chapters to yield estimates containing higher margins of error.

A specific discussion of the policy chapter was not requested and, is therefore not attempted here, with the exception of one remark. Before recommending changes in the system of exchange rates presently in existence much more work is necessary on the determination of the quantitative effects of fluctuating rates on the various transactions of the balance of payments as well as the timing of these effects. In one sense, however, it was refreshing to see that the Brookings study did not take a dogmatic position in terms of either fixed or freely flexible "exchange rate fundamentalism."

STATEMENT BY ROBERT W. TUFTS

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In his letter inviting a comment on the Brookings study Senator Douglas indicated that the Joint Economic Committee's "primary interest is to assess the likelihood that the study's projections will be realized." In this paper I will therefore limit myself mainly to this question, but will make a few comments on the study's recommendations.

The principal points I wish to make can be summarized as follows:

1. I am more optimistic than the authors about the prospect for 1968.

2. I am less optimistic about developments in the next year or two.

3. I believe that the money market has become international, with the result that we must coordinate our monetary policies with those of the other major countries and rely, if necessary, mainly on fiscal policy to achieve high levels of employment, production, and income.

4. I strongly dislike the suggestion that the "best alternative" to a new international payments system is a "modified flexible exchange rate system," involving a dollar-sterling bloc and a Common Market bloc.

The Brookings study has been widely applauded, and I wish to join in congratulating the authors on their ingenuity and daring. An exercise on the flying trapeze is tame in comparison with the swings of the balance of payments.

Fortunately the usefulness of the appraisal does not depend on a close correspondence between the actual outcome in 1968 and the projections. No doubt the authors will be more surprised than their readers should events suggest that they had been seers. Their study is policy oriented; its value is to be judged by its contributions to economic policy.

On this count Messrs. Salant and company have made an important contribution. The policymaker asks for expert projections of this kind not in order to foresee the future but to shape it—to make the future conform more closely to our hopes than it otherwise would. If the study is roughly accurate in assessing the balance-of-payments impact of full employment policies and economic aid programs, as I believe it is, our present payments difficulties need not deter us from pursuing bold policies to promote economic expansion at home and economic development abroad. It is no secret, however, that we have been deterred by our difficulties, and in combating this tendency the study serves a very useful purpose.

THE PROSPECT FOR 1968

At the outset it should be emphasized that the authors of the study were not asked to forecast the balance of payments in 1968. We do not know what outcome they would have forecast had they attempted

to make realistic assumptions about the key variables. Their study projects what will happen if certain other things happen. In particular the Council of Economic Advisers wanted an expert judgment of (p. 40¹)—

* * * how the balance of payments in 1968 would be affected if unemployment [in the United States] were rapidly reduced to 4 percent of the labor force and the Government's long-term growth objectives were achieved.

This request is clearly relevant to the problem faced by CEA in advising the President on national economic policies. The President surely wants an expert judgment on the question: If the United States adopts strongly expansionary policies, will these policies generate acute payments difficulties? Deflation is the classical remedy for a nation with such difficulties. But deflation is a bitter pill to administer when a nation's resources are far from fully employed.

It is in no sense a criticism of the study, therefore, to question whether the United States will achieve the rapid rates of growth assumed as a basis for the "initial" and "alternative" estimates presented in the study. The authors themselves state (p. 35):

The projections made in this report are not unconditional forecasts. They are estimates of what the assumptions imply, made without assessing the probability that the assumptions will be realized.

The study reaches the cheering conclusion that even with a rapid rate of growth in the United States, our competitive position in relation to Western Europe would improve.

In my view the rates of growth assumed for the United States are not realistic. The Joint Economic Committee wishes to know, I take it, how more realistic assumptions would affect the projections. Four points need to be made:

1. The United States is not likely to achieve a rate of growth of 4.8 percent (the "initial" assumption) or 4.5 percent (the "alternative" assumption) over the next 5 years. Congress does not seem to be ready to adopt the bold measures which would be needed. The administration itself has not proposed policies adequate to reach these rates. It is placing major reliance on tax reduction. No amount of tax reduction, however, is likely to carry the country to full employment (defined as 4 percent unemployment) unless it is accompanied by substantial and regular net public borrowing. The reason is that private investment is unlikely to exceed funds available from internal business sources by an amount as large as private saving, even when the national income is as far below full employment levels as it now is. This view is not yet accepted to the degree necessary to make it politically feasible to run "deficits" (i.e., public borrowing for public investment programs) of the size and regularity needed for full employment.

2. Largely for this reason the moderate rise in export prices projected in the study seems reasonable. I would be less confident about holding down the rise were the rate of growth to reach 4.5 percent or more. At the same time I am more optimistic than the authors that private investment will take much advantage of technological developments, thus making substantial gains in productivity, but I doubt that this factor would offset demands for higher wages and the temptation

¹ Except as noted, all page references are to the committee print of the Brookings study.

to raise prices in the market conditions associated with a rapid rate of growth.

3. Western Europe will probably continue to grow at a faster rate than the United States, not the slower rate assumed in the study. The reserves of the Western European countries are so large that balance-of-payments considerations will not deter them from pursuing expansionist policies. Furthermore, even rather conservative governments in Western Europe do not equate borrowing for public investment with fiscal irresponsibility, with the result that a larger part of the task of maintaining high levels of employment and income can be carried by fiscal policy in Western Europe than in the United States. The political commitment to growth in Western Europe is strong.

4. Moreover, some important political changes are to be expected in Western Europe in the next few years. On the whole the new governments are, I think, less likely to adopt strong anti-inflationary measures than the ones they replace. As a result expansionary forces may lead to some inflation. The authors of the Brookings study, it should be noted, believe that they may have been too conservative in their estimate of Western European price increases.

The combination of a slower rate of growth in the United States and inflationary tendencies in Western Europe may result in a greater improvement in the competitive position of the United States than has been projected by the Brookings study. In this event the Common Market may be encouraged to reduce import barriers as a means of combating inflation, a factor which would help to ease our payments position.

For these reasons I am more optimistic about the prospect for 1968 than the study and believe that it may understate the improvement in the "basic balance" by that time.

The future rate of U.S. economic growth is mainly dependent on political decisions, and the Joint Economic Committee is in a much better position than an outside observer to judge what economic policies are politically feasible under present circumstances. It would be interesting to obtain an estimate of our payments position in 1968 based on the committee's best guess about rates of growth here and in Western Europe.

THE SHORTRUN PROSPECT

Can we, however, afford to wait for underlying forces to improve our position?

The Brookings study has been read by some to mean that we can afford to wait and need not take prompt steps to slow down or reserve gold losses and the accumulation of liquid dollar assets by foreigners. The authors themselves endorsed this interpretation of their study in their testimony before the Joint Economic Committee (p. 260):²

Representative WIDNALL. Professor Salant, the Brookings study in effect advocates the policy of sitting tight while awaiting favorable economic developments which are assumed will occur to improve the situation with a minimum of pain or effort on our part. A deterioration of the Western European situation and a sharp improvement in our own, will, in short, correct our deficit even while the level of our aid expenditures overseas is assumed to increase substantially. Is that a true characterization of your report?

Mr. SALANT. Yes; I think it is.

² Hearings before the Joint Economic Committee, "Outlook for United States Balance of Payments," pt. 2, 1963.

Representative WIDNALL. Now the study's generally hopeful point of view is in sharp contrast to the position taken by Secretary Dillon before the Joint Economic Committee on July 8. Secretary Dillon said there was not much time to waste in solving the deficit problem, and that unless very substantial progress is to be made in the next year or two, the United States would face a very uncomfortable situation.

Now how do you reconcile your report with what Secretary Dillon said?

Mr. SALANT. Well, I can only say we are not as alarmed as he is about it * * *.

Mr. Salant's testimony was consistent with the recommendation made in the study (p. 253) that the Government should not "at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves."

Even if underlying longrun forces are favorable, however, it does not necessarily follow that acute shortrun difficulties will not compel the United States to take action to defend the dollar. One may be bullish about 1968 and bearish about developments in the next year or two.

A new international payments system to provide adequate liquidity without putting reserve currencies under great strain from time to time is desirable, but with the best luck it will not be planned, negotiated, and put into effect to meet a crisis in the near future. In fact, a strengthening of the dollar's position may be needed as a precondition to agreement on a satisfactory plan.

The margin of excess gold reserves now possessed by the United States is so slim that a serious weakening of confidence and heavy pressures on the dollar could occur at any time. An obviously desirable step is the removal of the 25-percent reserve required as backing for Federal Reserve notes and deposit obligations, as recommended by the study. It is to be hoped that Congress will remove the requirement promptly, so that the Federal Reserve Board will not have to suspend it at a time when the reserves available for international settlements have been exhausted.

But this step is not, I believe, enough. In case of need it would give us additional time to adjust our policies. But it does nothing to meet our difficulties.

Broadly speaking, there are three courses of action open to us. First, we might sharply curtail dollar expenditures abroad by reducing U.S. forces in Western Europe. (It should be strongly emphasized that even drastic cuts in foreign economic aid would be of very little help in easing our payments problem. Those who look to such reductions to solve our payments problem are looking in the wrong place.) Obviously we do not want to keep more forces in Europe than necessary, or to keep them there longer than they are needed. We should not and need not, however, reduce our forces for balance-of-payments reasons.

Second, we could impose controls on capital movements, but this would conflict with other goals and should be a course of almost last resort.

Third, we could slow down or reverse the movement of capital by permitting interest rates to find an appropriate level in relation to rates in Western Europe.

For reasons to be developed in the next section, the third course is, I believe, the one we should follow, the one which would yield maximum benefits at minimum costs in terms of other policy objectives.

In my judgment the penalty for inaction may well be that circumstances will compel us to act when the choices are narrower and more painful.

THE INTERNATIONALIZATION OF MONEY MARKETS AND ITS IMPLICATIONS

Concern over the balance of payments appears to have inhibited to some degree the adoption of strongly expansionist policies in the United States. Although it is true, I think, that our competitive position will be stronger if we continue to grow at recent rates than at rates of 4.5 to 4.8 percent, this is of course not an argument for a slower rate of growth.

On the contrary, the study's major contribution is its conclusion that a rapid rate of growth is consistent with a significant improvement in our longrun balance-of-payments position. One hopes that this view will prevail despite the fact that most of us were brought up on the notion that a deficit country should deflate.

If the deficit could be reduced or eliminated by maintaining substantial unemployment, the bargain would still be a poor one. As the Joint Economic Committee vividly and properly emphasized in its report on the "1963 Economic Report of the President," it would be absurd to swap \$30 to \$40 billion of production for a \$2 to \$3 billion reduction of the deficit.

The road to a reconciliation of the goals of domestic and foreign economic policy lies in freeing monetary policy of the burden of promoting expansion and placing this burden mainly on fiscal policy, at least when the major Western European countries are keeping interest rates high. I support Mr. Lary's testimony before the Joint Economic Committee on this subject.

I share with some members of the committee a dislike for a hard-money policy when there is much unemployment and idle capacity, although I seriously doubt that high interest rates will deter investment when other conditions are favorable. But we should not overlook the internationalization of the money markets. It has happened. No nation, not even the United States, can afford to neglect it. Foreign borrowers will seek to borrow where money is cheap; domestic lenders will try to lend where money is dear. Monetary policies in the major countries must therefore be coordinated, or capital will flow away from low interest rates to markets where they are high. Efforts to prevent such flows would be partly successful at best and would be in conflict with other goals of foreign economic policy.

The Joint Economic Committee could do a great service by pointing out the implications of the internationalization of the money markets for national economic policies, particularly the new role of fiscal policy in a period when cheap money, no matter how desirable domestically, will promote disequilibrating capital movements and intensify balance-of-payments difficulties.

A rise in interest rates, together with the removal of the 25-percent reserve requirement, would probably enable us to meet any short-term problems without special controls or undesirable restrictions and could pave the way for negotiations on a new international payments system.

IMPROVEMENT OF THE INTERNATIONAL PAYMENTS SYSTEM

It has long been clear that the present international payments system needs to be replaced by one which can be relied upon to provide adequate international reserves to support a rising volume of world trade without putting excessive strains on one or two reserve currencies. I strongly endorse the study's recommendation that the United States take the lead in planning and negotiating a new system. Agreement on a satisfactory system would have important political as well as economic consequences, and could be useful in assisting economic growth in the developing countries.

In my judgment, however, the Brookings study seriously errs in recommending a "modified flexible exchange rate system," involving a dollar-sterling bloc and a Common Market bloc as the best alternative to a truly international system. The two-bloc proposal would accentuate existing tendencies for the Atlantic nations to divide into two political, military, and economic blocs and might exacerbate economic rivalries. Progress toward Atlantic "partnership" would be jeopardized by this proposal, but would be helped by an international system providing adequate liquidity. I therefore hope that this two-bloc proposal will be quietly forgotten.

STATEMENT BY JAROSLAV VANEK

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My first and most emphatic observation is that the forecasts presented in the Brookings study ought not to be unduly relied on in designing our long-range policies. Not that I would doubt the competence of the authors—we could hardly hope for a much better piece of work than that offered by the Brookings team; but this may not be enough to learn with any degree of accuracy the events to take place 5 years hence.

Suppose, as may well be the case, that the responsible authorities base their judgment on the Brookings forecasts and consequently do not undertake any fundamental corrective measures with regard to our balance of payments. Indeed, with a basic surplus of nearly \$2 billion, or even with a negligible deficit in 1968, there would be nothing basically to be worried about. Turning to page 82 of the report, one finds that, among other things, such a policy decision would be based on an elasticity coefficient of 2.5, derived from an empirically established index of 4 on the grounds that 4 “is too high to be plausible.” If the authors deemed it plausible that the true index is 1 instead of 2.5—incidentally, 1 is a number that many competent economists would consider the most realistic—the Brookings projections would have been lower by about \$2.5 billion; what is more important, the resulting policy might have been quite different. If, on the other hand, the implausible finding of 4 were used, the projection for 1968 would have come out as high as a surplus of \$4 billion—a figure that even staunchest optimists might find hard to believe.

But there is another reason to believe that the likely (or expected) range of outcomes is wider than that between minus \$0.6 billion and plus \$1.9 billion, predicted for 1968. The two figures are based on two different sets of assumptions: the first corresponds to a relatively lower rate of growth in the United States and in Europe and to less inflation in Europe than does the second. Now, because the authors do not assume any correlation between economic conditions here and abroad, it is hard to understand why the other two possible combinations of circumstances were left out; that is, why the assumption of a high rate of growth here was not coupled with less growth and inflation in Europe, and vice versa. Either of these situations is as likely to arise in the future as those considered in the report; and consequently, a deficit of perhaps \$3 billion or a surplus of perhaps \$4 billion is fully consistent with the assumptions of the Brookings team, and actually just as likely as the two figures produced (i.e., minus \$0.6 and plus \$1.9 billion).

Some of the projections used in obtaining the forecasts raise serious doubts in my mind. The position that there will be “an approximate stability of wholesale prices” between now and 1968, on the assumption of a 4.8 rate of growth of the U.S. GNP, I find absolutely untenable. Actually, it is even in contradiction with other parts of the

Brookings report and with observed historical data. It is true that wholesale prices (and the GNP deflator applicable to goods) have been relatively stable over the past 5 years or so. But it must be remembered that in this period unemployment was somewhere near 6 percent on the average, and in most industries there was a good deal of excess capacity. The rate of growth of GNP of 4.8 percent forecast by the Council of Economic Advisers is consistent only with a substantial reduction in the unemployment rate, perhaps to 4 percent or less. With that degree of tightness in the labor market and of capacity utilization we are bound to experience inflation of product prices; the inflation of about one and a half percent per annum of the 5 years preceding 1958, when employment conditions and capacity were comparatively tight, may be much closer to what we will be experiencing prior to 1968, if the projected rate of growth of GNP is correct. As is apparent from page 46 of the report, the logic of this argument does not contradict the beliefs of the Brookings authors.

A similar argument can be applied, and similar results expected, with regard to U.S. export prices. The reasons why export prices in this country should not increase appreciably given on page 81 are rather unconvincing especially in view of the evidence concerning price movements of metal products prior to 1960 presented on page 71.

The approximate effect of such alternative price data on the Brookings projections is minus \$2 billion. If we substitute for the assumption of price stability in the United States the assumption of a 1.5 percent inflation we obtain a balance-of-payments projection falling short of the Brookings figures by about \$2 billion.

The forecasts seem to contain a similar bias on account of the projections of European prices. The latter are (or were) expected to rise at the rate of a little below 3 percent per annum between 1960 and 1968. On the "initial assumptions" each percentage point of that projection (3 percent) represents about \$2 billion of our balance-of-payments position in 1968. For example, were the forecast of 3 percent incorrect and the true rate only 2 percent, then the Brookings forecast would have to be reduced by about \$2 billion.

Now, let me observe, parenthetically, that industrial wholesale prices in Germany grew at a rate of about zero percent over the last 2 years, following appreciation of the mark (see the IMF International Financial Statistics), and export prices even declined. This was in a period of extremely high (overfull) employment. I do not make these observations with an intent to extrapolate the data over the entire period through 1968—that would make the forecasts too grim. Rather, I would like to point out that there may be something entirely erroneous about the analysis of the European price situation, as presented in the Brookings study.

If not all, at least the principal European economies have been operating over the last 3 years at an unprecedented high level of employment and economic activity. Since 1960 the average rate of unemployment in France, Germany, Italy, and the United Kingdom taken together has been just about constant at a very low level of about 1.5 percent. There is no reason to expect that this situation will be drastically altered in the immediate relevant future, nor is such an alteration foreseen by the Brookings analysts. Now in a situation of extremely high employment, it can be expected that demand will be at least as potent a determinant of price managements as is supply,

and yet the entire¹ analysis of future (and present) price changes in Europe in the Brookings study is based on the consideration of supply conditions (see pp. 46-50). At most, supply conditions—at full employment—will determine a certain lower limit below which price increases cannot go;² but above such a limit, only domestic and foreign demand are the determinants of prices. Action of monetary and fiscal authorities appears here to be the decisive factor, rather than money-wage and productivity trends.

From the stability of prices in Germany already noted, and from the fact that even in other parts of Europe domestic and export prices have been relatively stable at least in some periods of full employment, it seems to follow that the lower limit imposed on inflation by conditions of supply is relatively low—perhaps as low as the zero rate observed in Germany since appreciation of the mark. The truly decisive factor, then, in determining the rate of inflation in Europe (perhaps with the exception of England) is the blend of monetary and fiscal policies engaged in by the authorities. In other words, the European governments appear to have, in a large degree, the autonomy of deciding how much inflation they want to have, while operating their economies at, or very close to full employment. If they let their prices rise at times, it is done among other reasons to prevent exorbitant balance-of-payments surpluses. In France, for example, the high rate of inflation recorded in recent years is much more closely related to persistent budgetary deficits and a supply of money expanding at a rate of at least twice as high as real output, than to a price-wage push. With a rate of unemployment of less than 1 percent, the French Government certainly could permit itself a greater monetary and fiscal restraint, if it wanted to stabilize prices.

To draw my conclusion from this discussion of the price-element of the Brookings forecasts, I would say that it is doubtful whether the competitive positions of the United States will improve at all between now and 1968, and consequently, whether the \$4.8 billion imputable to that factor will be gained (see p. 87). Whether we shall or shall not gain any significant portion of that figure will primarily depend on the willingness of the Europeans to inflate their prices; such an inflation certainly cannot be regarded as a necessary outcome of some natural forces.

There is one other brief observation I would like to make before concluding this comment. It concerns the projection of private capital outflow for 1968. I have very little precise evidence as to what our private capital outflow will be in that year. However, the predicted decline in our private foreign investment of all kinds from 2.6 to 2.1 between 1961 and 1968 I find rather startling. The figures presented on pp. 150 and 151 of the report indicate an increase in average return on direct investment from 8 to 9 percent over the period considered, and about 7.5 percent on all U.S. capital abroad. This compares (again using the data of the report) with a return of a little over 3 percent on foreign capital in the United States. These figures are only roughly indicative

¹ We say "the entire" here because other considerations only follow the elaboration and statement of the estimates actually used in the forecasts.

² In more technical terms, we claim here that the Phillips curve only provides us with a minimum rate of price or wage inflation, at full employment rather than with the actual rate of such an inflation.

of profitability in different parts of the world; also, it is not only profitability that determines international capital flows; security of investments, size of markets, rates of growth of receiving countries, and knowledge on the part of investors all are important factors. However, even these, in the absence of major political disturbances in the world, are likely to become more conducive to U.S. foreign investment in the next 5 years.

CONCLUSION

In this comment, I have attempted to substantiate my doubts that the projections of the Brookings study would become reality in 1968. I find hard to accept both the level and the range of the estimates. On the assumption that our GNP grows at the expected rate of 4.8 percent, and on the assumption that no devaluation or other corrective policy measures are introduced, I would revise the Brookings estimates of our balance of payments in 1968 downward by at least \$3 billion. Of course, a considerable range of uncertainty around such an estimate has to be permitted; actually, a range of a good deal more than that of \$2.5 billion, arrived at by the Brookings authors, is implicit even in the Brookings analysis itself.

STATEMENT BY HENRY C. WALLICH

Professor of Economics, Yale University, New Haven, Conn.

I would like to limit my comment on the Brookings Report to the narrow subject of the projections as they affect Germany, where I have just spent a year's leave. In my view, the price projections for Germany under the initial assumptions are too high. This applies particularly to the expected rise of export prices of 11 percent. The alternative projection of an 11-percent rise in the deflator seems realistic, but the associated increase in export prices of 7 percent still appears high.

THE PAST RECORD

The authors of the report may correctly claim that the German deflator is capable of advancing by 20 percent in 7 years, since it advanced by 23 percent during the 7 years ending 1961. This was a period, moreover, during part of which Germany still had substantial unemployment which has now given way to extreme overfull employment.

Nevertheless, during this period, the unit price of German exports increased by only about 4 percent. German exports rose rapidly, and their price stability therefore cannot be attributed to lack of demand. Rising salaries of a large bureaucracy, rapidly rising service wages, and higher housing costs have been pushing up the deflator, but export unit prices have not reacted to it.

PRICE POLICY

Prices are, to some extent, subject to policy action. The German Government, and especially the incoming Chancellor, Professor Erhard, are sensitive to inflation. Even if the same pressures should continue that have prevailed recently, there is a good chance that anti-inflationary action will be intensified hereafter.

New tax measures are under consideration. The President of the Bundesbank has made clear, repeatedly, that he will not finance an inflation. A group akin to the Council of Economic Advisers has been set up that is to advise on policy. While none of this assures stable prices, it indicates that the goal of price stability is taken very seriously.

ANTI-INFLATIONIST MENTALITY

Germany twice has seen her currency wiped out by inflation. The people are more sensitive to rising prices than in many countries. Business and labor both are export minded. The fear that inflation will hurt exports weighs heavily in German business policy and wage bargaining. Public reaction to the sharp cost-of-living increases in 1961-62 was strong.

FULL EMPLOYMENT MENTALITY

The German labor unions have given relatively more emphasis to employment and less to wages than American unions. They began to push powerfully for higher wages only after unemployment had virtually disappeared. For the 2 years 1961-62, they produced wage gains of over 10 percent per year, in the face of productivity gains of about half that magnitude. But in 1963, the unions were becoming less demanding, or the employers more willing to resist, and the rate of wage gains diminished. If a domestic slump should produce unemployment, the Government almost certainly would act to create demand. But if unemployment should come about primarily through lower exports, it will be taken as a strong warning signal.

ORGANIZED RESISTANCE TO INFLATION

Perhaps because of past experience of inflation, there exist organizations that conduct voluble propaganda against it. The Association of Savings Banks (all of which are municipally owned), is perhaps the best known, and its President, Mr. Butschkau, is a force in politics. Civil servants, businessmen and academics are not ashamed to belong to an "Action Group for a Social Market Economy" that conducted a convention and published a book under the title "Stable Money Has Priority." The Association for the Protection of German Savers is another such organization.

RELATIONS WITHIN THE EEC

The record of France and Italy during the last 2 years goes some way to bear out the projections of the Brookings Report. These national inflations, in turn, may be exported to Germany, whose balance of payments has once more swung into surplus mainly owing to higher sales to these two countries. At the same time, it seems clear that all EEC countries must vigorously combat inflation if the Community is to survive. Differential rates of inflation would make free trade very difficult; to agree on a common high rate would be almost impossible. Meanwhile, the spread of competition throughout the EEC should help to keep prices down.

It is difficult to balance nonquantitative considerations like the foregoing against the detailed projections of the report. In any case, it is clear that prices are harder to project than trade. The Brookings projections are sufficiently uncertain to disqualify them as a basis for policies decisive to the future of the dollar.

STATEMENT BY RICHARD WARD

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Concern over the balance of payments arises from the steady deterioration of U.S. reserves. The authors of the Brookings study fail to project reserve losses because they treat only a portion of the balance of payments, which they call the "basic balance." It is the total balance of payments which determines changes in reserves. The Department of Commerce computes the total balance by comparing all known transactions with changes in reserves. Elements included in the reserve position are gold (including convertible currencies) and liquid liabilities to foreigners. If recorded transactions and reserve changes are not in balance, the difference is entered as "unrecorded transactions" or "errors and omissions." This treatment takes reserve changes as given data and fits the balance of payments to these changes.

The basic balance concept considers only recorded transactions, and from these excludes certain items, largely short-term capital outflows. The difference between outflows and inflows by this definition constitutes the basic balance, but this difference is obviously not the total of reserve changes. Under one set of assumptions, the Brookings study projects the basic balance to move from an \$800 million deficit in 1961 to a \$1.9 billion surplus in 1968. But the actual balance-of-payments deficit in 1961 was \$2.4 billion, for that was the amount by which the Nation reduced its gold stock and increased its liquid liabilities to foreigners. The report makes no projection of this deficit.

All of the components of the balance of payments are interdependent, and consistent results requires a complete projection of all components. Short-term capital flows involve claims payable in less than 1 year or on demand. The study excluded these and unrecorded transactions because they "have so large a transitory element that it is difficult to analyze the outlook for the future." (p. 5). This approach assigns far too much significance to the somewhat arbitrary distinction between short- and long-term capital. Walther Lederer, chief of the Balance of Payments Division of the U.S. Department of Commerce, has commented:

The separation of long- and short-term capital is frequently misunderstood and overemphasized.

For instance—

* * * many loans classified as short-term are really revolving loans to the same customer * * *. Some loans may be set up and classified as short term to meet balance sheet requirements of the lending bank, but are not intended to be called.¹

¹ "Measuring the Balance of Payments," "Factors Affecting the United States Balance of Payments," Joint Economic Committee, U.S. Cong., 1962, p. 81.

It can be questioned that short-term capital movements are really "transitory." U.S. short-term claims on foreigners as reported by banks have risen from \$900 million at the end of 1950 to \$4.9 billion at the end of 1962. The Department of Commerce found, in a study, that the accumulation of short-term claims on foreigners for the period 1952-60 was almost continuous and that return flows were small and limited to brief periods.² In most of the few periods when reductions in short-term claims were registered in the statistics, it was not due to a return flow of capital, but to a conversion into long-term loans, mostly by the Export-Import Bank, sometimes by private sources.³

Short-term capital flows tend to react to other, autonomous, flows in the balance of payments by flowing in the opposite direction. If the basic U.S. balance turns to a surplus, as projected, movements in exchange rates would tend to increase the flow of this "accommodating," short-term capital from the United States. The United States itself has been the recipient of accommodating inflows, but they are not treated as capital movements in the U.S. balance of payments. Inflows are considered as settling items (changes in reserves) in the U.S. balance of payments because they represent liabilities potentially convertible into gold. On the other hand, the buildup of short-term U.S. assets abroad is not a part of U.S. reserves. These claims represent largely private rather than official holdings, and foreign countries do not maintain gold convertibility as the United States does. Liquid claims on the United States are a potential drain on the U.S. gold stock and are treated in the same way as a loss of gold. U.S. gold policy is thus important in formulation of the concept of the balance of payments.

To an increasing extent countries are retreating from the rather narrow view of particular definitions of balance-of-payments equilibrium.⁴ Along with changes in reserves come changes in other assets encompassing a whole spectrum of liquidity. Concentration on reserves looks at only one such change. If the United States were not committed to gold convertibility, it could then give parallel treatment to short-term assets and liabilities. Until such a reform is accomplished, short-term outflows will be viewed with alarm when they contribute to a balance-of-payments deficit.

The case for excluding unrecorded transactions from a projection is somewhat stronger than for short-term capital, but such transactions cannot be evaded if total reserve drains are to be projected. A defensible procedure would be to assign unrecorded transactions to one of the recorded items and project the total. Failure to project these transactions implicitly assumes they will be zero, a projection itself which must be justified if made. The most logical combination of unrecorded transactions is with short-term capital flows, which may be the true identity of much of these transactions because of the inadequacy of short-term statistics. Another reason for considering these components jointly is that they have behaved somewhat similarly in recent years. Unrecorded transactions resulted in receipts for the United States until 1960, when they turned to sizable outflows at the same time the recorded short-term capital outflows picked up.

² Survey of Current Business, June 1961, p. 15.

³ Lederer, "Measuring the Balance of Payments," op. cit.

⁴ For developments supporting this view, see International Monetary Fund, "Annual Report, 1963," pp. 47-48.

PROJECTION OF TOTAL BALANCE

Two motivating influences can be examined in projecting short-term capital flows—exports and interest-rate differentials between the United States and foreign countries. The Department of Commerce found in its study of the 1952–60 period that exports and the growth of short-term claims on foreigners were closely related.⁵ This relationship was upset in 1960, probably because of the influence on capital flows of speculation on exchange rate changes. The interest rate relationship has been examined by the Federal Reserve Bank of New York. The bank's representative has testified:

We have found that interest rate changes in our money and loan markets relative to those in major foreign financial centers have a marked and prompt effect on capital flows from and to the United States.⁶

Interest rate and export developments foreseen in the 1968 projection point toward continuance of rather sizable short-term capital outflows. Exports are projected to increase by \$14.3 billion. "As U.S. exports increase over the years, an increase in U.S. claims against foreigners through acceptance and other trade financing will be both natural and desirable.⁷ Interest rates are expected to be relatively low in the United States.⁸ In the 4 years after the establishment of European convertibility short-term capital and unrecorded transactions together accounted for an annual average of \$2.7 billion of outflows. The postconvertibility period seems the most meaningful as a starting point, since inconvertibility tends to block movements of funds seeking higher interest rates. On the basis of exports, the 1968 outflow might be expected to exceed this annual average, since the export projection is high.

However, speculation has contributed to these flows, and if the rest of the balance-of-payments projections are realized, speculation may diminish, though the projections are not sufficiently optimistic to expect that it will be eliminated. On balance I would tend to reduce the outflows from short-term capital and unrecorded transactions to about \$2 billion by 1968. Combined with the basic balance which was projected, the result would be elimination of the total deficit by 1968 under the "initial" assumptions and a total deficit of \$2.6 billion under the "alternative" assumptions. Admittedly this projection is not very scientific, but it is no less refined than some of the crucial assumptions of the 1968 projections. (For instance, as discussed below, the report merely assumed that the growth of U.S. plant and equipment expenditures in Europe was determined by two benchmark years, 1957 and 1963.)

Because of the interdependence of balance-of-payments elements, as noted earlier, a total projection would also require other adjustments. For example, the failure to project a complete balance of

⁵ Survey of Current Business, *op. cit.*

⁶ "Outlook for United States Balance of Payments," hearings, Joint Economic Committee, U.S. Congress, Dec. 12–14, 1962, p. 137.

⁷ C. Coombs, M. Ikle, E. Ranalli, and J. Tungeleser. "Conversations on International Finance." Monthly Review, Federal Reserve Bank of New York, vol. 45 (August 1963, p. 117.

⁸ "For the purpose of forecasting long-term capital flows, we assumed that the general level of long-term interest rates in the United States and in Western Europe in the future would not differ greatly from the current structure except for the possibility of a narrowing of the spread between countries" (p. 119). The same statement could be made for short-term rates, since the entire interest rate structure tends to move together.

payments manifests itself also in the current account. Short-term assets yield income and this is classified as a service export. The projection apparently excluded income from short-term assets in both its 1961 figures and its 1968 outlook, which illustrates the difficulty of applying a particular definition-of-payments balance. Investments income to the United States was \$3.8 billion in 1961, but the projection reduced this to a little less than \$3.5 billion.

The basic balance concept also complicates the statement of out-payments on investment income. Since a portion of the total U.S. deficits is settled by foreigners' acquisition of interest-bearing claims on the United States, it is necessary to project the growth of these claims in order to project the interest outflows. These claims are not projected since it would be necessary to project the total balance of payments to do so. The apparent technique was to exclude income payments on these liquid claims both from the 1961 figures and from the 1968 projection. Thus these outpayments were projected from a 1961 level of \$600 million, though in actuality such outpayments in 1961 were \$880 million.

LONG-TERM CAPITAL

The report is optimistic about the outlook for long-term capital outflows. Its projections can be summarized in the following table:

Long-term capital, 1968

[In millions of dollars]

	Outflows	Inflows	Net
Bonds.....	-750	+75	-675
Stocks.....	-300	+350	+50
Term loans.....	-175	-----	-175
Direct investment.....	-850	+150	-700

For portfolio investment, an outflow of \$1.2 billion is projected, about the same as in 1962. The 1959-62 average was \$1 billion, and these outflows continued high in 1963. It is hard to see why no increase in these outflows is expected, and apparently this optimism is not shared by the administration, considering its foreign interest equalization tax. The projection was made without consideration of the tax, and thus my comments will be directed to the outlook in the absence of the tax.

In the bond component of portfolio investment, the report sees some lessening of Canadian borrowing and a slight increase in European borrowing. In the Canadian case the reason for the expected decrease was the growing burden of repayments of past U.S. indebtedness as well as political opposition to such borrowing. Insufficient weight is given, however, to the stabilization of the Canadian dollar. Canadians borrowed heavily when there was no fixed United States-Canadian dollar exchange rate. The stabilized rate may considerably increase this borrowing, as apparently has already happened, though this might be partially offset by the development of a more active Canadian money market. The projection's interest rate assumptions are consistent with heavy borrowing, and there is no reason to expect a diminution in Canada's real need for capital by

1968. The need for capital is great in many other parts of the world, and there is strong possibility of increased borrowing from other areas. Government bond flotations might be a way by which countries will offset foreign exchange losses projected elsewhere in the report, particularly in the capital account. This is most likely in countries whose reserves are already low.

Evidence also points to increased flotations by foreign corporations. The Secretary of the Treasury testified with respect to portfolio outflows, "One of the most striking characteristics has been the sudden rise in sales of new issues by foreign corporations, particularly those in Europe and Japan, which in the past have been much less active than foreign governments in using our market facilities."⁹ He noted that profit margins of many European firms were coming under increased pressure, decreasing their ability to finance growth through retained earnings and causing them to come to the United States for capital. The 1968 projections foresee a continuation of this profit squeeze.

Similar criticisms could be made of the projection of term lending. In addition, other stimulants can be seen for this lending, some of which were noted in the report. The Export-Import Bank is encouraging bank participation in term lending and assisting in the establishment of insurance facilities. American banks are increasing their oversea activities, and further stimulation may be offered by the Federal Reserve's recent relaxation of regulations on such activities. Foreign banks have also stepped up their U.S. operations, particularly in New York where their operating authority was increased. These factors work in the direction of increased international lending in both directions, but the net flow is apt to be against the United States because of its greater exchange freedom and lower interest rates. (The interest equalization tax would not apply to bank loans.)

A small net inflow is projected from stock sales. This projection does not seem to adequately consider the attractiveness of European stocks which is likely to develop from the European Economic Community. This tendency may be stimulated by increased listing of such stocks on American exchanges. Countries are also taking steps to improve their capital markets.

The greatest capital account improvement is expected in direct investment. A projected outflow of \$850 million comes close to being half of what we have experienced in recent years. The main factor retarding this flow is the return on the growing stock of U.S. assets abroad. Secondly, reasonably conservative estimates are made with reference to the growth of such assets. The rate of return on U.S. investments in Europe is expected to fall by 2 percent per year. The report does not give specific figures, but it appears this would result in a rate of return of 10 to 10½ percent in 1968, since the return in 1961 was about 12 percent. This is a rather small decline, considering the wage pressure foreseen elsewhere in the report. The stock of investment assets in Western Europe was projected from a trend line based on 1957 and the 1963 expenditures anticipated by American business. The assumption that the intervening years were

⁹ "Interest Equalization Tax Act," hearings, Committee on Ways and Means, U.S. House of Representatives, Aug. 20-23, 1963, p. 61.

temporary may result in an understatement of investment expenditures, since it excludes some years of large outflows—almost \$1 billion in 1960.

The assumed growth of direct investment assets may be too low in view of the expected U.S. growth rate. In the past American direct investment has shown some cyclical tendencies, tending to rise with domestic prosperity. Bernstein has offered several reasons for this apparent tendency.¹⁰ Business executives may think the U.S. economy is indicative of the world economy and increase overseas investments accordingly during prosperity. Rising profits during U.S. expansion increase the possibility of using retained earnings for overseas investment. Much investment is made for the purpose of exploiting foreign supply sources, and supply needs will vary with the domestic business cycle.

In summary there seems to be a tendency to understate outflows on the capital account. Outflows from securities are little changed, where one might normally expect growth, particularly considering the likely course of interest rates. Direct investment falls because of increased earnings off existing investment. Some fall may be expected because of the earnings effect, but the total direct investment may be understated because of growing safety of investments in some parts of the world and the need for exploitation of foreign raw material sources. Most of the understatement in the capital account stems from factors associated with the projection's initial assumptions. The capital account projections appear more suited to the alternative assumptions.

CURRENT ACCOUNT

An improvement in the current account is projected, primarily on the basis of assumed price increases in Europe at a greater rate than the United States and the return flow of income from investments abroad. The income from investments is thus important for both the capital and the current account, but the report was not specific about the method of projecting that income. In order to determine income, it is necessary to project the size of assets and the rate of return on assets. I have already discussed this procedure for Western European direct investment. Information is scanty about the procedures for direct investment assets in other areas and for the assumed stock of portfolio investment in all areas. The rate of return assumptions were stated for U.S. direct investment in Europe, but for other areas and assets only vague statements such as "rise slowly through 1968" were used (p. 148). It would have been helpful if the report had been more explicit in its assumptions, considering the importance of this factor in the projected basic balance improvement.

The other major source of current account improvement is price relationships. Europe's price increases are based on increases in labor costs. The report noted, "It should be emphasized that this figure is not derived from our quantitative assumption, but represents what we consider to be a reasonable guess" (p. 47). In order to estimate the effects of the wage increases on prices it was necessary to project productivity and the amount of wage increases

¹⁰ Edward M. Bernstein, "International Effects of U.S. Economic Policy." Study Paper No. 16. Joint Economic Committee, U.S. Congress, Jan. 25, 1960.

absorbed by producers. The final price rise projected was 2.75 percent per year, and export prices were expected to advance 1.5 percent a year. U.S. price rises are given at 1.5 percent a year, an assumption which was not the responsibility of the authors of the projection. From this they assumed that U.S. export prices would rise by a negligible one half of 1 percent a year.

All of the improvement in the current account except income on investments comes from this alteration of price relationships. Although one cannot say such price developments are impossible, it seems dangerous to make a projection based on a change in price relationships. The U.S. price projection was not a part of the study. Perhaps if the same study group had made both projections, the difference might have been less.

In employing the projected prices it is the relation between home prices in Europe and export prices in the United States that causes the pickup in sales to Europe. Both these prices are important in the analysis, as well as the assumed mathematical relationship that prevails between these prices and exports. That relationship (a price elasticity of 2.5) was not based on historical data but was assumed. There has been considerable doubt concerning price elasticities in world trade, a doubt which has expressed itself in continuing debates over the efficacy of currency depreciation. In a recent study the Department of Commerce examined variables affecting exports to Western Europe, Japan, and Canada for 1950-62. Industrial production provided the best explanation for exports, and no effect could be discerned from relative price movements between the United States and other industrial countries.¹¹

Exchange rates introduce an additional element of uncertainty which complicates prediction of exports on price relationships. The report assumes exchange rates are unchanged, but it is not explicit as to what exchange rate in 1961 is used. Par values? Yearend market values? Average market values? How is the German revaluation of 1961 treated? What is the treatment of forward rates, which are the effective rates for those transactions covered on the forward market? Even if par values remain unchanged in 1968, different market rates for foreign exchange can offset price movements to some extent. For instance, within the range of rates allowed the British pound, the price of a U.S. import in pounds sterling can vary as much as 1.4 percent even though the dollar price is unchanged. The forward rate under some circumstances could vary even more since forward rates are not pegged. It would obviously not be feasible to predict market rates in 1968, but the possibility of fluctuation should have caused the authors to temper their projected effects of price competitiveness.

It is possible that the price projection does not adequately take into account the effects of the economic integration of Europe. This would be felt in the assumptions regarding productivity. Productivity was derived from the projection of gross national product and man-hours available to produce that product. From this was computed the needed output per man-hour and the investment required to achieve this output. Investment requirements are a function of capital-output ratios, which are difficult to estimate.

¹¹ Survey of Current Business, February 1963, p. 21.

The need for capital may be lessened if capital is used more efficiently, as is the goal of the European Economic Community. The effects of eliminating the duplication of industry behind tariff walls are to increase productivity and raise real incomes. The effects of European investment of recent years, which was directed toward rationalizing production, should be paying off by 1968.

The report offers support for its projection of improved U.S. competitiveness by noting that the projection is in the same direction as recent price and wage movements. As the report notes, the export price index does not bear out this contention. Even if this index is discounted, it should be noted that the increase in U.S. competitiveness has only taken place since 1959. Export price indexes continue to mirror a lack of competitiveness, and the U.S. share of world exports is declining. The report explains the declining share on the decreased importance of Latin America and Canada in world imports.

INTERNATIONAL LIQUIDITY

The final projection deals with international liquidity, the expected increase in world reserves, and the need for reserves. This requires a projection of total world payments as well as the role of reserves in these payments. This is a big leap from the U.S. balance of payments, but little space is devoted to this subject. The discussion is generally inadequate and appears outside the scope of the study.

The attempt to project liquidity illustrates the inadequacy of the basic balance concept. Projecting liquidity requires projecting the complete U.S. balance of payments, because increases in liquid dollars are increases in reserves. Since the study projected only the basic balance, it could not be used in projecting liquidity. Evidently the technique used was to multiply the 1962 increase in official dollar holdings by 6 to estimate the increase in dollar holdings in the 6 years 1962-67. (No U.S. deficit was assumed for 1968.) If this was the technique, it seems inconsistent with the statement that U.S. deficits will continue in "diminishing amounts" in 1963-67 (p. 238). Even if the U.S. balance-of-payments deficits continue at their present rate, there is no reason to believe the same proportion would be settled by increases in official dollar holdings as opposed to gold outflows or increases in private holdings. A gold outflow causes a shift in reserves but no net increase, and private dollar holdings do not affect reserves as measured here.

Another troublesome aspect of the projection is that increased liquidity is assumed to come only from increases in gold and dollars. A movement to increase reciprocal currency holdings as reserves is now underway among the major trading nations and is official policy of the United States.¹² This movement should not be taken lightly, for it is entirely possible to construct an international monetary system in which each country holds its reserves exclusively

¹² One of the aims of Federal Reserve operations in the foreign exchange market is: "In the long run, to provide a means whereby reciprocal holdings of foreign currencies may contribute to meeting needs for international liquidity as required in terms of an expanding world economy" (49th Annual Report, Board of Governors of the Federal Reserve System, 1963, p. 58).

in the form of currency holdings of other countries.¹³ The currency holdings would be used to defend the country's exchange rate when necessary. When a country encountered a balance-of-payments surplus, it would either peg its own exchange rate and thus acquire currencies or leave it to the deficit countries to defend their exchange rates and thus lose reserves. The total of reserves under such a system would depend upon the collective policy decisions of countries, and gold need play no role. Reciprocal currency holdings should not have been ruled out in the projected supply of liquidity.

The report makes two alternative projections of the need for reserves, both of which result in a shortfall by 1968. As the report notes, such a projection involves many imponderables, but the authors felt that "the relation between [payments] imbalances and the total volume of transactions is more likely to increase than to decrease" (p. 236). The authors fail to note that increased borrowing authority, such as central bank credits and the International Monetary Fund, can reduce the need for reserves. Central bank coordination can also reduce the need. The report states that to an increasing extent future payments imbalances will result from "structural" problems, such as technological change, and that these imbalances will require greater reserves because they are protracted. But it is questionable to say that the world needs reserves to cushion such developments. This is the type of imbalance for which long-term borrowing is suited. The authors also believe that short-term capital movements, which have increased since convertibility, are increasing reserve needs. But these movements can also be equilibrating by reacting to changes in exchange rates and interest rates. It is true that such movements can be destabilizing, but it is questionable to say that on balance they will be. Private short-term capital movements can be viewed as a substitute for changes in official reserves.

The authors seem to regard world reserves as inadequate because many countries have been forced to take policy measures to defend the balance of payments while they would otherwise consider these measures undesirable. This does not seem to me a tenable view of reserve adequacy. It is hard to imagine reserves sufficient to allow countries to ignore the balance of payments in policy decisions and await fortuitous circumstances to redress payments imbalances.

CHOICE AMONG ALTERNATIVES

In assessing the outlook for the U.S. balance of payments, the report's alternative projection appears much more reasonable and certainly safer than the initial projection. The alternative assumes a somewhat slower rate of growth both in the United States and Western Europe. More important, this projection does not rely on extreme divergences in price movements. It assumes the same movement in U.S. export prices as the initial projection (one-half percent per year) and that export prices in Europe advance at 1 percent per year. A rate of increase twice that of the United States is as much as should be counted on in assessing the U.S. balance-of-payments problem. As stated earlier, it also appears that the private invest-

¹³ For a complete description of such a system, see F. A. Lutz, "The Problem of International Economic Equilibrium" (Amsterdam: North Holland Publishing Co.) 1962.

ment projections are more consistent with the alternative than with the initial assumptions. The basic deficit would be \$600 million under the alternative assumptions. If short-term capital outflows and outflows from unrecorded transactions are \$2 billion, this leaves a total deficit of \$2.6 billion for 1968, which is close to the deficits of 1961 and 1962 and lower than the first half of 1963.

Assuming that the United States does experience deficits of this magnitude through 1968, what are the implications for U.S. reserves? The reserve cost over the period 1963-68 would be \$15.6 billion. There is no way of estimating how much of this deficit would be taken in gold. If the same proportion were taken in gold as the 1958-62 average, the total loss of gold would be about \$6 billion. At the end of 1968, then, the U.S. gold stock would stand at \$10 billion and liquid liabilities would be increased to \$37 billion.

The authors of the report also seemed inclined to favor the alternative assumptions. At one point they stated that the European growth targets of the initial assumptions "may be unrealistically high" (p. 225). Also, "Our best guess is that the basic deficit will be eliminated" (p. 230). Even if the more optimistic assumptions are realized, it could well be regarded as a conjuncture of events in 1968 rather than a continuing trend. Surely before too long the deterioration of the trade balance in Europe would result in policy measures to restore competitiveness.

Because of the uncertainties of the assumptions associated with projections, and because projections are to be used in decisionmaking, the report could have usefully made greater use of projections under alternative assumptions. For instance, projections might have been made with a high and low level of military expenditures abroad and a high and low level of foreign aid. A projection could be made hypothesizing a change in exchange rates, say a 10-percent upward revaluation of European currencies relative to the dollar. It would also have been helpful to have a projection assuming no change in prices, since the projections made did rely on an improved competitive position of the United States.

Although the report notes in several places that foreign countries may not tolerate the developments foreseen, it does not seem that this is given sufficient weight in the actual projections. To some extent the deficit in the U.S. balance of payments was "planned" by countries wishing to build reserves. Some countries make quantitative projections to their own balance of payments, projections which are actually goals. These projections seek to build reserves, and they serve as a fulcrum for policy aimed at that purpose.

It is highly dangerous to predict that Europe will tolerate wage rises which are clearly in excess of productivity. Some Western European countries have achieved a form of national planning specifically designed to avoid imbalances that lead to such ills as price increases. On both balance of payments and domestic grounds the inflation projected may be stopped by policy measures in the countries concerned. France, for instance, in mid-September 1963 began taking steps to stop its inflation, including price freezes on some products and reduction of tariff barriers to increase competition.

The initial projection would require the most favorable relationships for the United States. It sees a stepped-up rate of economic

growth coupled with an improvement in both the current account and the capital account. Ordinarily an increased growth rate might be expected to hurt the current account through increased import demand even if it does help the capital account. The assumption of improvement on both accounts is contrary to the usual prescription for payments imbalance—high interest rates to slow down domestic growth and thereby imports and to attract capital. Improvement on both the capital and current account is achieved in the 1968 projection only through an intricate set of assumptions regarding growth and prices in the United States and the rest of the world. The report leans toward the theory that vigorous growth is best for the balance of payments. If such a model is constructed, it should have been without reliance on the tacit cooperation of the world outside the United States.

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Some 2 years ago, President Kennedy stated that "our balance of payments has become one of the key factors in our national economic life." This remains true, notwithstanding the facts that the sum total of all of our private international payments—both debits and credits—is just barely above 10 percent of our gross national product, while merchandise trade takes less than 7 percent. Apart from noncommercial public sector expenditure, therefore, no other major trading nation would, thus, seem to be as independent of balance-of-payments restraints in formulating economic policy as the United States, were it not for the overriding importance of its responsibility as banker of the free world under the type of gold/exchange standards in effect since the war. This is why an examination of the balance of payments must consider this responsibility as a fundamental premise, in addressing itself to the question of how to reconcile the dual objectives of domestic growth on the one hand against external stability on the other. Because, as the study points out, our reserves are no longer adequate, we must rely on foreigners willingness to hold, and to continue to hold, dollars until certain deeper seated causes for our deficit have been removed (I hesitate to use the term "structural" because I am uncertain whether the present structure of our economy requires public expenditure abroad on the current scale—as the Communists would have it—or whether this must be weighed primarily as a voluntary political act). The question of confidence is, therefore, paramount, as it is in any banking relationship, and more particularly when the bankers' own liquidity is at issue. No promise of gaining additional resources, whether at home or abroad, can automatically be used to justify further reductions of liquidity. The point becomes even more acute when the additional resources are not actual long-term claims abroad, but merely represent the vague potential of additional GNP growth. In fact, to the foreign creditor, whether official or private, there can be a no more frightening statement than that made by the Subcommittee on International Exchange and Payments of the Joint Economic Committee (in its report "U.S. Payments Policies Consistent With Domestic Objectives of Maximum Employment and Growth") that: "to propose paying \$30 to \$40 billion per year in reduced incomes to American workers and investors to obtain a \$2 to \$3 billion per year reduction in the payments deficit is to reduce economic calculus to absurdity." If it is remembered that these \$2 to \$3 billion (or more) represent the amount by which foreigners are being asked to increase their dollar holdings each year without asking for gold, the reactions of these foreigners would more logically be that to insist on positing growth rates derived from theoretical models of an economy working at full

NOTE.—The views expressed in this statement are those of the author and do not necessarily reflect those of his firm.

capacity year in and year out at their expense would reduce the principles underlying the present international payment system to absurdity. This conclusion is, in fact, not at significant variance from the recommendation of the Brookings Institution study either to replace this system with its cumbersome restraints on maximum growth with more "flexible" arrangements, or else to tear it down altogether.

In principle, the apparent dilemma between growth and stability is one fully familiar to the committee because it is anchored in the legislation which created it, as well as the Council of Economic Advisers, after the war. Even at a time when the United States held more than half of the free world's gold reserves, and when balance-of-payments problems were what other people worried about, the fear of large-scale postwar unemployment was matched by some concern over how to maintain internal price stability, given the emphasis on economic growth and full employment. In a situation in which the awesome power of American production and resources required us to share our strength with the nations of a war-torn Europe, the United States reserved to itself the power to consult with the beneficiaries of these programs on how to resolve a dilemma of a somewhat comparable nature, though with entirely different proportions. Faced with the urgent need to reestablish economic viability, many of Europe's leading countries were tempted to reject monetary policy in favor of aggressive fiscal policies coupled with artificially high exchange rates. Only when the resultant inflationary strains threatened the very foundations of government, and caused a wave of devaluation, was there a return to the now widely accepted principle of aiming at a more realistic mix between stability and growth. As a consequence, both were achieved in more than satisfactory measure. Even those of the underdeveloped countries which are developing have learned the lesson. But while European countries, whose merchandise trade alone aggregates anywhere from 25 to 55 percent of GNP, have always been compelled to grant priority to safeguarding their external stability, this lesson still seems to be lost on a good many of our own policy-makers.

The terms of reference of the Brookings Institution study project a 4.8 percent annual rate of growth in constant prices on the theory that this rate would reduce unemployment to 4 percent of the labor force, thus relieving one of the main sources of the alleged \$30-\$40 billion "shortfall." This assumption in itself is, of course, highly questionable, if only because it represents an undifferentiated aggregate which, furthermore, in turn, is nothing but a residual 4 percent of the largest labor force the United States has ever had in its history. Even without probing further into the questionable reliability of our statistical data, which may be termed "masochistic" with at least as much justification as our balance-of-payments figures, certain structural facts stand out. The most significant unemployment rate, that for the breadwinners, is obviously considerably lower. Unemployment which, seasonally adjusted, was 5.6 percent in September, is concentrated among workers under 20 years of age (15 percent), nonwhites (above 10 percent) and adult women (5.8 percent); by contrast, the unemployment rate for adult men was only 4.1 percent, and for married men 2.9 percent, the lowest since 1957. In view of these facts, there is no statistical proof whatsoever that the stimuli needed to put a large part of these unemployed to work can be so qualified as to permit extrapolation of a given amount of GNP growth from a

given rate of unemployment with any degree of certainty, leave alone to imply that monetary manipulation will provide that stimulus. Nevertheless, already the opening paragraph of chapter I states that the weakness of the dollar "has been an important factor in inhibiting the United States from pursuing domestic monetary and fiscal policies that could raise its national output, with its present manpower and other resources, by an estimated \$30-\$40 billion." In appraising this statement, one wonders why, to quote the Chairman of the Council of Economic Advisers "an economy that is well on its way to a record advance in output of \$100 billion in 3 years still requires the stimulus (of a tax cut)." Having thus quoted Dr. Heller, it seems only fair also to cite his answer that "our economy has done well, but not nearly well enough to measure up to the expected goals and aspirations of the American people." This, of course, begs the question of whether these goals and aspirations refer merely to the maximum employment of manpower and resources, or whether they also include a minimum degree of domestic price stability and a measure of external equilibrium consistent with a stable, internationally acceptable dollar. If not, we are not talking about the same American people.

Because the initial assumptions given to the authors by the Council of Economic Advisers seemed unusually optimistic, we think it wise that the study has formulated an alternate set of assumptions, which interestingly leads to the conclusion that without the very large rise in Western European prices underlying the original assumptions, our basic balance of payments will still show a \$600 million deficit by 1968. We recognize the great difficulty of making projections of this type without taking into account cyclical fluctuations. Nevertheless, taking as its statistical base the recession year 1960, the authors writing in 1962, must have been aware that the recovery which dates from February 1961 was unlikely to show a 7-year linear progression. We have now, in the 33d month of this recovery, just slightly surpassed the physical growth projected by the study; and while our price stability since 1960 has clearly been superior to that of the much faster growing Western Europe, it was only quite recently that unit labor costs have actually begun to decline. With 5 more years to go in the total period encompassed by the study, there is no reason to assume suspension of the business cycle during that period. Should any recession intervene between now and then, it appears more than likely that either the high growth rates in the original assumption will not materialize or else that the need for countercyclical measures in monetary and fiscal policies will render the 1.5-percent annual price increase projection invalid. These questions seem pertinent in view of the present abundant liquidity of the economy, which by itself continues to fuel a powerful movement of funds abroad, despite the noticeable slackening of economic growth there. Whether the mere fact of a tax reduction alone will suffice to arrest this movement is much too uncertain to obviate the need for early action on the monetary front.

We notice that the authors have not attempted to correlate their two models—original and alternative assumptions—to extrapolate the key elements behind the tremendous swing from the \$1.9 billion surplus in the case of the former to the \$600 million deficit in the case of the latter by 1968. This \$2.5 billion swing in the basic balance is rather more than the entire deficit was last year and, in fact, almost as much as the average basic deficit since 1958, when the deficits started to get serious. Before commenting on the projections of individual com-

ponents, the question occurs why the higher rate of growth should produce such a large surplus and the more moderate rate only a relatively modest improvement. Mr. Bernstein has commented fully on the lack of realism in the assumed changes in prices and output and, particularly, on the fallacy of constructing a model on the basis of 1948 to 1960—a period which includes some of the most atypical years both in the United States and in Europe. But surely, theory apart, the authors' conclusion implies that utilization of resources and manpower must rapidly grow beyond the level of optimum efficiency. Past a certain point, full employment can only help to reduce overall efficiency and to raise unit costs, as more obsolete plant is brought back into operation. In the extreme, this would valorize past misinvestment, thus inhibiting those factors which protect a market economy against future misinvestment.

We are leaving aside for the moment the question of how validly one may compare rates of growth of output without reference to its composition as between capital goods and consumers' goods, durables and nondurables, and so forth, which obviously has an important effect on competitiveness, and thus on the volume and direction of our exports. Without reading into the terms of reference any meaning not intended by the Council, we might refer to a recent statement by Dr. Gerhard Colm—surely not an advocate of slow growth—to the effect that we could have a 5 to 6 percent annual growth rate, but that this would require “such an expansion of fiscal and monetary policy as would be compatible with a reasonable degree of stability only in case of rigid controls.” To go one step further, the chief spokesman for British Labor has only recently declared that there could be no doubt of his party's determination to attain its domestic growth objectives, even if they conflicted with balance-of-payments stability. Since the United Kingdom already has foreign exchange controls, this points in the direction of trade restrictions and, ultimately, devaluation which Mr. Wilson has stated would be considered as the lesser evil. As sterling is the world's only other key reserve currency besides the U.S. dollar, this recent comment lends some particular piquancy to the final recommendations in the Brookings Institution study, which echo Mr. Wilson's feelings to the extent of linking sterling and dollar together in a somewhat similar vein, both agreeing to resign their international responsibilities in preference to any concession—other than lipservice—to the elementary postulates of stability. Given the other assumptions, we are doubtful that GNP price increases can be held to 1.5 percent per annum between now and 1968, particularly with a 52-percent aggregate rise in Government purchases (against a 44-percent GNP rise), inventory accumulations to a point where inventories rise to 1 percent of the expanded GNP and an increase in the labor force sufficient to absorb all those seeking employment even as unemployment drops to 4 percent, all this accompanied by a greater drive to automation. Under the circumstances, it is difficult to escape the suspicion that the original assumptions were “loaded” to show that maximum growth, rather than hurt, would actually benefit our balance of payments significantly, whereas the lesser alternate growth rate would not even suffice to reestablish equilibrium in the next 5 years. On the fact of it, this would seem absurd, except for the fact that it is largely predicated on the central theory of Europe's inflating even more. As pointed out,

the post-1949 record of European growth makes this appear no more than a vague hope, entirely unrelated to reality. The fact is that, during the last 12 years, European growth was faster, despite restraints, than ours during that period, marked here by some lag in demand with but small restraints. If it is now suggested that we remain as neutral on the monetary front as we might be were there no balance-of-payments problem, that we stimulate growth by continuing to run budgetary deficits and, meanwhile, trust Europe to inflate so much more as to lessen the competitiveness of its export prices relative to ours, this can only be labeled a call for inaction wholly based on wishful thinking.

It will be remembered that for years European observers of our economic scene have cautioned that stimulation through fiscal means, such as our present tax bill, must be neutralized by more aggressive use of monetary tools. Last year, one of Germany's most respected bankers stated that economic growth without monetary stability was an illusion. Is it likely, then, that Europe would ignore its own advice to us in similar circumstances, particularly when one of the main reasons for Europe's slower growth is a manpower shortage which fiscal policy can do little to remedy, and a lack of long-term capital which monetary means could not eliminate without severe inflationary consequences, except through a rise in genuine savings? Also, a reduction of Europe's present short-term interest rate structure—just like a further rise in our money rates—would send back to the United States large amount of dollars (Eurodollars) the moment when the pull of interest differentials had ceased—something which would no doubt improve our overall balance of payments in a way not contemplated by the authors of this study. Suffice it to say that Europe cannot be deemed to have suffered from inadequate growth because of high interest rates, mainly for the reason that the marginal utility of capital is much higher than here, where capital often has to leave the country in search of higher return abroad. How then can we justify a prediction that Europe will pull our chestnuts out of the fire by inflating, and seriously predict that its export prices will rise three times as fast as ours by 1968? With no excess liquidity in Europe, monetary policy there can be very effective, particularly by refusing to finance consumption. Furthermore, given its much lower per capita output, Europe can still raise productivity a good deal through additional capital inputs, thus achieving a significant increase in output without the large price rises envisaged by the study. Lastly, Europe has successfully used import liberalization to keep domestic prices down and can continue to do so with the present level of its external reserves. This, however, can benefit our exports only if our own export prices remain competitive, now that Europe has overcome most of its production bottlenecks. If on the other hand, there were anything like the 20-percent rise in gross national product prices envisaged by the study—and even if export prices then rose only by 11 percent (which we doubt)—Europe would obviously attempt to curb the inevitable balance-of-payments pressure by promptly cutting back its imports, mainly from the United States rather than from its Common Market partners.

The Brookings study likewise errs in assessing import propensities at given gross national product levels on the basis of relative prices. This is an unwarranted oversimplification, because the substitution of

imports for domestic production is not always a function of prices; this applies as much to the sale of Volkswagens in America as it does to the pattern of Europe's fuel imports, to name just two obvious examples. Moreover, the Common Market countries may be expected to shift their purchases of raw materials increasingly to their affiliated overseas territories, thus replacing cheaper raw materials from Latin America and Asia. The resultant cost increases may be more than compensated by larger purchases of manufactures by these countries which would, of course, primarily benefit Europe, whereas the reduction in Latin American exports will reduce that area's ability to absorb U.S. goods. It may thus no longer hold true that Europe always suffers more from rising commodity prices than the United States, especially since, at the present time, a large part of any such incremental income accruing to Latin America would go into the repayment of commercial debts to Europe, thus again reducing any ensuing benefits to our own export.

Space limitations do not permit a detailed examination of the validity of all the price changes projected by the study, which the authors themselves have labeled as highly tenuous. Suffice it here to refer to Mr. E. M. Bernstein's comment that a 2-percent overestimate of U.S. receipts, together with a 2-percent underestimate of U.S. payments over these 8 years would represent a shortfall in our basic balance of \$1.5 billion in 1961 prices. This margin for error is much too wide to permit a purely econometric approach to replace business analyses. Our large balance-of-payments surplus with Europe has featured such items as sales of jet aircraft, now nearly completed, and shipments of capital goods normally made in Europe, at a time when excess demand in Europe tended to stretch delivery periods to extremes. This condition likewise has now been substantially remedied. It is difficult to single out any similar factors to support the enormous increase in U.S. exports to Europe envisaged by the study. On the contrary, it appears more than likely that our agricultural exports will not be maintained at the levels which likely future European growth would permit, given the troublesome political restrictions.

Without being critical, we wonder how much faith can be put in the projections of private long-term investment. As regards direct investment, the authors equate their expectations of substantial inflationary pressures in Europe with lower profit margins, which leads them to conclude that this type of investment will no longer grow. Since the actual outflow of funds connected with direct investment abroad has, for some years now, remained fairly stable at about \$1.7 billion per annum (although it seems to run somewhat higher this year), we would not dispute this conclusion. But it may be pointed out nevertheless that a large part of such investment is induced by the rise in external tariffs, especially in the Common Market where the U.S. loses exports and must, therefore, protect its markets, even if such investment is not initially profitable. It may be noted that we have until recently invested in much riskier areas overseas, for precisely that reason, undeterred by lower profitability. If, on the other hand, we were to accept the proposition of reduced direct investment because of lower profits expectations, it follows that this must also affect at least one category of our own exports.

We likewise have no quarrel with the projections of portfolio flows—both in and out of the United States—even though the new

interest equalization tax has introduced a further element of uncertainty here. As far as new bond issues are concerned—by far the largest part—we expect no further outflow to Europe while H.R. 8000 is pending and, if enacted, at least until 1965. The outflow to Canada will be considerably less than envisaged, since the agreement with Canada provides for a ceiling of about \$300 million, reduced by redemptions of perhaps half that amount. On the other hand, we would find it difficult to comment meaningfully on the period 1965–68. As far as stocks are concerned, we are again in general agreement with the authors that the principal wave of American purchases of European—and, possibly, Japanese—stocks probably topped out already in 1961. The study correctly outlines a number of factors which would have tended to limit any large future rise in purchases of foreign stocks even without the proposed tax. These reasons generally militate against Americans assuming the extra risks involved unless there are offsetting extra potentials for capital gain. Since, in our own projections, we would assess likely rates of GNP growth over the next few years at between 3 percent and 4 percent per annum both for Western Europe and for the United States, we feel that such opportunities will not be too plentiful. Of course, we would not undertake to assess stock market trends over that long a period of time, leave alone movements in individual securities that happen to catch inventors' fancy at any given time. However, one should not forget that, apart from the expectations of capital gain, fear of the dollar has begun to play a not inconsiderable role in movement of portfolio capital either way, i.e., additional purchases of certain types of foreign securities, such as gold mining shares, by Americans, and, conversely, a reduction in purchase of U.S. securities by foreigners. In fact, despite the inadequacy of our statistics, we suspect significant elements of capital flight showing up not only in private investment abroad, but also being hidden among residual items, such as the large category of unrecorded transactions and net errors and omissions. As far as direct investors are concerned, these outflows may take the form of loans and advances to foreign subsidiaries as well as leads and lags in collecting royalties and dividends; in the case of portfolio investors, it may be the purchase of foreign securities through foreign banks, rather than American brokers.

The study contemplates a modest rise in foreign direct investment in the United States, reflecting better performance of our economy, and a somewhat larger increase in foreign purchases of American securities, due to higher levels of investible incomes in Europe and the relative attractiveness of American securities. There is insufficient assurance of the latter. Several features of our own tax law still pose important obstacles to such increased purchases of U.S. securities—in fact to the very establishment of brokerage accounts here. (Of course, foreigners can buy U.S. securities through their local banks, but this involves payment of double commissions.) The need here is not—as is often believed—for special incentives for foreigners to buy U.S. securities, but merely for removing existing elements of discrimination. More important, however, is the fact that foreigners will not increase investments in the United States unless and until their confidence in the dollar is restored. Despite the rise in U.S. stock market prices since summer, we have observed net disinvestment by foreigners ever since July 18th when the new interest equalization

tax proposal was made public. Most European private and central bankers feel that it would be a serious mistake to tax acquisition of existing foreign securities abroad along with new issue activity.

Chapters VI and VII deal with foreign economic and military aid, the two categories of public sector expenditures which account for a \$4.8 billion outflow in 1961, and \$4.9 billion last year (before Government debt prepayments) thus more than absorbing the entire payments surplus generated by the private sector on current and capital account combined. Even though this fact points to the critical nature of this parameter, neither projection nor analysis can usefully apply the statistical technique employed elsewhere in the study. Levels of military spending reflect mainly the cold war outlook, and are essentially guided by the deployment of troops abroad and the pattern of procurement. In the case of economic aid, both loans and grants, projections used are those of AID, which envisages an astounding \$2.1 billion increase in its own programs by 1968; total aid is to rise by \$2.4 billion, with payments to Latin America playing a large role, and no significant drop in any major geographical area. The difficulties in measuring the balance-of-payments impact of this vast increase, admitted by the authors, merely emphasize how little we know about the actual effect of past and present aid on the payments balance, even in the specific context of judging the gains accruing from the tying of expenditure. Despite all these uncertainties, however, we remain totally unconvinced that the projected more than 100-percent rise in these programs by 1968 would not raise the payments deficit by much more than the \$400 million estimated by the study.

Our doubts center on two areas: the effect of aid on commercial export levels and the true impact of the Public Law 480 program. While the authors recognize the tendency of tied aid to distort normal trade patterns, we do not share their belief that such distortions are largely neutralized by incremental imports on the part of the third countries benefiting from U.S.-financed procurement wherever the latter remains untied. Virtually all of these countries hold substantial reserves of their own, so that additional exports do not cause a concomitant import rise except for raw materials—which do not generally come from the United States. All we know is that since almost all aid recipients have, quite properly, foreign exchange controls, their importers are by no means free (as the authors imply) to utilize the saving in hard currency expenditure by purchasing additional U.S. goods, even where price and credit terms are competitive; also, buying outside of the United States often offers certain other advantages not available where aid is tied. In too many cases, the leakage in Western European reserves thus contains significant elements of a concurrent leakage from official to private ownership, so that the reserve accretion represents illegal hoarding on the part of the recipient country's nationals. This portion of the increment is, therefore, not available for an offsetting rise in U.S. exports to Europe, although the U.S. balance-of-payments impact may be mitigated where hoarders acquire dollar assets. Admittedly, this factor can only be dealt with through tighter administrative supervision; but we wonder why the study seems to disparage the attempt to achieve just that end by the proposed expanded use of letters of credit, the proceeds of which must be spent in the United States. Perhaps this could be more useful than is assumed here, if only by assuring that our aid effort yields the

optimum results consistent with a situation where it must impinge on our payments balance to some degree. It goes without saying that this cannot be achieved in the typical case without effective foreign exchange controls, the need for which the authors appear to deplore. Moreover, foreign aid often frees a significant amount of foreign exchange for military expenditure—to name just one principal item—on the part of recipient governments, in the absence of which they could undoubtedly afford to import commercially some of the goods now provided by U.S. aid.

It is likewise possible to view the true import of Public Law 480 shipments in a manner quite different from that of the authors. As the study correctly points out, the balance-of-payments relief of surplus commodity shipments to recipient countries frees foreign exchange earmarked for (priority) imports. But this does not necessarily mean that this gain returns to the donor, nor, as the authors state, that the direction of its expenditure should be expected to follow historic (pre-aid) precedent in this respect. In theory, one purpose of such aid is to permit these countries to industrialize more rapidly, by freeing labor from low productivity agriculture. In practice, however, many of these countries have become impatient with the resultant slow rate of growth, with the result that quite frequently these exchange savings create an exponential drain on our future balance of payments. This happens when these sums are used to procure capital goods, such as steel mill equipment, from third countries, with the entire savings being used as downpayment only, and the balance being financed by credits, usually insured by the governments of the exporting country. These credits, of course, must very often be repaid with the proceeds of future U.S. aid—or with the exchange savings arising from it. It would, therefore, be quite wrong, for instance, to conclude that large proportions of these savings will ultimately return in the form of additional U.S. exports. On the contrary, we have today already a situation in which several Latin American countries will require a continuing high level of aid—though not as high as projected here—merely to meet their present obligations to international institutions and European creditors.

To be sure, the report states that “we do not regard Public Law 480 as costless from a balance-of-payments point of view,” but we do think that the authors have seriously underestimated its impact. This may be due to their awareness of the pressure for putting our surpluses to work in some form rather than to accumulate storage charges on them. But if we can contemplate selling such surpluses to the Soviet Union at world market prices—with the United States subsidizing the cost differential—does it not seem paradoxical to argue that this pressure is not so great that we should not, at least, attempt to reap a secondary benefit by supplementing the Public Law 480 program with some proportion of commercial sales. If not, this only confirms the view that our agricultural subsidy program is badly in need of reform, and that we might actually gain more in balance-of-payments terms by exporting some of these surpluses commercially than we would lose through the reduced purchasing power of competing free world exporters. In other respects, too, there are some fairly obvious illusions about the benefits of Public Law 480, as evidenced by the statement that “a European commercial market for U.S. frozen poultry was largely opened by earlier shipments under Public Law 480.”

Perhaps our principal criticism of the two chapters lies in the fact that they nowhere clearly spell out the incontrovertible fact that our balance-of-payments deficit originates entirely in the public sector. According to one recent computation, this public sector deficit amounted to \$4.9 billion last year against a private sector surplus of \$3.7 billion. The \$1.2 billion difference represents our basic deficit, before adding the \$1 billion residual item of unrecorded transactions and net errors and omissions. Even assuming the bulk of this latter category to represent nongovernmental transactions, this would still not invalidate this statement, which demonstrates that our deficit is not a structural one at all, but one which originates outside of the economic sphere. Without ignoring the additional output and income generated by some of these expenditures, the fact remains that the resultant balance-of-payments deficit has the opposite effect.

Precisely because the nature of the problem is essentially political, it would be a serious mistake to postpone the harder choice before us merely on the hope that Europe and Japan would come to our support by sharing in this type of aid. The authors were, therefore, wise in putting this source of relief at not more than \$100 million by 1968—less than 2 percent of the presumptive 1968 level. As regards repayments of Export-Import Bank loans, there is no mention of the possibility of defaults upsetting the present schedule.

There is, in short, no convincing proof of the authors' contention that "most aid * * * is reflected in U.S. exports, even if only indirectly." Yet, this quotation illustrates the spirit of indifference—not to call it defeatism—which marks so many of the study's negative conclusions concerning the benefit of positive action. This Hamlet-like attitude may reflect a degree of preoccupation with matrixes designed to picture a causative chain of economic interaction, without sufficient attention being paid to differences between primary and secondary effects and the time lag between them. After all, the fact that we may be in surplus by 1968—although certainly not for the reasons advanced by this study—does not relieve us of the need to deal with the more pressing problems which confront us at this time, long before 1968. There may emerge, in this long run, a so-called "liquidity problem"—but, more likely, the free world's financial system would be dead if we were to postpone action until then. As the President stated in his message of July 18: "We do not pretend that the task of long-range reforms of the system is any substitute for the actions that we ourselves must take now."

This pervasive tendency to ignore national (and international) priorities is evident from the first page which contains the amazing statement that "elimination of the deficit may not suffice to restore the dollar's strength because that alone might not increase the attractiveness of the dollar for foreign and domestic holders." The only way we can find to rationalize this statement is that the methods proposed by the study would surely have the effect of destroying confidence in the dollar—although they are not directed at eliminating the deficit, but merely at insuring that others will continue to finance it.

To be sure, should the United States attain a balance-of-payments surplus, this will necessarily involve some other countries losing reserves. But this truism can hardly justify the incredible conclusion that "achievement of a U.S. balance-of-payments surplus could have

damaging consequences for the free world, unless it were part of a broader change in international economic policy." The arrangements devised in the form of Central Bank cooperation to conserve international liquidity in order to permit us to resolve our present difficulties will, of course, be at the disposal of any nation showing a deficit vis-a-vis ourselves in the future. Under Secretary Roosa has repeatedly stated our willingness to accept and hold currencies of the other major Western trading nations, provided only that they, in turn, will submit to the disciplines required to permit such currencies to be treated as reserve moneys. Obviously, therefore, the task at hand is to solve our priority problems now, since we have already laid the groundwork for dealing with the secondary one.

At this year's meeting of the International Monetary Fund, both the Fund and the governments of the 10 major trading nations, known as the Paris Club (which includes the United States), have decided to study the so-called liquidity problem. They have wisely ruled out a priori any resort to changes in the gold price or in the system of fixed exchange parities, in full recognition of the immense danger which either suggestion would entail. What those responsible for the recommendations have totally failed to comprehend is the fact that the large demands for added liquidity arise not from any likely increase in the value of world trade, but rather from large short-term capital movements which inevitably result from such loose talk about tampering with a system that has served the free world well for 20 years. The fallacy that a rise in the volume of trade requires a corresponding increase in monetary circulation—whether domestic or international—has been exposed repeatedly, not only by the author in previous testimony before your committee, but, also, more recently, elsewhere.¹ Because the entire Brookings Institution study deals with the basic balance of payment, its terms of reference exclude the most important factor, viz the effect of short-term capital movements which may be set off by interest-rate differentials as well as lack of confidence in the dollar. The very last that must, therefore, be said about including these truly frightening recommendations is that they represent a complete non sequitur to the contents of the study proper. It is to be hoped that the committee will exercise extreme caution in basing any policy recommendations on these findings.

¹ "The Rejection of the Triffin Plan and the Alternative Accepted," by Burton G. Malkiel, *Journal of Finance*, September 1963.

STATEMENT BY DONALD A. WELLS

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The United States Balance of Payments in 1968 is the report of the Brookings Institution on the outlook for the U.S. balance of payments. Basically, it is an attempt to project recent trends in prices, output, and international capital movements as they relate to U.S. international payments and receipts. It is not primarily a forecast. "The projections made in this report are not unconditional forecasts. They are estimates of what the assumptions imply, made without assessing the probability that these assumptions will be realized" (p. 35). The authors have been frank in their recognition of the qualifications which must accompany their analytical conclusions. Some of the public comments on the Brookings report have been less careful in this respect.

One shares with the writers of the report the highly speculative nature of the projection of net balance in international payments. The temerity to estimate the condition of U.S. international payments and receipts at the end of a 5-year period does not rest with the authors, however, and any misgivings in this direction are not relevant to this analysis. In addition, this report has served a useful purpose by making available statistics and information which has not been available before. This is especially true for the analysis of feedback effects and U.S. market shares in regional product markets.

This evaluation will concentrate on two aspects of the Brookings report. First, the methodology will be examined. Second, the nature and relevance of the assumptions of the analysis will be considered. The examination of assumptions receives the greatest attention because of the close dependence of the projections on these assumptions. Thus, the focus of this paper is on the analytical conclusions of the report, and not on the policy recommendations. It should be recognized that the appraisal of the analytical conclusions cannot be extended to the policy recommendations.

METHODOLOGY

The emphasis upon Western Europe

The study concentrates on relative price and income changes in Western Europe and the United States. Developments in other countries are not analyzed, partly because the competitive position of European producers is of primary importance to foreign sales of U.S. manufacturers, and partly because countries outside these two areas do not have large and persistent imbalances in their international accounts. "* * * Their combined cumulative net position over a period of years may be neglected in projecting broad trends affecting the U.S. balance" (p. 26). Thus, the analysis is simplified to an appreciable extent by the concentration on these two major industrial areas.

While it is true that countries in the rest of the world cannot incur persistent deficits, given the low levels of their present international reserves, it is not clear that some will not increase their reserves to some extent, particularly those countries which experience rising incomes and levels of trade. Also, changes in prices and incomes in one group of countries relative to others may affect the U.S. balance of payments. For example, if Latin American countries were to experience faster rising incomes, the character and direction of U.S. foreign investments might be altered as a result. If U.S. investments in the Western Hemisphere were stimulated relative to U.S. investments in Western Europe, a given volume of foreign investment would have a different impact on the U.S. balance of payments. A greater proportion of international receipts is spent in the United States by Latin American countries compared to the proportion by countries of Western Europe. Thus, changes in the relative competitiveness and incomes of different areas of the world could have an impact on the U.S. balance of payments which would not be reflected in the Brookings study.

The net basic balance

The report focuses on the net basic balance, which is defined as "the part of the total balance consisting of the net balance of goods and services, including investment income, and the net balance of aid and long-term capital flows" (p. 5). The net basic deficit, of course, is less than the total net deficit; the latter includes the outflow of U.S. private short-term capital. The concept of the net basic deficit is used to focus on changes in the international payments position not related to transitory elements. Changes in net international payments may result from cyclical movements, speculative pressures, and other fortuitous factors. The focus on the net basic balance is an appropriate one. Achieving a balance in the net basic balance will ease the speculative pressures on the U.S. dollar. However, it is not implied that there will be no net short-term capital outflow with a basic balance of zero. In fact, the authors recognize that "a net flow of short-term capital, either inward or outward, may be a condition of equilibrium in a growing world economy. If so, balance in total U.S. international payments would imply a deficit or surplus in the basic balance" (p. 8). With these qualifications, it is appropriate for the purposes of this study to concentrate on the likely changes in the net basic balance as it has been defined.

The model

The equations used to determine the functional relationships between real income and relative prices and U.S. exports and imports to and from Western Europe are derived for the most part from the econometric model constructed by Jacques J. Polak and Rudolph R. Rhomberg of the International Monetary Fund. These equations are subject to all the qualifications of any derived from an econometric model, and the authors have specifically recognized these limitations. In the model, the level of U.S. exports and imports depend upon real income and relative prices in the United States and Western Europe. The quantitative relationships established are based on historical data for the period 1948-60. "These relationships

may not correctly measure the effect of the independent variables on the dependent ones" (p. 34). " * * * During the period covered by the model there was considerable correlation between the two independent variables themselves" (p. 35). "Moreover, we not only extrapolate in time. For the GNP, we also extrapolate well beyond the numerical range of the variables on which the equations are based * * *" (p. 35).

It is not very meaningful, however, to dwell on the limitations of the model. It does point out how little we know about the relationship between exports and imports and the appropriate independent variables. Also, it does suggest that the study might have presented more than one set of balance-of-payments projections. (See Hal B. Lary, "The United States Balance of Payments," hearings before the Joint Economic Committee, pt. 2, July 29 and 30, 1963, p. 303.)

ASSUMPTIONS

The rate of economic growth

The nature of the assumptions may be illustrated by the statement of Walter W. Heller regarding the projected 4.8-percent annual increase in the U.S. gross national product. " * * * The projected level of GNP represents an estimate of what GNP would be if unemployment were at the level of 4 percent * * *. The reason for suggesting that Brookings should use a growth rate corresponding to a 4-percent level of unemployment was that we wished them to explore whether or to what extent our return to a satisfactory level of employment in the United States might be consistent with the restoration of equilibrium in our balance of payments." (Material inserted in the "U.S. Balance of Payments," hearings before the Joint Economic Committee, pt. 2, July 29 and 30, 1963, p. 335.) Thus, the principal factor explaining the higher rate of growth of the United States relative to that for Western Europe is the projected high rate of growth of the U.S. labor force. Yet the projected improvement of the U.S. balance on current account is highly dependent upon the assumed rate of growth. If a U.S. growth rate of 4.8 percent is assumed, net exports of goods and services will increase in 1968 by \$4.2 billion compared with the 1961 level. If this growth rate is reduced to 4.3 percent, and that of Western Europe from 4.3 to 3.8 percent, the improvement on current account is \$1.7 billion. A reduction in the assumed rate of economic growth for each area by one-half percent reduces the improvement of the basic balance from \$2.7 to \$0.2 billion.

The authors describe the projections as being "based on rather optimistic assumptions as to the growth rates of GNP in the United States and Western Europe" (p. 60). The lower rate of growth for the United States which is projected under the alternative assumptions would appear to be more realistic in light of the performance of the U.S. economy over the past decade.

Income effects

The report concludes that real income changes in the United States and Western Europe between 1961 and 1968 probably will result in a worsening of the deficit on current account for the United States. Merchandise imports are expected to increase by \$3.3 billion from

1961 to 1968, with other accounts in the current account resulting in an increase of \$4.4 billion in U.S. payments to Western Europe. The increase in U.S. receipts, on the other hand, is projected to be only \$2.4 billion. The Polak-Rhomberg equations were modified and were the basis for arriving at these figures.

Historically, U.S. imports have fluctuated directly with changes in national product. The trade balance tends to be dominated by reactions in imports to income changes (p. 22). It is reasonable to conclude with the authors that income effects will have an adverse effect on the U.S. basic balance. The impact in terms of a dollar amount can be estimated with less certainty.

Relative price movements

In projecting the change in U.S. export prices to 1968, the report assumes an annual rise in the U.S. GNP deflator of 1.5 percent, and that this rise will be accompanied by an approximate stability of wholesale prices. Export prices are assumed to increase at an annual rate of about 0.5 percent. Over the period 1959-62, while the wholesale price index in the United States was stable, the unit value index of manufactured exports rose by slightly more than 5 percent. This inconsistency in the behavior of these two indexes is attributable to deficiencies in the price index of exports of manufactures (appendix to ch. III). For Western Europe, the projected rise in GNP prices is 20 percent between 1961 and 1968, while the average annual rise in export prices is assumed to be 1.5 percent.

The net effect in 1968 of the improved competitive position of the United States on the U.S. trade balance is calculated to be \$4.8 billion. The assumed changes in relative prices are basic to the projected improvement in the U.S. balance of payments and merit examination.

It is difficult to assess whether or not relative price stability is consistent with the projected annual rate of growth of 4.8 percent. The stability of the wholesale price index in recent years has been associated with significantly lower rates of growth. The anticipated annual increase in the labor force of approximately 1.5 percent may exert some steady influence on prices. Similarly, the increased rate of growth may promote better use of capacity and induce cost-saving investment. At the same time, however, the increased rate of economic growth is likely to strain resources in particular sectors of the economy. Bottlenecks in raw material supplies and shortages of skilled labor illustrate the types of developments which could exert upward pressures on costs and prices. It does not seem possible to forecast with even a reasonable amount of certainty the relationships between wholesale and export prices and the projected 4.8 percent rate of economic growth. The Brookings study has illustrated the complexity of the problem in attempting to answer questions like these, the inadequacy of available statistics, and the nature of the assumptions which must be made to postulate functional relationships between the variables under consideration.

It does seem reasonable to conclude, however, that price rises in Europe will be greater than in the United States. The growth of the labor force will be slower in most European countries; there will be little or no natural increase in Western Germany. France and Italy have experienced considerable rises in prices in the past 2 years, and it is too early yet to tell whether or not the recent deflationary

program in France will be successful in curbing increasing costs and prices.

Policy variables may be decisive in determining the trend of prices in the EEC. Agricultural policies will determine the future trend of U.S. agricultural exports to the European Common Market. Similarly, policies with regard to cartels and other restrictive devices, movement of capital and labor, and other factors affecting the nature of the markets within the EEC have yet to be determined. To the extent that market forces are restrained, prices will tend to rise more quickly than if competition is fostered in both product and factor markets. It is still too early to assess the likely direction of EEC policies in this respect.

The continuance of nationally determined fiscal and monetary policies by the EEC countries, and the existence of national monetary reserves in this area, may result in greater application of deflationary policies by member countries than would be warranted if reserves and monetary and fiscal authority were centralized. If an improvement in the U.S. international accounts occurs, there is no reason to expect that it will fall evenly on each of the EEC countries. One or two of the member countries may experience a deterioration in their international accounts corresponding to the improvement in the U.S. balance of payments, and they may react by tightening credit and imposing restraints on demand. This would be true especially for those member countries which do not have the sizable international reserves of Western Germany and France. Given the relatively high interdependence of the economies of the emerging customs union, these policies might impel restrictive actions on the part of other member countries even if their international accounts are in surplus. Under the type of institutional framework which presently exists in the EEC, such a chain of events easily could occur.

On balance, I agree with the report that relative price movements between the United States and Western Europe should improve the competitive position of the United States in world markets. I would be very hesitant, however, to be very specific about the magnitude of the changes in the U.S. balance of payments which would accompany this improvement in the competitiveness of U.S. exports.

EEC commercial policy

The authors attempted to determine the effects of the formation of the European Common Market on U.S. exports by estimating the "EEC effect." The EEC effect is defined as the difference between the projected level of U.S. exports to the Common Market countries and an estimate of the level which would have existed without the Common Market. The study concludes an estimated loss in 1968 of \$750 million, \$650 million as a result of a loss of U.S. exports to the EEC, and \$100 million as a consequence of an EEC-induced loss of U.S. exports to third countries.

The principal factors explaining this loss are:

1. Approximately one-third of U.S. exports to the EEC are agricultural products. The evolving variable levy system for the EEC "insures an absolute level of protection" (p. 111). The loss is estimated at \$350 million.

2. The new EEC common external tariff will be more protective than the old national tariffs. The future EEC tariff has been examined to determine the amount of protection it affords to the

dominant low-cost suppliers within the EEC. "The essence of economic integration for producers within the Community is that they will be operating within a large unprotected market and they must meet the competition of low-cost producers of other EEC countries in order to survive. Thus, the large low-cost producers will determine the competitive position of the Common Market as a whole" (p. 101). On the basis of this approach, the common tariff on 75 percent of all manufactured products will be raised considerably. This protective effect will cause a loss in U.S. exports to the EEC of \$200 million.

3. Tariff preferences given associated overseas countries will discriminate against countries of Latin America and Japan; this latter group of countries spends a considerably higher proportion of its international receipts in the United States compared with the associated overseas countries. The estimated loss is \$100 million.

The trade diverting effects of the EEC as they relate to U.S. exports are analyzed very effectively in the study. The degree of trade diversion which eventually occurs will depend heavily on future tariff reduction negotiations. The negotiation and subsequent implementation of tariff reductions is likely to be a lengthy process, and the timing of any reductions will be important in determining their effects on U.S. trade by 1968. The emphasis of the report on the importance of the tariff negotiations under the terms of the Trade Expansion Act is appropriate. It is unlikely that tariff reductions will be implemented in time to alter significantly the estimated projections of this section, however.

Foreign economic assistance and defense transactions

Projections of foreign economic assistance and defense transactions are very hazardous because of their dependence upon policy decisions. Errors in the estimate of future foreign economic assistance will cause substantially smaller changes in the balance-of-payments impact, however. For example, the study estimates that if expenditures of the Agency for International Development (AID) increases to \$3.9 billion in 1968, compared with \$1.8 billion in 1961, the basic balance will worsen by not more than \$300 million. Thus, less than 15 percent of AID expenditures results in an outflow of gold and dollars. Increased tying of foreign assistance to U.S. goods and a geographical shift in aid toward Latin America are cited as the principal reasons (p. 189). The study does an excellent job of presenting data and analyzing feedback effects as they relate to U.S. foreign assistance.

Estimates of foreign defense expenditures necessarily rely on many assumptions concerning the state of international affairs, the nature of the Western alliance, etc. The report assumes an improvement of \$1.1 billion in 1968 compared with 1961. Since the anticipated improved condition of the U.S. balance of payments is an important variable itself in arriving at these estimates, the projections are highly conjectural. I would agree with the report that some improvement is likely.

Private foreign investment

The report concludes that the effects of long-term capital movements will improve the net basic balance for the United States by

approximately \$1.5 billion. The primary explanation for this improvement is an anticipated rise of dividends and interest payments to U.S. investors. A decrease in the level of the long-term capital outflow to Western Europe is expected to be offset by a decrease in U.S. exports to other areas resulting from export displacement by U.S. firms operating abroad.

U.S. private dividend and interest receipts increased from \$2.1 billion in 1956 to \$3.2 billion in 1962; the projected level for 1968 is \$4.5 billion. In view of the substantial increase in U.S. direct foreign investments over the past 5 years, the projected rise in U.S. dividend and interest receipts appears to be a conservative estimate.

The impact of long-term capital flows abroad on the balance of payments involves more than a calculation of investment flows and earnings on these investments. Export displacement or stimulation and imports from U.S. firms operating abroad, for example, should be determined. A recent study of the operations of U.S. foreign enterprises over the period 1950-59 produced two conclusions which are relevant to these considerations. (See Homan, A. Gerlof, "Some Measures and Interpretations of the Effects of the Operations of U.S. Foreign Enterprises on the U.S. Balance of Payments," paper presented at the annual meeting of the Western Economic Association, August 1963.) First, the U.S. net basic balance was improved by operations of these firms. It was estimated that for firms in Europe capital outlays were recovered by earnings in approximately 10 years. Second, U.S. imports from U.S. firms operating abroad were concentrated on raw materials; in 1957 only 1.7 percent of the total sales of U.S. foreign enterprises in Europe were to the United States. It is likely that U.S. investments in Western Europe are responsible for a very low volume of U.S. imports.

The Brookings study indicates that U.S. foreign investments are a source of future strength in the U.S. balance of payments. Any efforts to restrain artificially the long-term investments by U.S. firms and investors may not be of any benefit to the balance-of-payments position of the United States except on a short-term basis.

CONCLUSIONS

The Brookings study of the U.S. balance of payments is an important contribution to the analysis of the forces which determine the net basic balance for the United States. In terms of the broad trends which are derived in the analytical conclusions, I am in agreement with the study.

There are limitations to these conclusions which must be recognized; for the most part the authors explicitly recognize them. In some cases the assumptions about the trends of independent variables were fixed not on a basis of their probability but for some other purpose. The U.S. growth rate is a primary example. Some relationships which are relevant to the study were either ignored or oversimplified because of the unavailability of the necessary statistics. And, last, future policy decisions will have an important bearing on the projections in the study. Fiscal and monetary policies in both the United States and Western Europe will have an important bearing on future prices and incomes in the two areas. In the report the

general (and natural) tendency is to assume no basic changes in the trends of present policies.

The future rates of economic growth in Western Europe and the United States which are projected in the report are essential to the improvement in the U.S. net basic balance. The income and price effects of relatively high rates of growth in Western Europe are essential to a rising level of U.S. exports. Similarly, a higher rate of economic growth for the United States, and the increased level of investment which will accompany this growth, is of primary importance in reducing the deficit.

The authors have assumed that the Western European countries will permit the price rises which are projected in the report. In Western Europe there are substantial pressures for rising wages and consumption levels. But the restraints recently imposed in France illustrate the range of restrictive devices available to European officials and their willingness to use them. With foreign transactions a relatively high proportion of national product, European officials are highly responsive to pressures on the balance of payments. The central question becomes: Will Western European authorities check the tendencies toward rising prices or restrain the rises in income which are necessary to achieve a rising level of international receipts for the United States? If the answer is "Yes," then the projections of this study will not be realized and the improvement in the net basic balance will not occur.

The United States is not relieved of its responsibility for restraining price increases and taking the appropriate steps to promote economic growth. Neither can it improve its international payments position without the appropriate policies by the prominent surplus countries in Western Europe.

STATEMENT BY C. R. WHITTLESEY

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The sponsorship of the study of the "U.S. Balance of Payments in 1968" as well as the individuals directly concerned with the project were a sufficient guarantee that the task placed before them would be expertly handled. The authors did what other competent professionals would have done in the circumstances. They scrutinized strategic items in the balance, examined their behavior in the past and the present, and drew logical conclusions ("projections") for the future. They stuck closely to quantitative data and measured, refined, and manipulated the materials with the aid of statistical and mathematical techniques supported by computers. Reliance on such data and such methods has the virtue that it helps to overcome biases arising out of an author's personal judgment. It emphasizes facts and avoids opinion. It yields conclusions that can be defended—defended, that is, against other economists and before congressional committees.

The results which these procedures produce are reasonable but it does not follow that they are realistic. The conclusions reached, it may be remarked, are in the mainstream of current economic thinking. At any given time that is the most comfortable place for an expert to find himself, but let us not forget the stream of sophisticated economic thinking in the twenties, the thirties, and the fifties or the flotsam of economic judgments which it carried. New era economics, stagnation, chronic dollar shortage. Those judgments seemed reasonable enough in the light of assumptions made at the time, but they failed to allow for important developments which were both unforeseen and, for the most part, unforeseeable.

The techniques employed in the present study are intended as protection against just such mistaken judgments. The thought remains, however, that again significant influences may enter in, which are likewise unforeseen and unforeseeable. To say this much is in no way to disparage the study or its originators. At any given time we must do the best we can with the knowledge we have; and there is no reason to suggest that what is before us is other than the best that presently can be done. But doubts and reservations survive, as the observations below will endeavor to make clear.

The letter of instructions from Senator Douglas called for a statement addressed "primarily to the scope, assumptions, methods, inferences (read implications?), and findings of the study." The policy recommendations of the report were subordinated, though not absolutely excluded from consideration. The discussion will follow this plan of organization.

SCOPE

The scope of the study is unduly constricted, first of all, in its analytical focus. The opening paragraphs direct attention, it is

true, to the position of the dollar "in the markets and eyes of the world." Moreover, the changed position of the dollar is explicitly declared to be only in part the reflection of a deterioration in the U.S. balance of payments (p. 1). Elsewhere "the fundamental problem" is given as "the basic inadequacy of the international monetary mechanism in relation to the requirements of the free world."¹ And it is said that "no position of the balance of payments—whether surplus, deficit, or balance—would simultaneously free the United States from undesirable constraints and provide for needed expansion. * * * *The present problem is not primarily a balance-of-payments problem*" (pp. 242-243).²

Despite these qualifications, the focus of the study is narrowly on the balance of payments. This emphasis is understandable in view of the terms of reference. Nevertheless, it gives too little consideration to the position of the United States in the world economy. It would have been helpful to have had greater elaboration of the observation with respect to the importance of internal developments in the United States relative to other countries (p. 212).

Specifically, it would seem that the United States is economically the strongest country in the world and that this will remain true for the foreseeable future. The economic strength of the country, both absolutely and relative to that of the rest of the world, is surely a significant element in the long-run position of the dollar. We have three related but distinct problems before us: (a) the U.S. balance-of-payments situation, (b) the world liquidity position, (c) pressure on the dollar. Neither the distinctions nor the inter-relationships are sharply enough delineated. But, more especially, the longer run bearing of the economic strength of the United States upon each of them individually and all of them collectively is not sufficiently analyzed.

It can be argued that the weakness of the dollar referred to at the start of the study is illusory, temporary, and reversible. The appearance of weakness reflects in large measure pressures resulting from relatively volatile personal judgments. Current underconfidence in the dollar is partly a reaction from earlier overconfidence in the dollar. Both were influenced by the highly abnormal situation which existed at the end of the war when foreign economies were badly crippled and the U.S. economy was not. Mistaken judgments as to the degree and permanence of U.S. economic superiority have been succeeded by what may well prove to be equally mistaken judgments as to the significance of the more rapid growth rates abroad than in this country. A reevaluation of U.S. prospects (upward) and of foreign prospects (downward) would have a very great effect on the balance of payments and the position of the dollar. Recent swings in Canada's international financial position show how suddenly and with what startling consequences such reevaluations can occur.

As is the case with other writings on the subject, moreover, the study directs attention toward supply factors affecting the liquidity problem, to the neglect of demand factors. The importance of "confidence" and of "willingness to hold dollar assets" is explicitly recog-

¹ This expression of opinion strikes me as refreshingly specific even though I do not in the least agree with it.

² Italic added.

nized (p. 211 and elsewhere) but the bearing of psychological influences in generating pressures from the side of demand for liquidity does not receive the detailed analysis that it deserves. Moreover, greater consideration might have been given, among other questions, to the position of gold relative to that of the dollar and to the implications of the significant strengthening that has taken place in the position of a number of European currencies.

Finally, the time focus of the study is altogether too restricted. The limited time perspective is disclosed in the opening paragraphs. That the dollar is now a weak currency is accepted as self-evident, at the very time when the authors imply (cf. "was regarded") that earlier views as to the strength of the dollar were shortsighted.³ Surely the contrast in prevailing opinions within so short a period of time should have warned the authors to attempt a longer perspective than they have given us.

The study might well have examined the circumstances that attended the shift in balance-of-payments items and the relative position of the dollar. The reason for doing so would be twofold, to account for the reversal from apparent strength to apparent weakness of the dollar and to evaluate how basic and enduring the transformation may have been.

The following developments may be mentioned as having provided an abnormal inducement to American investment abroad in the post-war period, with resulting strain on the U.S. balance of payments. Some of them are mentioned in the study. Their importance, however, in influencing the export of American capital is not adequately assessed, particularly in relation to the timing and the cumulative effects of the movement.

(a) "Large American investments in Europe may have occurred mainly to make up a deficit of commitments in that area" after 1929 (p. 140).

(b) Extraordinarily rapid expansion of costly oil development (exploration and construction of facilities) abroad.

(c) High rates of economic growth abroad.

(d) Rise of the Common Market which led to the establishment of factories and other facilities in order to obtain the benefit of protection within EEC and possibly a preferred status for future trade with Africa (p. 141).

(e) Realization by American industrialists that getting established early overseas might provide a competitive advantage in the future (p. 145).

There are reasons for believing that inducements such as the foregoing may tend to diminish in strength both absolutely and relatively:

(a) Some are of a temporary or one-shot character.

(b) Others were largely the result of conditions resulting from the depression of the thirties and World War II which no longer exist.

³ I do not wish to quibble over the meaning to be attached to the adjective "weak." But surely a strong currency under abnormal pressure (if that is the case) should not be confused with a currency which is weak in the sense in which that term is generally applied. The point is particularly worth noting in light of the argument recently advanced by my colleague, Prof. Ervin Miller, that the strain on the dollar may be attributable in significant measure to ill considered derogation of the dollar by Government officials and other influential persons (New York Times, Sept. 15, 1963).

(c) The mood of optimism could give way to elements of disillusionment and fear. Among the influences tending in that direction may be mentioned:

i. Antiforeign sentiment and criticism of foreign ownership (as in France, and elsewhere).

ii. Political change and possible leftist moves (as in Ceylon and elsewhere).

iii. Deterioration of tax, exchange, and currency conditions (as in Canada, France, and elsewhere).

(d) The relative attractiveness of investing in the United States as compared with foreign countries may increase.

A complete reversal in the present relative position of the dollar is not to be ruled out in terms of either logic or historical precedent. But even a gradual narrowing of the existing gap could produce responses in this country and abroad that would leave present judgments as to the weakness of the dollar looking pretty silly. The study might have gone considerably farther than it did in keeping these larger and longer perspectives to the fore.

ASSUMPTIONS

The explicit assumptions of the study as summarized on pages 213-214 and indicated elsewhere are as reasonable as any that could be offered. Moreover, they provide a necessary foundation for the conclusions presented. How much conviction they carry to the individual reader is likely, however, to depend more on the individual's particular orientation, including his biases and hunches, than on compelling logical or empirical evidence. With this disclaimer, one personal judgment is that:

(a) The assumption of a rise of 4.8 percent per annum in U.S. gross national product may prove somewhat high.

(b) The price rise of $1\frac{1}{2}$ percent per annum as measured by the gross national product deflator may also be on the high side.

(c) The estimate of an increase of more than 100 percent in the AID program appears generous.

(d) Some deviation from the price rise suggested for Western Europe and therefore some departure from existing exchange rates seem not unlikely.

Greater reservations attach to what seem to be certain implicit assumptions running through the study. It is a rather delicate task to attempt to name these assumptions. They are nowhere categorically affirmed and some of them are specifically disavowed. Nevertheless, the list will indicate the character of overall impressions left with at least one reader.

(a) The dollar is weak in some genuine and presumably lasting sense. This point was touched upon above.

(b) Liquidity requirements are functionally related to the volume of international transactions (pp. 234, 243, 8, and *passim*). This view accords with prevailing lay and even professional opinion. Space does not permit an adequate examination of the position. It flies in the face, however, of a number of pieces of evidence: England maintained liquidity for herself and served as banker for much of the rest of the world prior to World War I with monetary reserves which presently appear ridiculously small; international

liquidity crises have occurred in periods of contracting rather than expanding world trade, e.g., the thirties; even the period of increasing trade and production combined with extension of the gold standard in the latter part of the 19th century can hardly be said to have created an international liquidity problem in the sense under discussion now.

Liquidity requirements are dependent on methods of conducting trade and finance and on domestic as well as international monetary provisions, not to mention states of mind. The assumption of parallelism between trade and the need for liquid assets implies the supporting assumption that those elements will remain as they are at present.

It is further to be observed that the hardening of various currencies referred to above (p. 4) would seem to have added significantly to the world's supply of liquid monetary resources. Agreements begun in 1961 between the Federal Reserve and foreign central banks for the borrowing of foreign currencies, the so-called "swap arrangements," constitute a device for utilizing other currencies to supplement existing liquidity reserves. The fact that they are employed on a temporary or contingency basis does not alter or obscure the fact that these currencies are now part of liquid monetary reserves. The agreements may well be regarded as the possible forerunner of a more general use of such currencies for reserve purposes, a development which could lead the way to a lasting solution of the problem of inadequacy of international monetary reserves.

(c) Certain specified items are "basic" in terms of the balance-of-payments problem, including pressure on the dollar (pp. 5, 9, et seq.). It is clearly desirable to try to sort out influences that are more strategic from those that are less. But we must not conclude that what is "nonbasic" ("transitory"?, p. 5) can then be pushed aside. It could be argued that the nonbasic items are the most important in that they create the acute pressures which are the essence of liquidity problems. The study falls short in failing to examine this aspect of the problem adequately.

There is a tendency to evaluate long-term investment in terms of normality and to regard short-term capital movements as residual, possibly even as equilibrating and cushioning. This may be a carry-over from old gold standard reasoning which, far from providing guidance, is likely to mislead; short-term movements frequently possess disequilibrating, self-inflammatory characteristics. Moreover, the inclusion of long-term capital movements in the basic balance gives insufficient consideration to certain "nonbasic" attributes, especially their susceptibility to psychological and transient influences. Long-term investment abroad is dominated much more than in the past by direct investment (cf. p. 23). The attitudes and behavior of American industrialists, especially in companies with foreign subsidiaries having substantial cash flows, are quite different from those which have customarily governed portfolio investing abroad. And they are by no means immune to transitory influences.

(d) With respect to foreign trade:

- i. Advances in real income and export capability abroad are likely to be unfavorable to the United States (pp. 58, 91).
- ii. Productivity developments in the future will be less favorable than in the recent past to export industries (p. 83).

iii. The effectiveness of tying clauses is to be regarded as reasonably certain.

iv. Considerable reliance is to be placed on bilateral relationships with relatively little consideration to either multilateral consequences or the possible effects of extension of credit and foreign aid on existing trade patterns.

The tentative nature of some of these assumptions and the possibility of offsets is acknowledged. Nevertheless the impressions noted here seem to be conveyed, and likewise seem open to considerable question.

(e) Balance-of-payments considerations "have played an important role in failure to achieve the * * * objective of maximum production and employment" (p. 244). "Preoccupation with balances of payments probably will override considerations that are fundamentally more important" (p. 243).

This contention has frequently been advanced. No one would deny its application in the case of the famous but relatively inconsequential "operation twist." It is by no means certain, however, that policies would have been substantially less restrictive in the absence of the balance-of-payments problem. The Board of Governors' understandable and overriding aversion to inflation is sufficient to account for the line of policy that has been followed. Balance-of-payments conditions have provided a convenient excuse for doing what might have been done anyway as a defense against inflation.

(f) Existing and perceived tendencies may be expected to continue (pp. 209, 148-149, and *passim*). The authors tend to emphasize prices, income, and profits and to neglect expectations as influenced by political, institutional, developmental, and monetary factors. Changes in expectations and attitudes are introduced to account for the shift in relative attractiveness of investing in Europe compared with the United States after World War II without adequate consideration of the possibility of the opposite sort of shift playing an important role in the coming years.

One of the negative influences with respect to the relative inducement to invest in the United States has been the growth of overcapacity. The possibility is dismissed too lightly that a similar problem might develop abroad—and the quicker, the more correct are contemporary opinions as to the productive genius of the Germans, the Japanese, and others. Apart from the direct effects this could have on the inducement to invest abroad, there are the possible indirect effects which overcapacity could produce in the form of layoffs, labor unrest, political uncertainty, and monetary insecurity. If these contingencies are at all credible, the continuity assumption loses much of its plausibility.

METHODS

The findings of the study are based primarily upon projections. The grounds for questioning reliance on this method of analysis are sufficiently indicated in the two previous sections. Moreover, they are clearly pointed out in the study itself: the authors repeatedly call attention to uncertainties attaching to the analysis. Nevertheless, conclusions are derived and estimates presented in precise, quantitative terms, confronting the reader with an impression of exactness

and accuracy which the previous warnings fail to controvert.⁴

It is a little as though by acknowledging uncertainties the authors consider that they are excused from being thought to have overlooked them; and can then proceed to do so. If the reader is expected to assume that the uncertainties cancel out, or that, being uncertain, they should be given a weight of zero, these intended expectations are not specified. And in any case such expectations would have to be regarded as highly suspect.

Percentages and ratios included in the calculations seem at times to be somewhat summarily chosen (pp. 180, 182). Frequently, as has been said, serious uncertainties exist and are noted. At other times one has the feeling that a small shift in one of the major items, such as might reasonably be expected to occur, could greatly outweigh other items which are calculated to so fine a point (pp. 148-149, 135-138).

It would be captious to find fault with the use of quantitative data. Nor is there any desire to criticize the use of refined methods of statistical analysis. But the effect of the methods used is to give the appearance of a degree of substance and precision which is spurious. Fuller reiteration of the qualifications at a later point combined with a more generalized discussion of relevant influences would have been desirable.⁵

IMPLICATIONS

A number of apparent implications of the study have been noted in the preceding sections. Others will be noted in the section which follows. Accordingly, they will not be taken up separately here.

FINDINGS

Some of the points which might legitimately have been discussed under the heading of "Findings" have already been touched upon, e.g., the alleged influence of balance-of-payments considerations on internal policies for employment and growth and the likelihood of the projections for 1968 being realized. By the same token, certain of the points mentioned here might perhaps have been treated elsewhere, e.g., the conclusion ("assumption"?) that any sort of exchange control should be avoided and that the 25-percent gold requirement should be abandoned ("proposal"?).

No specific grouping of "findings" as such is given in the report. The following list of what can be construed as findings has been selected partly in order to provide a basis for certain concluding observations with respect to the fundamental problem before the committee, that of the international position of the dollar.

1. The balance-of-payments position of the United States should improve substantially in the coming half decade. Agreed.

2. The competitive position of the United States can also be expected to improve. Agreed, though the analysis seems to run too much in terms of narrow price considerations.

⁴ Cf. pp. 85-87, 104, and passim.

⁵ A certain ambiguity, not altogether of the authors' making, attaches to the distinction between "projections" and "forecasts." Presumably forecasts should always be interpreted in the light of explicit or implicit assumptions; and that seems to be all that is involved in sticking to the word "projections." That the basic assumptions used in the study were laid down by others is understood; but if the authors in insisting that they are not forecasting mean to suggest that they disagree with the assumptions substantially, this fact and its implications could be more clearly indicated.

3. The present problem is not primarily one of the basic balance of payments, and no position of the latter would solve the former (pp. 242-243). Agreed that the basic balance of payments as defined is not decisive; disagreed, with the apparent suggestion that the international liquidity problem and the position of the dollar are intractable and endemic.

4. Devaluation of the dollar is undesirable (p. 254). Agreed.

5. Balance-of-payments considerations should not be allowed to dictate policies which are undesirable on grounds of major domestic or longrun international considerations (p. 253). Agreed.

6. International monetary reserves are likely to be inadequate (pp. 234, 238, and passim). Disagreed.

7. Any type of exchange restriction should be avoided (p. 250 and passim). Disagreed. The question of degrees of policy should be examined. Moreover, consideration should be given to such devices as the interest equalization tax and capital issues committees of the type well known abroad. A categorical repudiation of all possible means of resisting flights of capital or disruptive and self-inflamatory shifts of short-term funds, if this is what is meant, is by no means to be conceded out of hand.

8. The requirement that gold reserves of 25 percent must be held against note and deposit liabilities of the Federal Reserve is irrational. Most fervently agreed. By requiring that the gold be held idle we deprive ourselves of the use for settling international balances of between three-fourths and four-fifths of our gold stock, a situation similar, to use the familiar analogy, to requiring that three-quarters of a city's firefighting equipment always be kept sitting in the firehouses. Removing the requirement would add 40 percent to the free world's available stock of monetary gold—or a considerably higher percentage if we allow for the fact that a substantial proportion of gold reserves are, in effect, similarly immobilized by other countries.

Besides relieving the liquidity problem for both the United States and the world, removal of the 25-percent reserve requirement would help in another respect. The freeing of so large an amount of gold should tend to correct the obsessive but delusive notion that, in some fundamental, longrun sense, gold is "better" than the dollar. The hollowness of that misconception was fairly well recognized in the thirties and forties when it was often said that gold was tied to the dollar rather than the dollar to gold. It is self-evident that the value, i.e., the purchasing power, of gold has declined just as much as that of the dollar in recent years. And at times during the past few decades it would surely have fallen a great deal more but for the support afforded gold by its link to the dollar.

By immobilizing approximately \$12 billion our legal requirement contributes to a world scarcity of the metal. The result is to sustain the fiction that gold is superior to the dollar as an international monetary asset. And this fiction, which is largely of our own contriving, is at the root of the continuing difficulties of the dollar. As matters now stand, those difficulties, as the study strongly argues, may continue even after the balance of payments is brought into adjustment. The idea that the maintenance of that tremendous hoard of idle gold serves some important purpose is tribal fetishism and nothing more.

Far from weakening confidence in the dollar, as some critics have suggested, removal of the requirement should have the opposite effect,

by multiplying so greatly the effective gold reserves of the country. It would tend to overcome the fear that our available reserves may be exhausted or restrictive actions induced in anticipation of such exhaustion. It is erroneous to identify removal of the 25-percent gold certificate requirement with abandonment of gold as our monetary standard. Instead of weakening the tie with gold, freedom of access to reserves now immobilized would remove any doubt as to our present ability to maintain it. There is strong historical evidence for believing that confidence in the dollar would be strengthened.

The committee's primary interest was declared to be "to assess the likelihood that the study's projections will be realized." The committee is fully aware that no projection of this sort can be anything more than an informed guess. This is because of the unavoidable uncertainty of a great proportion of the strategic variables upon which the future outcome will depend. At the same time, the study seems defective in failing to give sufficient attention to psychological influences. While these are acknowledged they are not well integrated into either the sectional or the aggregate findings.

The manner in which the projections are arrived at and the precise quantitative form in which they are presented cannot obscure their uncertain character. Anything that could be put in their place would, of course, suffer from the same limitations. In asking for comments on the likelihood of the projections being realized, therefore, the committee is asking how the responders' guesses compare with those of the Brookings staff. That this responder's guesses differ at a number of places has been made sufficiently clear. The differences may be regarded as reflecting personal judgments as to the probable bearing of intangible influences such as are noted above.

In short, the detailed projections of the study are not likely to be realized at all closely. The reason is not that there are serious flaws in the data or in the manner in which the data are analyzed. It is, rather, that relevant influences cannot, realistically, be formalized in this way. On the other hand, the "projection" of a probable improvement in the balance-of-payments position of the United States is sufficiently reasonable so that the only serious question seems to be one of the exact timing of the improvement, about which no one can speak with great assurance. A more fundamental observation is that the dollar is not now and is not likely to become a genuinely weak currency, as that term is customarily understood.

In a longer perspective, the drain of gold from the United States is best regarded as a correction of the disbalance in distribution of the world's stock of gold that resulted from the avalanche of gold which descended upon the United States shortly before and in the first year of World War II. It was that earlier situation, not the present, that represented the true disequilibrium. It could be argued that we still have some distance to go before our share of gold should be considered disproportionately small. The ability of foreign countries to attract gold in these past few years is a measure of the success which has attended efforts to restore strength and vigor to oversea economies.

STATEMENT BY JOHN WILLIAMSON

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Economic forecasting is, as everyone is well aware, a hazardous occupation, both to those who are brave enough to undertake it and to those who make use of its results. If it is to assist rather than mislead those responsible for policy formulation, a projection should enable the reader to form some estimate of the range of probable outcomes. Ideally, this would embrace four steps: indicating the range of reasonable assumptions, and showing the way in which the outcome responds to variations in these assumptions; and, similarly, indicating the range of error in estimates of the relationships (e.g., the equations) involved, and assessing the sensitivity of the outcome to this type of error. The econometric relationships that were used in the Brookings study¹ will not be examined in this paper with the critical attention they deserve. We shall, however, attempt to contribute to the first two steps enumerated above, by evaluating the plausibility of some of the assumptions, illuminating which assumptions are particularly critical, and giving some indication of the way in which the basic balance might respond to a change in the growth rate. The only way in which the study concedes the need for an investigation into this issue of sensitivity is by including an "alternative projection," in which three independent variables are altered simultaneously,² but this fails to illuminate which are the critical assumptions. Indeed, some of the changes in the independent variables partially offset one another and so lead to rather similar results in both cases, thus tending to lend a misleading aura of certainty to the conclusions.

THE ASSUMPTIONS

A basic assumption of the study is that no countries other than the United States or the European members of OECD are likely to run a sustained basic surplus or deficit for some years in the future.³ It follows that any increment in the foreign exchange earnings of the "rest of the world"⁴ will be spent, finally coming to rest in the reserves of the OECD countries (excluding Canada). In support of this assumption, it is noted that neither the underdeveloped countries as a group, nor Japan, have in fact run substantial and prolonged imbalances over the postwar period. It is suggested that this is likely to continue: on the one hand, these countries cannot run a substantial deficit for lack of the necessary

¹ "The U.S. Balance of Payments in 1968." materials presented by the Brookings Institution to the Joint Economic Committee, 88th Cong., 1st sess. (1963). This is referred to subsequently as the Brookings study, or simply the study.

² *Ibid.*, p. 40.

³ *Ibid.*, pp. 23-28.

⁴ We shall follow the study in using this term to refer to Canada plus all the non-Communist nonmembers of OECD, and in using the term "Western Europe" to mean the European members of OECD.

reserves, while, on the other, their demand for goods and services is too urgent to permit them the luxury of accumulating significant hoards of foreign exchange.

Although the rest of the world has not, in aggregate, run a sustained payments imbalance in recent years, a breakdown of this grouping suggests that it would be dangerous to rely on this remaining true. The only theoretical reason for expecting approximate balance in the future relies on the urgency of the demand for goods for development purposes. But the identification of the rest of the world with the underdeveloped countries is too much of a simplification. In fact, a breakdown of the rest of the world into "poor" and "rich" countries shows that the near constancy of the total reserves of this group has been the result of two offsetting trends. On the one hand, the total reserves of 22 countries with per capita income below \$300 in 1957 fell from \$6.3 to \$3.7 billion between 1951 and 1961. In contrast, the total reserves of 18 "rich" countries increased over the same period from \$9.2 to \$12.7 billion.⁵ Thus, although the total reserves of (most of) the rest of the world rose only from \$15.5 to \$16.3 billion, this apparent constancy conceals significant divergences between different types of countries.

Because the large preindependence reserve balances of India, Egypt, Pakistan, Indonesia, and the Philippines have been run down to low levels, it seems that the poor countries now have little more than minimum working balances left and will therefore have to eliminate their deficits. This implies that, unless the richer countries cease their net accumulation of reserves, the rest of the world as a whole is likely to absorb reserves in coming years. There are several factors which could prevent this result—a number of countries with significant reserves have acquired independence only recently and may proceed to spend these; the desire for development may increase in intensity and so lead richer countries to give a smaller priority to reserve accumulation; or some of the richer countries may feel that their reserves are now adequate and so cease their accumulation. Despite these possibilities, it seems more probable that the rest of the world will absorb than that it will disgorge reserves in the near future. The assumption of "no change" is an immensely useful approximation, but it is probably biased in an optimistic direction.

A group of assumptions which were heavily criticized during the hearings⁶ concern the rates at which wages and prices will increase over the next 5 years. The study displays a rather curious difference in the way these figures are arrived at for the United States as opposed to Europe. In the American case, a rate of price rise is assumed and an implied rate of wage increase is calculated from

⁵ Countries were classified as "rich" or "poor" on the basis of estimates of per capita income contained in Douglas Dosser and Alan T. Peacock, "International Distribution of Income with 'Maximum' Aid," forthcoming in the Review of Economics and Statistics. Any dividing line between rich and poor countries that lay between \$200 and \$500 would have yielded a similar conclusion. The 18 "rich" countries were Argentina, Australia, Brazil, Canada, Chile, Cuba, Finland, Ireland, Israel, Japan, Lebanon, Malaya, Mexico, New Zealand, Panama, Spain, Switzerland and Venezuela. The 22 "poor" countries were Bolivia, Burma, Ceylon, Colombia, Dominican Republic, Ecuador, Egypt, Ghana, Guatemala, Honduras, India, Indonesia, Iran, Iraq, Jordan, South Korea, Pakistan, Peru, Philippines, Rhodesia, Syria, and Thailand. Figures of monetary reserves were obtained from International Financial Statistics, IMF, January 1962, p. 22.

⁶ "The U.S. Balance of Payments," hearings before the Joint Economic Committee, 88th Cong., 1st sess. (1963).

this; while, for Europe, a rate of wage increase is assumed and the implied price rise is derived from this.⁷ Obviously this is immaterial if it reflects only the manner in which the figures are presented in the study and not the way in which they were derived. If the latter is involved, however, then a serious issue is at stake. We are very far from having an adequate econometric explanation of the inflationary process at the present time, but the principal body of work that has been done in this area relates the rate of wage increase to the level and rate of change of unemployment.⁸ It therefore seems preferable to assume a rate of wage increase in the light of expected unemployment conditions and, from this, to calculate the implied rate of price increase—the procedure that the study adopts for Europe.

Despite this, it happens that the rate of wage increase assumed by the study for the United States is much closer to that suggested by this type of empirical work than are the assumptions made for Europe. The annual price rise of 1.5 percent assumed for the United States implies an annual wage increase of 4.4 percent, which is approximately the rate indicated by a recent estimate⁹ of the "Phillips curve" and the study's assumptions about unemployment levels. In contrast, the assumption of a 6-percent annual wage rise in Britain presupposes, according to Lipsey's estimates, that unemployment there will average little over 1 percent over the next 5 years:¹⁰ this figure seems improbably low. It is true that we are not dealing with a particularly stable relationship, so that it would be possible for future wage increases to reach the study's guess even if unemployment were rather higher. Indeed, four of the five figures for the most recent years (which are quoted in the study¹¹ and form the basis of its estimate of future wage increases), lie above the historical curve plotted by Phillips and Lipsey.¹² Perhaps this indicates a recent upward displacement of the curve which will validate the study's assumption; but it seems at least as likely that the current campaign for income restraint will lead to a series of observations below the historical curve in the immediate future. Again, one is obliged to conclude that, while the study's estimate is not unreasonable, if bias does exist it is almost certainly in a direction that leads one to an oversanguine view of the prospects for the U.S. basic balance.

The wage rise assumed in the principal continental countries is 8.7 percent per annum. The only justification given for this figure is that it is in line with the experience in the past 2 years—years of abnormally low unemployment. So far as the author is aware, "Phillips curves" have not been plotted for any of the continental countries: it is not, therefore, possible to gain any accurate idea of the extent of unemployment implied by the figure of 8.7 percent. Nonetheless, it is clear that such rapid wage increases do presuppose continuing inflationary pressure and exceptionally low unemploy-

⁷ Brookings study, p. 40 v. p. 47.

⁸ See, for example, A. W. Phillips, "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957," *Economica*, November 1958; R. G. Lipsey, "———: A Further Analysis," *Economica*, February 1960; W. G. Bowen and R. A. Berry, "Unemployment Conditions and Movements of the Money Wage Level," *Review of Economics and Statistics*, May 1963.

⁹ *Ibid.*, p. 172.

¹⁰ Lipsey, *op. cit.*, p. 4.

¹¹ Brookings study, p. 46.

¹² Lipsey, *loc. cit.*

ment in France and Germany—circumstances which seemed more likely to be realized a few months ago, when the study was written, than at the present time (October 1963). It is almost inconceivable that wages will rise much more rapidly than this, but it is not at all improbable that they will rise considerably less.

This conclusion is disputed by the study on grounds that are conceptually mistaken.¹³ It is stated that a 3-percent annual price rise is “* * * the most conservative * * * assumption * * * not seriously inconsistent with the growth targets of Western Europe.”¹⁴ It is a minimum figure which may be exceeded if “price inflation” develops, as the study expects to occur on the basis of some extraordinarily tenuous estimates.¹⁵ However, the annual wage rise of 8.7 percent (which leads to the prediction of a 3-percent price rise) is a figure which can only be expected to occur if excess demand for labor leads to very low levels of unemployment. Since the pressure of excess aggregate demand leads to the low unemployment which is the basis for predicting a rapid wage rise, it follows that “price inflation” is already taken account of for computational purposes by the cost increase.¹⁶

Several other instances in which the study selects the least conservative reasonable assumption may be mentioned. For example, it is assumed that the fall in the prices of primary products has now ceased and that a period of approximate stability has started.¹⁷ This may well be, but the one thing that no one expects is any general and sustained upward movement. Again, there is the assertion that the competitive position of the United States has improved over the past 3 years, which is true only if the wholesale price index really is a better measure of competitiveness than the export index.¹⁸ At another point, it is tacitly taken for granted that Western Europe would permit an increase in its balance-of-trade deficit with the United States from \$3 billion in 1961 to \$4.6 billion in 1968.¹⁹ Bearing in mind the great difficulty of reversing well-established trade flows, it is at least possible that Europe would be reluctant to let this happen; for there always remains a chance that future political developments will lead to a curtailment of U.S. defense expenditure in Europe.

Although Mr. Lary, in his testimony during the hearings,²⁰ cited two instances in which the study's assumptions appeared to err on the side of pessimism, the general impression one gains is overwhelmingly in the other direction. While the assumptions made are not implausible, they are fairly consistently the most optimistic of the range of reasonable assumptions.

SENSITIVITY OF THE RESULTS

Table I portrays the sources of projected changes in the basic balance between 1961 and 1968 under five different sets of assump-

¹³ The argument was repeated during the hearings, on pp. 240 and 263.

¹⁴ Brookings study, p. 50.

¹⁵ *Ibid.*, p. 53.

¹⁶ The distinction between demand and cost inflation rests on the position of the Phillips curve, rather than on whether or not observed points lie on this curve (as the study implicitly assumes).

¹⁷ *Ibid.*, p. 59.

¹⁸ *Ibid.*, p. 78.

¹⁹ *Ibid.*, pp. 80-83.

²⁰ Hearings, p. 302.

tions. The figures shown are the "balance-of-payments cost" of various factors. For example, the item labeled "U.S. aid" shows the additional cost to the basic balance involved in the anticipated expansion of the foreign aid program; it is the projected increase in foreign aid minus the increase in exports that this additional aid would induce. Similar adjustments were made by netting out induced exports (or reductions in exports) whenever appropriate.

The first two cases are based on the initial and alternative assumptions that are used in the study. The final three columns present a crude estimate of the type of impact that a slower U.S. growth rate might have on the basic balance. Achievement of the administration's rather ambitious growth target is another of the dubious assumptions made by the study, and, in view of the lively controversy on the subject during the hearings,²¹ I thought it would be of interest to investigate what could be expected to occur if growth fell short of this aim. Since it would make a great deal of difference whether the slower growth was caused by a slower rate of increase in employment, a slower rise in productivity, or some combination of the two, three different projections are shown.

Despite the rather crude way in which many of its entries have been calculated, table I illustrates a number of important points.

1. Its layout follows the principles developed in the second part of table VIII-2 of the study. It is regrettable that this approach was not pushed a little further, since such a table provides a convenient summary of the causes of projected changes in the basic balance. In particular, it permits one to identify readily the relative importance of the different factors discussed in the study—something which is not achieved by any table in the study itself.

2. There is a disturbing difference between the results reported in the study and those yielded by the methods used to construct this table. (Compare the study's improvement of 2.8 in case A and 0.2 in case B with the table's figures of 4.9 and 2.3 respectively.) The only difference in the method employed is substitution of the equations in the appendix to chapter III in place of the elasticity estimates as a means of calculating the effects of changes in relative prices. Since both of these sources were utilized in the study, this provides a rather impressive example of the danger of attaching too much significance to the quantitative results of this type of analysis.²² On the other hand, the improvement of case A over case B is 2.1 in both cases, so that it is reasonable to hope that a comparison of the last three columns with case A will yield the desired measure of the impact of a change in the growth rate on the basic balance.

3. The table indicates the total magnitude of all the "independent" forces that are expected to operate on the balance. Some of these forces are, admittedly, not wholly independent of one another, but they have been listed separately whenever there seems reason to suppose that policy measures might be able to influence one item without affecting the other. For example, the gain in real income is related to the rate of inflation. The second and fourth rows are

²¹ *Ibid.*, p. 249.

²² However, it may be of some comfort to note that the figures yielded by this alternative procedure suggest a substantially greater improvement in the basic balance than do those presented in the study.

TABLE I.—Sources of projected changes in the basic balance, 1961–68

[In billions of dollars]

Item		Case				
		A ¹	B ²	C ³	D ⁴	E ⁵
Identification	Source of change					
5 ⁶	European real income.....	4.5	4.0	4.5	4.5	4.5
25 ⁶ , 28 ⁶ , 29 ⁶ , 30 ⁶ - 5 ⁶	U.S. real income.....	-5.3	-5.0	-4.2	-4.2	-4.2
6, +7 ⁶	Effect of change in relative prices on exports.....	5.6	2.9	5.6	3.9	9.0
25 ⁶ , -7 ⁶	Effect of change in relative prices on imports.....	-1.2	-1.0	-1.2	-1.5	1.2
10.....	EEC discrimination.....	-6	-6	-6	-6	-6
18, -14.....	Military exports.....	.5	.5	.5	.5	.5
27, -13.....	Military expenditures.....	.4	.5	.4	.4	.4
28 ⁶ , 29 ⁶ , 30 ⁶	Miscellaneous.....	-4	-4	-4	-4	-4
36, 37, -11 ⁶	Long-term private capital ⁷.....	.5	.5	7 ⁶ - 5	7 ⁶ - 5	7 ⁶ - 5
16, -11 ⁶	U.S. investment income.....	1.5	1.5	1.8	1.8	1.8
26.....	Foreign investment income.....	-5	-5	-3	-3	-3
40, 41, 42, -8.....	U.S. aid.....	-4	-4	-4	-4	-4
9.....	European aid.....	.1	.1	.1	.1	.1
44, -12.....	Government repayments.....	.2	.2	.2	.2	.2
Totals:						
Items making for improvement in balance.....		13.3	10.2	13.1	11.4	17.7
Items making for deterioration in balance.....		8.4	7.9	7.6	8.1	6.4
Change in basic balance.....		4.9	2.3	5.5	3.3	11.3

¹ Initial assumptions of the study.² Alternative assumptions of the study.³ Growth rate of 3.8 percent (rather than the study's 4.8 percent) in the United States, consisting of a 2.2-percent annual productivity gain and a 1.6-percent annual increase in employment (i.e., constant unemployment); other assumptions are the same as the study's initial assumptions.⁴ The same as C, except that the 3.8 consists of 1.9 productivity rise and 1.9 employment increase (i.e., the slower growth is caused by smaller productivity gains than anticipated).⁵ The same as C, except that the 3.8 consists of 2.9 productivity rise and 0.9 employment increase (i.e., the slower growth is caused by a failure to absorb labor as fast as anticipated).⁶ Partial inclusion of that item.⁷ This item represents a guess rather than a calculation.

SOURCES

Each row corresponds to 1 or more rows of appendix table 10, as identified by the reference numbers in the 1st column. Figures were derived principally from that table and the appendix to ch. III.

¹In calculating cols. C to E, a rate of wage rise was computed from one of the Bowen-Berry equations and the assumed state of the labor market. The rate of increase of GNP prices was calculated from this and the assumed rate of productivity increase. In line with the study, it was assumed that export prices rose 1 percent per annum less than GNP prices. This provided the data from which to estimate 1968 flows of goods and services from the equations in the appendix to ch. III. Feedback ratios were derived from the appendix to ch. VI.

It will be observed that, for cases A and B, the results presented in the table differ from the conclusions reached in the study. This arose because the study used an elasticity figure to estimate price effects on merchandise trade, rather than the equations of the appendix to ch. III. There may also have been a few differences in the assumptions used, since it was difficult to locate all of these in the study.

Although it is impossible to explain exhaustively the derivation of these figures, an example may prove helpful. The second row is labeled 25⁶, 28⁶, 29⁶, 30⁶ - 5⁶, which means that it contains part of the items shown in lines 25, 28, 29, and 30 of app. table 10, with a part of the item shown in line 5 subtracted. The entry in this row for case C is -4.2, meaning that, under the assumptions of case C, the projected growth of U.S. real income will lead to a rise in imports with a balance-of-payments cost of \$4.2 billion. This figure was calculated as follows: Merchandise imports from Western Europe were calculated by equation (1), p. 267, as they would have been if prices had remained constant between 1961 and 1968. The increase was found to be 2.1. Similarly, the rise in U.S. real income would cause additional imports of 3.2 from the rest of the world over the (predicted) 1961 level. Using the appendix to ch. VI, one can deduce that these imports would induce additional exports of approximately 53 percent of their own size. The balance-of-payments cost of imports from the rest of the world is therefore only 1.5. In addition to merchandise imports, the equations on p. 267 permit one to relate transportation and tourist expenditures to income expansion; this contributes another 0.6 to the balance-of-payments cost. The total of 4.2 shown in the table is the sum of 2.1 (imports from Europe), 1.5 (imports from the rest of the world), and 0.6 (services).

disaggregated, however, because it may be possible to devise a policy instrument (such as wage restraint) which would permit a given growth rate to be achieved at the cost of less inflation. The table assists in estimating the balance-of-payments benefits of any success such a policy might have.

4. The table is of assistance in identifying which are the critical elements in determining the outcome of the balance. Most of the items listed are comparatively small in magnitude and stable as between one case and another. These properties suggest that the factors involved are unlikely to lead to major unforeseen developments.

The major items are the effects of changes in real income, in relative prices, and flows of long-term private capital. Although changes in real income are certain to lead to quite large increases in trade flows, these items are fairly stable. They are likely to lead to a deterioration in the basic balance rather less than \$1 billion. The situation is quite different as regards the impact of changes in relative prices. Here the results vary dramatically between one case and another, varying from an improvement of \$10.2 billion in case E—where it was assumed that rising productivity and unemployment resulted in falling American prices—to a low of \$1.9 billion in case B. Whether the trade balance shows the projected improvement depends largely on whether the study's forecast in this area is fulfilled. When discussing the assumptions, we found reason to question whether European prices will in fact rise as fast as the study assumed. The table suggests that whether they do or not will be a critical factor in determining whether solution of the balance-of-payments problem will be relatively painless.

The other important item is the flow of long-term private capital. The past volatility of this item, together with the failure to derive convincing explanations of its size, lead one to mistrust the precision of the study's estimates, which are based on post-hoc qualitative explanation of the expanded outflow of the late 1950's. A hypothesis that was advanced recently²³ implies that internal expansion would also solve the external dollar problem, by virtue of the fact that long-term capital flows are so strongly responsive to comparative growth rates that changes in the capital account consistently over-compensate swings in the trade balance. If this hypothesis were valid, the turnaround in the private capital account shown in table I would be seriously underestimated. So long as we know no more than we do at the moment, entries for this item can be little more than guesses. Of all the topics covered in the study, the relationship between the level of internal activity and capital flows is the one which most requires further investigation.

5. A comparison of column A with columns C, D, and E permits one to gain some idea of the impact that growth has on the basic balance. One would expect a lower growth rate to influence the balance in four principal ways: First, the lower GNP results in smaller imports; as shown in the table, a 1-percent reduction in the growth rate would result in a balance-of-payments saving on this count of about \$1 billion after 7 years. Second, diminished imports from the rest of the world would result in a cutback of U.S. exports to that region. This effect is already allowed for in the figures given under the first (and, for that matter, the third) head, since all entries in the table show the net balance-of-payments cost of a particular event. Third, there is the complex relationship between growth and inflation. It is not the rate of growth in and of itself, but its two con-

²³ Jeffrey G. Williamson, "Dollar Scarcity and Surplus in Historical Perspective," *American Economic Review*, May 1963. Curiously enough, attention is drawn to this article in ch. I of the study, but it is ignored in ch. V.

stituent elements, the rate of employment increase and the rate of productivity increase, that are relevant in determining the behavior of prices. As may be observed by comparing columns C, D, and E, a faster rate of growth is good for the basic balance, insofar as it arises because of more rapid productivity gains, but harmful when it is caused by a more rapid increase in employment. If the rate of productivity gain were independent of the level of unemployment, it would be unequivocally true that the trade balance could be improved by increasing unemployment. This probably is true in the short run, but, over a longer period, it is certainly reasonable to suppose that investment in labor-saving machinery will be lower in the presence of excess capacity. Very broadly speaking, a reduction of 1 percent in unemployment may be expected to result in wages rising one-half of 1 percent per year faster than they otherwise would have done. In the long run, therefore, reduced unemployment will lower the rate of inflation (and benefit the basic balance on this count) only if each 1-percent decline in unemployment induces an increase in the rate at which productivity rises of more than a half percent per annum. I have no knowledge of any study directed to establishing the magnitude of this relationship, but I can see no reason on a priori ground for supposing that the link may not be this strong.

Finally, a faster growth rate presumably raises the profitability of domestic investment relative to foreign investment, thus leading to an improvement in the capital account. Since, as we have already pointed out, very little is known about the determinants of these flows, the change recorded in the table is no more than a guess. If it is of the right order of magnitude, and one is prepared to regard case C as what might typically occur if growth were slower, then it appears that in the short run faster growth would cost a modest deterioration in the basic balance. In the long run, it is not certain that it need result in any deterioration at all; but there are two critical unknown factors which prevent one reaching even a provisional conclusion in this case.

CONCLUSION

Whether the study's projection of the current account will be realized depends largely upon whether European prices rise over the next 5 years as much as it anticipates. Since we found reason to doubt whether this will occur, one must conclude that the projection is overoptimistic. So far as the capital account is concerned, there seems no reason to believe that the study's projection is biased in one direction rather than the other, but the accuracy of the projection is spurious. In consequence, the prospect for a recovery in the basic balance, as a whole, is much less certain than it is painted in the study.

The question this provokes is whether such an uncertain prospect demands further action to stem the deficit. My personal answer to this question is in the negative, but this is partly because I do not share the common view that the existing exchange-rate structure is sacrosanct. If further measures are to be taken, then I would judge that least harm is likely to follow from attempts (such as the interest equalization tax) to reduce the outflow of long-term capital. Ulti-

mately, however, one has to face the fact that, with fixed exchange rates, the only certain cure for an external deficit is deflation engendered by a restrictive monetary policy.²⁴ Since I personally judge the internal consequences of such a policy unacceptable, I would favor what one witness at the hearings colorfully described as a "do-nothing" policy.²⁵ After all, there are quite a few things which may turn up that could eliminate the deficit—significant inflation in Europe, revaluation by one or more European countries, political events which lead to a curtailment of military spending, a reduction in the capital outflow, or even sufficiently major crop failures in the Soviet Union. My own guess is still that the probability of one of these events turning up is quite high, while the chance of their converse occurring and so worsening the deficit is quite small. If none of these events do happen, then eventually one could undertake a modest devaluation of the dollar. There need be no great difficulty in financing the interim deficit if an exchange guarantee were introduced. Neither would the knowledge that the dollar might be devalued by 5 or 10 percent at some time in the next 10 years, provoke dangerous speculation. Only if the customary practice of overdevaluing were repeated would the speculators reap a profit and a danger of competitive devaluations ensue.

²⁴ If fiscal policy is contractionary, and monetary policy neutral, unfavorable effects on capital account may offset the gains to the current account; if a strongly expansionary fiscal policy is only partially offset by a tight monetary policy, deterioration in the current account may outweigh improvement in the capital account.

²⁵ Hearings, p. 278.

STATEMENT BY PAUL WONNACOTT

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In considering the balance of payments in 1968, Mr. Salant and his associates have been most careful to stress that their estimates should be interpreted as projections rather than as predictions. Specifically, they have proceeded on the basis of the assumptions laid out on pp. 39-50, 60-62, 213-214, and 225-227, including such postulates as a 1.5 percent per annum rise in the U.S. GNP price deflator, and a continuation of fixed exchange rates at their present levels. The care with which they have hedged their projections is admirable, particularly the manner in which they have stressed the "highly speculative" nature of their results, even if their postulates should prove to be accurate.

The committee's interest is in assessing "the likelihood that the study's projections will be realized"; in other words, the projection is to be assessed as a prediction. This task divides itself logically into two halves: First, given their assumptions, are their results probable, or are there plausible alternative projections which might have been reached? Second, are the assumptions themselves likely to turn out in 1968 to have been justified? This twofold division will be followed below, although it is clear that the limited scope of this paper prevents an even close approach to comprehensiveness. No attempt will be made to go deeply into the technical details of the Brookings projections; an effort will, rather, be made to consider the points at which the study might reasonably have taken a different turn, and to evaluate the significance of these possible alternatives for the policy conclusions of the Brookings study.

I. THE PLAUSIBILITY OF THE PROJECTIONS, GIVEN THE BASIC ASSUMPTIONS

If the basic Brookings assumptions (pp. 39-50, and 213-214) are taken as given, the question of the probable accuracy of the results depends on the stability of the econometric relationships between the United States and Western Europe which are used in the projections, and on the plausibility of the assumptions regarding Japan, the underdeveloped countries, and Canada. With respect to the econometric relationships, their use for intermediate range predictions may be questioned on the ground that they were originally intended for short-run cyclical analysis. Much more fundamental, however, is the question of whether the state of the arts has developed to the stage where the basic relationships in the economy can be determined with sufficient accuracy to give meaningful predictions. I have most serious doubts in this regard. Since the current account balance amounts to less than one-fifth of exports, and since exports amount to only 5 percent of GNP, little confidence should be placed on intermediate term predictions of even the current account until economists are able

to make intermediate term predictions of GNP which consistently fall within 1 percent of the actual figure. The probability of the Brookings projections turning out to be accurate is small. This is not to criticize the Brookings team, who stress the limitations of their work, but rather to emphasize the intrinsic difficulty of the task undertaken.

One of the most important things to note about the report is that the major liquidity problem foreseen is in part independent of the accuracy of the specific projections. The projections do, however, represent the sort of thing that could happen. It is, therefore, instructive to consider the type of factor which, in addition to changes in the econometric relationships, could result in the projections turning out to be inaccurate.

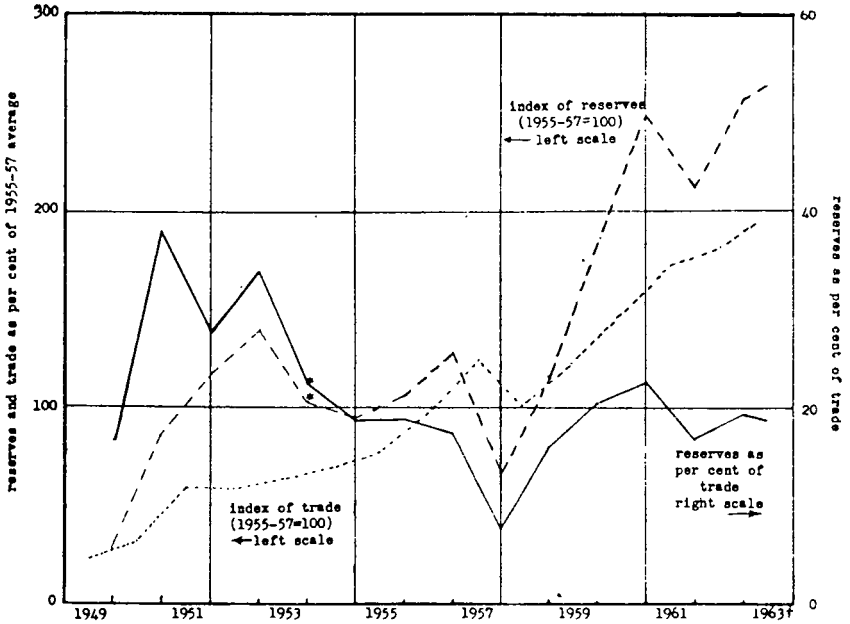
The Brookings investigators see their major problem as the determination of the combined net basic surplus of the Western European countries alone, which will be an approximate mirror image of the U.S. basic deficit (pp. 23-30 et passim). The line of reasoning by which Japan, the underdeveloped countries, and Canada are excluded from having significant basic balances is deserving of critical consideration.

It is clear from the behavior of the Japanese authorities over the past decade that balance-of-payments considerations have from time to time been the major motivating factor in restrictive policies. In other words, as noted in the Brookings report (p. 28), limits on growth have been set by the availability of foreign exchange. It does not necessarily follow, however, that "Japanese foreign expenditures, unlike those of the industrial countries of Western Europe, will approximately equal its foreign exchange receipts."

In order to explain Japanese exchange reserve policy in highly simplified terms, two alternate hypotheses might be considered. The first, which is that adopted in the Brookings report, holds that the Japanese believe some absolute level of foreign reserves to be the minimum, and that in consequence they tighten policy quickly when the reserves fall below this minimum, and loosen policy when reserves exceed this minimum. The alternative assumption, which is incidentally in line with the broader Brookings discussion in chapter IX of the need for international liquidity, is that the Japanese aim at keeping a reasonable minimum of reserves, but that the reasonable minimum is considered to increase at approximately the same rate as their foreign trade.

A consideration of the Japanese statistics for the past decade and a half does not give unambiguous support to either of these simple hypotheses. As can be seen from the chart on the following page, both the absolute level of reserves (the broken line) and the ratio of reserves to total trade (the solid line) varies considerably from year to year. Nevertheless, the ratio of reserves to total trade appears to be much more constant than the absolute level of reserves. Although the reserve ratio rose rapidly, and presumably abnormally, in the Korean war period, the ratio was relatively stable in the 9-year period after the Korean disturbance, with the sole major exception of 1957. On the other hand, the absolute level of reserves, while showing considerable instability from year to year, apparently followed a decided upward trend. In the light of this evidence, major reservations may be entertained regarding the Brookings argument that the basic Japanese imbalance will be small.

CHART 1.—Japanese reserves, 1949-63



*Series changes in 1953

†End of second quarter, 1963

Japanese reserves are those at end of period

Trade is the sum of exports and imports at current prices; 1963 figure represents first two quarters, seasonally unadjusted, at annual rates

Source: DIF, *International Financial Statistics*, September 1963, pp. 166-69; *ibid.*, March 1955, p.130

If the alternative simple assumption is made that Japanese reserves expand at the same rate as trade, Japan may be expected to absorb between \$530 million and \$2,330 million of reserves in the period from 1961 to 1968, even on the conservative assumptions that the upper limit of the rate of growth of Japanese trade is the rate which has actually occurred between 1953 and 1961, that is, 13.3 percent, and the lower limit is taken to be only 4 percent. If the larger of these figures turns out to be justified—and this is by no means impossible in the light of past trends—then the effects on the U.S. balance are likely to be significant. The 13.3-percent projection (from 1961) would have Japan acquiring reserves at the rate of \$470 million by 1968. It is not unreasonable to expect that \$200 of the \$470 million could come out of the projected improvement of the U.S. balance of payments; if so, the improvement foreseen by the Brookings study would have to be decreased from \$2.7 to \$2.5 billion. (Such Japanese behavior would completely wipe out the favorable movement of \$200 million foreseen by the Brookings team in their “alternative” projection.) On the other hand, if the Japanese rate of growth of foreign trade drops significantly, the effect on the United States might be expected to be in the range of \$50 to \$100 million per annum by 1968.

It should be noted that this consideration of the future of the Japanese balance of payments has accepted the major postulate of the Brookings study with regard to the Japanese, that is, that they have kept their reserves near the minimum, and that the reserves are likely to continue to be minimal in the future. Decreases below the

minimum will lead to restrictions while increases above the minimum will cause an easing of restrictions, and therefore to an increased rate of growth and increased imports. Dissent has, however, been made to the Brookings assumption that the Japanese minimum will remain an unchanged quantity of foreign exchange. It has rather been concluded that the amount considered to be minimal will grow along with Japanese foreign trade. It is important to consider why this should be so in order not only to shed more light on the possible Japanese future, but also to evaluate the plausibility of the Brookings assumptions regarding the underdeveloped world. Although this consideration is at odds with the specific Brookings assumptions regarding the unchanging minimum reserves required by Japan and the underdeveloped world, it is very much in the spirit of chapter VIII, which argues that the worldwide demand for international liquidity is likely to expand at least as rapidly as world trade.

In deciding on the appropriate amount of foreign exchange reserves, a country weighs the costs of holding reserves against the benefits to be derived. The costs are quite straightforward—in accumulating and holding reserves, the country forgoes spending its foreign exchange receipts, and therefore forgoes the imports which it might otherwise have acquired for the raising of the rate of investment or the level of domestic consumption of its people. The advantages of holding reserves are less easily defined, in part because they include such nebulous considerations as the power and prestige which are supposedly associated with those who have amassed large amounts of gold and foreign exchange. There are, however, economic advantages to be obtained by holding sizable foreign exchange reserves. Specifically, the major motive for holding foreign exchange reserves is to provide a cushion against unfavorable swings in the balance of payments until either the “swing of the pendulum” or the adjustment mechanism brings the accounts back into balance. The benefits of holding reserves, therefore, depend on four factors: the potential variability of the balance of payments, the expected availability of emergency financing, the strength of the general adjustment mechanism, and the willingness and ability to engage in direct interference with imports and capital flows in times of balance-of-payments difficulties. Since these factors have been dealt with in a generally admirable way on pages 234–240 of the Brookings study, they will not be considered in detail here. It might be noted in passing, however, that it is not clear why the study states (p. 237) that imbalances arising from differences in cyclical movements do not call for increased liquidity.

The growth of Japanese trade might reasonably lead to the belief that the absolute amplitude of swings in the balance of payments would increase; hence the trend toward larger reserve holdings is not at all inconsistent with the observed Japanese behavior in basing restrictive policies on the reserve position. Furthermore, large year-to-year deviations around a trend do not detract from the hypothesis that there exists a trend in desired reserves: reserves are held to be used when there is an adverse balance, and therefore they may be expected to drop from time to time as international conditions move against the country in question.

If this hypothesis regarding reserves is accepted, questions immediately arise regarding the behavior of the underdeveloped countries,

whose total absolute reserves have shown no noticeable trend in the past decade in spite of the growth in their trade. During the past decade, the underdeveloped countries have increasingly stressed development as a goal; this increases the importance of real capital, and thereby increases the evaluation of the costs of forgone opportunities involved in the holding of reserves. Hence, it is possible that the subjective costs of holding reserves have increased as rapidly as have the advantages, with the observed result that reserves have not grown. Although conclusions in this area must be highly speculative, it would seem reasonable to argue that, given the high priority presently accorded to the development objective in the underdeveloped world, a further increase in the priority of this goal would seem unlikely; the costs of holding reserves, while high, are unlikely to grow. Hence, it is altogether possible that, in spite of their economic difficulties, the underdeveloped countries will attempt to accumulate reserves during the coming decade—probably not very rapidly, but perhaps at the rate of 1 or 2 percent per annum. This would involve an absorption of reserves of between \$150 and \$300 million per annum, with a corresponding deficit for the United States in the neighborhood of \$75 to \$150 million.

Because of trends which may be faintly discerned in the underdeveloped countries, the desirability of holding reserves may rise much more rapidly in the future than in the past. There is reason to believe that more than a decade after a similar trend in Western Europe, the acceptance of doctrinaire socialism and government interference as a means of promoting growth in underdeveloped countries is slowly giving way to a greater dependence on the market mechanism. Hence, the direct control method of dealing with swings in the balance of payments may be looked on with increasing distaste. Insofar as this is seen as a possible outcome, the importance of providing adequate world liquidity will increase. This is not to argue, of course, that an increase in liquidity will necessarily lead to an abandonment of restrictions in the underdeveloped countries; such will be the case only if restrictions are considered highly undesirable per se. However, the increase in liquidity is a necessary condition; without both adequate liquidity and favorable trading conditions, these countries will be unable to dismantle controls irrespective of their distaste for such interference.

Canada, the third area which was excluded by the Brookings study from major significance in the "basic balance," is a somewhat different case from either Japan or the underdeveloped countries. Unlike Japan, Canada has had a relatively unchanged foreign exchange reserve position for the past decade, except for the recent period of exchange difficulties. Unlike the case of the underdeveloped countries, this stable reserve position has not been the result of the pressures for development restricting the freedom of policymakers. Rather, it has been the result of the use of a mechanism other than the running down of reserves to deal with changing forces affecting the balance of payments. Specifically, Canada has had a flexible exchange rate which allowed it to keep its reserves practically unchanged, and, indeed, obviated the basic need for reserves. However, now that Canada has abandoned the flexible rate, a simple extrapolation of the past level of unchanged reserves is no longer

valid. It is true that at the time of the recent rise of the discount rate, the Canadian authorities assured their counterparts in the United States that their objective was to prevent Canadian reserves from falling rather than actually to build them up. Nevertheless, it is doubtful that Canada will consider constant reserves adequate over anything but a short period if her trade continues to grow and if she remains on a fixed exchange rate. If Canada behaves in the manner foreseen as a general practice by the Brookings study, that is, if she attempts to accumulate reserves as rapidly as her trade expands, then by 1968 she may be expected to acquire reserves at the annual rate of \$140 to \$180 million. Because of the importance of the United States in trade, the major portion, say \$75 to \$100 million, of this increase in Canadian reserves will in all probability be reflected in the basic balance of the United States.

This, it should be noted, is a conservative estimate of the probable drain on the U.S. balance arising from Canada. In the last several years, great stress has been placed on the desirability of balancing the Canadian current account, rather than the overall accounts. While it seems improbable that a complete balancing of the current account will prove feasible in the coming decade, there has been a considerable movement in this direction in the past 2 years. Any sharp decreases in the Canadian current deficit from the \$1 billion per annum average of the past decade is likely to result in an equivalent, or nearly equivalent, decline in the U.S. favorable balance of trade. While it is true that such an adverse movement of the U.S. current account will in all probability be accompanied at least in part by a decline in U.S. capital exports to Canada, the potential conflict of goals in North America should be noted. Because of concern regarding her reserve position, the United States is anxious to balance her current plus long-term capital accounts; Canada, on the other hand, looks toward a balance on current account alone. If Americans continue to find investment in Canada attractive, at least one of the countries will probably find its objectives frustrated, and a rapid increase in Canadian reserves at the expense of the United States is a possible outcome.

If the results of departing from the position of the Brookings report on Japan, the underdeveloped countries, and Canada are summed, the unfavorable effects on the basic balance of the United States would lie between \$200 and \$500 million per annum by 1968. Although this effect is by no means trivial, it would not greatly alter the general nature of the Brookings projections for 1968, which would be cut down from a favorable basic balance of \$1.9 billion to the neighborhood of \$1.4 to \$1.7 billion.

On the other hand, the Brookings report points out that relatively minor changes in their basic assumptions would have very drastic effects on their results. Specifically, if U.S. GNP were to grow at 4.5 percent per annum rather than at 4.8 percent, and if total Western European growth over the period were to be only 29 percent rather than 33 percent, then the U.S. balance of payments would improve only \$0.2 billion from the 1961 deficit, leaving a basic deficit of \$0.6 billion. Therefore the basic assumptions, rather than the secondary assumptions about Japan and the underdeveloped countries, are of paramount importance in evaluating the probable accuracy of the Brookings projections.

II. PROBLEMS ASSOCIATED WITH THE BASIC ASSUMPTIONS

It is clear from the discrepancy between the results based on the Brookings initial assumptions and those based on their alternative assumptions that one of the key issues in the future of the U.S. balance of payments is the relative price trend in the United States as compared to that in Europe. As has been pointed out in the hearings held by the Joint Economic Committee in late July, it is very difficult to project the price trends in Europe because they depend to a considerable degree on policy decisions yet to be taken. The resolution with which the European countries will deal with the problem of inflation in the coming years cannot be known at this time, although the recent moves of the French imply that the Brookings report may underestimate this resolution. (Parenthetically, however, it should be noted that insofar as anti-inflationary policy includes not only the threat but also the implementation of lower tariffs, the adverse effects on the U.S. balance of payments may be partially offset.)

A second major difficulty which arises in the prediction of relative prices is the uncertainty regarding future exchange rates. Should domestic inflation in Europe proceed at a rapid rate, the possibilities of revaluation cannot be overlooked, and, if historical precedent is taken as a guide, these revaluations are likely to be overdone. Thus, an apparently favorable movement for the United States—that is, domestic inflation in the Western European countries—has potentially dangerous implications for our country.

The problem of the future course of relative international prices is further complicated by its partial dependence on the outcome of the current liquidity debate, of which the Brookings report itself is a major component. The possibilities of action by the European Community, and other countries, to protect their balance of payments by anti-inflationary policies, restrictions on imports, or currency revaluations will be greater if no action is taken to expand international liquidity than it would be if adequate liquidity were provided. Indeed, it may reasonably be argued that an increase in international liquidity is a prerequisite to a balancing of international accounts by the United States. Unless European and other countries refrain from action to protect their payments as the U.S. balance improves, it may be virtually impossible for us to balance our accounts with any reasonable amount of domestic restrictiveness.

A, and perhaps the, key question is therefore whether foreign, and particularly European, countries will acquiesce to an improvement of our accounts. Whether they will do so depends in large part on whether they consider the current U.S. difficulties to be essentially a classic case of international disequilibrium, with the drop in U.S. reserves balanced by a more than comfortable buildup in their reserves, or whether they consider the U.S. deficits to be partially desirable in that they have provided the rest of the world with needed reserves. There are major reasons for believing that the latter rather than the former approximates the truth. The former would imply that Europe would acquiesce in a U.S. devaluation of the dollar with respect to their currencies; yet, as Professor Patterson has noted on page 294 of the July hearings, it is doubtful that European countries would tolerate such a devaluation. Furthermore, in spite of the generally favorable position of Western Europe in the past years, con-

cern is being expressed there over signs of weakness in their international position.

The U.S. Treasury and Federal Reserve have supported the general position that, although international liquidity may become insufficient in the future, it is at present adequate, and stress must be placed on balancing the U.S. accounts as a necessary prerequisite to an expansion of liquidity. If, however, reserves are at present only adequate, the reverse of the priorities of the U.S. authorities may be supported. An improvement of the U.S. payments toward balance at a time of expanding world trade would imply a fall in foreign, and primarily European, ratios of reserves to trade; yet if these reserves are presently only adequate, countersteps by foreign countries may be anticipated.

Having been requested to confine my remarks to the likelihood that the Brookings projections will be realized rather than to their policy recommendations, I apologize for this excursion into the liquidity issue. However, for the reasons just noted, it may be concluded that one of the significant variables in a prediction of the U.S. balance is the probability of something being done along the lines recommended by Mr. Salant. In the light of this and other imponderables, an evaluation of the Brookings projections as predictions would be guesswork on my part. If I were to guess, I would estimate the U.S. basic balance in 1968 would be near zero or perhaps slightly negative if there is a significant expansion of world liquidity; if there is no such increase, I would expect the basic deficit to be not less than \$500 million.

Consideration should, however, be given to a point not mentioned in the Brookings report, which has a potential significance for the U.S. balance, and which may partially ease the need for an expansion of liquidity. As the EEC becomes more closely integrated, the several countries will, from an economic viewpoint, begin to resemble the parts of a single larger country rather than separate entities. It is inevitable that this will be accompanied by a financial integration, and insofar as this takes place, the need for a growth in European holdings of international reserves will be obviated. External trade among the members will approximate internal trade, and it will therefore be less necessary to hold international reserves as a hedge against shifts in this trade. Deficits among the countries will be dealt with through internal credit arrangements within the union.

As approximately half of recent international trade of the EEC members is with one another, this is potentially a very significant factor. Indeed, if complete integration of the EEC economies were to occur within the next decade, there might be no net increase in the demand for international liquidity on the part of those countries. Once again, however, specific predictions depend on a whole series of imponderables, political as well as economic. We may expect some relief from this source, but it would be unwise to see it as an adequate solution to the liquidity dilemma.

This paper has argued that, with respect to Japan, the underdeveloped countries, and Canada, the Brookings study has underestimated the growth in demand for international liquidity, while with respect to the EEC, the study has perhaps overestimated it. In sum, therefore, support is provided for the general Brookings analysis of the liquidity problem. This should not, however, necessarily be taken

as support of the Brookings policy recommendations. While an international central bank may be taken as a solution to the liquidity problem, there are major problems involved in developing such an institution, and the possibilities of a gradual revaluation of gold merit consideration as an alternative. The proposal of two currency blocs as a second best has been rated too high by the Brookings scholars. While flexible exchange rates, with safeguards, have much to recommend them in certain specific instances, they create major problems when they exist between reserve currency countries. Furthermore, the Brookings proposal would be a potential nightmare for Britain, with her close contacts with both the Continent and North America. After all, less than a year has passed since the odds on Britain joining the Common Market were considered high; it is questionable whether the situation has changed that much, or whether the future is sufficiently certain, to justify arrangements which might be interpreted as precluding intimate ties between Britain and the Continent.

STATEMENT BY LELAND B. YEAGER

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The Brookings report works with two different sets of assumptions. For the U.S. gross national product price deflator, U.S. export prices, and rest-of-the-world export prices, the levels initially and alternatively assumed for 1968 are the same. The alternative is below the initial figure by less than 5 and by 3 percent for United States and West European real GNP's, respectively, by 7½ percent for the West European GNP deflator, and by less than 4 percent for West European export prices.¹ Several balance of payments items, instead of being computed from the assumptions, are themselves assumed outright, and with the initial and alternative figures identical (p. 216). Many non-quantifiable assumptions—about technological developments and export promotion drives, for example—are not laid out explicitly and are therefore also the same in the two sets. In short, those few of the initial and alternative assumptions that differ at all differ by only a few percent at most. These differences are smaller than the range of error within which anyone can reasonably expect to forecast actual prices and outputs. Even so, the initial assumptions yield a 1968 "basic" balance of payments surplus of \$1.9 billion, while the alternative assumptions yield a "basic" deficit of \$0.6 billion. The \$2½ billion discrepancy is practically (95 percent) as large as the average actual deficit over the years 1958–62. (See the table on p. 6.)

Small differences in assumptions thus make large differences in results. This suggests how undependable either of the balance of payments projections is. Furthermore, these results refer only to the basic balance; the Brookings authors wisely avoid projecting the even more erratic total balance.

In testifying before the Joint Economic Committee on July 30, Walther Lederer and Gardner Patterson alluded to the optimism—optimism verging almost on inconsistency—of some of the Brookings assumptions, particularly those concerning the expected improvement in the price competitiveness of the United States in relation to Europe. The report assumes that European authorities would be much more lax in adopting tight monetary policies to combat comparatively rapid price inflation than to combat loss of international liquidity. It assumes a rise in U.S. export prices that seems optimistically low in relation to the assumed growth of GNP. The explicit assumptions imply strong upward pressures on European interest rates, which would presumably affect the U.S. balance on capital account unfavorably; yet the spread of European over American interest rates is assumed not to grow. For reasons to be given presently, however, a discussion of why any errors are more likely to be in one direction than the other would have to be speculative and would be irrelevant, anyway, to the

¹ These percentages are computed from the table on p. 215 of the Joint Economic Committee print of the report.

main comments that need to be made on the report and the problems it deals with. Notably enough, the authors' own central policy conclusion has little relation to their specific balance of payments projections.

Their figures are untrustworthy not only because they depend so sensitively on forecasted prices and production but also because the regression equations employed are themselves "subject to deep suspicion": they were derived mostly from annual data for 1948-60, when many changes were occurring in product availabilities during European reconstruction, in tariffs and other trade and currency policies, and in many other factors that could not be taken into account.² Not only the price assumptions but also the elasticities of demand and substitution admittedly have a "highly conjectural character." It is noteworthy that although one of their equations gave a price elasticity of European demand for U.S. exports of "more than 4," the authors, for undisclosed reasons, felt this value "too high to be plausible" and simply substituted a figure of 2.5 (pp. 80, 82).

To point out these things is not to criticize the Brookings authors. The nature of their task forced them to oversimplify and make intuitive judgments, which they did with courage and resourcefulness. Furthermore, they have been admirably forthright about all this. They explain, for example, that while trade depends in part on GNP levels, these depend in turn on such uncertain things as employment, capital accumulation, and the state of demand. They patiently explain the shortcomings of some price indexes used for lack of better ones. They note that their analysis of foreign aid is "necessarily very rough and speculative." They acknowledge their incomplete knowledge of such influences on the U.S. competitive position as how successfully research expenditures will yield new processes and products. They confess uncertainty not only about the future but even about the past: for example, how seriously the apparent decline in U.S. price competitiveness "has affected the balance of payments is a question to which no conclusive answer can possibly be given" (p. 70; cf. p. 79). They frankly acknowledge that some of the numbers they used, as well as the projections based on them, have "no scientific derivation" and are just "guesses" (e.g., pp. 47, 171-172, 230). In fact, it almost seems that the authors use more space impugning their own statistics and methods and conclusions than in actually reaching and stating these conclusions.

Why, then, didn't they simply throw up their hands in the first place and declare their assigned task impossible? (The assignment, by the way, evidently specified even some of the numbers to be assumed, such as future unemployment percentages, GNP growth rates, and the U.S. GNP deflator.) Well, the authors may have felt that their efforts would themselves be instructive, apart from any results reached. This is true: their large-scale, judicious, and conscientious attempt at the assignment is much more convincing than a priori skepticism would have been. Precisely because their best efforts have proved so open to question, the authors have made a valuable if implicit commentary on the whole approach to policy that presupposes the possibility of answering questions of the kinds they tackled.

² P. 58. Cf. pp. 264 ff. and *passim* on the neglect of most factors other than real GNP and relative prices.

A danger of misinterpretation remains. Although the authors repeatedly label their results as "projections," not forecasts, many of their readers will fail to keep this tenuous and hedging distinction always in mind. The authors are so conscientious and thorough in repeating their qualifications and warnings, in at least mentioning all sorts of influences, and in amassing figures that the balance-of-payment projections they so diffidently offer may take on an unwarranted prestige and authority.³

The U.S. balance on current account is subject to wide fluctuation because it is the difference between gross trade totals of roughly the same size that are themselves unstable, being marginal in relation to total economic activity. As for net outflows of investment capital, their increased size and erraticness from about 1956 illustrates how dramatically the climate affecting them can change. Short-term capital movements, which combine with the basic balance in the overall balance of payments, are still more erratic, being notoriously influenced (in changing and unknown degrees) by interest rates and apparently even more so by rumors and hunches concerning the strength of the dollar. This strength relates to the basic balance-of-payments position ultimately, but not in any close or calculable way. The same is true of foreign encashments of dollars into gold. Under existing arrangements, as the Brookings authors remind us and as historical parallels also suggest, the dollar might sometimes be weak even if the U.S. basic deficit were eliminated. For this reason, we can take little comfort in recent discussions of how current reporting conventions (such as asymmetrical treatment of short-term capital movements) tend to exaggerate the overall deficit. The Brookings report duly stresses how "projections of net balances in international payments, even of net balances in basic transactions, are highly speculative, even more so than economic forecasts in general" (p. 31).

We should take to heart the lesson of the specific historical changes that falsified the solemn diagnoses still being published as late as 1958 of a supposedly persistent "structural" tendency toward "dollar shortage," meaning a troublesome surplus in the U.S. balance of payments. Other changes of a similarly specific historical nature will emerge in the future: perhaps further oil discoveries in Europe, or European advances in aircraft design and production, or cost-cutting developments in Japanese shipbuilding, or successes and failures in resisting inflation in the United States and elsewhere, or—most significant of all—political and other events of which we still have no idea. And even if underlying tendencies did happen to favor the U.S. balance of payments in the middle and late 1960's, they might be deliberately offset (as the Brookings report notes) by the policy responses of European countries that would be finding themselves in the corresponding difficulties. One of the most striking lessons of postwar experience is that balance-of-payments troubles sometimes persist, sometimes change direction, sometimes give old victims a respite while turning to plague new ones—but never vanish.

³ In his insider's report on British aircraft production planning during World War II, Ely Devons laments "the failing of the majority of human minds * * * to assume that anything expressed in figures must necessarily be precise," regardless of how shakily based the figures might be. "The veneration paid to figures increased when they were neatly presented in well-laid-out tables, and reached its height if these tables were printed." It was of little use for statisticians to emphasize the guesswork involved or to indicate a range of error by giving both maximum and minimum figures: the average would come to be quoted as the best available figure. "Planning in Practice" (Cambridge at the University Press, 1950), pp. 155-157.

Though greater in degree, the difficulties of balance-of-payments forecasts (or even of "projections") are no different in kind from those of most other economic forecasts. Since economic behavior depends on innumerable factors, including "noneconomic" ones, accurate economic forecasting (beyond relatively short-run extrapolation) would hardly be possible apart from forecasts of all major aspects of human affairs, including forecasts of people's psychological reactions to the events they will experience. Almost by definition, history is the unfolding of unique events and combinations of events. Minor causes can have major consequences. (It can plausibly be argued, for example, that if only Queen Victoria had been a man instead of a woman, so that continued linkage of the Crowns of Britain and Hanover had impeded German unification, the entire course of subsequent history would have unfolded quite differently.)

Because history is unique, forecasting (soothsaying, foretelling the future) is fundamentally different from scientific prediction. Predictions are if-this-then-that propositions: if zinc and hydrochloric acid are combined, hydrogen will be released. In this sense, economists can predict. But just as it is unreasonable to expect a chemist to foretell how much zinc will in fact be combined with how much hydrochloric acid in a particular year, generating how much hydrogen, so it is unreasonable to expect an economist to foretell a country's balance of payments in the unique historical circumstances of a few years later on.⁴

Saying this is not to deny that econometric research can take advantage of the unplanned experiments cast up by history and can shed light on some relations among economic magnitudes. Research can be useful without justifying the adoption of policies predicated on the hope of reliable forecasts. It is ironic that some persons who vaunt their devotion to empirical methods should shrink from empiricism in facing up to actual experience with quantitative economic forecasts.

Some people will ask: Even if the Brookings projections are unreliable, are they not the best available? Must we not look into the future as best we can and frame policy accordingly? Well, it is pointless to insist on doing what we cannot do. Balance-of-payments policy oriented toward dealing with historical combinations of circumstances as they occur or are expected to occur will continue proving in practice to be a series of ad hoc expedients like the cut in the duty-free import allowance for returning tourists, the proposed interest-equalization tax, and the others that add up to what Prof. Gardner Patterson has aptly called a "back-door devaluation" of the dollar.⁵ Continual fiddling with such expedients would add, incidentally, to the problems of econometricians trying to derive formulas for use in future projections.

In which direction are the Brookings projections more likely to be in error? How might they be made more accurate? Well, these are

⁴ Astronomers can foretell future events within our solar system because they are dealing with an essentially closed system: known bodies move subject to known forces, with outside disturbances essentially absent. An economic system, in sharp contrast, is subject to all sorts of changing outside influences.

⁵ Testimony before the Joint Economic Committee, July 30, 1963, p. 204. As for the "tying" of American aid dollars, the Brookings report (pp. 172-173) notes that the use of irrevocable letters of credit for this purpose cannot have much effect unless the recipient government rations dollars to importers by means of exchange control. "The United States, long an opponent of exchange controls, thus finds itself employing a device which appears to require exchange controls to be effective."

the wrong questions to insist on, since precisely the most important lesson to be learned from the report is the irrationality making policy depend on any such projections. The lack of any mechanism continuously working to promote balance in international transactions nowadays is the real problem to be faced, not the problem of deficits that have been and are forecasted to be of particular sizes in particular years. The kind of thinking that framed the assignment imposed on the Brookings authors is responsible for unnecessarily allowing a state of affairs to continue in which "crises" can arise out of the sensitivity of the balance of payments to even moderate differences among countries in price-level movements, rates of economic growth, rates of interest, unspectacular changes in technology and consumer tastes, and unspectacular institutional developments.

Under present-day international monetary arrangements, it is simply not true that the monetary-fiscal policies appropriate to domestic economic health and to balance-of-payments equilibrium must always coincide. It is encouraging, therefore, to find the Brookings report questioning the all-too-familiar exhortation to heed the "discipline of the balance of payments." This discipline "is desirable only as a means to ends; it is desirable only if the ends are desirable. If balance-of-payments considerations force a country to curb inflation or prevent misallocation of its real resources, the balance-of-payments discipline is a means toward a valid national objective, and is desirable" (p. 244). It is just a fortunate coincidence, however, when the same policies happen to be required both to avoid a balance-of-payments deficit and to avoid inflation. We cannot count on the two targets always being alined so that a marksman can hit both bulls-eyes with a single shot. Unfortunately, under present arrangements, situations may well arise requiring an expansionary policy for domestic objectives but a contractionary one to correct an external deficit, or requiring a tight policy to prevent inflation at home but an easy one to ward off a troublesome external surplus. Why should balance-of-payments requirements be allowed to dominate policy choices and impose "the subordination of higher priority objectives"? (p. 244).

The Brookings report avoids the popular error of not seeing any more to the current problem than the U.S. deficit. In fact, the authors do not really deal at all with the deficit as such, except to come up with a hunch that it will probably go away of its own accord. Instead, they are mainly concerned with the contradiction in existing international monetary arrangements whose diagnosis has been popularized by Prof. Robert Triffin. If world production and trade continue to grow, countries will need more and more international reserves to tide themselves over occasional deficits. (In fact, for reasons explained on pp. 236-237, "the relation between imbalances and the total volume of transactions is more likely to increase than to decrease.") If foreign countries are to continue accumulating dollar reserves, the United States must keep on running payments deficits; curing them would only sharpen the troublesome question of what sources of reserves can supplement the seriously inadequate current production of gold. Letting the deficits continue, however, would mean letting the U.S. gold reserves become a smaller and smaller percentage of liquid liabilities to foreigners; the dollar would become more and more vulnerable to a loss of confidence. Under existing arrangements, a long-

run U.S. deficit is thus necessary yet alarming. The system becomes ever more precarious.

Notice that this, the main point of the Brookings report, together with the main recommendations derived from it, does not depend on the projections of the U.S. balance of payments in 1968. The figures serve as little more than an impressively decorative prelude.

Professor Triffin recommends adoption of a new internationally issued reserve currency; and the Brookings authors, though not going into detail, apparently favor this plan or something similar. Several early commentators on the Brookings report apparently suspect the plan of being a scheme to let the United States escape "discipline" and continue inflating with impunity. This particular fear seems exaggerated. The plan's purpose, rather, is to simplify the above-mentioned dilemma into a mere problem: a cure for the U.S. deficit would no longer deprive other countries of an adequate growth in total international liquidity, though the United States and every other country would still face the problem of avoiding persistent deficits.

A better founded objection hinges on the inconsistencies of trying to manage money supplies on two levels, the international and the national, when there is no reason to suppose that the two levels would always require the same degree of tightness or expansion. Since an international liquidity shortage might breed restrictions on international trade but ordinarily never breed deflation within countries, the hope is quite shaky that international liquidity would never be created in inflationary excess but always created only to stave off a deflationary shortage. More ample financing under the plan would allow countries with deficits to avoid or postpone or mitigate the controls or currency devaluations otherwise necessary. When those countries were financing larger or longer lasting deficits than they could otherwise have done, other countries would be experiencing correspondingly larger or longer lasting surpluses and stronger pressures of imported inflation.⁶

The Brookings report advocates keeping exchange rates so firmly and permanently fixed as to eliminate the familiar phenomenon of speculation based on anticipations of official adjustments in them. But when the authors rule out the methods of (1) ad hoc controls, (2) exchange-rate variation, and (3) manipulation of domestic money supplies, prices, and incomes in overriding response to balance-of-payments considerations, how do they expect disequilibriums ever to get adjusted away? Providing more adequate finance for deficits while passively waiting for them somehow to go away of their own accord is hardly a substitute for an adjustment mechanism.

Suppose, now, that governments stopped concerning themselves with international liquidity, external reserves, and foreign-exchange operations. Foreign balances would be held, instead, by banks and other private transactors. Holders would determine their foreign bank balances according to the same sorts of motives as govern their domestic bank balances and their inventories of ordinary commodities. With the pricing of currencies as free from official intervention as the pricing of ordinary commodities, the profit motive would usually keep inventories of foreign exchange, as of any ordinary commodity, near the levels appropriate to the needs of their holders in view of the costs of

⁶ For fuller analysis of the plan's inadequacies and probable inflationary bias, see Kyriakos, 1961, Fasc. 3, pp. 285-314.

tying up resources in that form. Foreign exchange even contrasts favorably with ordinary commodities in that large amounts of it could, at a price, be "produced" quickly if necessary. Banks could borrow abroad; balances in one money can turn instantly into foreign exchange by mere change of ownership.

Under this system, there could be no such thing as a shortage of international liquidity apart from deflationary shortages of domestic money within countries, which domestic policy could avoid. Anyone who wanted more than he already held of some particular foreign currency could always obtain it at the price that equated its supply and demand. Of course, an intensified foreign demand added onto the domestic demand for cash balances of a country's currency would exert a deflationary tendency on that country. Far from being burdensome, though, this chance for noninflationary creation of additional domestic money would allow the country to acquire real goods and services on indefinite loan from foreign holders of its money at zero or low interest. The fact that foreigners account for part of the long-run growth in demand for cash balances need cause no particular complications for monetary policy. The exclusively private (nonofficial) holding of foreign exchange would avoid the troublesome conflict between domestic and international considerations to be expected from attempts to manage a separate international money in addition to the various national moneys. Monetary stabilization has a better chance to succeed when it can be pursued in accordance with fairly simple criteria and on the national level and for national objectives alone than when liquidity management for international objectives complicates the task. In short, relying on flexible exchange rates to equilibrate balances of payments would simplify the liquidity problem also: if money supplies were not excessive or inadequate from national points of view, they could not be excessive or inadequate from the international point of view either.

The Brookings authors do recommend a much-modified system of flexible exchange rates as a second-best expedient in case their preferred recommendations somehow prove unacceptable. But they do not squarely face up to a choice among the three chief methods or mechanisms for balancing international payments. This unwillingness of economists to make a forthright choice seems paradoxical, considering that the most basic fact in economics is the impossibility of having all good things at once and the unavailability of choice. Of course the system of fluctuating rates, like any of the alternatives and like almost any line of policy in any field, has some disadvantages (usually exaggerated). (On the other hand, it also has several advantages besides those of providing a continuous adjustment mechanism and bypassing the entire problem of international liquidity.) It is curious that the authors, so acute in pinpointing the fallacies in other people's slogans, should tacitly accept the one that sees some special virtue in a middle-of-the-road position as such. Actually, a compromise may combine the weak rather than the strong points of policy extremes, yet seem advantageous precisely thanks to not having been described and examined in detail. Actually, it is doubtful that exchange-rate changes are less disruptive when they occur officially in sudden jumps (sometimes correctly and sometimes falsely rumored in advance) than when they occur in continuous, piecemeal, unspectacular fashion.

Although space does not permit considering this policy issue in any detail, one implication of the Brookings study does deserve particular notice. If balances of payments really are as sensitive to moderate differences in national price trends as the study suggests, even moderate exchange-rate variations should ordinarily suffice to offset their disequilibrating impact. In some places (e.g., p. 229), the report does come close to recognizing the high price elasticities of international demands and supplies that would be so favorable to operation of the exchange-rate mechanism of adjustment.

The United States could not introduce this system by itself, since other countries might conceivably keep on pegging their currencies to the dollar by means of official dollar reserves even after the United States had cut the link between the dollar and gold. But though their exchange-rate pegging would then still leave foreign countries exposed to balance-of-payments troubles from time to time, at least the precariousness of today's gold-exchange standard would be gone. The United States would no longer be holding any official gold reserves whose shrinkage could sap confidence. Speculation on a cut in the official gold content of the dollar could no longer threaten, since the dollar would no longer have any. Any run from the dollar would have to be a run into American goods and services. Unlike a run from a gold-pegged dollar, this could cause no crisis, since the withdrawal of funds would finance itself by and coincide with an export surplus of goods and services. Actually, it is hard to imagine what might motivate a foreign flight from dollars into goods except rapid American inflation, which would motivate such a flight by Americans also. Proper management of the money supply, no longer hampered by possible clashes between domestic and external requirements and with the authorities' task thus simplified, could avoid this. If inflation is undesirable (as I agree it is), we ought to be able to pursue monetary stability for its domestic advantages and not lamely depend on the always unreliable and sometimes perverse "discipline" of balance-of-payments disequilibrium.

By using a nongold dollar as an international reserve currency, foreigners would be foregoing the advantages of flexible exchange rates. The United States, though, would be benefiting from the cheap loans represented by the foreign dollar holdings.

In summary, three comments on the Brookings report deserve emphasis. First, whether or not the authors have done so intentionally, they have in fact demonstrated the bankruptcy of the approach that would frame policy according to supposed projections of the balance of payments. Second, the authors usefully point out some fundamental contradictions in existing international monetary arrangements. Third, however, they fail to recognize the need for a continuously operating international adjustment mechanism.

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I

Long-term projections are coming into vogue. In Western Europe, more or less comprehensive forecasts have been prepared for several countries, often with the objective of establishing guidelines for a national economy. At the same time, increasing attention has been given to questions of methodology, as witnessed—among other things—by the publications of the recently founded European Association for Medium and Long-Term Forecasting (ASEPELT).

Less work has been done on long-term forecasting in the United States although, in a recent study, the Resources for the Future has undertaken the monumental task of exploring trends in the U.S. economy up to 2000.¹ But this publication deals with trade prospects only marginally and hence it is of great interest to see a volume addressing itself to the question of prospective changes in U.S. trade.²

Trade projections generally involve greater error possibilities than projections concerning a national economy, since the former necessitate making assumptions and establishing relationships not only with respect to the domestic economy but also in regard to other economies. Especial difficulties attach to forecasting trade in manufactured goods, which dominate international exchange between the United States and Western Europe. In regard to primary products, reasonably stable relationships can be established between, e.g., material inputs and industrial output or food consumption and incomes, and the relative contribution of domestic production and imports can also be foreseen with some confidence. By comparison, the exchange of manufactured goods in the most volatile part of international trade, being largely dependent on changes in competitiveness that are difficult to predict.

In general, any projection of U.S. exports and imports will greatly depend on the assumptions made with regard to the principal variables affecting this trade. At the same time, the choice of the assumptions is necessarily influenced by subjective judgment, and subjective judgment is also involved in the criticism of the assumptions. It appears more useful, therefore, to examine the internal consistency and the analytical value of the model used in the projections in the light of our knowledge of economic relationships. This approach has the further advantage that it enables one to offer some general observations on problems of forecasting international trade.

*This paper was received too late for alphabetical inclusion in this document.

¹ H. H. Landsberg et al., "Resources in America's Future," the Johns Hopkins University Press, 1963.

² W. S. Salant et al., "The United States Balance of Payments in 1968," the Brookings Institution, 1963. Page references to this volume are indicated in square brackets.

II

In the model employed in the Brookings study, distinction is made between two industrial areas, the United States and Western Europe, and the rest of the world. Trade between the industrial areas is assumed to depend on their respective GNP's and the ratio of their import prices to the general price level; imports from the rest of the world are said to be related to the level of GNP and, under the assumption that the countries of the rest of the world spend all their foreign exchange receipts, changes in the shares of industrial areas in exports to the rest of the world would depend on their relative export prices.

The assumed relationship determining the exports (X) and imports (M) of an industrial area, e.g., the United States, can be written as follows:

$$(1) \quad X_1 = X_{12}(Y_2, P_2/P_{x1}) + X_{13}(P_{x1}/P_{x2}, R)$$

$$(2) \quad M_1 = X_{21}(Y_1, P_1/P_{x2}) + X_{31}(Y_1),$$

when subscripts 1, 2, and 3 refer to the United States, Western Europe, and the rest of the world, respectively, X_{ij} denotes exports from area i to area j , R stands for the foreign exchange receipts of the rest of the world, and Y_i , P_i , and P_{ix} refer to the gross national product, the GNP deflator, and the export price index of country i .³

Future levels of the gross national product are given by assumption in the model, changes in the general price level are determined by changes in hourly earnings, the gross national product, hours worked, and the share of labor in GNP, while export prices are assumed to be directly related to the general price level. In symbols,⁴

$$(3) \quad p_i = \alpha(w_i - y_i/h_i),$$

and

$$(4) \quad p_{ix} = \omega p_i$$

Thus, the model used in the Brookings study is based on a unidirectional relationship between the gross national product and prices on the one hand, and imports (exports) on the other, when the assumed values of GNP and the variables determining the price level are exogenous to the model. In other words trade, the only dependent variable, is uniquely determined by substituting assumed values for the exogenous variables into a predetermined set of functional relationships.

The assumption of a unidirectional relationship follows from the objective of the study—"to present estimates of the basic balance of payments in 1968 if GNP and the GNP price deflators in the United States and Western Europe take certain assumed values" [p. 35]. In

³ It is not necessary to separately introduce the exchange rate since, under the assumption of fixed rates, it can be assumed that all variables are expressed in dollars.

⁴ w refers to hourly earnings, h to hours worked, α denotes changes in the share of labor in GNP, and ω represents the relationship between export prices and the general price level; small (subscript) letters refer to rates of change in the variables.

other words, the projections are conditional forecasts, dealing with the balance-of-payments implications of assumed growth rates and GNP deflators.

Correspondingly, the implications of prospective changes in exports for economic growth and for changes in domestic prices are not considered and it is implicitly assumed that the growth rates (and price levels) postulated will be obtained in one way or another. This procedure follows from the terms of reference of the Brookings study and should not come under criticism. Still, it may be interesting to speculate what "feedback" effects an expansion of exports would have on the gross national product and on prices. More generally, the question is asked what differences, if any, can be found between export-induced and domestically induced growth.

There is little doubt that the expansion of exports has contributed to the rapid growth of national income in Germany during the fifties and differences in the export performance of, e.g., the British and the Italian economies also explain, in part, their respective growth record. Recently, an ingenious explanation for the process of "export propelled" growth has been offered by Wilfred Beckerman who purported to establish a technological link between exports and GNP. Beckerman argues that if a country has secured a competitive advantage at some point of its history, an expansion in its exports will give rise to new investments embodying advanced large-scale technology and the ensuing increase in labor productivity will be accompanied by a wage increase of a smaller magnitude, leading thereby to a fall in prices. The decrease in prices will then further stimulate exports, so that a cumulative expansion of exports, investments, and output is generated.⁵

Although Beckerman's model needs to be "constrained" by introducing the labor supply as a limiting factor,⁶ it serves a useful purpose in directing attention to the impact of exports on GNP and prices through the intermediary of technological change. But could the same result not be reached through domestically induced expansion? As far as the multiplier-effect of exports is concerned, the answer is in the affirmative, since there is no reason to believe that a domestic and a foreign trade multiplier would assume different values. Nevertheless, some differences are found with regard to other relationships, especially in the case of countries where exports account for a large proportion of output.

To begin with, the exports of most industrial countries are concentrated in selected branches of manufacturing where increases in exports contribute to the exploitation of large-scale economies and improvements in technological processes, while an expansion of domestic demand affects all sectors of the economy so that the impact on a single industry is relatively small. Also, given the high income elasticity of demand for services, an increasing part of the newly created domestic demand will be spent on service items where increasing returns to scale are generally of little importance and possibilities for technological improvements are limited. Finally, whereas "export propelled" growth makes available foreign exchange

⁵ W. Beckerman, "Projecting Europe's Growth," *Economic Journal*, December 1962, pp. 912-925.

⁶ B. Balassa, "Some Observations on Mr. Beckerman's 'Export-Propelled' Growth Model." W. Beckerman, "Reply," and B. Balassa, "Rejoinder," *Economic Journal*, forthcoming.

that can be spent on the increased imports accompanying the rise in incomes, considerations of balance-of-payments equilibrium appear as a constraint to the application of domestic expansionary measures.

It appears, then, that it would be useful to distinguish between export propelled and internally induced growth in their relationship to international trade and changes in prices and this distinction also has relevance for making projections. It would be desirable therefore to develop forecasting models embodying simultaneous relationships or feedbacks that would allow for the interrelationships between the growth of GNP, exports (imports), and prices.

III

Turning from the general problems of model building to the projections of the Brookings study, note should be taken of the importance of assumed changes in the U.S. competitive position for the forecasts. Under the initial assumptions, improvements in competitiveness would account for a \$4.8 billion increase in the U.S. surplus on merchandise account between 1961 and 1968 as compared to an improvement of \$2.7 billion in the basic balance, while under the alternative assumptions the corresponding figures are \$1.5 and \$0.2 billion [pp. 87, 216].

Thus, according to the projections of the Brookings study, the balance of payments of the United States would deteriorate in the absence of an improvement in the U.S. competitive position. A discussion of the methods used in forecasting changes in U.S. competitiveness and its impact on trade is therefore of special interest. Two relationships are of relevance here: changes in relative prices and price (substitution) elasticities in international trade.

As equation (1) indicates, in an industrial area the choice between imports and the consumption of domestic goods is assumed to depend on the price of imports and the general price level, represented by the export price index of the area of origin and the GNP deflator of the importing area, respectively. The Brookings study notes that "it might be questioned whether European GNP prices are the most appropriate price index to use for the purpose of calculating the price elasticity of European demand for U.S. exports" [p. 81] but the relative merits of the possible choice are not indicated. However, the use of the ratio of import prices to the general price level is clearly inferior to relating import prices to the domestic prices of import substitutes.⁷

This conclusion follows from generally accepted econometric principles. The less related are two goods between which we endeavor to establish substitution relationships, the greater will be the standard error of the calculated coefficient since the factors bearing on the relationship but excluded from the calculation will be more imports. And higher standard error means also larger forecasting error.

⁷ In a disaggregated projection, sectoral price indexes may be used, while in the absence of disaggregation, the ratio of import prices to the wholesale-price index, or, under the assumption that the range of exported and imported commodities is approximately identical in highly developed industrial countries, the ratio of export prices in the two areas would be an appropriate choice. In a recent study on U.S. imports, for example, the domestic price-variables were represented by the appropriate components of the wholesale price index. (R. J. Ball and K. Marwah, "The U.S. Demand for Imports, 1948-58," Review of Economic and Statistics, November 1962.)

In the present context, the relevant consideration is that changes in U.S. export prices will lead to substitution between internationally traded goods of domestic and foreign origin in Western Europe, while substitution against housing and services will be small. But the large differences between changes in the general price level and the export price index of industrial areas assumed in the Brookings study (see table 2 below) entail the implicit assumption that either substitution relationships between traded and nontraded goods are of importance or the elasticity of substitution between traded goods is considerably higher than the coefficient used in the projections.

This discussion also points to the need for disaggregation in making projections. Substitution relationships and income and price elasticities differ greatly between foodstuffs, raw materials, and manufactured goods, for example. There is little substitution between primary products on the one hand, and manufactured goods on the other; at the same time, demand for primary products is price-inelastic while elasticities are higher in the case of manufactured goods.⁸

These considerations are of especial importance in regard to U.S. exports to Western Europe. In 1961, 40.7 percent of U.S. exports of \$6 billion were agricultural products and 7.9 percent nonagricultural raw materials and fuels, while the share of manufactured goods hardly exceeded one-half.⁹ At the same time, the future of U.S. agricultural exports is determined by Government policies, here and abroad, rather than by changes in relative prices.

IV

Further problems arise in connection with the assumed relationships between the GNP deflator and the export price index. In the Brookings study it is claimed that "no firm basis exists for projecting changes in export prices, even if our assumptions about changes in GNP prices are correct. No tested hypothesis exists as to what determines the relationship between the general price level and export prices" [p. 91].

Nevertheless, theoretical considerations and available information on past trends can provide assistance in determining relationships between export prices and the general price level. I have elsewhere argued that the greater are intercountry productivity differentials in the production of traded goods (manufactured and agricultural products), *ceteris paribus*, the greater will be differences in wage levels. At the same time, as a result of competition among labor groups within each country, wage differences observed in manufacturing pertain also to the service industry, although productivity differentials are smaller there. Consequently, the gap between the prices of services and of internationally traded goods will be larger in countries with higher levels of productivity and hence differences in the average price level and export (import) prices will be positively correlated with intercountry differences in productivity.¹⁰

⁸ With respect to U.S. imports in the period 1948-58, for example, price elasticities of 0.34 have been derived for crude foodstuffs, 0.26 for crude materials, and 3.50 for manufactures (Ball-Marwah, *op. cit.*, p. 397).

⁹ OECD, "Foreign Trade," *Analytical Abstracts*, January-December 1962, No. 5. The data do not include sales of military equipment.

¹⁰ E. Balassa, "Patterns of Industrial Growth: Comment," *American Economic Review*, June 1961, p. 395.

These conclusions can also be applied to changes over time. In this connection, reference should be made to the double effect of productivity improvements in the production of traded goods on relative prices. On the one hand, the concomitant increases in the general wage level will raise the price of services; on the other, productivity improvements will tend to lower the prices of exports and import-competing goods. Correspondingly, in an international comparison of changes in productivity and prices, we would expect that the rate of increase of productivity be positively correlated with the gap between the GNP deflator and the export price index.

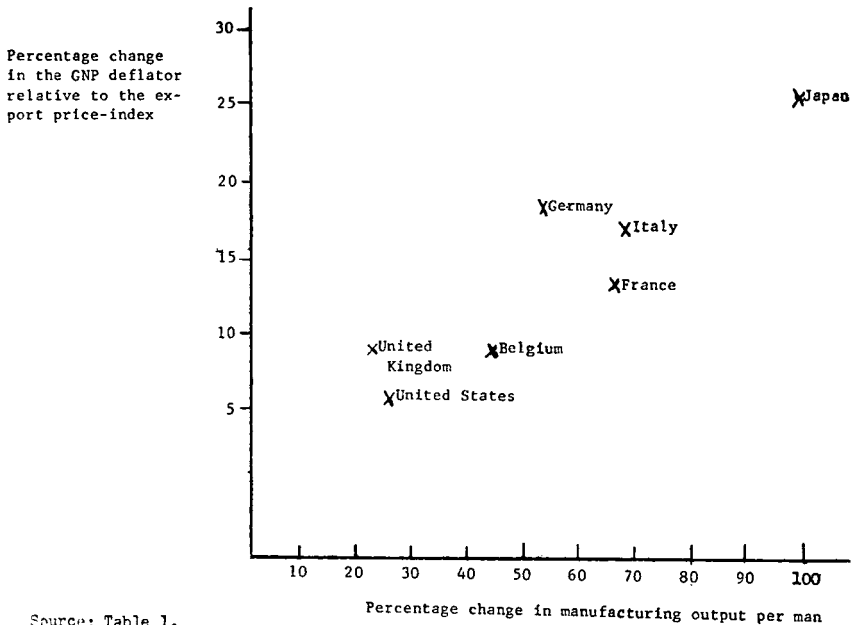
Data for the main industrial countries relating to the period 1953-1961 lend support to this proposition. If we exclude France where devaluation apparently had a differential effect on the general price level and on export prices, there appears to be a correspondence between, on the one hand, the increase in GNP per man and, on the other, the gap between the GNP deflator and the export price index. The United States and the United Kingdom, where productivity increased at the lowest rate in this period show also the smallest differences between the rise in the general price level and in export prices, whereas Japan, Germany, and Italy with the greatest increases in productivity experienced the largest gap between the two price indexes (table 1 on the following page).

But the unit value index calculated for all exports include agricultural goods where subsidies are of importance and we should therefore restrict our investigation to manufactured products. At the same time, it is generally acknowledged that the U.S. export price index for manufactures overestimates the actual increase in prices [p. 76], while the change in the base of the Italian index appears to have imparted a downward bias to the latter.¹¹ Hence, it is more appropriate to make use of the wholesale price index of manufactured goods in making comparisons. Correspondingly, changes in manufacturing productivity need to be considered. The relevant comparisons are made in graph 1 on the following page, indicating a positive correlation between the growth of manufacturing productivity and the ratio between the GNP deflator and the price index for manufactured goods.

¹¹ B. Balassa, "Recent Developments in the Competitiveness of American Industry and Prospects for the Future." "Factors Affecting the U.S. Balance of Payments," U.S. Congress, Joint Economic Committee, Washington, 1962, p. 40.

GRAPH 1

Changes in Productivity and Prices in the Main Industrial Countries, 1953-1961



Source: Table 1.

TABLE 1.—Changes in productivity and prices in selected industrial countries, 1953-61

[Index numbers for 1961, 1953=100]

	GNP per man (1)	Manufacturing output per man-hour (2)	GNP deflator (3)	Export prices (unit value) (4)	Export prices of manufactured goods (5)	Wholesale prices of manufactured goods (6)
United States.....	110	124	117	111	121	111
Belgium.....	118	143	114	96	95	105
France.....	133	165	103	92	99	91
Germany.....	142	152	128	101	105	109
Italy.....	132	167	115	83	80	98
United Kingdom.....	114	122	127	111	114	116
Japan.....	157	197	115	95	91	91

Sources: (1) B. Balassa, "Trade Prospects for Developing Countries," Studies in Economic Growth No. 2, Homewood, Ill., Richard D. Irwin, to be published in 1964. Data refer to the period 1953-60.

(2) B. Balassa, "Recent Developments in the Competitiveness of American Industry and Prospects for the Future," "Factors Affecting the United States Balance of Payments," U.S. Congress, Joint Economic Committee, Washington, 1962, p. 38.

(3) "The United States Balance of Payments in 1963," p. 73.

(4) U.N., Monthly Bulletin of Statistics, March 1962 and March 1963.

(5) "The United States Balance of Payments in 1963," p. 75.

(6) B. Balassa, "Recent Developments in the Competitiveness of American Industry and Prospects for the Future," p. 40.

Our results lead to the conclusion that in the area with faster increases in productivity we would also expect a larger gap between the GNP deflator and the export price index. This is not the position taken in the Brookings study, however. As table 2 indicates, the authors of the report expect productivity to rise at a rate considerably higher in Western Europe than in the United States under both the initial and the alternative assumptions, while the projected gap between the GNP deflator and the export price index is assumed to be smaller in Europe than in the United States in both instances.

Little explanation is given for the choice of these values, although some remarks are offered in regard to Western Europe. It is argued that while "export industries enjoyed a more rapid growth in productivity than industry in general and the economy as a whole in Western Europe . . . the advantage of the export industries in productivity growth is likely to diminish if not disappear, partly because investment will probably shift away from them" [p. 83].

This statement appears to conflict with theoretical expectations as well as with empirical evidence, however. A consideration of the experience of any industrial country indicates that productivity has a tendency to grow at a slower rate in the service industries than in manufacturing.¹² At the same time, within manufacturing, one can expect a positive correlation between exports and productivity, not only because an expansion of exports permits the use of more advanced technological methods, but also because comparative advantage shifts in response to changes in relative productivity-differentials. Finally, recent experience, e.g., in Germany, suggests that a successful export industry can bid away capital (and labor) from industries producing exclusively for the home market.

It appears, then, that the authors of the Brookings study underestimated the gap between the GNP deflator and export prices in Western Europe as compared to the United States. In this connection, consideration should be given to the effect of modifying the price ratios employed in the report for the estimates. Should we assume that the ratio between the increase in export prices and the GNP deflator in Western Europe will be the same as in the United States, the improvement in the U.S. export balance due to the competitive effect would be \$3.8 billion rather than \$4.8 billion under the initial assumptions and \$0.7 rather than \$1.5 billion under the alternative assumptions (table 2).

¹² In the 1950's the relevant annual percentage rates of growth for output per man in manufacturing and services are 2.9 and 2.3 in the United States, 3.3 and 1.8 in Belgium, 5.7 and 2.9 in Germany, 3.6 and 1.5 in Italy, 3.8 and 2.9 in the Netherlands, 2.2 and 1.4 in the United Kingdom, and 4.9 and 3.4 in Japan. (Bela Balassa, "Trade Prospects for Developing Countries," Yale Economic Growth Center Series No. 24, Homewood, Ill., Richard D. Irwin, to be published in 1964). The relevant information is not available for France.

TABLE 2.—*The competitive effect of projected price changes, 1961-68*

Prices (percentage change)	Brookings estimate		Revised estimate	
	Initial assumptions	Alternative assumptions	Initial assumptions	Alternative assumptions
United States:				
GNP deflators.....	+11.0	+11.0	+11.0	+11.0
Export prices.....	+4.0	+4.0	+4.0	+4.0
Western Europe:				
GNP deflators.....	+20.0	+11.0	+20.0	+11.0
Export prices.....	+11.0	+7.0	+7.0	+4.0
Competitive effect (billion dollars) on—				
U.S. exports to Western Europe.....	+3.5	+1.5	+3.5	+1.5
U.S. imports from Western Europe.....	-----	-.5	-.5	-.8
U.S. exports to rest of the world.....	+1.3	+5	+8	-----
Total.....	+4.8	+1.5	+3.8	+7

Source: "The United States Balance of Payments in 1968," pp. 81-90.

V

Further problems relate to the price and substitution elasticities used in the projections. The estimation of elasticities in international trade has a long history.¹³ In the various contributions the deficiencies of the elasticity calculations have been indicated but, at the same time, some relationships have also been established which can be helpful in examining the use of elasticity coefficients in forecasting.

In the Brookings study, a linear import demand function estimated by R. Rhomberg of the IMF has been utilized, and the price elasticities of imports into industrial areas have been calculated at the mean of the range of observations. Substitution elasticities between United States and European exports to the rest of the world have been derived in the same manner from a linear equation given in GATT, "International Trade," 1959 [p. 86].

The elasticities calculated from a linear equation at the mean of the sample cannot be properly used for projections, however, since elasticities tend toward unity if we extrapolate along a linear function.¹⁴ In the present case, all elasticities exceed unity (2.5 for the imports of Western Europe from the United States, 1.7 for U.S. imports from Europe, and 2 for substitution between United States and European exports to the rest of the world), hence their use for projections will impart an upward bias to the estimates.¹⁵

¹³ For a survey of the literature, see H. S. Cheng, "Statistical Estimates of Elasticities and Propensities in International Trade: A Survey of Published Studies," International Monetary Fund staff papers, August 1959.

¹⁴ The authors of the report purport to justify the choice of the elasticity coefficient instead of a linear regression coefficient in making projections by arguing that "price-quantity relations are logarithmic rather than linear" [p. 82]. But the reasoning is incorrect since either a logarithmic function is regarded more appropriate and then this would have to be fitted in the first place or the relationship is linear and hence extrapolation should be made along the linear function fitted to the observation; in neither case can we use one functional form in calculating a regression and another for forecasting.

¹⁵ A downward adjustment was made, however, in the case of European imports from the United States, where the linear regression yielded a price elasticity of import demand of 4 at the mean of the variables. But this estimate possesses little validity since the regression coefficient had a large standard error, although the regression has been fitted to 3-year moving averages of data so that the independence assumption of the least-squares method ceases to apply. At the same time, in Rhomberg's original calculation, the price elasticity of imports into Western Europe and Japan from the United States is given as 2.2 (Rudolf R. Rhomberg, "A Three-Region World and Income Model, 1948-60," a paper presented to the summer meeting of the Economic Society, Ann Arbor, Sept. 9-11, 1962. I am indebted to Mr. Rhomberg for having made a copy of his paper available to me).

Further, should we accept the substitution elasticity used in regard to imports into the rest of the world from the United States and Europe, which is corroborated by two independent estimates [p. 86], the price elasticities of import demand used in forecasting trade among industrial areas would appear to be overly high. This conclusion is reached by consideration given to the well-known relationships between price and substitution elasticities.

Price elasticities of import demand are always smaller than the corresponding substitution elasticities. If we take the case of the imports of manufactured goods into the rest of the world, for example, where the U.S. share is about 40 percent and the substitution elasticity is 2.6 [p. 86], the elasticity of demand for U.S. exports would appear to be 1.5-1.6 and for European imports 1.0-1.1.¹⁶

At the same time, other things being equal, demand elasticities calculated for trade between industrial areas would be expected to be smaller than demand elasticities derived from elasticities of substitution between the exports of industrial areas to third countries since the former is reduced by the tariff while nondiscriminatory duties do not affect the latter. But against this consideration we should set the existence of preferential arrangements in the Commonwealth and the franc area, as well as the tying of U.S. aid, which tend to reduce the elasticity of substitution between foreign suppliers in the rest of the world.

Among the coefficients used in the projections, the price elasticity of demand of European imports from the United States is of greatest importance since the competitive effect on these imports has been estimated as \$3.5 billion under the initial and \$1.5 billion under the alternative assumptions [pp. 82, 89].¹⁷ On the basis of the considerations noted in regard to the observed relationship between substitution and price elasticities, the elasticity of 2.5 used in the projections appears to be overly high.

Similar conclusions are reached if we consider that the demand for U.S. primary products (about one-half of imports) is price-inelastic in Western Europe so that the elasticity of demand for manufactures would have to exceed 4 in order to arrive at an average elasticity of 2.5. And should we use the ratio of import prices of manufactured goods to the domestic prices of manufactured goods instead of the ratio of import prices to the GNP deflator, the projections of the Brookings study would imply an elasticity of 8¹⁸—a figure which substantially exceeds all previous estimates.¹⁹

Note finally that if we chose to reduce the price elasticity of import demand used in projecting imports into Western Europe by one-third, the increase of American exports to Europe due to the assumed improvement in the competitive position of the United States would be \$2.4 billion under the initial assumptions and \$1 billion under the

¹⁶ Cf., Donald MacDougall, "British and American Exports: A Study Suggested by the Theory of Comparative Costs," pt. II, *Economic Journal*, September 1952, p. 493.

¹⁷ These results are not affected by the suggested revision of the export price index for Western Europe.

¹⁸ The price assumptions used in calculating this figure are those of the Brookings study. Should we use the revised export-price indexes of table 1, and elasticity of over 10 would result under the first variant, while the competitive effect would be nil under the second variant where export prices in Europe and the United States are assumed to rise at the same rate.

¹⁹ Cf. Arnold C. Harberger, "Some Evidence on the International Price Mechanism," *Journal of Political Economy*, December 1957, pp. 506-521.

alternative assumptions, reducing thereby the competitive effect shown in the revised estimates of table 2 to \$2.7 billion in the first case and \$0.2 billion in the second. Correspondingly, the U.S. basic balance would show a deficit of \$0.2 billion under the initial assumptions and \$1.9 billion under the alternative assumptions in 1968, as against a surplus of \$1.9 billion and a deficit of \$0.6 billion estimated by the authors of the Brookings study in the two cases, respectively.

VI

These considerations point to the possible overestimation of prospective improvements in the U.S. balance of payments due to the "competitive effect" in the Brookings study. On the other hand, modifications in the assumed growth rates, price levels, and income elasticities of import demand may give rise to upward adjustments in the estimates. Should one query the feasibility of the high rate of growth assumed for the United States, for example, an improvement in the U.S. trade balance would be indicated by reason of the assumed relationship between incomes and imports and, also, because a lower growth rate is likely to be associated with a more moderate increase in prices, improving thereby the competitive position of the United States in world markets.

But changes in the basic assumptions may lead to downward adjustments, too. For example, in view of the application of anti-inflationary policies in continental Europe, one may question the assumption that the average price level would rise at an annual rate of 3 percent in this area. Thus, changing the basic assumptions will open interesting vistas for possible future developments in the U.S. balance of payments. Such an exercise falls outside our chosen topic, however, since in the present paper we set out to examine the forecasting model used in the Brookings study and to discuss some methodological problems of long-term forecasting in international trade.

