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THE BALANCE OF PAYMENTS STATISTICS

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STATISTICS

OF THE

JOINT ECONOMIC COMMITTEE
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SUBCOMMITTEE ON ECONOMIC STATISTICS

TUESDAY, JUNE 8, 1965

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC STATISTICS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met at 10:05 a.m., pursuant to call, in room 1202, New Senate Office Building, Senator William Proxmire (chairman of the subcommittee) presiding.

Present: Senators Proxmire, Javits, and Miller; Representative Ellsworth.

Also present: Gerald A. Pollack, staff economist; James W. Knowles, executive director; Donald A. Webster, minority economist; and Hamilton D. Gewehr, administrative clerk.

Senator MILLER (acting chairman). The Economic Statistics Subcommittee of the Joint Economic Committee will come to order.

This morning we resume our hearings on the "Report of the Review Committee for Balance of Payments Statistics." The Review Committee's findings and recommendations both as to how the deficit should be defined and how the statistics should be improved are of major importance.

We are fortunate today in having before us three outstanding witnesses, whose insight, experience, and point of view will greatly contribute to our understanding of the policy issues raised by the Review Committee.

Our first witness is Mr. George H. Chittenden, vice president of the Morgan Guaranty Trust Co. of New York. Mr. Chittenden heads his bank's foreign exchange operations and has written extensively about international financial matters, including a study on the New York foreign exchange market. In addition, he has been associated with numerous Government and private organizations concerned with international finance.

I want to call attention to the "Morgan Guaranty Survey" for May 1965, which contains an excellent article illuminating and commenting on the issues raised by the Review Committee. I direct that the "Morgan Guaranty Survey" article on the Bernstein report be printed immediately following today's prepared testimony by Mr. Chittenden.

(Article referred to appears on pp. 96–108.)

Senator MILLER. The second witness, Mr. Hal B. Lary, has had a distinguished career in the U.S. Government, in the United Nations and with the National Bureau of Economic Research, where he is now Associate Director of Research.

He is the author of a path-breaking study entitled "The United States in the World Economy," which the Department of Commerce

published in 1943, and which now, unfortunately, is out of print. In 1963 he published a book entitled "Problems of the United States as World Trader and Banker."

We were privileged to have Mr. Lary as one of our witnesses when the Joint Economic Committee held hearings on the Brookings balance of payments projections in July 1963.

The name of our third witness, Walther Lederer, will be familiar to everyone who has been concerned with the U.S. balance of payments. Since 1954 Dr. Lederer has been Chief of the Balance of Payments Division of the U.S. Department of Commerce. His analyses of the balance of payments, published periodically in the Survey of Current Business, his contributions to other publications in this area, and his speaking appearances have made him a widely known and highly respected authority.

We are aware that Dr. Lederer disagrees sharply with some of the recommendations made by the Review Committee. His own point of view has been most fully elaborated—at least until his appearance today—in a study which he wrote for the International Finance Section of Princeton University, entitled "The Balance on Foreign Transactions; Problems of Definition and Measurement."

We meet this morning to get at the heart of the problem, to realize the full implications of various alternatives, and to try to reach an understanding of what would be the best course of action. So we are especially happy that we will have with us today witnesses who do not fully see eye to eye with the Review Committee and who can give us reasons for their own points of view.

Gentlemen, we welcome you here today and look forward to receiving your testimony. Mr. Chittenden, will you begin?

TESTIMONY OF GEORGE H. CHITTENDEN, VICE PRESIDENT, MORGAN GUARANTY TRUST CO. OF NEW YORK

Mr. CHITTENDEN. Thank you, Mr. Chairman.

I greatly appreciate this opportunity to appear before you to testify on the important work of Dr. Bernstein and his colleagues.

Being neither statistician nor economist, if I am able to make a contribution here this morning, it will be because my involvement in the foreign exchange and international money markets has given me some knowledge of the kinds of transactions which economists and statisticians conjure with in measuring the country's payments position.

I thank you and the committee for the high valuation you place on the Morgan Guaranty Survey's May 1965 article on the Bernstein Committee report. We are very pleased that it will be made a matter of record.

My remarks this morning, I am afraid, are a little longer than can be given in full during the time allotted to me. The full text, however, has been submitted to the committee, and I will brief it in spots in order to stay within the time allowed me.

Senator MILLER. Mr. Chittenden, the subcommittee often directs that the full text be placed in the record and if you would like to have that done, I would so direct and then you may elaborate on it by pointing up its highlights—if that suits you.

Mr. CHITTENDEN. That is satisfactory to me, sir.

Senator MILLER. All right, I direct then that the remarks in full be placed in the record following your remarks.

(See p. 90 for prepared statement.)

Mr. CHITTENDEN. Thank you, sir.

Those who have read that Survey article we were referring to a moment ago realize that it is critical of the findings and recommendations of the Bernstein Committee.

I will not spend too much time elaborating the difference of view. I would rather very briefly express the fact that, in addition to our differences of opinion, we who have studied the Review Committee's report in our bank have the highest admiration for the quality of research and work done by the Committee and its staff. We recognize the very real contributions that the text of the Committee's report makes toward a better understanding of the county's extremely complicated international payments position.

One particular point which the Review Committee stresses is the need for increased appropriations to carry on the work of the Balance of Payments Division of the Department of Commerce. We heartily endorse this suggestion, particularly as it applies to developing better information on capital flows. I understand that Commerce's request for additional funds of modest proportions has been turned down by the House. It is still possible, however, for the Senate to take corrective action.

On the vital question of how the U.S. net payments position should be defined, I feel obliged to take exception to the recommendations made by the Review Committee. This is not because I am fully satisfied with the way in which the Commerce Department has been keeping the accounts. In recent years, in a number of speeches dealing with the U.S. payments situation, I have made suggestions for changing specific aspects of Commerce's bookkeeping. Later on this morning I want to reiterate and elaborate some of these suggestions.

But, relatively speaking, my differences with Walther Lederer are mild. The liquidity approach which he employs makes sense to me in the light of the special role of the dollar as the anchor currency in the world monetary system. With selective refinements, I feel that Commerce's method can be improved. I see less chance and fewer salvage possibilities with the much more seriously deficient "official settlements" approach.

I think by now it is pretty well understood that there is only one key difference between the Bernstein Panel's measurement of the U.S. payments deficit and the measurement provided by Mr. Lederer. This is in the handling of changes in the short-term dollar holdings of foreign private parties.

The Commerce Department puts all increases in such holdings below the line, so to speak, conceding them to be one of the liquidity changes by which the payments deficit is measured. The Bernstein Committee, of course, puts these private capital flows above the line and counts them all as capital inflows and not as settlement items.

I would respectfully suggest that in different ways the accounting procedures of both the Commerce Department and the Bernstein Committee tend to create misunderstanding of the "banking" role of the United States in the world economy. This becomes clear, I think, if one bears in mind that banks perform two closely related principal functions: That of holding funds safe for owners and that of lending funds to users.

I would argue that Commerce—in its preoccupation with financial solvency—tends to overstress the depository function of banking, while the Bernstein Committee, in its eagerness to get the point across that foreigners' working balances must grow, tends to overstate the lending function.

In actual fact, the two are inseparable and one cannot be meaningfully assessed except in relation to the other. As leading banker for the world, the United States must be prepared to see its dollar liabilities to foreigners rise over time, but not so rapidly as to create doubts in the minds of depositors as to whether their funds are safe.

What confronts us here is a knotty and very difficult problem of judgment. One of the most significant facts about the "official settlements" approach is that it sidesteps this problem as regards dollar liabilities to private foreigners. By placing increases in such liabilities above the line, the Bernstein Panel implicitly assumes that precisely the correct amount of working balances is being provided and that the United States, as a supplier and lender of dollars, is erring neither on the side of generosity nor of frugality. In my view, that is a doubtful assumption. Just as it is possible for a commercial bank to overextend itself, so too does this danger exist for the United States as world banker.

At his appearance before this committee on May 11, Dr. Bernstein put great emphasis on the fact that a zero balance of payments deficit by the Commerce definition would not provide the world with additional dollars for working balances.

For the United States to continue supplying balances, he noted, Commerce's figures would have to be in the red. And his contention, in his appearance before this committee on May 11, was that there is something inherently inconsistent about an indicator which signals equilibrium at a reading other than zero.

May I stress that the special magic of zero completely eludes me. I find it especially strange coming from the chairman of a committee which has taken pains to warn against the hazards of simplicity and which has emphasized that the appropriate focus of payments analysis will change with changing circumstances.

It's worth noting that, thanks in part to the efforts of various members of the Joint Economic Committee, we have in recent years gotten away from the simplistic notion that there is something peculiarly appropriate about a zero reading in the Federal budget. We have come to appreciate that there are times when the budget should be balanced, but times also when either a surplus or a deficit may be desirable.

I think we must make the same kind of progress with our payments statistics, and our attitudes toward them, facing up to—rather than sidestepping—the difficult problems of judgment that are involved. What this implies is that we must develop an analytical approach to payments analysis that will help us decide what degree of departure from zero is appropriate at particular times.

With respect to needed growth in foreign private working balances, our starting point should logically be the trend of world trade. I think most people would agree with that. This has expanded during the past decade at an annual rate of about 7 percent. For two reasons, my inclination would be to place the current growth need for working balances somewhat below that percentage.

I'd do so, first, because expansion in foreign private dollarholdings has been particularly large in recent years (averaging about 10 percent since 1958), thus providing something of an operating cushion.

Secondly, I think we may currently be witnessing a tendency toward the more efficient use of dollars by foreigners—that is, more rapid turnover rates, higher velocity of international payments money—traceable in part to the development of the Euro-dollar market, which is an exceedingly efficient bit of financial machinery. Changing patterns of velocity, are, of course, highly relevant to the suggestion I'm making.

Thus, I'd estimate the current growth need for working balances at something like 5 percent annually. Five percent is an estimate. I hold no particular brief for 5 percent; perhaps it should be 3 percent or 7 percent. I would think, however, that it should be something less than the rate of recent years.

This implies an expansion in absolute terms of between $500 million and $600 million. By this standard, of course, the rise of almost $1.8 billion, or roughly 20 percent, which occurred in 1964 was excessively large. So, too, was the rise of about 19 percent that took place in 1959. Both instances provided particularly clear-cut advance warning that dollars were being spewed out at an unsustainable rate.

Since the dollar is not only the world's leading trading currency, but also its key reserve currency, some growth over time also must be expected in foreign official holdings of dollars. At present, however, I'd tend to regard this need as relatively small, since the cooperative efforts among this country and certain foreign countries during the last several years aimed at minimizing U.S. gold losses appear to have produced some residue of reluctantly held foreign official dollars balances. The dollar needs of foreign monetary authorities will change in the future, of course, depending on such things as the amount of newly mined gold that finds it way into official coffers and the evolution of multilateral credit facilities.

Others, looking at the present state of foreign official and foreign private dollar holdings, would undoubtedly come up with a somewhat different estimate of the amount by which Commerce's "balance on regular transactions" would differ from zero if the United States achieved something like payments equilibrium in 1965. I would put the deficit bias at between $500 and $800 million and argue that this should be a tentative target at which to shoot. More important than these particular figures, however, is the analytical approach, which I might note parallels that followed by our Federal Reserve officials in trying to judge what rate of increase is appropriate and safe in the domestic money supply.

If we can arrive at some rough consensus of what degree of departure from zero is normal at particular times (as we have done, for example, with our unemployment figures), I see no obstacle to achieving public understanding of this modified way of interpreting payments figures.

Senator MILLER. Might I ask you a question or two at this point?

Mr. CHITTENDEN. Certainly.

Senator MILLER. With respect to the monetary supply, you have, I believe, in effect, stated that we shouldn't be concerned too much by a so-called zero balance approach. This implies that we should be quite content and should probably welcome an increase in the monetary supply; is that right?

Mr. CHITTENDEN. Internationally, I believe you mean.

Senator MILLER. This implies that we should not only be willing to accept, but encourage an increase in our money supply; is that correct?

Mr. CHITTENDEN. Our domestic money supply?

Senator MILLER. Yes. That's what you were implying?

Mr. CHITTENDEN. That's implicit. From year to year there has, of course, been a regular increase in the domestic money supply, which has been tailored to the needs of the domestic economy, and it is analogous to suggest that the world needs an increasing supply of monetary liquidity as the volume of world business grows.

These two, I think——

Senator MILLER. In other words, you are drawing a parallel between our domestic monetary supply and the world monetary supply.

Mr. CHITTENDEN. Yes.

Senator MILLER. Well, now, the question gets into how much an increase——

Mr. CHITTENDEN. Yes.

Senator MILLER (continuing). With respect to the domestic monetary supply, granted that there may be differences of principle, but I presume that many people would suggest that the monetary supply increase be directly proportioned upon our true economic growth: is that not so?

Mr. CHITTENDEN. Yes.

Senator MILLER. I seem to recall an old economic principle that if our money supply increases more than our true economic growth, then as night follows day, we are going to have inflation.

Mr. CHITTENDEN. I am not——

Senator MILLER. Assuming that one is opposed to inflation or is concerned about it, then I suppose that they would like to have the money supply increase not more than a true economic growth.

(Senator Proxmire enters the room.)

Mr. CHITTENDEN. That is a desirable objective, of course, and no one yet has figured out how to measure precisely the needs nor respond to those needs with precision.

The point I am trying to make, of course, is that with the expansion of world business, even as with the expansion of domestic economic activity, there is a need for more money.

Senator MILLER. I think your point is very valid there. But I am suggesting to you that we may have considerably more difficulty in rationalizing the two points.

As I see it on the domestic scene, the test or the standard would be true economic growth.

Mr. CHITTENDEN. Yes.

Senator MILLER. And on the international scene, beyond whether we are capable of advocating or increasing the world money supply or the monetary supply on the basis of world economic growth, are you suggesting that that be the best, too?

Mr. CHITTENDEN. Growth in world business is even more difficult to measure than domestic growth, of course, because it is more complex and more diverse. The means of measurement that I have suggested here is the growth in world trade. That is one indicator, one key to appropriate increases in international liquidity. It is a convenient one. I make no brief for using it in isolation.

Senator MILLER. I am glad you said it is an indication, but that would be somewhat corresponding to our gross national product on the domestic scene, would it not?

Mr. CHITTENDEN. I think we are in the habit of using those two indexes in the same way; yes.

Senator MILLER. Yes; but I am sure you wouldn't advocate that we increase our domestic money supply by the amount of the increased gross national product?

Mr. CHITTENDEN. No; but there is some key in one to the other which is beyond me to define precisely. I think I can add no great wisdom to the existing supply of it on that subject.

Senator MILLER. That you are. I just wanted to make sure I was receiving your point of view on this and recognize that there is a relationship between—or at least there is a parallel between—our own domestic money supply and the world money supply.

But I was hoping that you might be able to give us a little better indication of how we might measure the amounts that should be increased each year, both domestically and on the international scene.

Mr. CHITTENDEN. I am sure there are many of us that wish we cound find that answer and then implement it.

Senator MILLER. Please continue.

Senator PROXMIRE (presiding). Let me just interrupt to say a personal note that I am delighted to see Mr. Chittenden here. He and I were at J. P. Morgan Co. years ago.

I am happy to see he has all his hair, hasn't aged, and is still more handsome than before and has developed a great deal of experience in this area in which he is testifying in this hearing. I am so happy to see an old friend I haven't seen for about 20 years.

Mr. CHITTENDEN. I am delighted to be here and to see you looking no older, though perhaps a little less adorned on top than when I last saw you.

To go back to the discussion, this, to my way of thinking, is the first of two major steps that we must take in the direction of improving our payments analysis. I will get to the other in a few minutes.

First, however, I would like to stress that the Review Committee's alternative recommendation takes us down quite a different and much less promising path. By excluding all changes in foreign private dollar holdings from its definition of the U.S. deficit position, it distracts public attention from developments that are bound to have a vital bearing on the international status of the dollar.

Sensing this itself, it tries—in effect—to undo some of the damage by proposing that changes in the short-term dollar holdings of foreign commercial banks be shown prominently as a separate category above the line in balance of payments tabulations. Considering, however, the public's tendency to focus mainly on the deficit figure itself, I feel that this procedure provides no guarantee that changes in foreign private dollar holdings will command the attention they deserve.

Moreover, I would strongly underscore the fact that on a short-term basis the "independent" evaluation of changes in private dollar holdings is especially difficult. This is because of the frequent large-scale intervention of United States and foreign monetary authorities in the exchange markets for the specific purpose of inducing private parties to hold more or fewer dollars (usually more) than they would be inclined to hold on a straight investment basis.

The German Bundesbank, for instance, may sell spot dollars to a German private bank on especially favorable terms, at the same time providing the private bank with a guaranteed safe exit from the dollars at some specified future date by entering into a forward exchange contract.

Swap transactions of this kind and outright forward exchange operations sometimes run into hundreds of millions of dollars quarterly, as has been disclosed in periodic reports prepared by Mr. Charles A. Coombs of the Federal Reserve Bank of New York.

Under Commerce's method of bookkeeping, these special exchange activities do not affect the reported balance of payments deficit, since there is a washout between the decreased dollar holdings of official parties and the increased dollar holdings of private parties.

Under the Review Committee's definition, however, the reported deficit would be held down in any period when private foreigners were induced to keep or to acquire more dollars than they would have been willing to hold, had they not been offered special incentives and deals.

This is a major flaw in the "official settlements" method. If special exchange transactions happen to total $250 million in a quarterly period, as they have on past occasions, this would have the effect of "prettying up" the deficit by a billion dollars at an annual rate.

The Review Committee is forced to concede the possibility of such distortion, but it seems to feel that this can be lived with if analysts give careful attention to the extent to which foreign commercial bank holdings of dollars have been influenced by official actions. But this is precisely what analysts cannot do, since no country's balance of payments accounting reveals the forward exchange contract liabilities of its central bank, treasury, or private business and financial community.

With a considerable time lapse, we do get an accounting in Mr. Coombs' reports of the nature of U.S. involvement in exchange markets, but the information usually comes too late to guide our interpretation of quarterly balance of payments reports.

The degree and the thoroughness with which other central banks report intervention activities varies greatly, and the whole constellation of information that belatedly does come from central banks is only partial by the time the analyst gets hold of it.

And we cannot reasonably demand it earlier, for there are times when it would be disadvantageous for the United States to reveal its forward exposure. It must wait until its position has been unraveled—that is, until forward contracts have been fulfilled during ensuing periods—as was the case with its enormous 1962 forward lira commitments.

It was only last autumn that we finally learned that they had totaled a half billion dollars at their peak. And that is only a part of that particular picture, since the Italian central bank, Banca d'Italia, had additional forward lira contracts of several hundred million dollars outstanding concurrently.

The net of all this is that the "official settlements" method can seriously warp payments figures over the short run. And it is in the short run, as Lord Keynes reminded us in another connection, that we do all our living.

None of these difficulties plague Commerce's accounting procedures, which is a prime reason why I favor concentrating on their improvement along the lines mentioned earlier.

Senator PROXMIRE. Could I interrupt for a moment, Mr. Chittenden? I recognize you have been responding to questions by Senator Miller, but because our time is limited and because we do have Mr. Lary and Mr. Lederer coming up, I would appreciate it if you could summarize in the next couple of minutes and we will come back in the question period to you.

Mr. CHITTENDEN. Well, my second recommendation is that the Commerce Department undertake a netting of criss-crossing or self-balancing banking transactions in instances where foreigners are "locked into" holdings of U.S. dollars that they have received because of closely linked liabilities to U.S. parties.

The Review Committee came to the conclusion that netting was neither desirable nor feasible, but I do not find this contention adequately supported in its report.

As the first candidate for netting, let me point to the existing statistics on the United States-Canadian market interrelationships. In the last couple of years, the non-Canadian dollar deposit liabilities of the chartered banks—most of which are U.S. dollars—have reached a level of almost $5 billion. One continuing flow of money from the United States to Canada involves the placement of U.S. dollar time deposits with chartered Canadian banks through the intermediary of their New York agencies.

From regular reports submitted by the Canadian bank agencies to the New York Fed, an accurate and current record is kept of the amounts of U.S. dollars the Canadian bank agencies receive from and owe to their head offices in Canada, as well as the use to which these funds are put in the U.S. market by these agencies.

It has always seemed unreasonable to me that this country's gross placements of dollar deposits with the Canadian banks should count as capital outflows, but that the important capital inflow represented by the reinvestment of a certain part of these dollars in our market should not be counted as an offset or as a capital inflow. This is a money market phenomena, a bit of market action that is perfectly normal. It is continuing and measurable. Some appreciable amount of money could appropriately be netted.

There is another area that should be combed for netting possibilities. That is the area of the Euro-dollar market. We should address ourselves to the question of who supplies the dollars to that market and undertake to determine also who holds those dollars, and to what end use they are put.

There is, I believe, a discernible percentage of the total amount of Euro-dollars, which is traceable in ownership to offshore U.S. entities, who by Executive Order No. 10905, I believe, are not, in fact, permitted to buy gold with their funds any more than the parent concerns could do in the United States.

It appears to me that this kind of money, if identified and accurately accounted, which I believe to be possible, could certainly be used as an item susceptible to offsetting part of our short-term liabilities to foreigners.

A large amount of these floating external dollars is banked with the foreign branches of U.S. banks which in turn rebank these dollars with their head offices at home.

Another area which too often has been dismissed as too difficult to deal with by netting is U.S. short-term investment abroad on a hedged basis—so-called interest arbitrage. Those relatively few banks and investment dealers that handle this type of transaction know almost exactly the degree to which short-term investments are hedged against exchange risk by the sale of forward exchange for dates to match the maturity of the investment instrument purchased. Is it not reasonable to use the total of this type of claim on foreigners in full or in part as a measurable offset to total foreign claims against us?

The interrelatedness of these transactions is complicated, but it is only through searching and sophisticated analysis, oriented to the actual workings of the marketplace, that a realistic and meaningful measurement of this country's international position can be made.

With a modest increase in staff, a bit more legwork, and closer cooperation with the Federal Reserve Board and the New York Federal Reserve Bank, the Treasury Department and, most importantly, the marketplace, I feel that this type of analysis is well within the capacties of the Commerce Department.

The several suggestions that I have made for netting do not exhaust the possibilities. I shall be happy to discuss this subject further during the question period if time permits.

Thank you.

Senator PROXMIRE. Thank you, Mr. Chittenden.

PREPARED STATEMENT OF GEORGE H. CHITTENDEN, VICE PRESIDENT, MORGAN GUARANTY TRUST CO. OF NEW YORK

I greatly appreciate this opportunity to appear before you to testify on the important work of Dr. Bernstein and his colleagues.

Being neither statistician nor economist, if I am able to make a contribution here this morning, it will be because my involvement in the foreign exchange and international money markets has given me some knowledge of the kinds of transactions which economists and statisticians conjure with in measuring the country's payments position.

Those of you who have seen the May issue of the Morgan Guaranty Survey have undoubtedly anticipated that I will be aiming some adverse remarks at the Review Committee's proposals. The analysis contained in the May Survey represents a consensus reached after lengthy discussion among a number of us at the bank who have followed payments matters closely over the years. Though I did not write it, I nonetheless propose to use it as the starting point for my comments here today.

The Survey article takes issue with the Review Committee's recommendations and conclusions, contained in chapter 9 of its report, as to how the country's net payments position should be defined and measured. We have nothing but admiration, however, for the committee's painstaking review of the many data-gathering problems associated with the elements that make up the total payments picture. The Panel's work in this area is splendidly informative. Hopefully, it will have the result of increasing Congress' willingness to appropriate funds for statistical improvements. This could well mean a heavier reporting burden for business and banks. Much as we at times complain about the existing reporting burden, that becomes a secondary consideration in the light of the vital national policy decisions which are bound to be influenced by our payments statistics.

In particular, I think it is penny wise and pound foolish to settle for less than the best information we can develop about U.S. capital outflows. These have grown very rapidly in recent years, and there is reason to suspect—because of the big swings in "net errors and omissions"—that some have gone unrecorded or been misinterpreted. Other witnesses are far better qualified than I am to put priority ratings on benchmark needs and to estimate the expenditures that would be entailed. My understanding is that considerable benefits could be derived from relatively small budgetary amounts.

As a case in point I would cite Commerce's pending request for an additional $100,000 annually to undertake a series of surveys relating to U.S. international

investments, including an updating of the 8-year-old benchmark data for direct investments. Congress last year denied Commerce the funds that it requested for this undertaking. Along with the Bernstein Panel, I would strongly urge that the money be voted in the present session. It is a matter of great concern that these funds have once again been deleted by the House Appropriations Committee. There is still time, however, for the Senate to initiate corrective action.

On the vital question of how the U.S. net payments position should be defined, I feel obliged to take exception to the recommendations made by the Review Committee. This is not because I am fully satisfied with the way in which the Commerce Department has been keeping the accounts. In recent years, in a number of speeches dealing with the U.S. payments situation, I have made remarks concerning specific aspects of Commerce's bookkeeping. Later on this morning I want to reiterate and elaborate some of these grievances.

But, relatively speaking, my differences with Walther Lederer are mild. The liquidity approach which he employs makes sense to me in the light of the special role of the dollar as the anchor currency in the world monetary system. With selective refinements, I feel that Commerce's method can be improved. I see no such salvage possibilities with the much more seriously deficient "official settlements" approach.

I think by now it is pretty well understood that there is only one key difference between the Bernstein Panel's measurement of the U.S. payments deficit and the measurement provided by Mr. Lederer. This is in the handling of changes in the short-term dollar holdings of foreign private parties.

The Commerce Department puts all increases in such holdings below the line in its payments tabulations, considering them to be one of the liquidity changes by which the payments deficit is measured. It reasons that these dollars may be readily shifted to foreign official accounts and that they therefore constitute almost as much of a potential claim on the U.S. gold stock as do dollars already in the accounts of foreign monetary institutions.

In the "official settlements" approach, all increases in the short-term dollar holdings of foreign private parties are placed above the line and regarded as ordinary inflows of capital to the United States. They are thus a credit entry, helping to reduce the size of the country's payments deficit. In defense of this procedure, the Bernstein Committee argues that, because of the financing role of the United States in the world economy, it is normal for private foreign holdings of dollars to expand as growth occurs in world trade. Far from being a source of worry, increases in foreign private ownership of dollars, the Bernstein Committee feels, should be viewed chiefly as a sign of the dollar's strength and acceptability.

I would respectfully suggest that in different ways the accounting procedures of both the Commerce Department and the Bernstein Committee tend to create misunderstanding of the "banking" role of the United States in the world economy. This becomes clear, I think, if one bears in mind that banks perform two closely related principal functions: that of holding funds safe for owners and that of lending funds to users. I would argue that Commerce—in its preoccupation with financial solvency—tends to overstress the depositary function of banking, while the Bernstein Committee—in its eagerness to get the point across that foreigners' working balances must grow—tends to overstate the lending function. In actual fact, the two are inseparable and one cannot be meaningfully assessed except in relation to the other. As lending banker for the world, the United States must be prepared to see its dollar liabilities to foreigners rise over time, but not so rapidly as to create doubts in the minds of depositors as to whether their funds are safe.

What confronts us here is a knotty and tortuous problem of judgment. One of the most significant facts about the "official settlements" approach is that it sidesteps this problem as regards dollar liabilities to private foreigners. By placing increases in such liabilities above the line, the Bernstein panel implicitly assumes that precisely the correct amount of working balances is being provided and that the United States as a supplier and lender of dollars is erring neither on the side of generosity nor of frugality. In my view, that is a doubtful assumption. Just as it is possible for a commercial bank to overextend itself, so too does this danger exist for the United States as world banker.

It is no secret that the management of a bank sometimes says no to the eager proposals of its own lending officers because it judges that the bank is, for the time being, "loaned up." This doesn't mean that the bank has no wish to continue growing or to see its customers keep growing and help them keep growing. It merely means that the management, mindful of its obligation to all depositors,

deems it necessary to call a breathing spell. Any method of payments bookkeeping which tends to direct our attention away from the need of judging considerations of this kind serves the country poorly.

At his appearance before this committee on May 11, Dr. Bernstein put great emphasis on the fact that a zero balance of payments deficit by the Commerce definition would not provide the world with additional dollars for working balances. For the United States to continue supplying balances, he noted, Commerce's figures would have to be in the red. And his contention is that there is something inherently inconsistent about an indicator which signals equilibrium at a reading other than zero.

May I stress that the special magic of zero completely eludes me. I find it especially strange coming from the chairman of a committee which has taken pains to warn against the hazards of simplicity and which has emphasized that the appropriate focus of payments analysis will change with changing circumstances.

It is worth noting that, thanks in part to the efforts of various members of the Joint Economic Committee, we have in recent years gotten away from the simplistic notion that there is something peculiarly appropriate about a zero reading in the Federal budget. We have come to appreciate that there are times when the budget should be balanced, but times also when either a surplus or a deficit may be desirable. I think we must make the same kind of progress with our payments statistics, facing up to—rather than sidestepping—the difficult problems of judgment that are involved. What this implies is that we must develop an analytical approach to payments analysis that will help us decide what degree of departure from zero is appropriate at particular times.

With respect to needed growth in foreign private working balances, our starting point should logically be the trend of world trade. This has expanded during the past decade at an annual rate of about 7 percent. For two reasons, my inclination would be to place the current growth need for working balances somewhat below that percentage. I'd do so first because expansion in foreign private dollar holdings has been particularly large in recent years (averaging about 10 percent since 1958), thus providing something of an operating cushion. Secondly, I think we may currently be witnessing a tendency toward the more efficient use of dollars by foreigners—that is, more rapid turnover rates—traceable in part to the development of the Euro-dollar market. Thus, I'd estimate the current growth need for working balances at something like 5 percent annually, which implies an expansion in absolute terms of between $500 and $600 million. By this standard, of course, the rise of almost $1.8 billion, or roughly 20 percent, which occurred in 1964 was excessively large. So too was the rise of about 19 percent that took place in 1959. Both instances provided particularly clear-cut advance warning that dollars were being spewed out at an unsustainable rate.

Since the dollar is not only the world's leading trading currency but also its key reserve currency, some growth over time also must be expected in foreign official holdings of dollars. At present, however, I'd tend to regard this need as relatively small, since the cooperative efforts among this country and certain foreign countries during the last several years aimed at minimizing U.S. goal losses appear to have produced some residue of reluctantly held foreign official dollar balances. The dollar needs of foreign monetary authorities will change in the future, of course, depending on such things as the amount of newly mined gold that finds its way into official coffers and the evolution of multilateral credit facilities.

Others, looking at the present state of foreign official and foreign private dollar holdings, would undoubtedly come up with a somewhat different estimate of the amount by which Commerce's "balance on regular transactions" would differ from zero if the United States achieved something like payments equilibrium in 1965. I would put the deficit bias at between $500 and $800 million and argue that this should be a tentative target at which to shoot. More important than these particular figures, however, is the analytical approach, which I might note parallels that followed by our Federal Reserve officials in trying to judge what rate of increase is appropriate and safe in the domestic money supply. If we can arrive at some rough consensus of what degree of departure from zero is normal at particular times (as we have done, for example, with our unemployment figures), I see no obstacle to achieving public understanding of this modified way of interpreting payments figures. This, to my way of thinking, is the first of two major steps that we must take in the direction of improving our payments analysis. I will get to the other in a few minutes.

First, however, I would like to stress that the Review Committee's alternative recommendation takes us down quite a different and much less promising path. By excluding all changes in foreign private dollar holdings from its definition of

the U.S. deficit position, it distracts public attention from developments that are bound to have a vital bearing on the international status of the dollar. Sensing this itself, it tries—in effect—to undo some of the damage by proposing that changes in the short-term dollar holdings of foreign commercial banks be shown prominently as a separate category above the line in balance of payments tabulations. Considering, however, the public's tendency to focus mainly on the deficit figure itself, I feel that this procedure provides no guarantee that changes in foreign private dollar holdings will command the attention they deserve.

Moreover, I would strongly underscore the fact that on a short-term basis the independent evaluation of changes in private dollar holdings is especially difficult. This is because of the frequent large-scale intervention of United States and foreign monetary authorities in exchange markets for the specific purpose of inducing private parties to hold more or fewer dollars (usually more) than they would be inclined to hold on a straight investment basis.

The Bundesbank, for instance, may sell spot dollars to a German private bank on especially favorable terms, at the same time providing the private bank with a guaranteed safe exit from the dollars at some specified future date by entering into a forward contract. Swap transactions of this kind and outright forward operations sometimes run into hundreds of millions of dollars quarterly, as has been disclosed in periodic reports prepared by Mr. Charles A. Coombs of the Federal Reserve Bank of New York. Under Commerce's method of bookkeeping, these special exchange activities do not affect the reported balance-of-payments deficit, since there is a washout between the decreased dollar holdings of official parties and the increased dollar holdings of private parties. Under the Review Committee's definition, however, the reported deficit would be held down in any period when private foreigners were induced to keep or to acquire more dollars than they would have been willing to hold had they not been offered special deals.

This is a major flaw in the "official settlements" method. If special exchange transactions happen to total $250 million in a quarterly period, as they have on past occasions, this would have the effect of "prettying up" the deficit by a billion dollars at an annual rate. The Review Committee is forced to concede the possibility of such distortion, but it seems to feel that it can be lived with if analysts give careful attention to the extent to which foreign commercial bank holdings of dollars have been influenced by official actions. But this is precisely what analysts cannot do, since no country's balance-of-payments accounting reveals the forward exchange contract liabilities of its central bank, treasury, or private business or financial community. With a considerable time lapse, we do get an accounting in Mr. Coombs' reports of the nature of U.S. involvement in exchange markets, but the information usually comes too late to guide our interpretation of quarterly balance-of-payments reports. And we cannot reasonably demand it earlier, for there are times when it would be disadvantageous for the United States to reveal its forward exposure. It must wait until its position has been unraveled, as was the case with its enormous 1962 forward lira commitments. It was only last autumn that we finally learned that they had totaled a half billion dollars at their peak. And that is only a part of the full picture, since the Italian central bank had additional forward lira contracts of several hundred million dollars outstanding concurrently. The net of all this is that the "official settlements" method can seriously warp payments figures over the short run. And it is in the short run, as Lord Keynes reminded us in another connection, that we do all our living. None of these difficulties plague Commerce's accounting procedures, which is a prime reason why I favor concentrating on their improvement along the lines mentioned earlier.

As I have said, there are two major steps we must take in the direction of improving our payments analysis. The first is to change our analytical approach to recognize and publicize that under the Commerce definition some departure from zero is consistent with payments equilibrium This would improve the meaningfulness of Commerce's overall summary indicator.

But there is also a need to correct certain deficiencies in the treatment and presentation of the constituent elements of the balance of payments, particularly with regard to short-term capital outflows. It is well understood, I think, that some of these outflows add only marginally to the potential demands which foreigners can make on the U.S. gold stock. This is the case where foreigners are "locked into" holding U.S. dollars that they have received because of closely linked liabilities to U.S. parties.

My second recommendation, then, is that Commerce undertake a netting of such crisscrossing transactions so as to represent the country's capital transactions in a more meaningful way. This will entail some writing down of short-term

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capital outflows and a corresponding reduction in the increases shown in foreign holdings of short-term dollar assets. As this occurs, it will of course reduce the indicated growth need for foreign working balances, but that is something that analysts can allow for. I am not prepared this morning to estimate the dollar sums involved in netting, but only to point to some areas where I think the procedure could appropriately start.

The Review Committee came to the conclusion that netting was neither desirable nor feasible, but I do not find this contention adequately supported in its report.

As the first candidate for netting, let me point to the existing statistics on the United States-Canadian market interrelationships. One continuing flow of money from the United States to Canada involves the placement of U.S. dollar time deposits with Canadian banks through the intermediary of their New York agencies. Canadian banking statistics give an accurate and up-to-date figure of the non-Canadian dollar deposit liabilities of the chartered banks, the bulk of which are U.S. dollars. At the end of December 1964, for instance, they stood at U.S.$4,852 million; at the end of January 1965, $4.965 million; at the end of April $4,394 million. From regular reports submitted by the Canadian bank agencies to the New York Fed, an accurate and current record is kept of the amounts of U.S. dollars the Canadian bank agencies receive from and owe to their head offices in Canada, as well as the use to which these funds are put in the U.S. market by these agencies. It has always seemed unreasonable to me that this country's gross placements of dollar deposits with the Canadian banks should count as capital outflows but that the important capital inflow represented by the reinvestment of those same dollars in our own market by the Canadian bank agencies should not be used as a partial offset. Since 1958, Canadian banks have held between $600 million and $1 billion of call loans in the New York market. During these years the Canadian agencies have, in fact, supplied between a third and a half of all of the call loan credit extended by the entire New York City banking community to brokers and dealers for carrying securities. The point in this is that a perfectly normal, continuing, and precisely measurable market phenomenon of competitive international banking, which incidentally is a matter of importance and value to the smooth functioning of the New York money and securities markets, has a disproportionately negative effect on the U.S. balance-of-payments computations as now made by the Commerce Department. In this one, quite simple, example of failure to use readily available statistics lies much of the reason why Commerce's payments figures have been criticized.

There is another area in which heretofore unpublished statistics which are now being gathered by the Fed on behalf of the Treasury could reasonably be used to determine on a current basis an appropriate offset to total foreign short-term claims on the United States. These are the statistics which are gathered weekly from all banks having branches abroad stating both the liabilities of the foreign branches to head office and head office liabilities to foreign branches on a country-by-country basis. Since these figures are not published I cannot quote them accurately, but my guess is that at least a half billion dollars is kept on deposit by the foreign branches of American banks with head offices in New York. It takes a pretty vivid imagination to consider that all of these deposits, safely stored with banks that are under the direct eye of our banking authorities, are appropriately includable in the outside world's total potential claims on the U.S. Treasury's gold stock. If I know anything about U.S. bank management, a substantial portion of these liabilities is clearly subject to control by U.S. residents and by no means beyond the influence of our monetary authorities.

There is another item in the complex of the Euro-dollar market which may also be subject to appropriate netting by expert analysts. This revolves around the question of who owns, supplies, and uses the sizable funds which float in the international money market, or Euro-dollar market.

There is very little direct U.S. resident, U.S. address, money on the books of American overseas branch banks. The bulk of the U.S. resident funds which find their way to the Euro-dollar market flow through the Canadian banks. By the time they reach the books of American branch banks abroad, the identity of their beneficial ownership has become totally obscured. But American overseas subsidiaries and affiliates, offshore trading companies, etc. have an instinctive (and entirely justifiable) habit of keeping their working capital cash surpluses in dollars rather than other currencies. These dollars seek temporary outlet in the Euro-dollar market; and a goodly proportion, again quite wisely, is placed in shortish time deposits with American branch banks abroad.

Dealing as I do in the Euro-dollar market I would estimate that approximately 20 percent of the Euro-dollar deposits in overseas branches of U.S. banks have

been received from U.S.-controlled or U.S.-affiliated depositors abroad, and are identifiable as such. In accordance with U.S. statute and regulation it would be illegal for these American-affiliated companies to buy or hold gold. Is it therefore reasonable to count that kind of money as a serious direct or indirect threat to our gold supply?

I do not suggest that enough data are now on hand to make this type of money an immediate candidate for netting against our foreign liabilities, but I do suggest that research in the general area of defining who owns all these foreign claims on us should be pursued and that the pursuit is neither such a herculean task as the Review Committee apparently believes it to be, nor so difficult or irrelevant as the Commerce Department heretofore seems to have felt.

Another area which has been dismissed as too difficult to deal with by those who might be inclined to indulge in statistical netting is the international money-market activity in short-term foreign investment on a hedged basis—interest arbitrage. A number of years ago, our bank and others began supplying our customers investment service which included short-term investment of funds, largely in the Canadian and British money markets. We started this business way back when foreign investment first became fashionable—long before anyone dreamed that one day it might also be "unpatriotic." Parenthetically I should state that since February 10 our customers' interest in this type of activity and our willingness to suggest it has been materially reduced, and the total outstandings of this type of investment have, during the past 4 months, declined by—I would estimate—approximately one-third. Prior to the imposition of "voluntary restraint," U.S. holdings of short-term Canadian paper alone totaled at least a half billion dollars.

Those relatively few banks and investment dealers that handle this type of transaction know almost exactly the degree to which these investments are hedged against exchange risk by the sale of forward exchange for dates to match the maturity of the investment instrument purchased. Is it not reasonable to use the total of this type of claim on foreigners in full or in part as a measurable offset to total foreign claims against us?

The interrelatedness of these transactions is complicated but it is only through such searching and sophisticated analysis, oriented to the actual workings of the marketplace, that a realistic and meaningful measurement of this country's international position can be made. With a modest increase in staff, a bit more legwork, and closer cooperation with the Federal Reserve Board and the New York Federal Reserve Bank, the Treasury Department, and, most importantly, the marketplace, I feel that this type of analysis is well within the capacities of the Commerce Department.

The several suggestions that I have made for netting do not exhaust the possibilities. I shall be happy to discuss this subject further during the question period if time permits.

Thank you.

The Bernstein Report[1]

The Payments Deficit—What Manner of Measure?

The balance of payments, like the vermiform appendix, doesn't attract attention until something is seriously wrong with it. Government statisticians began compiling payments figures, and publishing them in the Commerce Department's Trade Information Bulletin, in the early 1920's, but the surpluses and deficits that interested most Americans over the ensuing decades were in the Federal budget, not in the country's international transactions.

Popular discovery of the balance of payments came late in the 1950's, when large gold losses flashed word that something had gone wrong. By that time, the international accounts kept by the Commerce statisticians had long been showing red figures in U.S. financial dealings with the rest of the world. If the payments scorecard had been getting half the attention that was going to such well-watched indicators as industrial production, gross national product, or the unemployment rate, quite possibly corrective action would have begun much earlier.

In any case, the balance of payments is not likely soon to slip back out of public consciousness. The official quarterly readings—and the dribs and drabs of conjecture, surmise, and prediction that come between—will rank as important news at least as long as the present chronic deficit remains a threat to the dollar. But, if there is no longer any danger that balance of payments statistics will be ignored, there is real danger that their effectiveness as a warning device will be dulled by the controversy that has developed over precisely what the balance of payments deficit is.

The controversy began among specialists in payments accounting just about the time laymen were getting interested in the subject. Basically it involved a challenge to the Commerce Department's method of figuring the country's international financial position. The official presentation, critics charged, was overstating the payments deficit. They pointed out that Commerce was using stricter criteria than any other country. Commerce, in reply, noted that the United States occupies a unique position as custodian of the world's key reserve currency and therefore needs a singularly strict standard.

When specialists differ, laymen tend to doubt. Sensing the need to maintain public confidence in figures that would continue to have a vital bearing on national policy, President Kennedy in April 1963 announced that the Director of the Bureau of the Budget was appointing a Review Committee for Balance of Payments Statistics. This panel of eight economists from outside Government, known as the Bernstein Committee, after its Chairman, Dr. Edward M. Bernstein,[2] presented its report last month. The document's chief effect is to give formal statement to certain objections frequently leveled at the Commerce Department's approach, and presumably to set the stage for a decision at the highest level of Government as to how the payments books are to be kept in the future.

How that decision goes is important for reasons much deeper than mere considerations of statistical technique. What is at stake, indeed, transcends the sizable dollar differences between the U.S. payments position as it has been reported by Commerce and as it would have been stated under the system advocated by the Committee (table on p. 97). The choice ultimately made (an interdepartmental study group has been created to comment to the Budget Bureau on the Committee's report, and congressional hearings on the report have begun) will inevitably condition the making of national policies to deal with the balance of payments problem. It may well have a critical bearing

[1] Reprinted from the May 1965 issue of the Morgan Guaranty Survey, published monthly by Morgan Guaranty Trust Co. of New York.

[2] Besides Dr. Bernstein, who is a former Director of Research of the International Monetary Fund, the members were: Prof. Richard E. Caves, Harvard University; Mr. George Garvy, economic adviser, Federal Reserve Bank of New York; Mr. Walter N. Hoadley, vice president and treasurer, Armstrong Cork Co.; Prof. Harry G. Johnson, University of Chicago; Prof. Peter B. Kenen, Columbia University; Mr. Roy L. Reierson, senior vice president, economics, Bankers Trust Co.; Mr. Charles F. Schwartz, Assistant Director, Western Hemisphere Department, International Monetary Fund. The Committee was made advisory to the Bureau of the Budget pursuant to the Bureau's general responsibility for statistical coordination and statistical standards within the Federal Government.

on whether appropriate policies are pursued, and it certainly will affect the degree of public support that those policies receive.

Most of the 194 pages of the Review Committee's report[3] are devoted to technical questions that do not bear directly on the controversy that led to the panel's appointment. The group considers at length how best to arrange and label tabular material so as to make it serviceable to users. It also painstakingly reviews data-gathering problems associated with each element of the balance of payments (exports, imports, travel, etc.). It considers whether enough information is being collected in each case and whether the figures that do come in are correct.

Difference in deficits

[In millions of dollars]

Quarters	Deficit		Difference (1)−(2)	Quarters	Deficit		Difference (1)−(2)
	(1) [1]	(2) [2]			(1) [1]	(2) [2]	
1959—1st	1,101	748	353	1963—1st	1,170	923	247
2d	1,062	660	402	2d	1,314	1,129	185
3d	1,191	668	523	3d	379	172	207
4th	824	444	380	4th	398	33	365
1960—1st	761	334	427	1964—1st	267	83	184
2d	915	627	288	2d	622	577	45
3d	1,015	986	29	3d	659	258	401
4th	1,227	1,508	−281	4th	1,505	586	919
1961—1st	491	784	−293	Years:			
2d	554	43	511	1959	4,178	2,520	1,658
3d	728	429	299	1960	3,918	3,455	463
4th	1,298	787	511	1961	3,071	2,043	1,028
1962—1st	892	364	528	1962	3,605	3,333	272
2d	496	589	−93	1963	3,261	2,257	1,004
3d	918	1,304	−386	1964	3,053	1,507	1,546
4th	1,299	1,076	223				

[1] Col. (1) shows U.S. payments deficits on "regular transactions" (Commerce Department).
[2] Col. (2) shows deficits on "official settlements" (Bernstein Committee).

NOTE.—Quarterly data seasonally adjusted.

The Committee's work in this area combines scholarship and practicality. It should have constructive effect, especially in sustaining the newly broadened public interest in the Nation's balance of payments problem and in encouraging Congress to put up the funds with which the Commerce Department's Balance of Payments Division can do an even better job.

Not surprisingly, the report finds that a variety of improvements are possible in the complex task of gathering payments statistics. It states, however, that "the statistics currently collected and published provide a reliable basis for appraising the U.S. payments situation." There is no reason for thinking, it says, that any incorrect policy steps have thus far been taken because of gaps in statistical coverage, but it expresses concern that wrong policy decisions "could occur in the future" because of deficiencies in data.

Call for a new number

The juice of the report is in the 21 pages of chapter 9, where the Committee deals with the crucial question of defining and measuring the country's net payments position. The panel's basic conclusion is that the Commerce Department's concept "does not provide the most useful basis for summarizing the overall payments position, and may often yield a misleading impression of the position." It argues that Commerce's "balance on regular transactions" should be replaced by a new indicator, called the "balance settled by official transactions."

That such a changeover would have a profound impact on thinking about the U.S. balance of payments problem is clearly indicated by the table on this page. The official settlements approach yields a smaller deficit than does the Commerce Department's present method in all but four quarterly periods from the beginning of 1959 through the end of 1964. The discrepancies are often—as in the last half of 1964—very large. On the basis of annual figures, the two concepts produce markedly different impressions about the U.S. payments trend during the last several years. Whereas the deficit as computed by the Commerce

[3] "The Balance of Payments Statistics of the United States: Review and Appraisal." Available from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C., $1.50.

Department was in the $3- to $3.6-billion range in each of the years 1962–64, the official settlements deficit showed sharp year-to-year improvement in both 1963 and 1964. Conversely, the deterioration from 1961 to 1962 was more than twice as great in the official settlements version as it was on the regular transactions basis.

Clearly the two methods differ in the "feel" they create of the country's international financial position, and in the kind of policy decisions they are likely to evoke. Curiously, the language of the committee's report suggests that the members did not fully appreciate this. At one point the report notes that "the committee is recommending an important modification, but not a change so radical as to alter sharply the existing views as to the seriousness of the U.S.-payments problem in recent years."

The difference between any two systems of balance of payments accounting (there are many possible approaches besides the Bernstein and the Commerce methods) is in the compiler's view as to what matters most in the accounting country's international dealings. Every system deals with the same total set of transactions, all of which can be divided into two opposing categories: receipts and payments.

It is possible to take a completely neutral view of these transactions, making no distinctions whatever among the impacts that various kinds of transaction within each category have on the country's position. In such a view, all receipts are simply set against all payments (table on p. 100) and the credit side of the ledger balances the debit side—with the aid of an "errors and omissions" item which covers transactions missed by the detailed reporting. This simplistic method of presentation is a balance of payments in the most literal sense: the terms "deficit" and "surplus" don't enter into it.

Some analysts argue that payments accounting should go no further. To assign special significance to certain credits and debits, they insist, involves judgments that are too arbitrary to have place in a statistical display.

Such purism has an arbitrariness of its own. As most economists agree, it is important to focus on how the equality between payments and receipts comes about. Only by doing so is it possible to judge whether the pattern of a country's international transactions is sustainable. Consistently since the time of the 14th-century bullionists, for instance, it has been axiomatic that a country which pays its way internationally by selling goods to foreigners is in much better shape than one which is dipping into its reserves of gold to balance its accounts.

Accordingly, there is wide agreement that sales and purchases of gold have particular importance. Payments compilers recognize this by pulling them out of the simple credits-debits tabulation and, in the jargon of bookkeeping, dropping them below the line. In payments accounting, below-the-line items are called settling transactions, said to offset or finance the surplus or deficit which is the net result of all the items that are above the line.

The Commerce view

The question of which items other than gold transactions belong below the line is the hot nub of current debate about balance of payments accounting. Disagreements arise because economists hold different hypotheses as to what is most important about a country's international financial posture.

The Commerce Department stresses the U.S. special role of financial leadership in the world economy and its unique commitment to gold convertibility. From this premise it argues that the United States should keep its payments ledgers on a conservative "hope for the best but be prepared for the worst" basis. To that end it adopts an arrangement designed to highlight the way in which the country's liquidity position is being affected by international transactions.

This approach assumes that one of the main purposes of payments accounting is to warn of any persistent and significant deterioration in external liquidity—that is, in the relationship between current liabilities and the current assets available for meeting them. In line with this emphasis, Commerce statisticians sift through the columns of debits and credits with the specific objective of identifying: (1) changes in U.S. liquid liabilities to foreigners (making no distinction among different classes of claimant since all foreign dollar holdings are assumed to be potentially redeemable in gold), and (2) changes in liquid assets held by U.S. official bodies and therefore usable to meet any demands that foreigners may make.

The chief examples of the liquid liabilities thus singled out are foreign holdings of dollars deposited with U.S. banks, foreign holdings of marketable U.S. Government securities regardless of maturity, and foreign holdings of short-term debt instruments of U.S. borrowers other than the U.S. Treasury. On the asset side,

the statisticians look at what has happened to U.S. gold holdings, to U.S. drawing rights at the International Monetary Fund, and to holdings of convertible foreign currencies by the U.S. Treasury and the Federal Reserve System.

All such items are dropped below the line (table on p. 100). The columns of credits and debits above the line no longer being equal, the difference between them is taken to be the measure of the country's payments surplus or deficit in the period under consideration; it is, of course, precisely matched by the net effect of the transactions that have been pulled out and placed below the line.

The Committee's view

The Bernstein Committee traces its "official settlements" concept to a hypothesis that appears quite different from the one that is used by Commerce. According to the Bernstein report, the key to arranging a balance of payments presentation is to be found in the responsibility which national monetary authorities—the central banks and treasuries of countries around the world—bear for maintaining stable exchange rates for their currencies. In the course of carrying out this task, monetary authorities gain or lose reserve assets; they also experience increases or decreases in the liabilities they owe to other monetary authorities.

The Bernstein Committee focuses principal attention on these changes in international reserves (consisting of gold, convertible foreign currencies, IMF position and I O U's given by one monetary authority to another). It sees the size of such changes as the best available measure of the imbalance in a given country's international payments.

Thus, in constructing a statement of the U.S. balance of payments (table on p. 102), the Bernstein Committee places below the line principally those debits and credits which reflect changes in the reserves of U.S. monetary authorities and changes in U.S. liabilities to foreign monetary authorities. No distinction is made between "liquid" and "nonliquid" assets or liabilities. The test is whether the liability which has increased or decreased is owed to a foreign national monetary authority. If it is, it is considered to affect reserves and therefore goes below the line, even though it may be, say, an acquisition by a foreign monetary authority of a nonmarketable U.S. Government security whose maturity is far off.

GUIDE TO THE DIFFERENCE

The important bookkeeping differences between the Commerce Department way of figuring the balance of payments deficit and the method proposed by the Bernstein Committee can be traced in the tables on the next three pages. Table I lists by categories all the transactions which entered into the balance of payments in 1964, but does not show them as resulting in either deficit or surplus. Hence the designation as "neutral." Tables II (Commerce) and III (Bernstein Committee) contain the same material as Table I but arrange it to show a net imbalance—a deficit in both cases but of differing amount.

Each category of transaction bears the same identifying number in all three tables; the categories which the Commerce Department and Bernstein methods handle differently appear in boldface throughout.

The differences in handling come in decisions to place a given item above or below "the line"—the horizontal divider which cuts across tables II and III. The receipts (credits) and payments (debits) placed above the line are the ones regarded as producing net imbalance (surplus or deficit) in the country's international transactions. Placed below are the credits and debits whose net effect is considered to "finance" the imbalance—paying for it in the case of a deficit, or collecting for it in the case of a surplus.

"Above or below" decisions determine the nature and size of the imbalance computed from a given set of transactions. Putting a credit item above the line tends to increase a payments surplus or reduce a deficit; putting one below works in the opposite direction (for example, item 7h in table III, compared with treatment of the same item in table II). Putting a debit above tends to reduce a surplus or increase a deficit; putting a debit below works in the other direction. The two-sided arrangement of credits and debits is not observed below the line, but the nature of each item placed there is reflected by mathematical sign—plus for credits, minus for debits.

TABLE I.—*U.S. international transactions—"Neutral" concept, 1964; military grant aid is excluded*

[In millions of dollars]

RECEIPTS (CREDITS)	
1. Merchandise exports	25, 219
2. Services sold to foreigners	5, 384
3. Income on foreign investments of U.S. residents	5, 162
4. Sales of military equipment	758
5. Scheduled repayments by foreign countries on U.S. Government loans	572
6. Advance repayments by foreign countries on U.S. Government loans (including sales of Export-Import Bank paper)	122
7. Increase in foreign-owned assets in United States:	
(*a*) Private foreign long-term investment	241
(*b*) Miscellaneous U.S. Government liabilities (principally purchase by Canadian Government of special nonmarketable U.S. Government securities)	207
(*c*) Swiss Government purchase of special nonmarketable U.S. Government securities	30
(*d*) Foreign funds placed with U.S. Government as advance payments for purchase of military equipment	206
(*e*) Foreign funds placed with U.S. Government in connection with specific foreign aid transactions	48
(*f*) Short-term brokerage and commercial claims of foreigners	118
(*g*) Short-term claims of foreign central banks and governments, including all marketable U.S. Government securities and nonmarketable ones of short term or convertible to short term	1, 073
(*h*) Short-term claims of foreign commercial banks	1, 415
(*i*) Short-term claims of private nonbank foreigners	348
8. Net increase in dollar holdings of International Monetary Fund (decrease in United States drawing rights at IMF)	266
9. U.S. sales of gold	125
Total receipts	41, 294
PAYMENTS (DEBITS)	
10. Merchandise imports	18, 638
11. Services bought from foreigners	5, 565
12. Income on foreign-owned investments in United States	1, 304
13. Military spending	2, 807
14. Remittances and pensions	830
15. Net increase in U.S. private investment abroad:	
(*a*) Long-term	4, 253
(*b*) Short-term	2, 107
16. U.S. Government foreign grants and loans	4, 277
17. Net decline in private foreign holdings of U.S. securities other than Government	88
18. Net redemption of nonmarketable, nonconvertible U.S. Government securities held by foreign monetary authorities	66
19. Net withdrawal of funds held in United States by nonmonetary international organizations	246
20. Net acquisition by U.S. Government of convertible foreign currencies	220
21. Payments unaccounted for (errors and omissions)	893
Total payments	41, 294

TABLE II.—*Balance of payments—"Regular transactions" concept, 1964; military grant aid is excluded*

[In millions of dollars]

RECEIPTS (CREDITS)	
1. Merchandise exports	25, 219
2. Services sold to foreigners	5, 384
3. Income on foreign investments of U.S. residents	5, 162
4. Sale of military equipment	758
5. Scheduled repayments by foreign countries on U.S. Government loans	572
7. Increase in foreign-owned assets in United States:	
(a) Private foreign long-term investment	241
(b) Miscellaneous U.S. Government liabilities (principally purchase by Canadian Government of special nonmarketable U.S. Government securities)	207
(e) Foreign funds placed with U.S. Government in connection with specific foreign aid transactions	48
(f) Short-term brokerage and commercial claims of foreigners	118
Total receipts	37, 709
PAYMENTS (DEBITS)	
10. Merchandise imports	18, 638
11. Services bought from foreigners	5, 565
12. Income on foreign-owned investments in United States	1, 304
13. Military spending	2, 807
14. Remittances and pensions	830
15. Net increase in U.S. private investment abroad:	
(a) Long-term	4, 253
(b) Short-term	2, 107
16. U.S. Government foreign grants and loans	4, 277
17. Net decline in private foreign holdings of U.S. securities other than Government	88
21. Payments unaccounted for (errors and omissions)	893
Total payments	40, 762
Total receipts	37, 709
Deficit	3, 053
Deficit was financed by net effect of following transactions:	
I. Special Government transactions:	
6. Advance repayments by foreign countries on U.S. Government loans	122
7. Increase in foreign-owned assets in United States:	
(c) Swiss Government purchase of special nonmarketable U.S. Government securities	30
(d) Foreign funds placed with U.S. Government as advance payments for purchase of military equipment	206
18. Net redemption of nonmarketable, nonconvertible U.S. Government securities held by foreign monetary authorities	−66
Total special Government transactions	292
II. Change in U.S. external liquidity:	
7. Increase in foreign-owned assets in United States:	
(g) Short-term claims of foreign central banks and governments, including all marketable U.S. Government securities and nonmarketable ones of short term or convertible to short term	1, 073
(h) Short-term claims of foreign commercial banks	1, 415
(i) Short-term claims of private nonbank foreigners	348

TABLE II.—*Balance of payments—"Regular transactions" concept, 1964; military grant aid is excluded*—Continued

[In millions of dollars]

PAYMENTS (DEBITS)—continued

Deficit was financed by net effect of following transactions—Continued	
II. Change in U.S. external liquidity—Continued	
8. Net increase in dollar holdings of International Monetary Fund (decrease in U.S. drawing rights at IMF)	266
9. U.S. sales of gold	125
19. Net withdrawal of funds held in United States by nonmonetary international organizations	−246
20. Net acquisition by U.S. Government of convertible foreign currencies	−220
Total change in U.S. external liquidity	2, 761
Total of financing transactions	3, 053

TABLE III.—*Balance of payments—"Official settlements" concept, 1964; military grant aid is excluded*

[In millions of dollars]

RECEIPTS (CREDITS)	
1. Merchandise exports	25, 219
2. Services sold to foreigners	5, 384
3. Income on foreign investments of U.S. residents	5, 162
4. Sales of military equipment	758
5. Scheduled repayments by foreign countries on U.S. Government loans	572
7. Increase in foreign-owned assets in United States:	
(*a*) Private foreign long-term investment	241
(*c*) Swiss Government purchase of special nonmarketable U.S. Government securities	30
(*d*) Foreign funds placed with U.S. Government as advance payments for purchase of military equipment	206
(*e*) Foreign funds placed with U.S. Government in connection with specific foreign aid transactions	48
(*f*) Short-term brokerage and commercial claims of foreigners	118
(*h*) Short-term claims of foreign commercial banks	1, 415
(*i*) Short-term claims of private nonbank foreigners	348
Total receipts	39, 501

PAYMENTS (DEBITS)	
10. Merchandise imports	18, 638
11. Services bought from foreigners	5, 565
12. Income on foreign-owned investments in United States	1, 304
13. Military spending	2, 807
14. Remittances and pensions	830
15. Net increase in U.S. private investment abroad:	
(*a*) Long-term	4, 253
(*b*) Short-term	2, 107
16. U.S. Government foreign grants and loans	4, 277
17. Net decline in private foreign holdings of U.S. securities other than Government	88
19. Net withdrawal of funds held in United States by nonmonetary international organizations	246
21. Payments unaccounted for (errors and omissions)	893
Total payments	41, 008
Total receipts	39, 501
Deficit	1, 507

TABLE III.—*Balance of payments—"Official settlements" concept, 1964; military grant aid is excluded*—Continued

[In millions of dollars]

PAYMENTS (DEBITS)—continued

Deficit was financed by net effect of following transactions:	
I. Reserve transactions:	
7. Increase in foreign-owned assets in United States:	
(*b*) Miscellaneous U.S. Government liabilities (principally purchase by Canadian government of special nonmarketable U.S. Government securities)	207
(*g*) Short-term claims of foreign central banks and governments, including all marketable U.S. Government securities and nonmarketable ones of short term or convertible to short term	1, 073
8. Net increase in dollar holdings of International Monetary Fund (decrease in U.S. drawing rights at IMF)	266
9. U.S. sales of gold	125
18. Net redemption of nonmarketable, nonconvertible U.S. Government securities held by foreign monetary authorities	−66
20. Net acquisition by U.S. Government of convertible foreign currencies	−220
Total reserve transactions	1, 385
II. Special intergovernmental transactions:	
6. Advance repayments by foreign countries on U.S. Government loans	122
Total special intergovernmental transactions	122
Total of financing transactions	1, 507

Those Government gambits

The same transaction would also go below the line in the Commerce Department's "regular transactions" table, but would be shown separately as a special Government transaction financing the deficit. This handling has been adopted for a variety of large, special transactions which the U.S. Government has arranged in recent years. In most cases the purpose of the transaction has been to head off possible losses of gold by capturing dollars that have accumulated in foreign official hands. For example, the Government has persuaded a number of foreign governments to prepay debt owed the United States and to buy special nonmarketable U.S. Government securities. Arrangements also have been made which provide for advance payments by foreign governments on military goods purchased in the United States.

These transactions achieve the intended purpose of making the deterioration in U.S. external liquidity in a given period less than it otherwise would be. If treated as ordinary "credit" items above the line, however, they might well mask fundamental, longer term trends in the balance of payments.

Accordingly, the Commerce Department in 1963 began to show "special" transactions apart from "regular" ones. The difference between total credits and total debits above the line is identified as the surplus or deficit "on regular transactions" (table on p. 10). Below-the-line entries, showing the "financing" of the regular deficit, are divided into two groups. The first consists of such special Government transactions as have occurred; the second shows net changes that have occurred in U.S. external liquidity. The latter represents the portion of the imbalance on regular transactions that has been "financed" by means other than special Government transactions.

In principle, the Bernstein Committee agrees with Commerce the special arrangements improvised by the Government should appear below the line. In practice, it interprets "special" much more narrowly. The only item it so labels, in fact, is the prepayment of debt by foreign powers. It lets items such as advance payments on foreign countries' military purchases from the United

States go above the line (where they rank equally with exports actually delivered during the accounting period).

On the other hand, the Bernstein group is more stringent than the Commerce Department in treating the 1964 purchase by the Canadian Government of $204 million in nonmarketable U.S. Government securities. Commerce makes an exception to its rule for handling transactions in securities of this type. It puts them above the line, where they count as a regular inflow of capital to this country. The Department's handling is keyed to the fact that Canadian officials do not count these securities among their reserves of U.S. dollars. They exclude them from reserves because the Canadian Government has earmarked the proceeds (the securities mature over a space of 7 years) for the purchase of materials to be used in developing the Columbia River Basin. The Review Committee puts the $204 million below the line as a reserve transaction between monetary authorities, ignoring the fact that the Canadians don't count them as reserves. The fact that the Committee throws above the line a $30 million purchase of nonmarketable U.S. Government securities by the Swiss Government (choosing to view this particular transaction as an "investment" of surplus budget funds) while Commerce officially puts it below, probably proves nothing except that special Government transactions have profoundly complicated the problems of balance of payments accounting.

Main cause of the gap

Quantitatively, the most significant difference between the Bernstein Committee's "official settlements" rendering of a payments statement and the "regular transactions" version presented by the Commerce Department is in the handling of changes in short-term dollar holdings of foreign private parties—particularly foreign commercial banks. This divergence accounts for most of the gap between the deficits computed under the two systems.

In the Bernstein method, with its focus on transactions among monetary authorities, increases in short-term holdings of private foreigners go above the line as ordinary inflows of capital. With minor exceptions, the Commerce Department puts them below the line, considering them to be one of the liquidity changes by which the payments deficit is measured. Each dollar so handled means an additional dollar of reported deficit.

The Bernstein Committee makes several arguments in support of its method. It feels that the rapid increases which have been occurring in foreign private ownership of liquid dollar assets should be viewed chiefly as a sign of the dollar's strength and acceptability. Because of the special role of the United States in financing the world economy, it notes, growth in global dollar holdings is a natural accompaniment of expansion in international trade and investment.

The Commerce viewpoint does not involve any denial of the relevance of these points, although each of them obviously is valid in some immeasurable degree rather than in the absolute. But Commerce's principal defense of its own approach is that, whatever else the increased foreign holdings may be, they are potential claims on U.S. reserves and, therefore, a cautioning signal of further possible vulnerability. Whether the warning they give is mild or shrill depends mostly on the size of the increase. While the willingness of foreigners to continue adding to their dollar holdings speaks well for faith in the dollar, that faith is likely at some point to be undermined if the spewing out of dollars is rapid and sustained. As for the contention that a growing world economy requires growth in external dollar holdings, this is true on a long-term basis, but the very steep rise in such holdings in recent years may well be a signal that some pause in the growth is needed.

Inflows and outflows

The Bernstein Committee makes a considerable point of the lack of parallelism in Commerce's method of handling inflows and outflows of short-term private capital. While inflows are treated as a below-the-line settlement item, rather than as an above-the-line credit, outflows are posted above the line as a debit. The Bernstein group hits hard at this lack of "symmetry." Indeed, the Commerce stand on this point has drawn criticism from a variety of sources in recent years as being too austere—"calling them all," it is often alleged, "against the home team."

Officials in the Balance of Payments Division of the Department readily admit that the approach now used produces some bias in the direction of enlarging the reported deficit. They concede that some foreign claims on U.S. private parties could not in practice be liquidated. Normally, for instance, a foreign party borrowing dollars from a U.S. bank cannot cash the entire proceeds because

a portion is kept on deposit as a compensating balance. Yet present accounting lists the entire amount of the loan as increasing the payments deficit.

Many foreign claims are closely linked to liabilities that foreigners have to U.S. parties, and thus are for all practical purposes "locked into" dollars and not subject to encashment. A common instance is found in the deposit of U.S. dollars by a U.S. party in a Canadian bank, with the dollars then being employed by the bank in the New York money market. In essence, one U.S. party's dollars are being lent to another U.S. party, with the Canadian bank (usually through its New York agency office) serving as intermediary. In the balance of payments accounts as now kept, however, the U.S. deficit is enlarged. The unreality of this handling is pointed up by the fact that, if the same set of transactions happened to go through a New York branch (as distinguished from an agency) of a foreign bank, there would be no balance of payments effect, since branches are regarded as U.S., rather, than foreign, parties.

Anomalies resulting from interrelated capital flows have been the subject of discussion for several years, and there is general agreement—by Commerce officials as well as others—on the desirability of finding some statistically valid way to "net" the crisscrossing transactions. The effect of netting would be to reduce the total of short-term capital outflows, and correspondingly to reduce the increase in short-term dollar assets held by foreign private parties. Thus it would result in a smaller payments deficit.

The Bernstein Committee stresses the existence of close connection between some capital outflows and offsetting inflows. It does not favor attempting to net these. Its proposal, rather, bypasses the statistical difficulties which thus far have deterred the Commerce Department from undertaking a selective netting. The committee's approach, which simply lifts all changes in private foreign dollar holdings above the line as credits, leaves the related capital outflow items—investments abroad, bank loans to foreigners, etc.—untouched and unadjusted in the debit column. In other words, it is no more precise in dealing with the linkage of capital inflows and outflows than is the Commerce method. Overall, in fact, it probably is less precise. In effect, it treats the entire increase in foreign private dollar holdings as if it were linked to offsetting transactions.

Wish it were

The substantial writing down of recent payments deficits which the Bernstein method produces, chiefly because of its treatment of private foreign claims, creates a strong predisposition to find in favor of the "official settlements" concept. Life, presumably, would be easier for everyone concerned, including banks that carry on an international business, if last year's payments deficit was really only half as large as the Commerce figure says it was.

The persuasive power of a pleasant prospect is well demonstrated by the generally favorable early response the Review Committee's proposal has received. The Committee's own caveat, to the effect that the more wholesome looking deficit figure doesn't really make the payments problem less serious, apparently has not spoiled for many the happy feeling that a large part of the problem has been solved by definition. The Committee's work deserves to be judged by a stricter standard. The question to ask about its central recommendation of change in balance of payments reckoning is: How well would the system it advocates do the iob that payments accounting is supposed to do?

At one point the Committee's report states: "The most frequent use made of balance of payments statistics is to turn to them for answers to the question: Are things going well or badly, on the whole?" While the Committee takes pains to point out that this country's international financial position is too complex to be described by a single number, it also recognizes that the nature of human attention demands iust such a sole, simple figure as the quick indicator of how things are going.

Faced with this necessity, the Committee opts for the "official settlements" figure as the prime measure of payments deficit or surplus. In so doing it downgrades the importance of one large sector of international transactions—the short-term holdings of dollars by private foreign parties. This is the decisive failing of the Bernstein Committee's proposal. It would make the balance of payments a less complete, less timely, less useful indicator than it now is.

U.S. payments bookkeeping cannot afford to let what happens to the dollar holdings of private foreigners slip out of focus. Privately held dollars may, in fact, represent more of a problem than dollars held by monetary authorities, because the actions of the latter are much less likely to be motivated by fear and speculation. Monetary history provides repeated instances of pressure and crisis that developed because private parties suddenly turned against a currency.

The timing defect of the Committee's proposed summary measure is that it would be a coincident indicator, proclaiming trouble only after trouble had already become apparent in the foreign exchange markets and in conspicuous movement gold. Coincident, and even lagging, indicators can be useful in economic analysis, which seldom is hurt by a superabundance of data. The "official settlements" way of looking at the payments deficit is not without significance, but is preoccupation with central bank holdings of reserves robs it of timeliness. It is not in central banks that the troubles of currencies ordinarily start.

The key virtue of the Commerce Department's summary figure is that it is a leading indicator. By reflecting changes in all dollar holdings by foreigners, it cautions early that trouble may lie around the turn in the road. As the table on page 6 shows, one of the rare occasions when the "official settlements" deficit was larger than the Commerce deficit was during the "gold rush" in the London market in late 1960. Commerce's liquidity measure had been showing much larger deficits for some time previously, warning of possible trouble.

More recent events confirm the contrast. In both 1963 and 1964 the payments deficit according to the "official settlements" method shrank dramatically. This was a strange prelude to the huge gold losses that have occurred thus far in 1965. Nor did it hint of the gathering trouble that led in February of this year to imposition of the administration's voluntary program for reducing capital outflows.

The Commerce tabulations, by contrast, gave readings consistent with subsequent developments. They showed large deficits persisting over the last several years, with a particularly big rise in foreign private holdings of dollars in 1964.

The Bernstein Committee felt compelled to acknowledge that its treatment of foreign private dollar holdsing is not "wholly satisfactory." Its report recognizes that, instead of just passively buying and selling dollars to maintain stable exchange rates, monetary authorities often act aggressively to try to induce private parties to hold more or fewer dollars than they would otherwise be inclined to hold.

Swaps and forwards

At times, for instance, perhaps out of domestic monetary considerations, the German Bundesbank offers spot dollars in large quantities to private banks on especially favorable terms in order to draw marks out of the German economy. Such transactions take the form of "swaps," providing for reversal of the dollar-mark exchange at a specified future date. At other times, as part of the present pattern of international monetary cooperation, the Bundesbank may simply offer forward marks against dollars to commercial banks on more favorable terms than could be had in the market—the purpose being to encourage investment by private parties in U.S. dollar assets on a hedged basis.

The swap technique tends to be used when the objective is to move dollars from the central bank to private holders; forward operations are usually the mainstay when the aim is to discourage private parties from turning dollars in at the central bank. Swap or forward operations at times have run into hundreds of millions of dollars in a single quarter. Their effect on foreign commercial bank holdings of dollars is assumed to have been comparably massive. It is therefore conceivable that in such periods the U.S. payments deficit as computed by the "official settlements" method could have been "prettied up" by a billion dollars at an annual rate.

This would have been grossly misleading, since no country's balance of payments accounting reveals the forward exchange contract liabilities of its central bank, treasury, or private business and financial community. As to swap transactions, only the spot or cash side gets into the statistics.

Under the Commerce method of payments tabulation, which views both private and official foreign short-term holdings as a measure of liquidity, special exchange activities of central banks do not cause distortion.

Considerations of this kind moved the Committee to concede at some length the strategic importance of changes in short-term dollar holdings of foreign commercial banks, and to urge that they "be shown prominently" in the payments table. This hardly would meet the difficulty: without knowledge of what the authorities have been doing, the analyst has no firm basis for evaluating the information, however prominently it may be displayed. Since the figure's place in the Bernstein payments table would be below the line, the defidit would be artificially held down during any period when United States or foreign monetary authorities were inducing private foreign holders to keep or acquire dollars they otherwise would not be inclined to hold.

The distinction made by the Bernstein Committee between dollars held privately and dollars held officially is questionable for other reasons as well. Some foreign monetary authorities from time to time hold a large proportion of their dollars either in foreign private banks or in foreign branches of American banks in order to enjoy the returns offered by the Euro-dollar market. Dollars so held show up in balance of payments statistics as U.S. liabilities to private parties, even though they are beneficially owned and controlled by foreign monetary authorities. No precise information is available on their extent, but from time to time the Euro-dollar holdings of officials probably run well in excess of $1 billion. If the "official settlements" concept were employed, routine moves of such funds between commercial bank accounts and official accounts would deceptively affect the U.S. payments deficit or surplus.

Even international financial transactions not directly involving U.S. parties could cause swings in the U.S. payments accounts under the Bernstein Committee's plan. For instance, the recent sterling crisis (during which British monetary authorities sold dollars to support the pound) undoubtedly led to some transfer of dollars from official into private hands—especially insofar as the dollars sold were borrowed from other official foreign holders and sold to buyers willing, for the present, to continue holding dollars. Had the Committee's method of bookkeeping been in use, this would have reduced the reported U.S. payments deficit. Under the present bookkeeping system, which doesn't distinguish among different types of foreign dollar holders, there would be no effect on the deficit.

Liquidity after all

In this communicative age, a report 2 years in preparation is not likely to yield many surprises when it finally appears. The Bernstein Committee document has at least one. This is the degree to which it accepts—although with a difference that is crucial—the liquidity orientation which is the basis of Commerce Department payments accounting. Except for its exclusion of privately held foreign claims—and it must be emphasized that this is a huge "except"—the Committee shows the same preoccupation with resource-liability relationships as do the analysts in the Balance of Payments Division.

Ostensibly, where it discusses the Commerce concept in the report, the Committee rejects liquidity as the key to payments accounting. When the arithmetic gets down on paper, however, what the "official settlements" tabulation measures is liquidity—a special, narrowly conceived kind, to be sure, but still liquidity.

Not at all surprising is the fact that the review committee has in no way made simpler the tangled topic that is the balance of payments. For the unnamed financial writer who told the Committee: "All I want is one number, with no ifs, buts, or maybes," the report offers no encouragement. In fact, the Committee adds some ifs, buts, and maybes of its own to the thicket of qualifiers that has always interlaced the bookkeeping of international flows of wealth.

The Committee's report is especially complicated in its overall effect by the thorough job it has done of rebutting many of its own arguments. There are few things to say against the document that it doesn't, at one point or another, say against itself. The effect is to weaken the thrust and, it is to be hoped, lessen the likelihood that the Committee's main recommendation will be adopted.

Grave mistake to switch

For switching to the "official settlements" method of computing the payments deficit would serve the country poorly. It would delay receipt of vital signals warning of trouble in U.S. financial dealings with the rest of the world. It would ignore the building up of dollar liabilities around the world until they arrive at the very threshold of presentation—in the central banks which are able, and in some cases ready and more than willing, to cash them for gold from this country's supply.

What basically enabled the Bernstein Committee to make such a proposal was the way in which it chose to view the consequences of the U.S. unique position in the world financial system. It recognized the dimensions and the distinctiveness of this country's monetary and economic role, but seemed unwilling to admit that this creates vulnerability along with opportunity. Such unwillingness is explicit in the Committee's citation of closer conformity with other countries as an argument for U.S. adoption of the "official settlements" concept. The fact that the U.S. deficit under present accounting cannot be matched up with identifiable surpluses in other countries strikes the Committee as undesirable. The panel heard, and faithfully reports, the reasons for nonconformity advanced by the head of the Balance of Payments Division, Dr. Walther Lederer, who is

the chief architect of and leading spokesman for the "liquidity" method of payments accounting. In essence these reasons are:

1. The U.S. dollar is the chief reserve currency, held and used throughout the world; while other countries are obliged to maintain their currencies' parity with the dollar, the United States has the much broader obligation of being ready to redeem foreign dollar holdings in gold.
2. Many other countries use or are willing to use direct exchange controls of one kind or other to help defend their currencies; the United States is committed against this course.
3. As the chief source of finance, both public and private, to the world, the United States must view its international balance sheet with a degree of conservatism that other countries do not require. U.S. short-term claims on foreigners are qualitatively very different from foreign claims on U.S. parties. The bulk of what the United States owes is payable on demand; many U.S. claims are short-term in name only and cannot be considered liquid in any meaningful economic sense.

These considerations, all arguing for the stricter approach of the present accounting basis, did not persuade the Committee.

Work to be done

To hold that the "regular transactions" method should be retained, and the committee's principal recommendation rejected, is not to impute ultimate perfection to the present method. Clearly there is a need to take account of the close interrelations that exist between certain short-term capital inflows and outflows. Foreign-held dollars which in practice are not freely usable by their owners should be netted out of U.S. private short-term capital outflows. This would have the effect of reducing the payments deficit, but only by making it represent reality more faithfully.

Commerce officials have for some time been studying the possibility of making such selective adjustments and have concluded that they are both feasible and desirable. Some of the figures needed, however (for example, those pertaining to compensating balances), would have to be estimates, and there is a reluctance to put them in the ledgers alongside hard figures taken straight from the books of businesses and banks.

The solution may be to do the netting in supplementary tables, showing an "adjusted" short-term capital outflow figure and an "adjusted" balance of payments surplus or deficit. This would add to the proliferation of summary figures that has been occurring in the pages of the Department of Commerce's Survey of Current Business in recent years, but an abundance of figures is not in itself an evil—if the figures are sound ones.

Senator PROXMIRE. Our next witness is Mr. Hal B. Lary, National Bureau of Economic Research.

Mr. LARY. Mr. Chairman. Many outside the professional field must wonder why it is that the theorists and technicians experience such difficulty in arriving at a consensus in this matter of definitions. The root of the difficulty is, I think, that everyone, both laymen and economists, would like to have a measure of the surplus or deficit that could be taken as a fairly close approximation of the real disequilibrium in a country's international position. And yet no measure of the deficit, however defined, can be relied upon for this purpose.

Senator PROXMIRE. Let me just say, I think you are highlighting your statement, which is fine. We will put the whole statement in the record and I would appreciate if if you could complete it as rapidly as possible, so we will have as much time as possible for questioning.

Mr. LARY. Yes; I shall do so, Mr. Chairman.

(Prepared statement referred to appears on p. 113.)

Mr. LARY. No matter how we define it, any measure of the deficit would require major adjustments to serve as an indicator of disequilibrium. Since these adjustments cannot in fact be made, except qualitatively or with a wide margin for error, balance of payments technicians have to fall back on secondhand solutions with a lot of room for honest disagreement.

According to the "liquidity" concept now employed by the Commerce Department, it is prudent to treat a rise in foreign private dollar balances from the outset as an impairment of our international liquidity position rather than wait for the dollars to be shifted over to foreign central bank accounts here. The "liquidity" concept is thus considered by its proponents to provide "the most sensitive indicator" of shifts in this country's international financial position and a "relatively early signal" of the need for analysis and possible corrective action. Failure to provide such advance warning, it is said, "would deprive the monetary authorities of the opportunity to take corrective actions in anticipation of reserve losses, in time for such actions still to be constructive, and it would also fail to alert the public that such actions were needed."

No one acquainted with international monetary history would deny the existence of the risks to which the "liquidity" concept is addressed. The monetary authorities of any country must be alert to these contingencies. It is elementary that their policies must be such as to prevent unduly large and protracted losses of reserves, if their intention is to maintain the currency at the existing foreign exchange level. And we must agree that in our recent experience reserve losses have, indeed, been large and protracted.

Granted all this, it does not necessarily follow that changes in international liquidity, as defined by the Commerce Department, should serve as the organizing principle for the balance of payments.

First of all, it seems to me that the "liquidity" criterion, focusing as it does on the risk of disruptive withdrawal of foreign private holdings, fails to give adequate attention to the positive reasons that lead foreign banks, firms, and individuals to acquire and hold dollars, and that it underrates the substantial and continuing advantages of the dollar and of the U.S. money market as a medium and a place for investing liquid resources.

An informative exposition on this subject is given in a recent paper by Fred H. Klopstock, manager of the Research Department of the Federal Reserve Bank of New York. More information and research are needed, but I think it is already clear that there are good reasons for the kind of growth indicated in the charts on pages 112 and 114 of the Bernstein Committee report.

In his Princeton paper 2 years ago, Mr. Lederer stressed the long-term growth, with few reversals, of U.S. short-term assets abroad. It would seem that the point is no less valid with regard to foreign short-term assets here. I scarcely need add that the dollar volume of international trade and other transactions has also risen rapidly over this period.

Again, I am not suggesting that we can afford to take a carefree view of our responsibilities in these matters. But neither must we look on every dollar of increase in foreign private short-term investments here as bringing a day of reckoning that much nearer.

Moreover, it may well be that the increase in foreign private liquid dollar balances during the last several years is considerably overstated, with the effect of overstating also the deficit as measured on the "liquidity" concept. This is my second main doubt about the concept: that it is probably a good deal less accurate in measuring what it seeks to cover than commonly supposed.

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A principal reason for thinking so relates to the "errors and omissions" item, discussed in chapter 7 of the Bernstein Committee's report. In the nature of the case, one cannot say anything for sure about this residual item. And yet its pattern through time, as shown in the chart on page 86 of the report, is strongly suggestive of large, unreported capital inflows throughout the period 1934 to 1959, followed since then by substantial unreported outflows. If we knew the facts, therefore, the net increase in foreign private liquid claims here during the last 5 years might well prove to be much smaller than appears from the reported data.

It may be, of course, that the unrecorded foreign funds presumed to have been withdrawn would not have been classed as "liquid." But that possibility underlines, in my view, the unsatisfactory nature of the "liquidity" criterion as an organizing principle for the statistics. It is narrowly defined for its indicated purpose and leaves out elements that would figure importantly in a liquidity crisis, if it should come to that. I have in mind foreign-owned stocks and bonds and the famous "leads and lags" which develop on ordinary commercial payments, not to mention the American liquid capital which could come on the market in such an eventuality.

My third criticism of the "liquidity" concept is that it needs reconsideration to take account of the impressive cooperation achieved between United States and foreign monetary authorities in countering disruptive shifts of private liquid funds. European countries gaining reserves have shown themselves anxious to avoid complicating matters by attracting private funds.

The most effective measures of cooperation have been the currency swaps and forward operations in the foreign exchange market, on which Mr. Coombs of the Federal Reserve Bank of New York has periodically reported.

More needs to be done, particularly in the coordination of credit policies on both sides. Perhaps we are at a point where more progress in this respect, too, is possible, now that some slack has developed in the Italian and French economies and that, on our side, we may be able to rely more on tax and budget policies for domestic expansion. But we have already gone far enough in international cooperation, I think, to render obsolete the view that the policies of foreign monetary authorities can only complicate rather than alleviate our problems.

My fourth criticism follows from the first three. This is that the "liquidity" criterion may be undesirable and unreliable as a "sensitive indicator" and "early signal." Sensitivity is not necessarily a virtue in a statistical series.

Let me quote in this connection from a document well known already to the Joint Economic Committee. That is, the report on "The Price Statistics of the Federal Government," prepared several years ago by the Price Statistics Review Committee of the National Bureau of Economic Research at the request of the Bureau of the Budget. In the chapter on wholesale prices (p. 68), the report comments:

> The literature abounds with statements of the need for a sensitive price index which measures the immediately current or prospective movements of wholesale prices, as a guide in policy formation and in predicting business movements. * * * Often what seems to be implied is that the index number should be based upon

prices which change often or by relatively large amounts. * * * Sensitivity in this context means only exaggeration, and it is difficult to see any purpose in exaggerating current price movements.

I would hold the same doubt with regard to the deliberate choice of a "sensitive indicator" of the balance of payments deficit, particularly when the development to which it is supposed to point lags so far and so uncertainly behind. The monetary authorities scarcely need to have the figures grouped in this particular way for purposes of their own analyses and operations.

And as far as alerting the public is concerned, this can be a two-edged sword. It may, on the one hand, serve the constructive purpose of developing the understanding and cooperation needed for remedial action. But it may also touch off speculative activities and create excessively pessimistic expectations in foreign official circles and so aggravate the problem instead of merely calling attention to it. I would, therefore, urge, if possible, neutrality rather than sensitivity as the best guide to statistical practice in these matters.

The fifth and last main criticism which I would express regarding the "liquidity" concept is that it may be misleading as a guide to policy. To be sure, the same sort of doubt may be raised regarding the deficit measured on any other basis, but I am particularly worried by the implications of the "liquidity" concept in this regard.

If we were to take as our immediate objective an improvement of $3 billion in the balance in relation to the 1964 results, I fear that we would bring excessive pressure on a number of countries in a weak position before the squeeze was really felt by the strong surplus countries. I have spelled out this view somewhat more fully in a recent paper attached as annex B.

If we think of the longer run, an even balance on the "liquidity" definition would mean that foreign commercial banks, firms, and individuals could increase their dollar working balances and other funds here only at the expense of the official reserves of foreign countries. This might not be so unpleasant for us for a while, if only the effects could be concentrated in the right places at the right time. But as a continuing proposition, such an outcome would scarcely be consistent with the growth of world trade and production.

Mr. Chittenden has just said that he sees no need to aim at a zero balance if we continue to follow the "liquidity" concept. It does seem to me in that connection that there is a little point in applying a definition of the balance of payments which tends systematically to show a deficit if we then have to explain that the deficit doesn't really mean what it seems to.

My concern as to the policy implications of the "liquidity" concept may seem like borrowing trouble, since—at least until very recently—we have fallen so seriously short of balancing our international accounts. No one could say that we had been led to act with undue vigor.

The basic reasons for the long duration of the problem have little to do with the definition of the deficit, I believe, and can be summed up as follows:

1. The difficulty of foreseeing at any one time during the last half-dozen years the full sequence and strength of the changes in the world to which we have had to adjust;

2. The special necessity for the United States, because of its size, to try to avoid making adjustments at the expense of weaker countries—a problem unique to the United States, as I say, because of its size;

3. The possession of large reserves and borrowing privileges, as a reserve center, relieving us of the necessity to make adjustments more swiftly and ruthlessly.

Now, our room for maneuver has considerably shrunk, and we have invoked far more vigorous and direct measures to correct the deficit. The goals we set and the kind of guidance provided by the balance of payments, therefore, become more crucial questions than before.

Mr. Chairman, in my written statement I go on to explain that I still have a certain preference for the basic transactions concept. Incidentally, the Bernstein Committee might well have noted that this concept has been applied in another study well known to the Joint Economic Committee; that is, the Brookings balance of payments study of 2 years ago.

I would, however, recognize that there may be practical difficulties in the application of that concept. It is perhaps more useful as an analytical tool than as a regular method of presentation. If there must be only one measure of the deficit for purposes of publication, I would tend to go along with the "official settlements" concept.

Senator PROXMIRE. You tend to go along with the Bernstein position.

Mr. LARY. I think that the recommendation of the Bernstein Committee would provide a more balanced definition of the deficit than that to which I have just been voicing objections.

Even those who agree on the desirability of the change frequently say that we should, nevertheless, wait for a more propitious moment; that we should not make the change now because it might look as if we were doctoring the figures. I do not know what the balance of payments will look like this year, but there is one shift which seems likely to me, and that is that the deficit will actually be smaller on the definition now used by the Commerce Department than on the "official settlements" basis.

This is because the rise in foreign private short-term funds here was very, very large last year, and some reflux could be expected. In addition, the likelihood is reinforced by the voluntary restraints program inaugurated in February, which is bound to have the effect of undoing some of the relationships that Mr. Chittenden referred to. Incidentally, this may give a false impression of improvement in the balance of payments to that extent.

Therefore, it seems to me that if the officers responsible for a decision in this matter find a change desirable they may also find this year a particularly good time to inaugurate the change. If the "official settlements" approach produces the larger deficit, it could scarcely be argued that the figures were being juggled.

Senator PROXMIRE. Thank you, Mr. Lary.

PREPARED STATEMENT OF HAL B. LARY, ASSOCIATE DIRECTOR OF RESEARCH, NATIONAL BUREAU OF ECONOMIC RESEARCH [1]

"The confusion concerning the meaning of a deficit or a disequilibrium in the balance of payments is almost as old as the study of political economy." [2] If that statement is no longer quite as true as it was when Professor Machlup wrote it 15 years ago, the improvement is due in no small measure to the illuminating contributions which we have had from Mr. Lederer both in developing and in interpreting the statistics. And now we are further indebted to the able Committee headed by Mr. Bernstein for its judicious and informative report and particularly for its efforts to appraise the meaning and the merits of different definitions of a balance of payments surplus or deficit.

I

Many outside the professional field must wonder why it is that the theorists and technicians experience such difficulty in arriving at a consensus in this matter of definitions. The root of the difficulty is, I think, that everyone, both laymen and economists, would like to have a measure of the surplus or deficit that could be taken as a fairly close approximation of the real disequilibrium in a country's international position.[3] And yet no measure of the deficit, however defined, can be relied upon for this purpose. Numerous adjustments would need to be made made which, in fact, cannot be made except in qualitative terms or with a very wide margin for error. To cite an old example, one would need to take account of the relation between the level of employment and the level of imports and exports. Countries may be importing less and exporting more, or importing more and exporting less, than they would at normal levels of employment. One would also want to allow for the effects of any special controls or restraints imposed on imports or other payments. And one would want to sort out any special short-run influences affecting the accounts. I would say, for instance, that late last year and early this year we experienced a great flight of capital from this country—a flight not of foreign but of U.S. capital and one inspired not by fear of the dollar but by fear that restrictions of some sort were about to be imposed on further capital outflows. Any measure of the deficit not adjusted for this situation could not be relied upon to indicate the more fundamental elements in our international position.

The impossibility of making such adjustments in the statistics means that the technicians are forced to fall back on second best solutions, and that they have a lot of room for honest disagreement. It is therefore appropriate that the Bernstein Committee should warn, as Mr. Lederer has warned before, that, "The definition and measurement of a balance of payments surplus or deficit is a matter of analysis rather than accounting." [4] Ideally, one might hope that the analysis, conclusions and policy implications would be much the same regardless of which concept of the deficit is taken as the starting point or, indeed, even if the figures are not arranged so as to show any particular balance identifiable as the deficit. The real world is rather different. The facts needed are hard to come by and hard to interpret. As just one example, the Bernstein Committee rightly stresses the serious deficiencies in the information available on relative prices.[5] Other aspects of competitiveness are even less subject to quantitative expression. Analyses of the balance of payments problem therefore differ widely, and views on policy seem to diverge even more.

These considerations do not mean that questions of definition and presentation are unimportant. The least we can do is to try to ensure that the concepts employed are as logical as possible and that they do not themselves become sources of any unnecessary confusion.

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[1] This statement presents the views of the author and does not engage the responsibility of the National Bureau of Economic Research.

[2] F. Machlup, "Three Concepts of the Balance of Payments and the So-Called Dollar Shortage," the Economic Journal, March 1950.

[3] The Bernstein Committee, speaking of the problem of defining the deficit, goes so far as to say, "In the Committee's view, the main purpose of a summary indicator of the balance of payments position should be to indicate the extent of any disequilibrium that may exist in the country's international transactions." (Report, p. 109.)

[4] Report, p. 2.

[5] For information on a study by the National Bureau of Economic Research, see "International Price Competitiveness: A Preliminary Report," Irving B. Kravis, Robert E. Lipsey, and Philip J. Bourque (in press).

II

The differences in the three concepts of the deficit discussed in the Bernstein Committee's report turn essentially on the treatment of private short-term capital movements. As frequently noted, the treatment accorded by the Commerce Department's Balance of Payment Division under the "liquidity" concept is explicity asymmetrical, U.S. private short-term capital going above the line and foreign private short-term capital going below it. The "official settlements" concept would remove this asymmetry by putting both elements above the line, and the "basic transactions" concept would do so by putting both below the line. These are the most essential and characteristic differences in the presentation of the figures, though questions also arise concerning the treatment of the errors and omissions item and various lesser matters.

These differences in statistical presentation reflect some important differences in views, or at least in emphasis, concerning the most significant characteristics of private short-term capital. As I see it, the liquidity concept focuses on the risk of disruptive withdrawal of foreign private short-term capital and accords this type of capital flow a treatment different from that given to other private capital flows. The official settlements concept stresses conformity to ordinary market forces and makes no major distinction between United States and foreign private short-term capital in this regard. And the basic transactions concept, at least as I have used it, attributes particular significance in both cases to sensitivity to monetary policy.

There is something to be said for each of these ways of looking at private short-term capital, and one aspect does not exclude another. The question is whether one or another is sufficiently dominant or typical to provide the main organizing principle for the presentation of the balance of payments.

III

As I understand it, the "liquidity" criterion, in putting changes in foreign private liquid dollar balances below the line, treats additions to these holdings as a passive and probably temporary acceptance by foreign banks and other private foreigners of part of the backwash of excess dollars generated by the deficit on items placed above the line. The other part of this excess would be that accruing to foreign central banks in the form of additions to their own dollar or gold holdings as they engage in operations to prevent the foreign exchange value of their currencies from rising above the prescribed limits. The "liquidity" concept sees no essential difference between these two parts. Even if there is a genuine rise in foreign private demand for dollars to be held as working balances or for other purposes, this demand is regarded as unstable and unreliable. Each increment adds by so much to the potential claim on our own reserves. Some of these balances nominally privately owned may, in fact, already belong to foreign central banks or be subject to their control. Other privately owned funds may be withdrawn from this country in response to a tightening of credit or other measures by foreign monetary authorities. Or, on their own initiative, foreign commercial banks and other private holders may at some point elect to reduce their dollar balances as other currencies become more acceptable and usable in international finance. In the worst case, which becomes more likely as foreign balances here rise, the owners may lose confidence in the dollar and start a self-aggravating exodus. Dollars withdrawn for any of these reasons accrue to foreign central banks and become, actually or potentially, a direct claim on our gold reserves.

In this view of the matter, it is prudent to treat a rise in foreign private dollar balances from the outset as an impairment of our international liquidity position rather than wait for the dollars to be shifted over to foreign central bank accounts here. The "liquidity" concept is thus considered by its proponents to provide "the most sensitive indicator" of shifts in this country's international financial position and a "relatively early signal" of the need for analysis and possible corrective action. Failure to provide such advance warning, it is said, "would deprive the monetary authorities of the opportunity to take corrective actions in anticipation of reserve losses, in time for such actions still to be constructive, and it would also fail to alert the public that such actions were needed." [6]

No one acquainted with international monetary history would deny the existence of the risks to which the "liquidity" concept is addressed. The monetary authorities of any country must be alert to these contingencies. It is elementary

[6] Quotations are from Walther Lederer, "The Balance of U.S. Payments: A Statement of the Problem" (in The Dollar in Crisis, Seymour E. Harris, editor, 1961), p. 120, and The Balance on Foreign Transactions: Problems of Definition and Measurement, Princeton University, 1963, p. 65.

that their policies must be such as to prevent unduly large and protracted losses of reserves, if their intention is to maintain the currency at the existing foreign exchange level. And we must agree that in our recent experience reserve losses have indeed been large and protracted.

Granted all this, it does not necessarily follow that changes in international liquidity, as defined by the Commerce Department, should serve as the organizing principle for the balance of payments. For one thing, the monetary authorities themselves have more direct, immediate and detailed information on changes in foreign private liquid balances than that given in the balance of payments. For another thing, alternative concepts of the deficit do not call for suppression of any of the data on this subject now published or for any neglect of the subject in the analysis. But there are other more specific reasons for questioning the validity of the present method of measuring the deficit. I shall give them as briefly as possible, because many of the relevant facts have been covered in the Bernstein Committee's report and in the hearings held here on May 11 and also because I have developed my own views at some length in a study published by the National Bureau of Economic Research 2 years ago, excerpts from which are attached to this statement (annex A).

First of all, it seems to me that the "liquidity" criterion, focusing as it does on the risk of withdrawal, gives inadequate recognition to the positive reasons causing foreign banks, firms, and individuals to acquire and hold dollars, and that it underrates the substantial and continuing advantages of the dollar and of the U.S. money market as a medium and a place for investing liquid resources. An informative exposition on this subject is given in a recent paper by Fred H. Klopstock, Manager of the Research Department of the Federal Reserve Bank of New York.[7] More information and more research are needed, but I think we already know enough to see that there are good reasons behind the long-term growth revealed by the charts on pages 112 and 114 of the Bernstein Committee's report. In his Princeton paper 2 years ago, Mr. Lederer stressed the long-term growth, with few reversals, of U.S. short-term assets abroad. It would seem that the point is no less valid with regard to foreign short-term assets here. I scarcely need add that the dollar volume of international trade and other transactions has also risen rapidly over this period. Again, I am not suggesting that we can afford to take a carefree view of our responsibilities in these matters. But neither must we look on every dollar of increase in foreign private short-term investments here as bringing a day of reckoning that much nearer.

On the other hand, it may well be that the increase in foreign private liquid dollar balances during the last several years is considerably overstated, with the effect of overstating also the deficit as measured on the "liquidity" concept. This is my second main doubt about the concept: that it may be a good deal less accurate in measuring what it seeks to cover than commonly supposed. A principal reason for thinking so relates to the "errors and omissions" item, discussed in chapter 7 of the Bernstein Committee's report. In the nature of the case, one cannot say anything for sure about this residual item. And yet its pattern through time, as shown in the chart on page 86 of the report, is strongly suggestive of large unreported capital inflows through the period 1934 to 1959, with heavy concentrations at times of political and financial disturbances abroad. The abrupt shift in the errors and omissions item to a large debit starting in 1960 is in keeping with this view, since the reversal followed the return to currency convertibility by Western European countries and the stabilization of the French franc in particular. Whatever other factors may have contributed to this change, including unrecorded outflows of U.S. private capital, it seems plausible that there have been substantial unrecorded outflows of foreign private capital since 1960. If we knew the facts, therefore, the net increase in foreign private liquid claims here during the last 5 years might well prove to be much smaller than appears from the reported data. It may be, of course, that the unrecorded foreign funds presumed to have been withdrawn would not have been classed as "liquid." But that possibility underlines, in my view, the unsatisfactory nature of the "liquidity" criterion as an organizing principle for the statistics. It is narrowly defined for its indicated purpose and leaves out elements that would figure importantly in a liquidity crisis, if it should come to that. I have in mind foreign-owned stocks and bonds and the famous "leads and lags" which develop on ordinary commercial payments, not to mention the American liquid capital which could come on the market in such an eventuality.

My third criticism of the "liquidity" concept is that it needs reconsideration to take account of the impressive cooperation achieved between U.S. and foreign

[7] "The International Money Market: Structure, Scope, and Instruments," Journal of Finance, May 1965.

monetary authorities in countering disruptive shifts of private liquid funds. European countries gaining reserves have shown themselves, I think, anxious to avoid complicating matters by attracting private funds. The most effective measures of cooperation have been the currency swaps and forward operations in the foreign exchange market, on which Mr. Coombs of the Federal Reserve Bank of New York has periodically reported. More needs to be done, particularly in the coordination of credit policies on both sides. Perhaps we are at a point where more progress in this respect, too, is possible, now that some slack has developed in the Italian and French economies and that, on our side, we may be able to rely more on tax and budget policies for domestic expansion. But we have already gone far enough in international cooperation, I think, to render obsolete the view that the policies of foreign monetary authorities can only complicate rather than alleviate our problems.

My fourth criticism follows from the first three. This is that the "liquidity" criterion may be unreliable as a "sensitive indicator" and "early signal." Sensitivity is not necessarily a virtue in a statistical series. Let me quote in this connection from a document well known to the Joint Economic Committee; that is, the report on "The Price Statistics of the Federal Government," prepared several years ago by the Price Statistics Review Committee of the National Bureau of Economic Research at the request of the Bureau of the Budget. In the chapter on wholesale prices (page 68), the report comments:

"The literature abounds with statements of the need for a sensitive price index which measures the immediately current or prospective movements of wholesale prices, as a guide in policy formation and in predicting business movements * * *. Often what seems to be implied is that the index number should be based upon prices which change often or by relatively large amounts * * *. Sensitivity in this context means only exaggeration, and it is difficult to see any purpose in exaggerating current price movements."

I would hold the same doubt with regard to the deliberate choice of a "sensitive indicator" of the balance of payments deficit, particularly when the development to which it is supposed to point lags so far and so uncertainly behind. The monetary authorities scarcely need to have the figures grouped in this particular way for purposes of their own analyses and operations. And as far as alerting the public is concerned, this can be a two-edged sword. It may, on the one hand, serve the constructive purpose of developing the understanding and cooperation needed for remedial action. But it may also touch off speculative activities and create excessively pessimistic expectations in foreign official circles and so aggravate the problem instead of merely calling attention to it. I would, therefore, urge neutrality rather than sensitivity as the best guide to statistical practice.

The fifth and last main criticism which I would express regarding the "liquidity" concept is that it may be misleading as a guide to policy. To be sure, the same sort of doubt may be raised regarding the deficit measured on any other basis, but I am particularly worried by the implications of the "liquidity" concept in this regard. If we were to take as our immediate objective an improvement of $3 billion in the balance in relation to the 1964 results, I fear that we would bring excessive pressure on a number of countries in a weak position before the squeeze was really felt by the strong surplus countries. I have spelled out this view somewhat more fully in a recent paper attached as annex B. If we think of the longer run, an even balance on the "liquidity" definition would mean that foreign commercial banks, firms, and individuals could increase their dollar working balances and other funds here only at the expense of the official reserves of foreign countries. This might not be so unpleasant for a while, if only the effects could be concentrated in the right places at the right time. But as a continuing proposition, such an outcome would scarcely be consistent with the growth of world trade and production.

My concern as to the policy implications of the "liquidity" concept may seem like borrowing trouble, since—at least until very recently—we have fallen so seriously short of balancing our international accounts. No one could say that we had been led to act with undue vigor. The basic reasons for the long duration of the problem have little to do with the definition of the deficit, I believe, and can be summed up as follows:

(*a*) The difficulty of foreseeing at any one time during the last half-dozen years the full sequence and strength of the changes in the world to which we have had to adjust;

(*b*) The special necessity for the United States, because of its size, to try to avoid making adjustments at the expense of weaker countries;

(c) The possession of large reserves and borrowing privileges, as a reserve center, relieving us of the necessity to make adjustments more swiftly and ruthlessly.

Now, our room for maneuver has considerably shrunk, and we have invoked far more vigorous and direct measures to correct the deficit. The goals we set and the kind of guidance provided by the balance of payments, therefore, become more crucial questions than before.

IV

If one is troubled by the doubts I have expressed regarding the ambivalent treatment of private short-term capital under the "liquidity" concept, the question is which way to move to obtain a more balanced and symmetrical treatment. On the "official settlements" basis recommended by the Bernstein Committee, foreign private short-term capital would go above the line along with private U.S. short-term capital as ordinary transactions. Only changes in official reserves (along with special intergovernmental transactions) would go below the line. In support of this treatment, the report states: [8]

"The size of these transactions in international reserves provides the best available measure of the market intervention that has been necessary, of the gaps that have had to be filled, and hence of payments disequilibria."

This exclusive emphasis on changes in official reserves may be justified by practical considerations. But it fails to take into account that market intervention by the monetary authorities assumes the form not only of direct purchases and sales of gold and foreign exchange but also of changes in credit conditions affecting private capital flows. Let me quote what Mr. Bernstein himself said on this subject a few days ago in his testimony before the Subcommittee on International Finance of the Senate Committee on Banking and Currency:

"One of the purposes, and one of the principal effects, of monetary policy is to induce a desired change in foreign private holdings of dollars. I believe that an analysis of the behavior of the liquid assets of foreign commercial banks and other foreign private holders will show that they have been responsive to U.S. monetary policy and that they are a major justification for the use of monetary policy as an instrument for improving the U.S. balance of payments."

Later in the same statement, speaking of the new voluntary program to reduce capital outflows, Mr. Bernstein said:

"Credit policy should be used to reinforce the voluntary program by slowing down the growth of bank reserves, so that banks do not have so much funds that they can lend too freely abroad, and by holding up money market rates in this country, in order to narrow the interest differential which attracts large sums from U.S. nonbank concerns to foreign financial centers. Incidentally, such a credit policy will also provide a greater inducement for foreign commercial banks and other private foreigners to hold more dollars in our banks and in our money markets."

It is considerations of this nature which led me to invoke the criterion of "sensitivity to monetary policy" and to place all private short-term capital movements, both United States and foreign, below the line along with official settlements. The "basic transactions" then go above the line. This approach does not require, of course, that all elements included in short-term capital be equally responsive to monetary policy. Nor does it mean that the United States must be able to liquidate today what it loaned only yesterday. It is sufficient under all ordinary circumstances that monetary policy be able to act on the margins, to reduce the outflow of U.S. short-term capital and increase the inflow of foreign short-term capital, or vice versa, as the case may be.

The advantage of the "basic transactions" approach is that it does not confuse temporary accommodations in short-term capital flows with more fundamental adjustments in the items above the line. By contrast, the "official settlements" presentation seems to assign the same value to an increase in receipts of foreign short-term money as it does to an increase in earnings from exports of machinery.

It, therefore, still seems to me that the "basic transactions" method is a useful way of presenting the figures and provides a good starting point for analysis. I may also note, especially since the Bernstein Committee's report failed to do so, that essentially the same organizing concept was used 2 years ago in another study well known to the Joint Economic Committee; that is, the Brookings balance of payments study [9] prepared by another group of able economists headed by Walter Salant. I suspect, therefore, that good use will still be found

[8] Report, p. 110.
[9] "The United States Balance of Payments in 1968," Washington, 1963.

for this approach and that it may be improved as an instrument of analysis with further research on the behavioral characteristics of the capital and other items.

On the other hand, I do recognize that difficulties arise in the regular application of the basic transactions concept. Other types of capital movements, in addition to short-term, respond in some measure to monetary policy. And the treatment of errors and omissions raises difficult questions. As a practical matter, therefore, I support the adoption of the official settlements concept, if indeed practice must settle on only one definition.

Even on the part of those who agree on the desirability of a change, it is sometimes suggested that it should not be done now but only later after our international payments come into better balance. Otherwise, it is said, we will be suspected of doctoring the figures. I do not know how close we may come to a balance this year. But one shift which seems to me very likely is that the deficit may well be smaller on the present definition than on the official settlements basis. This expectation is prompted by the fact that the increase in foreign private short-term balances was so very large last year and by the further fact that they will now feel the effects of our own voluntary restraints program. I therefore expect that these foreign private balances will decline this year, and consequently that the deficit will be smaller if we continue to enter these items below the line than if they go above it. It therefore seems to me that, if the officers responsible for a decision in this matter find a change desirable, they may also find this year a particularly good time to begin the change. If the official settlements approach produces the larger deficit, it could scarcely be argued that the figures were being juggled.

Annex A to prepared Statement of Hal B. Lary

[Pages 11 to 22 from Chapter II and all of Appendix A from *Problems of the United States as World Trader and Banker,* by Hal B. Lary, National Bureau of Economic Research, 1963.]

Chapter II

Sketch of the Balance of Payments Since the War

An appraisal of our international payments position needs to take account of the way it has evolved in recent years and of the varied forces which have shaped its development. The point of central interest is the size and persistence of the deficit. Section 1 of this chapter traces the course of the deficit over the postwar period and considers some of its cumulative effects, and is also concerned with the concept of the deficit and how the deficit appears according to alternative methods of measurement.[1] Section 2 reviews our balance-of-payments experience more broadly and relates developments in our foreign trade and other transactions to the course of events in the United States economy and in the rest of the world. Section 3 discusses the problem of making valid generalizations about our balance-of-payments position and how it has altered over the postwar period.

1. *The Concept and Evolution of the Deficit*

Distinction Between Liquid Capital Movements and Other Transactions

The approach taken here reflects the view that it is useful to distinguish flows of liquid capital from other transactions in the balance of payments. In recent years, liquid funds have proved to be extremely mobile, as evidenced by the data given in Table 1 on the large recorded flows of United States and foreign private short-term capital

[1] For a fuller discussion of concepts and methods of measurement of the balance of payments, see Appendix A.

TABLE 1

EVOLUTION OF THE DEFICIT IN THE U.S. BALANCE OF PAYMENTS ON THREE CONCEPTS
(millions of dollars)

Period	Deficit (—) on Basic Trans-actions[a] (1)	Recorded Net Outflow (—) of U.S. Private Short-Term Capital[b] (2)	Unrecorded Trans-actions (errors and omissions) (3)	Deficit (—) on Commerce Department's Definition (1+2+3)[c] (4)
1950	— 3,432	— 127	— 21	— 3,580
1951	— 717	— 65	477	— 305
1952	— 1,599	— 48	601	— 1,046
1953	— 2,608	117	339	— 2,152
1954	— 1,054	— 669	173	— 1,550
1955	— 1,461	— 187	503	— 1,145
1956	— 1,021	— 457	543	— 935
1957	— 449	— 188	1,157	520
1958	— 3,655	— 362	488	— 3,529
1959	— 4,232	77	412	— 3,743
	(— 4,667)[h]			(— 4,178)[h]
1960	— 1,900	—1,433	— 592	— 3,925
1961	— 527	—1,332	— 602	— 2,461
	(— 1,216)[h]			(— 3,150)[h]
1962[i]	— 573	— 626	— 696	— 1,895
	(— 1,302)[h]			(— 2,624)[h]
Quarters[j]				
1960 I	— 581	— 103	4	— 680
II	— 375	— 260	— 140	— 775
III	— 443	— 555	— 159	— 1,157
IV	— 501	— 515	— 297	— 1,313
1961 I	116	— 406	— 29	— 319
II	858	— 316	— 366	176
	(134)[h]			(— 548)[h]
III	— 868	— 235	193	— 910
	(— 793)[h]			(— 835)[h]
IV	— 633	— 375	— 400	— 1,408
	(— 673)[h]			(— 1,448)[h]
1962 I	— 268	— 314	106	— 476
II	— 110	18	— 134	— 226
	(— 186)[h]			(— 302)[h]
III[p]	— 52	— 173	— 494	— 719
	(— 523)[h]			(— 1,190)[h]
Cumulative totals				
1950-1962[k]	—23,085	—5,143	2,956	—25,272
1950-1957	—12,341	—1,624	3,772	—10,193
1958-1962[k]	—10,744	—3,519	— 816	—15,079

(continued)

TABLE 1 (concluded)

Period	Increase in U.S. Liquid Liabilities[d] to Other Than Foreign Monetary Authorities		Deficit (—) on Official Settlements Basis (4+5+6)[e] (7)	Increase in U.S. Liquid Liabilities[d] to Foreign Monetary Authorities[f] (8)	Gold Sales or Purchases (—) by the United States[g] (9)
	Commercial Banks (5)	Other (6)			
1950	303	— 35	— 3.312	1,569	1,743
1951	498	345	538	—485	— 53
1952	31	193	— 822	1,201	—379
1953	— 59	107	— 2,104	943	1,161
1954	— 41	68	— 1,523	1,225	268
1955	414	— 10	— 741	700	41
1956	419	255	— 261	567	—306
1957	50	575	1,145	—347	—728
1958	48	454	— 3,027	752	2,275
1959	1,140	320	— 2,283	1,552	731
			(— 2,718)[h]		
1960	104	257	— 3,564	1,862	1,702
1961	615	587	— 1,259	517	742
			(— 1,948)[h]		
1962[i]	— 60	387	— 1,689	979	710
			(— 2,418)[h]		
Quarters[j]					
1960 I	457	— 19	— 203	153	50
II	132	203	— 556	462	94
III	5	— 47	— 1,233	596	637
IV	—490	120	— 1,572	651	921
1961 I	— 19	— 55	— 382	36	346
II	414	156	659	—329	—330
			(— 65)[h]		
III	154	80	— 675	405	270
			(— 600)[h]		
IV	66	406	— 861	405	456
			(— 901)[h]		
1962 I	429	263	230	—420	190
II	—256	246	— 322	529	—207
			(— 398)[h]		
III[p]	—218	—219	— 1,175	625	550
			(— 1,646)[h]		
Cumulative totals					
1950-1962[k]	3,477	3,406	—18,480	10,790	7,690
1950-1957	1,615	1,498	— 7,080	5,373	1,707
1958-1962[k]	1,862	1,908	—11,400	5,417	5,983

NOTES TO TABLE 1

[a] Goods and services (including military expenditures), government grants and capital, and private long-term investment.

[b] Less net inflow of funds through changes in foreign commercial credits to the United States (these changes being netted out in column 2 rather than included in columns 5 and 6 in order to conform to the Commerce Department's present method of calculating the deficit).

[c] Equals, with signs reversed, sum of columns 5, 6, 8, and 9. But see notes i and j.

[d] As defined by the Commerce Department, liquid liabilities include foreign holdings of deposits, U.S. Treasury bills and certificates, bankers' acceptances, commercial paper, and other short-term claims on the United States (and also foreign holdings of U.S. government bonds) as reported by banks in the United States, government agencies, and nonfinancial concerns (i.e., exporters, importers, and industrial and commercial firms). For the years 1950-1954 it is assumed that all transactions of foreign countries in U.S. government bonds were for the account of foreign monetary authorities; thereafter an estimated division is made between these and other accounts.

[e] Equals, with signs reversed, sum of columns 8 and 9.

[f] Includes changes in U.S. liquid liabilities to the International Monetary Fund.

[g] Includes, beginning March 1961, changes in holdings of foreign convertible currencies by the U.S. monetary authorities.

[h] Figures adjusted to exclude effects of unscheduled repayments of foreign obligations to the U.S. Government, as follows: 1959, $150 million in first quarter and $285 million in fourth quarter; 1961, $724 million in second quarter, of which $75 million was advanced from the third quarter, and $40 million in the fourth quarter; 1962, $76 million in the second quarter and $471 million in the third quarter.

[i] First nine months (preliminary data) at annual rate, seasonally adjusted except as explained in note j.

[j] Columns 1 to 4 are seasonally adjusted. (Quarterly figures in columns 5, 6, 8, and 9 add to the amounts given in column 4 before seasonal adjustment of the latter.)

[k] Through third quarter of 1962.

[p] Preliminary data.

SOURCE: U.S. Department of Commerce.

as well as by the capital movements which may be inferred from the behavior of unrecorded transactions (that is, errors and omissions).[2] The monetary authorities are accordingly confronted with new problems because of their ability to influence the cost and availability of credit and, hence, to affect the conditions determining international flows of liquid funds.

This is not to say that variations in the size and direction of liquid capital movements are to be explained only, or mainly, by changes in relative interest rates at home and abroad. The determining conditions are varied and variable. The steps towards external ("nonresident") currency convertibility taken by most Western European countries at the end of 1958 and subsequently by Japan were especially important both in enabling their banking and business concerns to increase working balances in the United States and in removing an obstacle to the extension of American credits to these countries. Changes in the value of several leading currencies and speculation of varying intensity in these and other currencies, including the dollar, have also been important influences, along with more usual economic forces affecting the demand for credit and the flow of funds. Moreover, changes in credit conditions in different countries will have more effect on some kinds of capital flows than on others. To allow for such factors is, however, a very different matter than to conclude that—under any given set of circumstances—a change in interest rates in the United States compared with those in other financial centers would have little effect on capital flows between them or on the relative size of their credit extensions to third countries.

Other sectors of the balance of payments are subject to a different or wider range of economic forces, as in the case of foreign trade and investment, or are determined essentially by political objectives, as in the case of economic aid and military expenditures abroad. Responsibility for policies affecting these different activities is dispersed,

[2] It is usual to define liquid capital movements in terms of the characteristics of the assets acquired—that is, whether or not the assets can be turned into cash quickly and without appreciable loss. The United States monetary authorities may, however, be more concerned with keeping fresh outflows of liquid funds from becoming unduly large than with the possibility of obtaining the liquidation and return of American funds which have already been placed abroad. From this point of view, one may think of liquid capital movements as embracing more or less the whole of so-called "short-term" capital movements, and some types of "long-term" capital movements as well.

except as they are coordinated at the highest levels of government. Monetary policy has little or no effect on some of these items and influences others only indirectly and gradually through changes in incomes, prices, and profits. From the standpoint of balance-of-payments objectives, these various types of transactions tend to be slow to adjust in the desired way and sometimes act perversely. It is, however, also appropriate to describe them as "basic transactions," since their combined behavior provides a measure of the adequacy of this country's competitive strength and its ability to defend the value of its currency.

This does not mean that an even balance on basic transactions is necessarily a sufficient goal of policy. An appropriate objective in this regard would have to be determined in the light of various considerations, including views and policies with respect to the size of liquid capital flows.[3] The distinguishing feature of the latter as contrasted with basic transactions is, however, that the monetary authorities have the possibility of acting quickly so as to keep outflows of liquid funds within tolerable limits and ward off excessive demands on gold arising from this source. A solution to the payments problem need not therefore require raising the surplus on goods and services by enough to cover these flows along with all the other more stubborn burdens resting on the balance of payments.

The size of the problem presented by liquid capital flows is inadequately revealed by the data provided through the reporting network of banks and business concerns in this country. Americans may, for instance, hold deposits directly in foreign banks rather than through American banks, or buy and sell other foreign assets through channels which pass outside the reporting system. Similar possibilities exist with respect to shifts of foreign capital into and out of the United States. A clue to such transfers may be found in the balance-of-payments entry for "unrecorded transactions," though this residual item registers the net effect of all errors and omissions, wherever they may arise in the balance of payments, and could not be attributed only to unreported capital movements. The play of capital movements is, however, suggested by the sudden shift in this item after 1959. Though varying in

[3] The composition of liquid capital movements is also important since, depending on their nature, they may affect the availability of funds for payments on basic transactions. To take one example, further commented on below, the growth of American credits to Japan in 1960 and 1961 undoubtedly contributed to the rise in United States exports to that country.

size from year to year, it had been regularly positive in sign, indicative of net unrecorded receipts, during the whole of the period 1951 to 1959 (Table 1), and averaged some $500 million per year. It then shifted abruptly to a minus quantity of approximately $600 million in both 1960 and 1961 and even more in 1962 on the basis of data for the first nine months. This turnabout of $1.1 billion gives some reason to suppose that the large negative residuals which started in 1960 may considerably understate the amount of unreported capital outflows and their contribution to the large deficits of the last three years as measured by the Commerce Department.[4] Philip Bell, in a correlation analysis covering the period 1952-1961, found that the entry for unrecorded transactions had, in fact, varied closely with the reported movements of United States private short-term capital, and he estimated that the amount of unreported capital flow of this nature was well in excess of $1 billion in both 1960 and 1961.[5]

THE SIZE AND CUMULATIVE EFFECT OF THE DEFICIT

Table 1 shows the balance on basic transactions as here defined, comprising exports and imports of goods and services, government

[4] This reasoning presupposes that the errors and omissions which accounted for the plus residuals in the 1950's (and which could represent either an underestimate of receipts or an overestimate of payments on "recorded" transactions) have persisted on into later years, but, since 1960, have been outweighed by unrecorded capital outflows. As an alternative, or complementary, explanation, it is possible that the phenomena responsible for the residuals have now been reversed. Thus, there is good cause to think that, in the earlier period, Europeans wanting to escape exchange controls or the risk of devaluation, and Latin American dictators or others wanting to hedge against the future, acquired assets in the United States, and that they may now have ceased to do so or even shifted funds from the United States to other countries. Many such transactions would have been handled through domestic names and addresses or in other ways so that both the earlier inflows and the later outflows of funds would have escaped the reports filed by American banks and businesses on their liabilities to foreigners or other records of capital movements.

[5] Philip W. Bell, "Private Capital Movements and the U.S. Balance-of-Payments Position," in *Factors Affecting the United States Balance of Payments* (Joint Economic Committee), Washington, December 1962, pp. 395-481. Bell reports a particularly close relation between unrecorded transactions and (1) claims on Canada and Europe reported by nonfinancial concerns in the United States and (2) foreign-currency claims on Canada reported by United States banks. His study also contains a useful statement of the reasons why capital movements may fail to be caught by the reporting system. For a fuller statement of the sources of errors and omissions in the estimates, see Walther Lederer, "Measuring the Balance of Payments," American Statistical Association, *1961 Proceedings of the Business and Economics Statistics Section*, Washington, 1962, pp. 42-44.

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grants and capital, and private long-term investment. It also shows the balance including, in accordance with the Commerce Department's practice, transfers of United States private short-term capital and unrecorded transactions. When the net flow on these latter items is inward, as was generally true of the 1950's, the adverse balance on the Commerce Department's definition is smaller than that on basic transactions. The opposite result ensues when these flows are outward, as in 1960 and 1961.

Without exhausting the range of possibilities, Table 1 presents the balance according to yet another concept—that is, on the basis of "official settlements." The rationale of this concept is that changes in liquid liabilities to foreign private holders[6] are not merely a passive consequence of the state of the United States balance of payments, as might be true of changes in the reserves of the monetary authorities, but reflect rather the positive interest of foreign commercial banks, business concerns, and other holders in increasing or, on occasion, decreasing their working balances and other liquid assets in dollars. Changes in these assets, like those in United States private short-term claims on other countries, would therefore be entered in the balance of payments before computing the deficit or surplus, leaving gold sales or purchases and changes in the liquid claims of the monetary authorities as the direct measure, with signs reversed, of the balance.

The "official settlements" measure of the balance is, however, deficient in that some central banks, in addition to their direct dollar claims on the United States, have come to hold important dollar balances through commercial banks in their own or other countries.[7] An uncertain but apparently significant part of what appears in United States sta-

[6] See Table 1, columns 5 and 6. In addition to nonbanking concerns and private individuals, column 6 includes foreign government agencies other than central banks and treasuries, and international organizations other than the International Monetary Fund.

[7] Oscar Altman estimates that the central banks and monetary authorities of twenty or twenty-five countries hold deposits of dollars or sterling (mainly dollars) outside the United States and the United Kingdom, respectively. He further estimates that these official dollar deposits account for the greater part of the dollar funds employed in the "Euro-dollar market"—that is, the multibillion-dollar international money market developed during the last four or five years by commercial banks in London, Montreal, Paris, and other financial centers for deposit and loan operations in U.S. dollar funds. See Oscar L. Altman, "Recent Developments in Foreign Markets for Dollars and Other Currencies," in *Factors Affecting the United States Balance of Payments* (Joint Economic Committee), Washington, December 1962, pp. 483-523.

tistics as liabilities to foreign commercial banks therefore really belongs to central banks. Shifts between official and private dollar accounts in the United States may occur for other reasons as well, so that it becomes difficult to assign a clear meaning to changes in these separate categories.[8]

All three concepts of the balance of payments portrayed in Table 1 are alike in showing deficits most of the time, and very large cumulative deficits, over the period 1950 through the first nine months of 1962. The cumulative deficit is largest on the Commerce Department's definition, amounting to $25.3 billion, of which $15.1 billion is accounted for by the last four and three-quarters years. The cumulative deficit on basic transactions is only moderately smaller for the whole of the period, but with rather more of it in the earlier part and some $10.7 billion in the later part. As measured by official settlements, the cumulative figure for the twelve and three-quarters years is $18.5 billion, or considerably smaller than on either of the other two bases, but that for the later part of the period is slightly larger than the deficit on basic transactions. In all cases the deficits for some of the more recent years are greater still if the figures are adjusted, as also indicated in the table, to exclude advance repayments of foreign debt to the United States Government.

As noted in Chapter I, the balance-of-payments deficits incurred prior to the Suez crisis of 1956-57 served an essential purpose in enabling other countries to rebuild their monetary reserves and in laying the basis for the subsequent restoration of currency convertibility. Under these circumstances, the deficits of that period could scarcely be regarded, even now, as early evidence of some competitive inadequacy, especially in view of the prevalence at that time of discrimination against imports from the dollar area. But they may nevertheless have contributed significantly to our subsequent difficulties by permitting the balance

[8] This problem is illustrated by the following passage from the International Monetary Fund's *Annual Report 1962*, p. 171: "Because world reserves conventionally cover only official holdings, their size is affected by transactions between the official sector and the private bank and nonbank sectors. Shifts of this sort may reach significant proportions. In December 1961, for example, the German commercial banks converted into deutsche mark foreign assets in excess of $600 million for seasonal requirements, including window dressing purposes. Most of this was reflected in an increase in the Bundesbank's net reserves. An even larger amount of such assets was deposited abroad by the commercial banks in the following month. If it had not been for this single factor, world official exchange holdings would have shown only a very small increase during 1961."

of payments to assume a structure which, with the added burdens and increased foreign competition of later years, has proved difficult to correct.

Though the deficits registered since the Suez crisis have been large by any standard, they show a rather different size and evolution according to which of the three concepts is considered. They appear largest and most stubborn on the method of measurement employed by the Commerce Department. On this basis, and adjusted to exclude debt prepayment to the United States Government, the deficit reached a peak of $4.2 billion in 1959, remained over $3 billion in 1961, and was still at an annual rate of $2.6 billion in the first nine months of 1962. On the basic transactions concept, and again adjusted to exclude debt prepayment, the deficit was as high as $4.7 billion in 1959 but fell to $1.9 billion in 1960 and to an even lower level in 1961 and 1962. Measured by official settlements, the deficit rose to a peak of more than $3.5 billion in 1960, dipped below the $2 billion level in 1961, but then rose again to a rate of $2.4 billion on the average for January-September 1962.

All three methods of measurement thus show a decline in the deficit in the last two years compared with earlier levels. The improvement has not yet gone far enough, however, to preclude a further deterioration in our reserve position. The composition of official settlements given in Table 1 is of interest in this regard. Of the cumulative total of these settlements from 1950 to 1956, about 30 per cent was in gold and the remainder in the form of increases in the liquid dollar assets of foreign and international monetary authorities. For the period 1958 through September 1962, more than 50 per cent was in gold. This change seems to suggest that, as the cumulative effect of the United States deficits and the rise in other countries' reserves, foreign monetary authorities have become more disposed to regard gold as the preferred means of receiving settlement.[9]

Evidence which runs "contrary to a so-called 'rush' to obtain gold" has been developed by Oscar Altman in an analysis of the relation

[9] The share of gold in official settlements could also vary, without signifying a shift in foreign preferences, if in one period gains in reserves accrued chiefly to countries which hold their reserves largely in dollars and in another period to countries which hold them predominantly in gold. For an analysis of central bank practices in this regard, see a forthcoming study by Peter B. Kenen, *Reserve-Assets Preferences of Central Banks and Stability of the Gold-Exchange Standard,* Princeton Studies in International Finance No. 10.

between United States gold movements and the size of its balance-of-payments deficit or surplus as measured by official settlements. On the basis of the relation for the period 1946 to 1961 (depicted in Chart 3), Altman found that, as long as official settlements made by the United States did not exceed $350 million per year, other countries added these receipts to their dollar balances rather than take gold, but that each increment in official settlements above that level was effected to the extent of some 55 per cent in gold.[10] It would therefore be the increased size of the United States balance-of-payments deficits after 1957 rather than a shift in foreign preferences that explains the higher proportion settled in gold.

Altman's results would not appear, however, to eliminate the hypothesis that the preferences of foreign monetary authorities have shifted toward gold. If the points for the years 1949 to 1956, designated by circles in Chart 3, are looked at in isolation from those for other years, they do not show a very clear pattern.[11] Six of the eight years form a cluster from which no dominant relation emerges, and the gold outflow for the whole of the 1949-1956 period was smaller, and that for 1958-1961 larger, than would be indicated by Altman's equation. Irrespective of whether or not there has been a shift in foreign preferences, however, the more important conclusion suggested by Altman's analysis is that the United States could scarcely expect to continue to run large deficits without further substantial gold losses.

[10] See Oscar L. Altman, "Quelques Aspects du Problème de l'Or," *Cahiers de l'Institut de Science Economique Appliquée,* Series R, No. 7, October 1962. With the balance-of-payments deficit defined (1) by official settlements (as in Chart 3) and (2) by official settlements plus the increase in liquid dollar holdings of foreign commercial banks, the relations found by Altman for the period 1946 to 1961 are expressed by the following equations (in billions of dollars):

(1) Gold outflow = —0.200 + 0.566 deficit
(2) Gold outflow = —0.282 + 0.543 deficit

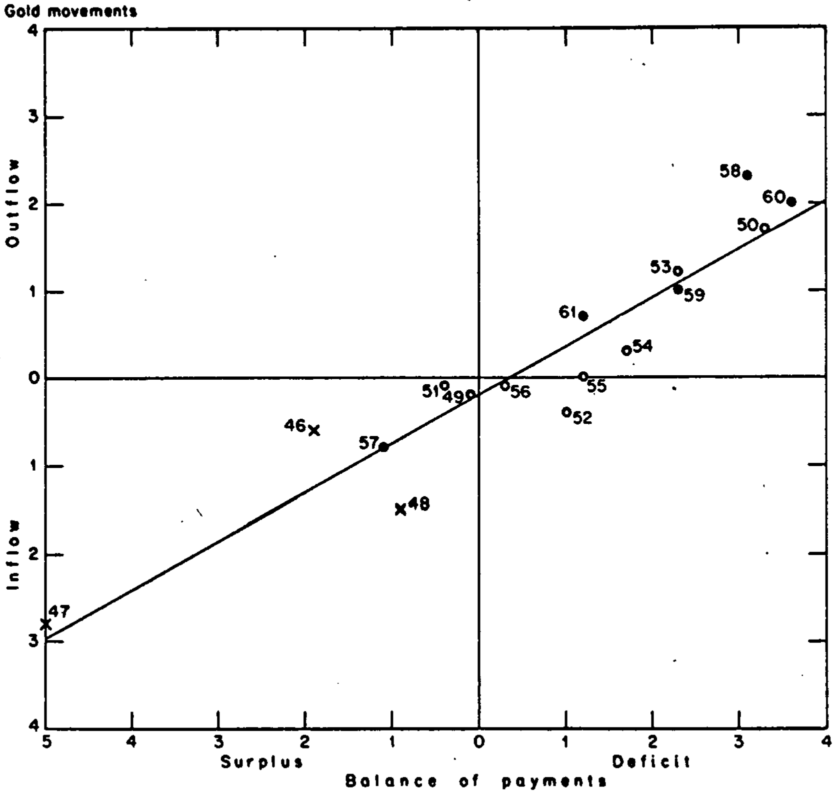
If the years of large U.S. balance-of-payments surpluses (1946-1948) are eliminated, the corresponding equations for the period 1949 to 1961 are:

(1a) Gold outflow = —0.284 + 0.614 deficit
(2a) Gold outflow = —0.348 + 0.580 deficit

[11] As Altman indicates (see preceding note), it may be preferable to disregard the early postwar years of large United States surpluses.

CHART 3

U.S. Balance of Payments and Gold Movements, 1947 to 1961



NOTE: Reproduced from data supplied by Oscar L. Altman (see note 10, Chapter 2). The balance-of-payments surplus or deficit corresponds to the "official settlements" concept, adjusted (along with the data on gold movements) to exclude gold sales to the United States by the International Monetary Fund in 1956, 1959, and 1960 for the purpose of acquiring income-earning U.S. Treasury bills and notes. The data also differ in some other respects from those given on "official settlements" in Table 1.

APPENDIX A

A Note on Alternative Ways of Presenting the Balance of Payments

It has seemed useful in this study to stress the new importance of international movements of liquid capital for the balance of payments and for economic policy, and, without losing sight of certain interrelations, to distinguish these movements from other international transactions. The present note extends the discussion and considers the implications of the increased international mobility of liquid capital for the definition and presentation of the balance of payments.

It is hoped that this discussion, though brief and exploratory, will provide some new perspectives on issues which have long engaged the attention of international trade theorists and balance-of-payments specialists and contribute to the development of thought about some of our current problems.

Direct repetition of ideas dealt with in the main body of this paper has been held to a minimum, and this note should be read in conjunction with the relevant portions of Chapters II and IV, especially pages 11-17 and 117-126.

1. *The Search for an Organizing Concept*

For the United States or any other country committed to exchange rate stability, with unrestricted convertibility into other currencies, a central point in any concept of the balance of payments concerns

the country's ability to assure an adequate command over internationally acceptable means of payment with which to defend the external value of its currency. The balance of payments, as a statistical digest of a country's international transactions,[1] is looked to in this context as a basis for explaining the past and as a guide to the future. Many factors must, of course, be considered in addition to those directly observable in the balance-of-payments accounts. These include the general state of demand and employment at home and abroad, changes in the relative levels of costs and prices, shifts in demand and supply affecting particular products, and conditions influencing the international flow of capital. No method of organizing and presenting the balance of payments can be self-explanatory. Some may, however, provide a better starting point for analysis and policy formation than others. Or, if no one method clearly commends itself above the rest, a consideration of alternative methods may at least reveal their various shortcomings.

If all transactions are accounted for, the balance of payments must balance—that is, it will add algebraically to zero. The identification of a "surplus" or "deficit" therefore involves the segregation of certain items from the main body of the balance of payments as being different in some significant respect from the rest. The question of presenting and measuring the balance of payments can thus be posed in terms of the search for a suitable distinguishing principle or organizing concept for determining which items are to be placed in the main body of the balance of payments ("above the line") and which are to be placed outside ("below the line"). Account being taken of errors and omissions ("unrecorded transactions"), both groups of items will net out to the same figure with opposite signs.

The view developed here is that the nation's international transactions can usefully be grouped according to the main causal forces operating on them and, hence, according to the types of policy action affecting them. This approach, as applied in the present study, leads to the division of the accounts into two groups on the basis of the degree of sensitivity to monetary conditions and policies. The balance computed in this way corresponds to that sometimes called the "basic

[1] It may be noted that the expression "balance of payments" is commonly used to refer to either, or even simultaneously to both, of two ideas: (1) the statistical summary of a country's international receipts and payments over a given period or (2) the surplus or deficit shown by such a statement, computed as the difference between certain of its items.

balance," though the expression "balance on basic transactions" would seem more appropriate and will be employed in this paper.[2] The method of grouping the accounts employed since the war by the Department of Commerce is based on a different objective, described as that of measuring changes in the nation's "international liquidity."[3]

Summary statements corresponding to the two principal alternatives discussed here are given in Table A-1.[4] It will be seen that the difference between the two arrangements derives from the disposition of two items—recorded movements of United States private short-term capital and unrecorded transactions—changes in which are believed to reflect largely also movements of liquid funds.[5] The question is

[2] In an area in which terminological confusion thrives, the expression "basic balance" or "basic deficit" seems particularly unsuitable and misleading since it may appear to mean that special adjustments have been made to arrive at some measure of the basic disequilibrium or "hard-core" deficit (for instance, allowances for increased imports at higher levels of employment, for abnormal elements in exports, such as a lumping of jet aircraft deliveries during a short period of time, etc).

On the other hand, the expression "over-all balance," frequently used to designate the Commerce Department's definition, also suffers from lack of precision and may be misleading. As will be clear from an examination of Table 1 (Chapter II), it is less comprehensive in the types of transactions placed "above the line" than the "official settlements" version of the balance, which, as noted below, some would prefer.

[3] Recently, the Commerce Department has introduced in its reports, on an experimental basis, a supplementary presentation with a division corresponding to the balance on basic transactions and containing certain useful details as well, especially with regard to the Government's own international operations. (See Table 2 in the articles on the balance of payments in the *Survey of Current Business* for March, June, and September 1962.) This new presentation employs the term "Balance on Goods and Services, Government Assistance, and Long-Term Capital Accounts" for what is here more briefly called "Balance on Basic Transactions."

[4] The left side of the table is condensed from the familiar summary Table 1 appearing regularly in the quarterly balance-of-payments articles in the *Survey of Current Business,* and all references in the present note to the tabular representation of the Commerce Department's concepts are to that source.

[5] As discussed in Chapter II, the entry for unrecorded transactions presents serious analytical difficulties, registering as it does the net effect of all errors and omissions in the balance-of-payments estimates. There seems to be little doubt, however, that the big changes observable in the item have been closely associated with short-term capital movements. This also seems to be the conclusion pointed to in the *Survey of Current Business,* September 1960, which introduced a review of the significance of fluctuations in the residual during the postwar period with the following observation: "The close relationship between the changes in the net of unrecorded transactions in the balance of payments and conditions which can be expected to induce such short-term capital movements is indicated by the experiences during the postwar period."

TABLE A-1

Summary Schemata for Alternative Ways of Presenting the Balance of Payments
(billions of dollars)

I. Based on Concept of "Net International Liquidity"

		1958-1959 (average)	1960-1961 (average)
	Items Treated as Making Up the "Over-all Balance"		
1.	*U.S. payments, recorded*	28.6	31.6
2.	Imports of goods and services	22.1	23.1
3.	Remittances and pensions	.8	.9
4.	U.S. government grants and credits	3.1	3.7
5.	U.S. private long-term capital	2.5	2.5
6.	U.S. private short-term capital	.2	1.4
7.	*U.S. receipts, recorded*	24.5	29.0
8.	Exports of goods and services	23.3	27.6
9.	Repayments on U.S. government loans	.8	1.0
10.	Foreign capital, excluding liquid funds	.4	.4
11.	*Unrecorded transactions net*	.4	— .6
12.	*Balance on items listed above*	—3.6	—3.2
	Items Treated as Measuring Change in "Net International Liquidity"		
13.	Gold and convertible currency holdings of U.S. monetary authorities	1.5	1.2
14.	Liquid liabilities to foreign and international monetary authorities	1.2	1.2
15.	Liquid liabilities to foreign commercial banks and other private or international holders	1.0	.8

(continued)

TABLE A-1 (concluded)

II. Based on Concept of "Sensitivity to Monetary Policy"

	1958-1959 (average)	1960-1961 (average)
ITEMS TREATED AS MAKING UP THE "BALANCE ON BASIC TRANSACTIONS"		
1. *U.S. payments, recorded*	28.4	30.2
2. Imports of goods and services	22.1	23.1
3. Remittances and pensions	.8	.9
4. U.S. government grants and credits	3.1	3.7
5. U.S. private long-term capital	2.5	2.5
6. *U.S. receipts, recorded*	24.5	28.9
7. Exports of goods and services	23.3	27.6
8. Repayments on U.S. government loans	.8	1.0
9. Foreign long-term investment in U.S.	.4	.4
10. *Balance on items listed above*	—3.9	—1.2
ITEMS TREATED AS "SENSITIVE TO MONETARY POLICY"		
11. Gold and convertible currency holdings of U.S. monetary authorities	1.5	1.2
12. Liquid liabilities to foreign and international monetary authorities	1.2	1.2
13. Liquid liabilities to foreign and commercial banks and other private or international holders	1.0	.8
14. U.S. private short-term capital[a]	— .1	—1.4
15. Unrecorded transactions, net	.4	— .6

[a] Less changes in foreign commercial credits to the United States.

SOURCE: Table B-1.

NOTE: Detail may not add to totals shown because of rounding.

whether these items should be placed "above the line," as is the current practice of the Commerce Department (left half of table), or "below the line," as the alternative approach suggested here (right half of table) would have it. Similar questions may be raised with regard to some of the other capital items, as will be seen later.

It is apparent that the way this question is decided has an important bearing on the measurement of the deficit. When the net flow of funds in the form of reported U.S. short-term capital or through unrecorded transactions is outward, as in 1960 and 1961, the adverse balance as computed by the Commerce Department will be greater than that indicated by the alternative method. The opposite result is produced when these flows are inward, as was true, on balance, of the 1950's.

It is no mere coincidence that interest in alternative approaches to the balance of payments has greatly increased in recent years with the appearance of large deficits in this country's international accounts. The subject itself is, however, much older. Both of the principal concepts considered in this paper have their antecedents in the history of balance-of-payments theory, and enough will be said of still other approaches to indicate the considerable diversity of thought and practice in this area. One should therefore not assume that there has hitherto been some unique way of measuring the deficit or surplus which is only now being called into question.

2. *The Concept of International Liquidity*

The liquidity concept underlying the Commerce Department's familiar summary balance-of-payments tables has been explained by Walther Lederer, the officer in charge of this area of the Department's work. After stating that the purpose is "to measure the changes in our capability to defend the exchange value of the dollar," he adds: "This defense is the responsibility of our monetary authorities and their capability depends upon their liquid resources and the liquid claims which can be exercised against these resources."[6]

[6] "Measuring the Balance of Payments," in American Statistical Association, *1961 Proceedings of the Business and Economics Statistics Section*, Washington, 1962, p. 45. See also Lederer's contribution, "The Balance of United States Payments: A Statement of the Problem," in Seymour E. Harris (ed.), *The Dollar in Crisis*, New York, 1961, pp. 114-136. These articles, though written in a personal capacity, are a fuller exposition of the concepts expressed in the regular balance-of-payments articles carried in the *Survey of Current Business* (see, for example, the issues for September 1960, p. 10, and March 1962, pp. 19-21).

The liquid resources referred to in Lederer's statement include the country's gold reserves and, since March 1961, convertible foreign currencies held by our monetary authorities (i.e., Treasury and Federal Reserve). The liquid liabilities include all foreign-owned bank balances and other short-term assets in the United States together with U.S. Government securities (of all maturities) held by foreigners, whether official or private, and including also international agencies, both monetary and other. Decreases in our liquid resources or increases in our liquid liabilities reduce our international liquidity, and changes of the opposite nature increase it. The sum of the changes in these various items is thus taken to measure the net change in our international liquidity and hence the "surplus" or "deficit" corresponding to this concept.

Alternative Ways of Treating U.S. Liabilities

Questions may be raised as to whether certain of these items should be treated differently in the measurement of the deficit. There is considerable support for a definition whereby only official settlements between the monetary authorities would be entered "below the line," and changes in liabilities to commercial banks and other foreign holders would be entered "above the line."[7] Though all foreign assets here can be regarded as potential claims on our reserves, the case for making a distinction according to the official or unofficial status of the holder appears rather strong. Private claims on the United States, by commercial banks and others, are sometimes discussed as if they were merely the passive result, or even reluctant acceptance, of the backwash of our own balance-of-payments deficits. There may be such an element in balances held here on official account, especially to the extent that

[7] Table 1, Chapter II, shows the composition of the deficit on the official settlements basis compared with other definitions, and the discussion on pp. 18-19 points to some of the practical problems arising in the application of this concept. See also Gardner's and Triffin's views discussed later in this note.

foreign central banks or governments, to support the dollar, may refrain from converting as much of their dollar accruals into gold as they would otherwise do. But the large accumulation of short-term assets here by foreign commercial banks and other holders, excluding monetary authorities—rising from $3.1 billion at the end of 1949 to $5.7 billion at the end of 1957 and to $8.2 billion at the end of September 1962—is to be explained, in the main, as the deliberate acquisition of dollar funds for the useful purposes which they serve.

It may also be noted that the presentation of the United States balance of payments in the recent Annual Reports of the International Monetary Fund[8] corresponds to yet another definition of the deficit, whereby the items entered "below the line" include changes in short-term and other liquid liabilities to official institutions and also to commercial banks, but not to other private holders.

The foregoing questions relate to the inclusion or exclusion of certain foreign claims according to the status of the holder as reported in the statistics. Still other questions arise as to whether certain components of these assets, if they could be separately identified by the reporting system, should be segregated from foreign liquid claims on the United States. For instance, the compensating balances which foreign borrowers are required to keep on deposit, generally ranging from 15 to 20 per cent of the amount borrowed, are not really liquid. Similarly, banks in other countries accepting dollar deposits (creating so-called "Euro-dollar" accounts) find it necessary to immobilize a substantial part of the dollar assets so acquired against their dollar liabilities. In practice, it might well be impossible to distinguish these from other foreign assets. The Commerce Department has, however, begun to segregate (and enter above the line) changes in foreign commercial credits to the United States.

Asymmetry in Treatment of Assets and Liabilities

The most distinctive and debatable feature of the Commerce Department's practice is the difference in treatment accorded American private short-term capital compared with that given to foreign private short-term capital, movements in the former being entered above the line and movements in the latter below. This practice has been criti-

[8] See p. 80 (1960) and p. 81 (1961).

cized, by myself among others, as asymmetrical.[9] Thus, if an American bank and a foreign bank exchanged deposits, each crediting the other with $100, the two operations would not cancel out in the Commerce Department's presentation. Instead, the rise in American short-term assets abroad would appear above the line with a minus sign as an outflow of capital contributing to the deficit, and the rise in foreign short-term assets here would appear below the line with a plus sign as a direct measure (with signs reversed) of the deficit.

The point has also been made that the Commerce Department's practice, if universalized, would lead to mutually inconsistent results in that, in a time of generally rising international financial transactions, several financial centers might simultaneously record an increase in foreign private claims on them without reporting any offsetting assets. To revert to the illustration in the preceding paragraph (and barring other transactions), both the United States and the foreign country concerned would show a balance-of-payments deficit of 100 on this basis. The risk is that a number of leading countries might become simultaneously concerned about a deterioration or lack of improvement in their individual balances of payments and engage in mutually conflicting policies in the effort to strengthen them. That this risk is not altogether negligible is suggested by a recent analysis of differences in national statistical practices appearing in the *Staff Papers* of the International Monetary Fund.[10]

In reply to these criticisms, Lederer has stressed that, unlike foreign private short-term claims on the United States, United States private short-term assets abroad are only in part in the form of liquid claims on other leading financial centers and include large amounts of trade and other credits to countries, especially Japan and some of the Latin American countries, which could not be quickly mobilized in

[9] In a paper presented at the American Economic Association in December 1960, "Disturbances and Adjustments in Recent U.S. Balance-of-Payments Experience." *American Economic Review*, May 1961, pp. 417-429.

More detailed criticisms were formulated by Walter R. Gardner ("An Exchange-Market Analysis of the U.S. Balance of Payments," *IMF Staff Papers*, May 1961, pp. 195-211). Further reference to his criticisms and proposals is made later in this appendix.

[10] Poul Høst-Madsen, "Asymmetries Between Balance of Payments Surpluses and Deficits," *IMF Staff Papers*, July 1962, pp. 182-198. See also the article "What, No Creditors?" *The Economist*, January 20, 1962, p. 254.

case of need.[11] He has drawn the further important distinction that American private short-term assets abroad are less surely available to our monetary authorities, if needed, than would be true in the reverse case of foreign private liquid claims on us. The reason for this distinction lies in the difference in the degree of influence or control exercised over the national money market and banking operations by American monetary authorities compared with their foreign counterparts.[12]

Shortcomings in the Liquidity Concept

If the relevant test is the certainty and speed with which funds, once invested internationally, can be *repatriated,* it is hard to find serious fault in the Commerce Department's practice. On the Department's definition, however, the liquidity criterion itself may suffer from certain deficiencies in relation to the broad objective assigned to it—that is, to measure changes in the ability of the United States to defend the exchange value of the dollar. It would seem that the Commerce Department's approach to this objective is sharply focused on the eventuality of a currency crisis in which all *foreign* liquid claims on this country are suddenly exercised. The question implicit in that approach is: How has the capability of the United States to meet such a crisis altered, during any given balance-of-payments accounting period, as the result of changes in our gold or other official reserves and in foreign official and private claims on them?

First of all, one may ask if this question is not rather narrowly formulated as a regular guide to the state of the balance of payments. Our liquid assets and liabilities sometimes change for reasons which have little to do with the fundamental factors in our international payments position. It will be suggested in a moment that, within the limits of what can be gleaned from this or that way of looking at the data, the balance on basic transactions is probably a better guide to this country's ability to defend the dollar than the net change in international liquidity.

The eventuality of a convertibility crisis is, however, also a legitimate and necessary concern. But in this regard the Commerce Department's concept of international liquidity is subject to the further criti-

[11] See Table 5, Chapter II.

[12] For a fuller statement of Lederer's views on these points, see the references mentioned in footnote 6.

cism that changes in foreign liquid claims on us relate to only a part of the potential demands on our reserves. It is a measurable part and also a strategic part, since foreign-owned balances are doubtless particularly sensitive to changing conditions at home and abroad. But this last observation is also true, and perhaps increasingly so, of large though not readily identifiable parts of American-owned dollar funds. *All* liquid assets in this country—not merely the smaller part of the whole which is owned abroad—may be regarded as potential claims on United States reserves in that they may be exchanged for other currencies and thereby accrue to foreign central banks entitled to request conversion into gold.[13] Events of the last three years have demonstrated that the monetary authorities must be prepared to reckon with, and may have to counteract or curb, large outflows of American private funds and also those outflows which appear to be hidden in the errors and omissions item.[14]

It is true that there is no way whereby the balance of payments could take account of changes in financial conditions or psychological attitudes that may add to, or subtract from, potential *domestic* demands on our gold reserves through capital transfers abroad. But this difficulty serves to emphasize the limitations inherent in the international liquidity concept as a guide to the balance of payments. It might seem that one should at least include in our payments to other countries (i.e., "above the line") the amount of American private short-term capital which has actually moved abroad in any given period as giving some kind of indication of what the future outflow of this nature could amount to. The burden of the argument developed here is that the one does not provide even the roughest kind of guide to the other, and that an assessment of potential future capital outflows must reckon with many

[13] The frequently invoked analogy with a bank (though perhaps useful for devising titles to papers such as this one) will thus be seen as an oversimplification, and points to a limitation in the concept of net international liquidity as a basis for measuring the balance of payments or for assessing changes in the capability of the authorities to defend the dollar. A bank cannot be confronted with a drain from within on its liquid resources (unless the officers make off with the cash), but a nation can be faced with this problem and sometimes is.

[14] This point has been strongly emphasized by Walter Gardner: "In short, there is virtually no limit to the amount of U.S. funds that could flow abroad if the inducements were sufficient. The picture that the Department of Commerce balancing item gives of the changes in the ratio of reserves to certain liabilities is a picture that touches only the fringe of this potential problem. The greatest possibilities for mischief lie in the very categories that are omitted from the Commerce package" (*IMF Staff Papers*, May 1961, pp. 203-204).

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factors, including above all the ability of the monetary authorities to pursue policies aimed at keeping such flows within tolerable limits.

3. *An Alternative Concept: Sensitivity to Monetary Policy*

It is the particular concern of the monetary authorities with international movements of liquid funds that provides the clue to the organizing concept employed in the present study. This approach attempts to distinguish between our international transactions according to their sensitivity to monetary policy, those judged to be relatively sensitive being placed below the line and the rest above.

Monetary policy is here thought of as policy affecting the terms on which capital can be lent and borrowed, including not only the activities of the Federal Reserve banks but also the debt management operations of the Treasury. It would also include any taxes, special charges, or other discrimination, other than that which the market itself may establish, between the terms available to domestic borrowers and lenders and those available to foreign borrowers and lenders—a point of greater relevance at present to foreign monetary regimes than to that of the United States. For present purposes, moreover, monetary policy should include any intervention by the authorities in the foreign exchange market such as to influence spot or forward rates.

The concept of sensitivity to monetary policy, as applied to international transactions, includes the notions of certainty of response, speed of response, and magnitude of response, the idea being that certain transactions are likely to be generally more responsive than others in all three respects or in some weighted combination of them. Further research, and perhaps further experience under recently restored conditions of currency convertibility, will be needed to test the validity of this distinction and, if valid, to determine how individual types of transactions should be classified.

The Strategic Role of the Basic Transactions

The transactions to be placed above the line according to the sensitivity concept would be those which are influenced chiefly by general economic forces, as in the case of foreign trade and investments, or by our political and military objectives, as in the case of government expenditures for military purposes and foreign aid.

As noted in Chapter II, responsibility for policies affecting these various types of transactions is dispersed, except as these policies are coordinated at the highest levels of government. Monetary policy has little or no effect on some of these items and influences others only indirectly and gradually through changes in incomes, prices, and profit expectations.

Variations in these transactions may be great, both relatively and absolutely, and have major effects on the balance of payments. They do not necessarily move, however, in the direction needed for balance-of-payments adjustments and may not be readily amenable to policy changes determined by these purposes. Seen in a balance-of-payments context, these transactions tend to be slow to adjust and are sometimes perverse in their behavior.

It is, however, also appropriate to describe them as "basic transactions," since their combined behavior provides a measure of the adequacy of this country's competitive strength and its "capability to defend the exchange value of the dollar." Changes in the balance on basic transactions are therefore bound to be of distinct and strategic interest in an evaluation of our balance-of-payments strength or weakness and in the determination of policies affecting these items.

The Tactical Role of the Sensitive Items

The items to be grouped below the line would be those which are relatively sensitive to monetary policy and which are therefore the particular responsibility of the monetary authorities. They include, first of all, changes in official holdings of gold and convertible currencies for the reason that these assets can always be sold to support the currency. They also include those movements of private liquid funds, both foreign and American, which are influenced by differences in monetary conditions at home and abroad.

By their nature, these sensitive items can be made to serve only in a temporary or tactical capacity to alleviate, or to avoid adding to, strains arising elsewhere in the balance of payments. They could not indefinitely compensate a serious imbalance in basic transactions. Indeed, if confidence in the strength of the currency weakens under such conditions, the flow of liquid capital may react adversely and add to the loss of reserves. Even in the absence of such conditions, flows of liquid funds are not to be thought of merely as passive "balancing

items." This would tend to be true of official funds (except when central banks or governments are, for example, borrowing for the specific purpose of building up their reserves). But movements of private funds are motivated by many factors, ranging all the way from meeting the needs of foreign customers and acquiring working balances to transfers of idle funds in search of higher yields.

It must be noted, moreover, that private short-term capital transactions may themselves exert a causal influence on the balance of basic transactions. This is notably true with regard to the provision of export credits, which may be as important as price or other factors in our competitive position in foreign markets. Exports and export financing by the United States are thus not independent of each other—as they would tend to be if the facilities of the various national money markets were open to all countries without being tied to exports or otherwise restricted. A reduction in the net flow of export credit from the United States would therefore tend to mean some reduction also in United States exports. The effect may be a good deal less than one-for-one, however, since credits extended by American banks serve to finance imports not only from the United States but also from third countries, or to release other funds for this purpose, and since foreign borrowers do, in fact, have considerable and increasing access to other sources of financing, as discussed below.

The key question concerns the ability of the American monetary authorities to act so as to obtain—when needed—a net benefit to our reserve position, whether by *inducing an inflow* of funds or by *curtailing an outflow*.[15] This two-pronged statement of the question, it should be noted, contrasts with the focus of the liquidity concept on the difficulty and uncertainty of effecting a quick repatriation of American private short-term assets abroad. The chief problem may be

[15] Much the same view was expressed in the *Survey of Current Business*, December 1960, p. 10, which summed up its analysis as follows: "The recent balance of payments developments suggest, therefore, two problems: The immediate requirement of checking the outflow of short-term capital, and the longer range requirement of bringing about a further improvement in the balance on our major interchange." It may also be noted that this statement seems to make about the same distinction as that suggested in the present paper between basic transactions and items sensitive to monetary policy. The statement would seem to be still valid as a characterization of our balance-of-payments position on the basis of developments through the first nine months of 1962, marked by the renewal of large-scale outflows of liquid funds in the third quarter (as far as can be judged by the behavior of "unrecorded transactions").

simply to prevent, or reduce, the further outflow of funds into such assets, irrespective of whether, or how quickly, the assets outstanding can be enticed home again. The same contribution, in absolute amount, to the strengthening of the balance of payments is made when an outflow of, say, 1,000 is reduced to one of 500 as when an outflow of 300 is replaced by an inflow of 200. The practical significance of this point and of the distinction made with the liquidity concept stands out clearly enough in relation to the size of the recorded and unrecorded outflows in 1960 and 1961.

Even so, it should not be supposed that American private short-term assets abroad are completely illiquid. This would scarcely be true of unreported American short-term funds abroad—an element which may be overlooked in evaluations of liquidity based on what is known about the composition of reported assets. With respect to the latter, moreover, it seems reasonable to assign a fairly high degree of liquidity to claims on leading foreign financial centers, amounting to some $2 billion at the end of 1961, or about one-third of the total short-term claims on all foreign countries as reported by American banks and nonfinancial concerns. For the rest, it is doubtless true that most other countries would not be able, in the typical case, to reduce their *total* foreign short-term indebtedness very quickly, or perhaps not at all. But, as their obligations to American lenders mature, they may be induced by appropriate changes in our policies to undertake some refinancing in foreign money markets, including the active and well-supplied Euro-dollar market.[16] The significance and future potentialities of this relatively new source of financing should not be overlooked, since foreign commercial banks have large holdings of dollars and ready access to more through the Euro-dollar market and their own central banks.[17] Such credit operations in dollar funds between for-

[16] There is sometimes a tendency, it seems, to confuse (1) the liquidity, or lack of it, of *total* foreign claims on a particular country and (2) the liquidity of a *particular claim or set of claims* on that country. Even a country which is over-extended in its total external short-term indebtedness may find it advantageous, if interest differentials change, to shift, for instance, some of its acceptance financing from New York to other centers.

[17] A comprehensive description of the Euro-dollar market has been provided by Oscar L. Altman in two papers, "Foreign Markets for Dollars, Sterling and Other Currencies" *IMF Staff Papers*, December 1961, pp. 313-352, and "Recent Developments in Foreign Markets for Dollars and Other Currencies," in *Factors Affecting the United States Balance of Payments* (Joint Economic Committee), Washington, December 1962, pp. 483-523.

eigners, it must be remembered, do not add to the total amount of foreign liquid claims on the United States but rather, as previously noted, tend to make these claims less liquid than they would otherwise be. Moreover, operations in the international Euro-dollar market, though competing with the national money markets of other countries, are largely free from the restrictions applied in some of these markets.

4. *The Question of What to Include Among the Sensitive Items*

Stress is frequently placed on the practical difficulty of making a meaningful distinction between "short-term" and "long-term" capital movements—the fact that these terms do not necessarily mean what they may appear to; that statistics can only be based on the maturities of the assets acquired, those maturing in one year or less being considered, in United States practice, short-term and others long-term; that these maturities may not correspond to the intentions of the owners of the assets; and that their intentions may in any event change, so that funds placed in long maturities may be withdrawn after only a short time or, contrariwise, funds placed in short maturities may be continuously reinvested in similar or other assets, or may not be available upon maturity because of the inability of the borrower, or borrowing country, to make payment. The statistical data available may therefore match rather poorly with theoretical concepts or analytical needs.[18]

This difficulty is less serious than might at first appear when we seek to apply the sensitivity criterion. It will have become clear from the preceding discussion that, under this concept, references to the "outflow of private liquid funds" concern their liquidity and sensitivity to monetary conditions *at the time the flow takes place* and not simply their liquidity, or lack of it, *after* the flow has occurred. Under present conditions, it may be less important for the United States to be able to reverse the direction of the net movement than to influence, as may be needed, the size of the outflows. We are therefore more concerned with

[18] Discussions of these problems will be found in "Inflows and Outflows of Foreign Funds," Bank of England, *Quarterly Bulletin*, June 1962, pp. 93 ff., and "Short-term Capital Movements and the United States Balance of Payments," Federal Reserve Bank of New York, *Monthly Review*, July 1962, pp. 94 ff.

the behavioral characteristics of the outflows in this regard than with the length of life of the assets acquired.

RESPONSIVENESS OF SHORT-TERM CAPITAL TO MONETARY POLICY

The susceptibility of short-term capital flows to the influence of monetary policy should be subject to empirical test, though, in fact, the conditions necessary for such a test have existed for only a relatively short time in postwar experience. Thus the balance-of-payments article in the December 1960 issue of the *Survey of Current Business* commented as follows:

> International investments of liquid capital, particularly purchases and sales of negotiable short-term obligations such as acceptances and Treasury bills, and changes in deposits held in foreign banks are influenced by differences among countries in interest rates earned on such investments.
>
> In order to react to interest rate differentials, international capital movements must also be relatively free of exchange control or other restrictions. It was, in fact, the removal of such restrictions by most of the European countries in early 1959, and more recently by Japan, that made the balance of payments of the United States much more subject to international financial competition than it had been prior to that time.[19]

The role of interest rate differentials in determining these movements is also stressed by E. M. Bernstein, who observes that "the recorded outflow of U.S. private short-term funds in recent years has been very responsive to interest rates in the United States and abroad" and attributes to the emergence of significant differentials in these rates the "enormous outflow" of U.S. private short-term funds in 1960 and 1961.[20]

Recently, the influence of interest rate differentials on international movements of capital has been called into question on the ground that study of the quarterly data on capital movements during the last several

[19] P. 7. After examining the course of interest rates in the United States, Canada and the United Kingdom, the *Survey* (p. 10) further observed: "The apparent advantage of holding liquid funds abroad based upon interest rate differentials with or without forward cover paralleled the movement of short-term U.S. capital as shown in the available statistics, and a similar movement of other funds as is suggested by the swing from the usual net receipts to net payments on unrecorded transactions."

[20] "Interest Rates and the U.S. Balance of Payments," *Public Policy*, Cambridge, Mass., 1961, pp. 169-187. Subsequently, in a paper presented at the meeting of the American Finance Association on December 28, 1962, Bernstein qualified his position on this point, stressing the importance of other factors in addition to interest rate differentials in causing international capital flows.

years shows little or no significant relation to changes in interest rates.[21] It would, however, be most surprising if a systematic relationship between these variables were to emerge, given the numerous other factors which have influenced international capital flows.[22] But this does not mean that—in any given period and with developments as they actually were except in regard to interest rates—a narrower margin between interest rate levels in the United States and abroad would not have meant a smaller net outflow of liquid funds from this country. Nor can one overlook the possibility that large capital flows motivated by differences in interest yields may, through their effect on the reported balance-of-payments deficit and gold flows, disturb confidence and thereby spark other flows out of any relation to such changes in interest rates as may have occurred in the meantime.

Given the fact that some of the important influences affecting capital movements are not susceptible of measurement, it is not yet clear that statistical analysis can either prove or disprove the traditional view that interest rates are important in their effects on international capital flows. It would also be difficult to conclude from the available data anything as to the extent of the relative change in interest rates that might be needed to produce desired results. It could be that a

[21] See paper by Philip W. Bell, "Private Capital Movements and the U.S. Balance-of-Payments Position," in *Factors Affecting the United States Balance of Payments* (Joint Economic Committee), Washington, December 1962, pp. 395-481. Bell's treatment of this question is based on a correlation analysis covering quarterly changes in various types of capital movements since the beginning of 1957. For a defense of the view 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," see the statement by Fred H. Klopstock, Manager, Research Department, Federal Reserve Bank of New York, before the subcommittee on International Exchange and Payments of the Joint Economic Committee on December 13, 1962. A qualitative evaluation of the responsiveness of different types of capital flows to relative degrees of credit availability among countries and relative levels of market interest rates will be found in Stephen H. Axilrod and Ralph A. Young, "Interest Rates and Monetary Policy," *Federal Reserve Bulletin*, September 1962, pp. 1110-1137.

[22] These include, starting with 1957, the balance-of-payments difficulties of the United Kingdom in that year and of several other countries in 1958, the steps toward convertibility of leading foreign currencies at the beginning of 1959, strong speculative pressures on the dollar and on the price of gold in the second half of 1960, the appreciation of the German mark and the Dutch guilder in March 1961, the ensuing speculative movements of the next several months directed largely against the pound, changes in the Canadian tax law at the end of 1960 providing inducements to U.S. companies with Canadian subsidiaries to shift liquid funds to Canada, and the depreciation and stabilization of the Canadian dollar in early 1962.

relatively small change for the United States would be as effective as a much greater change in the case of, say, the United Kingdom.

The role of interest rate differentials in determining the movement of short-term funds may therefore be obscured at times by other influences. In its *Annual Report* for 1961, however, the Board of Governors of the Federal Reserve System makes clear enough its view that a change in short-term interest rates on the downside, with a widening of the differential between domestic and foreign money markets, "could have led to greater outflows of short-term capital and so worsened the balance of payments."[23] The report is less explicit as to whether a change on the upside would have appreciably reduced the very large outflows which did occur or would have been outweighed by other factors. One may detect a certain difference in emphasis between the effects of a reduction and the effects of an increase in interest rates, possibly reflecting the Board's concern that "To reduce these outflows significantly would have required greater restraint on the availability of bank credit and expansion of liquidity than was appropriate for the domestic economy in 1961."[24] This is, no doubt, the more difficult part of the problem—that is, whether and to what degree credit conditions can be tightened, if needed to curtail the outflow of capital, without running counter to domestic objectives and political forces. The new constraints to which the monetary authorities are subject in this regard and some of the implications for broadening the instruments of economic policy are discussed in Chapter IV of this paper.

Responsiveness of Other Capital to Monetary Policy

In considering the sensitivity of long-term capital movements to monetary policy, we need not, for reasons already noted, be concerned by the fact that these categories do not necessarily mean what they appear to: the essential question is whether the items, regardless of what they are called, are amenable to the tools of monetary policy. Walter Gardner[25] has, in fact, made a proposal, advocated also by Robert Triffin[26] with some amendments, for bringing together in one

[23] Board of Governors of the Federal Reserve System, *Annual Report*, 1961, p. 6.

[24] *Ibid.*, p. 32.

[25] *IMF Staff Papers*, May 1961, pp. 195-211.

[26] "The Presentation of U.S. Balance of Payments Statistics, General Comments," in American Statistical Association, *1961 Proceedings of the Business and Economics Statistics Section*, Washington, 1962, pp. 51-57.

TABLE A-2

U.S. BALANCE OF PAYMENTS—GARDNER PRESENTATION
(in billions of U.S. dollars)

	1957	1958	1959	1960[a]	1960 First Half	1960 Second Half[a]
A. Market Goods and Services						
1. Exports	19.4	16.3	16.2	19.4	9.6	9.8
2. Imports	—13.3	—13.0	—15.3	—14.7	—7.7	—7.0
3. Trade Surplus	6.1	3.3	0.9	4.7	1.9	2.8
4. Net Services (excl. item C)	2.5	1.9	1.6	1.7	0.8	0.9
Total item A	8.6	5.2	2.5	6.4	2.7	3.7
B. Direct Investment	— 2.1	— 1.1	— 1.3	— 1.6	—0.6	—1.0
C. Noncommercial Transaction (excl. item G)						
1. Military expenditures	— 3.2	— 3.4	— 3.0	— 3.0	—1.5	—1.5
2. Government aid abroad	— 2.2[b]	— 2.6	— 2.4	— 2.8	—1.4	—1.4
3. Government interest receipts, etc.	0.3[b]	0.3	0.2	0.3	0.1	0.2
4. Private transfers	— 0.5	— 0.5	— 0.6	— 0.6	—0.3	—0.3
Total item C	— 5.6	— 6.2	— 5.8	— 6.1	—3.1	—3.0
D. Basic Balance (A through C)	0.9	— 2.1	— 4.6	— 1.3	—1.0	—0.3
E. Open-Market Capital (excl. item G)						
1. Portfolio securities, etc.	— 0.5	— 1.4	— 0.4	— 0.4	—0.1	—0.3
2. Short-term						
(a) Assets	— 0.3	— 0.3	— 0.1	— 1.2	—0.2	—1.0
(b) Liabilities to						
(i) Commercial banks	0.1	c	1.4	0.1	0.8	—0.7
(ii) Other	0.6	0.4	0.2	c	—0.1	0.1
3. Net errors	0.8	0.4	0.8	— 0.9	—0.2	—0.7
Total item E	0.7	— 0.9	1.9	— 2.4	0.2	—2.6
F. Exchange-Market Balance (D + E)	1.6	— 3.0	— 2.7	— 3.7	—0.8	—2.9
G. Compensatory Financing						
1. U.S. loans	— 0.4[b]	0	0.4	0	0	0
2. IMF dollar assets	— 0.4	c	0.3	0.7	0.2	0.5
3. Other official dollar assets	c	0.7	0.9	1.8	0.5	0.8
4. Gold	— 0.8	2.3	1.1	1.7	0.1	1.6
Total item G	— 1.6	3.0	2.7	3.7	0.8	2.9
For comparison with Item G above						
Department of Commerce balancing item	— 0.5	3.5	3.8	3.8	1.4	2.4

NOTE: Reproduced from Walter R. Gardner, "An Exchange-Market Analysis of the U.S. Balance of Payments," *IMF Staff Papers,* May 1961, Table 2, p. 206.

[a] Preliminary figures.

[b] Under the Anglo-American Financial Agreement as amended, the United Kingdom borrowed $122 million in 1957 (item G1), paid $73 million of interest (item C3), and repaid $49 million of principal (item C2). These amounts are not entered in the U.S. balance of payments statistics.

[c] Less than $50 million.

TABLE A-3

U.S. BALANCE OF PAYMENTS—TRIFFIN PRESENTATION
(years or yearly rates, in billions of dollars)

Line		1950-57	1958	1959	1960
1.	I. *Gross Current Account Surplus*	6.8	7.2	4.5	7.9
2.	A. Conventional current account	2.2	1.6	—0.6	3.1
3.	B. Military exports under grants	2.2	3.4	3.1	3.0
4.	C. *Plus* military expenditures	2.4	2.3	2.0	1.8
5.	II. *U.S. Military Programs and Basic Capital Exports*	8.2	9.4	8.4	9.2
6.	A. U.S. Government	7.2	8.3	7.1	7.6
7.	1. Military programs	4.7	5.7	5.1	4.8
8.	a. Export financing	2.2	3.4	3.1	1.8
9.	b. Dollar settlements	2.4	2.3	2.0	3.0
10.	2. Economic programs:	2.5	2.6	2.0	2.8
11.	a. Export financing				2.2
12.	b. Dollar settlements				0.6
13.	B. Direct investment (net)	1.0	1.1	1.3	1.7
14.	1. U.S. capital	1.0	1.1	1.4	1.7
15.	2. Foreign capital (—)	[a]	[a]	—0.1	—
16.	III. *Basic Balance*: I-II	—1.4	—2.1	—3.9	—1.3
17.	IV. *Open Market Capital*	—0.4	1.2	—1.5	2.7
18.	A. U.S. capital	0.6	1.8	1.0	2.2
19.	B. Foreign capital	—0.6	—0.2	—1.9	—0.2
20.	1. Dollar holdings	—0.4	—0.2	—1.5	—
21.	2. Other	—0.2	—	—0.4	—0.2
22.	C. Errors and omissions	—0.4	—0.4	—0.5	0.6
23.	V. *Official Settlements*: III-IV	—0.9	—3.3	—2.4	—4.0
24.	A. U.S. gold and convertible currency holdings	—0.2	—2.3	—1.1	—1.7
25.	B. International institutions:	—	—0.3	—0.4	—1.0
26.	1. IMF capital subscription	—	—	1.4	—
27.	2. Dollar holdings (—)	—	—0.3	—1.8	—1.0
28.	C. Foreign monetary authorities' dollar holdings (—)	—0.7	—0.7	—0.9	—1.2

NOTE: Reproduced from Robert Triffin, "The Presentation of U.S. Balance of Payments Statistics, General Comments," in American Statistical Association, *1961 Proceedings of the Business and Economic Statistics Section*, Washington, 1962, Table I, p. 56.

[a] Unavailable separately, and included with long-term foreign capital (line 21).

SOURCE: *Survey of Current Business.*

group all private capital transactions, both short-term and long-term, excluding only direct investment. This group, designated "open market capital," would be intermediate between transactions comprising a "basic balance" (differing from those here called "basic transactions" by the exclusion of the long-term capital items listed in the intermediate group) and a set of balancing items termed "compensatory financing" by Gardner and "official settlements" by Triffin. Their groups differ from each other, however, not only in terminology and type of detail but also in content because of Gardner's aim to identify and include in his final category certain loans and repayments as "compensatory" when made for balance-of-payments purposes. The presentations developed by Gardner and Triffin to illustrate their proposals are reproduced here as Tables A-2 and A-3, but their original articles and explanatory notes should be consulted for a fuller statement of their views.

Gardner and Triffin seem to place special emphasis on the "volatility"[27] of the items grouped under "open market capital"—a much looser organizing concept, it would appear, than that of sensitivity to monetary policy, and one of less operational significance. Such a broader grouping may nevertheless be consistent with the sensitivity criterion, if further study and experience show that the long-term capital items involved are relatively responsive to monetary conditions and policies. One may doubt that the relation is very strong in the case of transactions in equities, which bulk large in the category of "long-term" capital flows, but it may hold with respect to new bond flotations and other transactions in fixed-interest securities as well as long-term bank credits. If so, there could be considerable merit in a proposal like Gardner's and Triffin's for grouping the latter types of transactions, along with private short-term capital movements, in a category intermediate between "basic transactions" and "official settlements."

"Compensatory Financing" and "Major Special Transactions"

Gardner's endeavor to mold the balancing items ("below the line") according to the concept of compensatory financing merits further comment because of the special interest it offers as an extension of earlier experimental work along this line by the International Monetary

[27] Gardner refers to the items included in this group as "all those forms of capital movement that can easily shift from market to market—a sort of footloose capital."

Fund[28] and as an application of the distinction which has figured prominently in theoretical discussions between "autonomous" or "spontaneous" capital movements, on the one hand, and "accommodating" or "induced" finance, on the other.[29] Referring first to his twofold grouping above the line ("basic balance" and "open-market capital"), Gardner explains his objectives as follows:

> ". . . . If this great aggregate of what might be termed autonomous transactions does not balance out, the exchange rate of the country will be pushed up or down, and the authorities must supply whatever compensatory financing is required to keep the rate from moving outside the support points. Thus we have autonomous transactions above the line matched by compensatory financing below the line. The compensatory financing may take the form of a movement of reserves, or a drawing on the International Monetary Fund, or the use of ad hoc loans or other financing for the purpose. It is only as we draw a line of this sort and group above it the autonomous transactions, and group below it the compensatory financing that comes into play only because the autonomous transactions fail to balance, that we see what it is that is pushing the country's international exchange rate up or down and creating an exchange-market problem.[30]

The application of these principles may involve a considerable element of subjective judgment, since the identification of special compensatory financing implies an opinion about the underlying causes and motivations of particular operations. If, for instance, the International Monetary Fund, the International Bank, and various national credit agencies and commercial banks join together in the extension of credits and loans to a particular underdeveloped country, how much of the total amount provided is to be regarded as "compensatory" and how much as "developmental" financing?

Such problems are thoroughly familiar to the proponents of the concept of compensatory financing and do not necessarily invalidate its use as an analytical device.[31] One may wonder, however, if the objectives which it is intended to serve may not be met equally well by the Commerce Department's practice of showing in its summary

[28] This approach was discussed in considerable detail in a section on "The Concept of Compensatory Official Financing" in International Monetary Fund, *Balance of Payments Yearbook, 1938, 1946, 1947*, Washington, 1949, pp. 4-24.

[29] Cf. J. E. Meade, *The Balance of Payments*, Oxford University Press, 1952, p. 11.

[30] *IMF Staff Papers*, May 1961, p. 196.

[31] See, for example, the discussion of "extraordinary financing" in Poul Høst-Madsen, "Measurements of Imbalance in World Payments 1947-58," *IMF Staff Papers*, November 1962, pp. 343-368.

balance-of-payments table a final balance adjusted for "major special transactions" (Table A-4). The emphasis in this case is on the "nonrepetitive" nature of transactions having "a major effect on quarterly changes in net payments or receipts, such as subscriptions to international institutions, advance debt repayments or major private transactions." The notion of "major special transactions" is much broader and perhaps more arbitrary in application than that of compensatory financing, but these limitations are made clear in the way in which the data are presented and discussed.

One problem concerning the Commerce Department's practice in this regard is that what is "major" and "special" in the *quarterly* figures may be much less so in the annual data. Thus, one may wish to show a balance for the fourth quarter of 1960 adjusted to exclude such large lumps as the $370 million Ford transaction in the United Kingdom and the $74 million subscription to the International Development Association, but it is much more doubtful that the balance for the whole of the year should be so adjusted.[32]

[32] The special adjustments employed in some of the tables and charts in the present paper (noted in each instance) are limited to the exclusion of extraordinary receipts in the form of unscheduled debt payments to the U.S. Government. In addition all tables and charts exclude the payments of U.S. subscriptions to the International Monetary Fund in 1947 and 1959 (see Table B-1, note a), but these transactions are already omitted from the Commerce Department's summary presentations of the balance of payments (i.e., Table 1 in the regular quarterly balance-of-payments article in the *Survey of Current Business*).

TABLE A-4

PAYMENTS (—) AND RECEIPTS TREATED AS "SPECIAL TRANSACTIONS" IN THE U.S. BALANCE OF PAYMENTS, 1959-1962

(millions of dollars)

Year and Quarter		Quarterly or Annual Total (millions of dollars)	Detail (millions of dollars)	Remarks[a]
1959	I	150		Prepayment by Germany of amortization scheduled for 1961-1965 on settlement (original amount $1 billion) which Germany agreed to pay for postwar economic assistance.
	II	—100		Special relatively large direct investment transaction in Canada.
	IV	285		Prepayment of debt by foreign governments.
1959	Total	335		
1960	II	— 80		Capital contribution by the U.S. to the Inter-American Development Bank.
	IV	—444	—370	Payment by a U.S. corporation to purchase minority interests in one of its European subsidiaries.
			— 74	Capital subscription to the International Development Association.
1960	Total	—524		
1961	II	724	649	Extraordinary debt repayments by foreign governments ($587 million by Germany, $40 million by the Netherlands, and $20 millions by the Philippines).
			75	Receipt of principal and interest advanced from third to second quarter.
	III	— 75		
	IV	—520	40	Prepayment of debt by Italy.
			—150	Private bank loans to Japan, guaranteed in part by U.S. Government.
			—100	Loan to the Philippines subsequent to revaluation of the Philippine currency and reduction in foreign exchange restrictions.
			— 38[b]	Relatively large sales of stock by a foreign company newly registered on a U.S. stock exchange.
			— 62	Capital subscription to the International Development Association.
			—110	Capital subscription to the Inter-American Development Association.
			—100	Very short-term (year-end) deposits with European banks.
1961	Total	129		

(continued)

TABLE A-4 (concluded)

Year and Quarter		Quarterly or Annual Total (millions of dollars)	Detail (millions of dollars)	Remarks[a]
1962	I	100		Reversal of operation noted in last item listed above (1961 IV).
	II	76	60	Payment by France deferred from 1957.
			16	Prepayment of debt by Sweden.
	III	471	293	Prepayment of debt by France.
			178	Prepayment of debt by Italy.

[a] The explanations given are derived from the text and tables of the quarterly balance-of-payments articles in the *Survey of Current Business.*

[b] Amount (not specified in source) obtained by difference between detail specified for other items and the total given for the quarter.

SOURCE: U.S. Department of Commerce, *Survey of Current Business,* various issues, 1959-1962.

(Annex B to prepared statement of Hal B. Lary)

THE STATE OF THE BALANCE OF PAYMENTS

(By Hal B. Lary, Associate Director of Research of the National Bureau of Economic Research) [1]

I

The results for the first quarter of 1965 announced a few days ago tell us remarkably little about the current state of the balance of payments. The long dock strike in January and February was alone enough to deprive the figures of any clear significance. Even more important, the new balance of payments measures announced by the President on February 10 established a watershed between the first half and the second half of the quarter. We know that the rainfall was heavy on the other side of the divide, but we are still learning about the climate on this side.

To go back a bit, as recently as last autumn we seemed at last to be making good progress on the balance of payments problem. The latest data then available showed that during the 12 months ended June 30 the deficit had been only $1¾ billion—still large but a marked improvement over earlier periods. Gold losses had been only some $200 million during that period, and we had recently been able to make some small gold purchases. There was a congratulatory mood in Washington. The newly enacted interest equalization tax, along with various measures taken earlier, was given a large share of the credit for these encouraging results.

Then, as winter came on, things began to fall apart. The deficit in the fourth quarter was the highest ever and brought the deficit for the calendar year 1964 to $3 billion, much worse than had been hoped for only a short time before. The big change was in the outflow of U.S. private capital, which rose to a record total of $6.4 billion, not counting reinvested earnings of U.S. foreign subsidiaries. This was 50 percent more than in 1963 and 75 percent more than the 1959–63 average.

Several reasons may be invoked for this abrupt change of fortune. For one thing, interest rates rose and credit became tighter in major foreign financial centers. Second, the volume of new Canadian security issues was unusually large in the fourth quarter, some of these issues having been postponed pending enactment of the interest equalization tax. Third, worry that this tax, under the Gore amendment, might be applied to bank loans of 1 year and over may have provoked an increase in these loans as well as still larger commitments for future loans. Finally, we began to feel the disturbing effects of the British sterling crisis in November and of the more aggressive French gold-buying policy announced in January.

The cumulative effect of these developments was to generate further large outflows of U.S. private capital in the early weeks of 1965. Bank lending proceeded apace, and many business firms are thought to have transferred funds abroad that they would actually need only later on. The size and self-aggravating nature of these flows meant that action to defend the dollar had to be concentrated in this area, and quickly.

II

My impression is that the measures taken pursuant to the President's message of February 10 will be effective, at least for the next year or so, in holding the outflow of capital well below the 1964 level. One reason for thinking so lies in the circumstances which I have just recited. Something like a flight of capital had got underway by the time the President acted. But it was not, I think, a flight from the dollar. One indication is that very little of the bank lending or deposit of corporate liquid funds abroad was denominated in foreign currencies.

[1] This paper, given on May 21, 1965, at the annual meeting of the National Industrial Conference Board, presents the views of the author and does not engage the responsibility of the National Bureau of Economic Research.

Another is that all through this period foreign commercial banks and other private foreign holders added heavily—and presumably of their own free choice—to their dollar balances here. The flight of U.S. capital was stimulated rather by the growing belief that restraints of some sort were about to be imposed on further outflows. Needless to say, once such a belief gains hold, it tends to become self-fulfilling. But this also means that, when restraints are in fact imposed, they are likely to be more easily enforced than if the capital flows had been inspired by doubts about the currency.

The new restraints are particularly likely to be effective, I believe, as far as bank lending is concerned. This is a big part of the whole question, since the net increase in foreign loans and credits by U.S. banks came to $2½ billion last year, and the guidelines aim at holding the further increase to not more than $600 million for the whole of this year. The chances of reaching this target are enhanced by several factors. The banks that really count in foreign lending are few in number; their guidelines are relatively simple and rigorous; they are likely to feel, as part of the Nation's monetary system, a responsibility to help support the dollar; and they may also feel exposed to the risk of adverse reactions in Congress in case of failure.

Much the same sort of reasoning applies to that part of the operations of American companies which consists of the placement of liquid funds in Canada and other foreign money markets, usually in the form of U.S. dollar deposits. These operations accounted for a net outflow of close to $600 million last year. Merely to refrain from any further increase would improve the balance of payments by that amount in comparison with 1964—a simple point sometimes overlooked. A further contribution would be made to the extent that some of these funds are repatriated.

The situation as regards the foreign direct investments of U.S. companies is more complex. The number of firms involved is far greater; the guidelines are less clear cut and emphatic; and the penalties of noncooperation may be more remote. Moreover, the various effects of direct investments on the balance of payments, and particularly the timing of these effects, are difficult to sort out. There is sometimes a tendency to take credit now for earnings that will be received only after some years—a consideration more relevant to the longrun outlook than to the immediate problem. For these reasons I would doubt the effectiveness of voluntary, or compulsory, restraints on direct investment, if long continued. But at least for the next year or so, some reduction from the outflow of $2.3 billion in this form last year would seem likely.

Some of the reductions which I have suggested may be canceled by increased capital outflows in other and perhaps less detectable ways. Nevertheless, on all counts combined, it seems to me reasonable to expect that the new restraints will bring the total outflow of U.S. private capital down sharply from the 1964 level of $6.4 billion—perhaps to somewhere in the range of $3 to $4 billion typical of most other recent years.

It does not follow that the balance of payments will improve to the same extent. One reason is that part of the effect will be to reduce earnings from exports rather than the deficit, since some of our exports depend directly or indirectly on the flow of capital. Independently of this connection, the market for our exports in some countries looks less buoyant now than last year. This is also suggested by the fact that export orders for durable goods, as reported by the Bureau of the Census, were no higher in the first quarter of this year than a year earlier. Our imports, on the other hand, should show a good increase in keeping with the rise in U.S. economic activity. One must also suppose that our military expenditures abroad have recently been increasing without their effects on the balance of payments being fully neutralized. In other words, it is no doubt still true that part of each dollar spent in Vietnam turns up in Paris. And American tourists are not great patriots—at least not until they get abroad—and may not be deterred by exhortation. The role of their expenditures may, however, be exaggerated: the net debit on travel account rises by only some $50 million a year.

We can also note other more favorable and perhaps more enduring tendencies. Our competitive position in world trade looks a good deal stronger, in terms of relative prices, than it was a few years ago. American companies with foreign subsidiaries seem to be making an extra effort to push exports as a preferred way of meeting the balance-of-payments targets assigned to them. And earnings remitted from our foreign investments have been rising by some $400 million a year, net of foreign earnings here, and are likely to continue to rise rapidly even if new American investment abroad proceeds only at the pre-1964 rate.

All things considered, I would expect the balance of payments to show a significant improvement over last year, even if a good deal less than the reduction in capital outflow. The improvement from March on could be striking precisely because the capital outflow was so great in January and February.

This raises the question of how much improvement is actually needed in the balance of payments. I mentioned earlier, as a token of confidence in the dollar, that foreign commercial banks and other private holders had continued to add to their dollar balances here. The increase in foreign-held balances, excluding those belonging to central banks and treasuries, was $1.5 billion last year and more than $550 million in the first 2 months of this year. These large inflows of foreign funds (in addition to other types of foreign investment here) served as a partial offset to our own outflows of U.S. private capital. They do not appear so, however, under the balance of payments accounting methods employed by the Commerce Department. On this basis, the outflow of U.S. private capital, including short term, is placed "above the line" before drawing the balance and hence is treated as contributing to the deficit. But the increase in foreign private liquid claims on us is entered "below the line," along with the increase in foreign official balances and our gold losses, as a means of financing the deficit and hence as a measure of the deficit. The Bernstein Committee in its report just submitted to the Bureau of the Budget recommends that the items entered below the line should be limited to official balances and gold; that is, "official settlements." On this basis the balance of payments deficit last year would be $1.5 billion—only half as much as given by the Commerce Department's arrangement of the figures.

The practical point at issue is that, if we were to set our sights unwaveringly by the Commerce Department's calculation of the deficit, we might find that we were curtailing the outflow of U.S. capital too much and putting pressure on other currencies. This would not be objectionable if we could draw reserves from, say, France and Germany. But the risk is that the pressure will first fall on countries less able to bear it, causing them to take restrictive action on their side and adding to the less favorable tendencies in world trade and production which I have mentioned.

In brief, we may soon face an awkward choice between doing too much or too little in our efforts to strengthen the balance of payments. We may do too much to the disadvantage of some of the weaker countries in world trade and payments. And we may do too little to satisfy our critics—and, more to the point, our creditors—in European central banks and finance ministries. Neither horn of this dilemma is very inviting. It would ill serve our interests to add to recessionary forces abroad. But we have also seen that the French in particular are not loath to threaten the present dollar exchange standard before there is anything satisfactory to put in its place. In this situation, I can only suggest that every dollar withheld from investment or expenditure in continental Western Europe is worth several times as much to the U.S. balance of payments at this crucial juncture as a dollar saved anywhere else in the world.

III

Rather than speculate further about the near-term prospects, I should like to consider briefly the implications of our experience in recent years for the longer run. What does this experience mean for the way we address ourselves to future balance-of-payments problems and, more broadly, for the organization and operation of the international monetary system?

A great deal of attention is being devoted to reform of the international monetary system in the hope of avoiding strains and uncertainties such as we have been experiencing. Too much of this attention is focused, I think, on the mechanics of the system and not enough on the economics. That is to say, there is an undue fascination with institutional devices governing the amount and availability of international liquidity, while too little study is given to problems of keeping within whatever limits prevail.

Even if, as I hope, international monetary reform is far more liberal than seems likely in the present state of thinking in continental Europe, the United States will almost certainly face much narrower limits for financing balance-of-payments deficits than it has known in the past 15 years. Our scope for doing so has been unique because of the size of the gold stocks which we had amassed by the end of the Second World War and because of the desire of other countries to restore and build up reserves and working balances of dollars. Both sources of financing are now greatly depleted. Reform of the international monetary system may make

our position easier in the future than it would otherwise be—but nothing like as easy as it has been. The point deserves to be stressed because there seems to be a good deal of confusion on this score—some of it attributable, I think, to the zeal with which proponents of reform argue their cause.

A reasonable expectation would therefore be that—with or without reform of the international monetary system—the United States will be much more subject than heretofore to the constraints imposed by the balance of payments under stable exchange rates. Whether these contraints are borne easily or become intolerable is likely to depend upon how successful we are in keeping our external accounts reasonably in balance without sacrificing other important objectives and principles. And success in this regard is likely to depend, in turn, upon our ability to develop better instruments of policy and greater skill in their use.

Looked at in this perspective, our experience of the last several years is not very encouraging. We have seen some brilliant tactical innovations to finance the deficit and to soften its impact on our gold stock. And we have seen also a number of specific measures to reduce the deficit, some in ways which everyone might applaud and others of a more controversial nature.

But these have been, in the main, ad hoc expedients. Little progress has been made in modeling and adapting the broad instruments of economic and monetary policy to serve both our domestic and our external objectives. Under the old 19th-century gold standard, I may remind you, a balance-of-payments deficit was expected to cause a loss of gold, a contraction of the money supply, a tightening of credit, and a fall in incomes and prices. These changes were expected in turn to attract capital, encourage exports, and reduce imports, thus serving to correct the balance-of-payments deficit. The opposite set of events was expected in countries with balance-of-payments surpluses—that is, an expansion of the money supply, an easing of credit, and shifts in trade and in capital flows such as to eliminate the surplus.

Understandably, few countries today would be willing to go very far in applying the old orthodoxy at the expense of significant fluctuations in employment, production, and prices. It would seem that little remains of the classical adjustment mechanism. A partial but perhaps important exception in our own case is our success in maintaining, for several years, greater price stability than most of our competitors, and this doubtless owes something to the persistence of unemployment here and overfull employment in some other countries. It may be that such a differential trend in prices is, as the Netherlands Bank suggested several years ago, "the only policy which remains available as a means of restoring equilibrium." Perhaps this way of adjustment is not so negligible after all, if one may judge by the pronounced strengthening of our trade balance over the last several years. But the experience also suggests that time—and therefore financing—are needed for these effects to work themselves out.

A fair conclusion up to this point would be that we can scarcely hope to be very deft and quick in adjusting the trade balance one way or the other as may be needed. It then becomes all the more essential to be able to deploy policy, particularly monetary policy, so as to keep capital movements from imposing heavy and protracted strains on the balance of payments. This certainly does not mean that interest rates here must equal the highest rates abroad. But it does mean, I think, that we cannot expect to maintain over long periods credit conditions and interest rates widely different from those prevailing in other leading centers.

It is here that the clash of opinions in this country is especially sharp—that is, over the question of using monetary policy to keep the outflow of private capital within limits consistent with our overall balance of payments position. And it is here that the failure to find solutions is most manifest. The monetary authorities have kept a troubled eye on this problem, and have had some success in nudging up short-term rates without raising long-term rates. It seems clear, however, that their policies have been mainly determined by domestic economic considerations, and that they have felt severely limited in shaping policy to meet our external problems. Many critics would have liked to see an even more unqualified priority for domestic objectives and a still firmer commitment to monetary ease and low interest rates. The familiar argument is that, especially in the United States where the foreign sector is so small a part of the whole economy, the balance of payments tail must not be allowed to wag the dog.

If this view correctly expresses the alternatives before us, then we are indeed poor in the range of policy measures that can be applied to the capital component of the balance of payments. With little room to employ monetary policy for this purpose, we can only hope for the best and, in extremis, invoke emergency meas-

ures such as those now being used. By the test of our actions, so far, our policies for influencing international capital movements seem to have been reduced, in the main, to direct intervention aimed at forcibly adapting the flow of private foreign investment to whatever level is permitted by the rest of the balance of payments.

This may not be the worst of all possible worlds, but it fits ill with our longstanding preference for broad economic policies operating impersonally through the market system. One must be concerned about the efficiency, equity, and viability of a policy which tends to favor old, well-established operators against newcomers and which puts the main burden on those most willing to comply and rewards the least cooperative. The possibility of going all the way to direct controls, involving approval or disapproval of individual foreign investment transactions, opens up still more disturbing questions of feasibility, justice, and honesty in administration.

It is therefore a good time to ask whether measures of this kind are really the best we can devise in developing policy and strategy for keeping the external accounts in balance. Is it true that the achievement of our employment and growth objectives must preclude the use of the broad and impersonal instruments of monetary policy for balance of payments ends?

This question needs to be looked at in relation to fiscal policy. In the last few years the idea of "fiscal drag" has gained wide acceptance and, indeed, considerable popularity, since it has been instrumental in the tax reductions which we have had and those in prospect. This is the view that our tax rates since the war have been so high as to constitute a barrier to economic expansion and full employment, and that, as the economy grows and generates additional tax revenues, tax esmust be cut or expenditures increased if recurrent fiscal drag is to be avoided.

From this view it would logically follow that rapid monetary expansion and low interest rates are not an indispensable feature of the American scene but have hitherto been required to compensate for the unnecessarily restrictive effects of fiscal policy. With a fresh approach and emphasis to fiscal policy, perhaps we will now be able also to reassess the role of monetary policy and to develop a better reconciliation between our domestic and our international objectives.

Our international difficulties have been aggravated because the Common Market countries have manifested, on their side, the same sort of perverse policy emphasis under the opposite set of internal and external circumstances. They have tended to rely on tight money rather than tight fiscal policies to combat overheating and inflation. In doing so, they have helped to attract the capital inflow and to create the balance of payments surpluses of which they complain. Here also the interests of the world economy would be served if these countries would rely more on tax and budget policies for stabilizing their own economies and adapt their monetary policies more closely to international needs.

(Annex C to statement by Hal B. Lary)

Hypothetical Illustration on the Balance of Payments Deficit on Three Concepts

The differences in the three concepts of the deficit are illustrated in a highly simplified form in the accompanying table showing various hypothetical situations. In situation A we see a surplus on goods and services offset by Government economic aid and by a net outflow of U.S. and foreign private long-term capital, giving an even balance on "basic transactions." If, in accordance with the "liquidity" concept, we also enter the outflow of U.S. private short-term capital above the line, we have a deficit of 100. This we assume to be offset by an inflow of foreign private short-term capital. If this inflow, too, is entered above the line, as would be done on the "official settlements" basis, the accounts again appear to be in balance.

In situation B a gap emerges in "basic transactions" because of a decline in exports and a rise in imports, giving a deficit of 100. With U.S. private short-term capital flowing out as before, there is a still larger deficit of 200 on the "liquidity" concept. This is, however, partly offset by the continued inflow of foreign private short-term capital, leaving a deficit of 100 on "official settlements" covered by gold sales and an increase in foreign official claims on the United States.

In situation C the deficit on "basic transactions" and that on the "liquidity" basis are the same as in B, but the flow of foreign private short-term capital turns outward rather than inward, greatly increasing the deficit on "official settlements."

Situation D shows a contrary development: The outflow of U.S. private short-term capital is reduced and there is a large inflow of foreign private short-term capital. These changes reduce the deficit on the "liquidity" basis compared with situations B and C and eliminate the deficit on the "official settlements" basis.

Finally, in situation F balance is assumed to be restored in "basic transactions," and the movements of U.S. and foreign private short-term capital are the same as in situation A, yielding again a deficit according to the "liquidity" concept and an even balance on "official settlements."

This sketch of hypothetical situations serves only to show how the several measures of the deficit change in relation to each other with variations in the component items. It may also be noted that, in the examples given in the table, the deficit is always smaller on the "basic transactions" concept than on the "liquidity" concept, and so it will always be except when there is a net withdrawal of U.S. capital from abroad. And the deficit is smaller on the "official settlements" basis than on the "liquidity" basis except when there is a net withdrawal of foreign private short-term capital from the United States, as in situation C.

The deficit according to 3 concepts under various hypothetical conditions

Line	Item	A	B	C	D	E
1	Goods and services transactions, receipts	1,000	950	950	950	1,050
2	Goods and services transactions, payments	700	750	750	750	750
3	Goods and services transactions, balance	300	200	200	200	300
4	Government grants and credits	−100	−100	−100	−100	−100
5	Private long-term capital United States and foreign	−200	−200	−200	−200	−200
6	Balance on "basic transactions" concept	-------	−100	−100	−100	-------
7	U.S. private short-term capital	−100	−100	−100	−50	−100
8	Balance on "liquidity" concept	−100	−200	−200	−150	−100
9	Foreign private short-term capital	100	100	−100	150	100
10	Balance on "official settlements" concept	-------	−100	−300	-------	-------
11	U.S. gold and other reserves	-------	50	100	-------	-------
12	U.S. liabilities to foreign monetary authorities	-------	50	200	-------	-------

Note.—In this simplified presentation it is assumed that there are no errors and omissions and no "special" Government transactions.

Senator PROXMIRE. Our next witness is Mr. Walther Lederer, Chief, Balance of Payments Division, Office of Business Economics, U.S. Department of Commerce.

We are very happy to have you, Mr. Lederer.

Mr. LEDERER. Before I start my remarks, I would like to state that I am speaking here entirely for myself, as an economist who has had a reasonable experience in balance of payments analysis. But whatever I will say here in no way reflects the position of the Department of Commerce.

Mr. ELLSWORTH. Mr. Chairman, at that point, with the witness' permission——

Senator PROXMIRE. Yes, Mr. Ellsworth.

Mr. ELLSWORTH. You are appearing here as the Chief of the Balance of Payments Division in the U.S. Department of Commerce, and yet you say whatever you say in no way reflects the position of the Department or any other part of the Government.

I wish you could explan that a little bit.

Mr. LEDERER. I am appearing here as an economist. I am not appearing here as Chief of the Balance of Payments Division. I happen to be that at the moment, but what I am going to say is my own personal opinion. It is not the opinion of the Department or people in the Budget Bureau or any other part of the Government.

Mr. ELLSWORTH. In other words, what you are saying is that the Budget Bureau has not seen this statement you are about to make nor approved it and neither has the Secretary of the Department. Is that what you are saying?

Senator PROXMIRE. In all fairness, I think it should be said Mr. Lederer was invited to testify as an individual, as a competent economics expert in the field, and not invited as a spokesman for the Department of Commerce or the administration. Is that correct?

Mr. LEDERER. That is correct.

Senator PROXMIRE. So that the burden is on the committee rather than on Mr. Lederer if he speaks as an economist. We have asked him to do that, feeling he will have much greater freedom.

Mr. ELLSWORTH. I am delighted to have Mr. Lederer as a witness, but I wanted to clarify what his position was. I appreciate the chairman's clarification as well as Mr. Lederer's.

Senator MILLER. Can I—would the chairman yield?

Senator PROXMIRE. Yes, certainly.

Senator MILLER. I can appreciate that we don't want to add to Mr. Lederer's problems and have him appear as anything but as an individual and a very appreciated economist. But I was wondering if there is any official position by the Department of Commerce or if it would be feasible for the committee to obtain an official position from the Department of Commerce.

Mr. LEDERER. I think the committee should have to address itself to the Secretary of Commerce for that purpose.

Senator PROXMIRE. I might say, it is my understanding from Mr. Knowles, our staff director, that no position has been taken by the Department of Commerce, which I would suggest is a desirable situation indicating they are open minded.

They are waiting until all the testimony is in, not only the Bernstein testimony, but the testimony of Mr. Chittenden, Mr. Lary, Mr. Lederer, and other experts, and then they will make up their minds.

Certainly, I think the minds of all members of this committee are open, those who are here this morning. We are anxious to hear the competent witnesses before we decide. I think it is helpful that the Department of Commerce has taken the same position.

Mr. ELLSWORTH. Mr. Chairman, in that connection——

Senator PROXMIRE. This is the only way Mr. Lederer can be an advocate. He is a very able advocate, and it is so good to have these contrary viewpoints.

Mr. ELLSWORTH. I appreciate that and in connection with making a full record and making a full foundation of the position of the Government, or lack of position of the Government, I wonder if the staff has been able to get what I requested at our last hearings. That is the letter of authorization of the Bernstein Committee.

I haven't seen it yet.

Senator PROXMIRE. It is my understanding it will be published.

(Documents originally requested by Representative Ellsworth for inclusion in the record appear on pp. 31–36 in pt. 1 of these hearings.)

Mr. ELLSWORTH. Thank you very much.

Senator MILLER. Might I ask, just for a little clarification, is it the chairman's understanding that the Department is going to come up with a firm position on this problem in the near future?

Senator PROXMIRE. Well, we have no notion as to timing. I presume that they will have to make a decision one way or the other when these balance of payments positions are specified, spelled out, presented, and published.

Senator MILLER. I wonder if it would be in order to ask that the committee ask the Secretary whether or how soon we might expect a firm position from the Department of Commerce. And I say this because I realize that we can officially here accept Mr. Lederer's position as an individual. This is not rare at all. It is done quite often.

I did it myself when I was with the Government many years ago, but nevertheless, it is realistic to appreciate the fact that members of the press and the public generally will give great weight to the thinking within a department when some official, especially someone like Mr. Lederer, sets forth his personal views, and I think it might be helpful if he could—I think as a matter of record—point out that the Department has not made or reached an official position on this and we would like to know approximately when we might obtain an official position from the Department.

Senator PROXMIRE. I might say this is to be an interagency position. It is one to be made by the Treasury, Commerce, Bureau of the Budget, and perhaps other agencies have to be consulted. At any rate, this is one that I understand they are anxious to make as soon as the information is in.

They have to make it as a matter of necessity because they have to make these reports, and I think it is very helpful that the Senator from Iowa points out that the public wants to know and we want to know.

It is helpful in determining our policy in the Congress if we have these statistics presented to us in an agreed way just as soon as possible.

Senator MILLER. Would the chairman yield at that point?

Senator PROXMIRE. Yes.

Senator MILLER. It seems to me it is difficult for this committee, and speaking more for the legislative branch, to appropriately comment on this until we have heard the executive branch's position.

We might agree with it and we might not. But I think it would be helpful in the overall understanding of this if we could have the executive branch come out with their position on this in the rather near future.

Then, we are in a position to make our report, I think, much more meaningful than it otherwise would be. I would urge the chairman to do what he could to obtain some official statement from the executive branch before we come out with our final advice on this.

Senator PROXMIRE. Well, you see, this puts us in an interesting position, because the executive branch is going to decide it. They have the power and authority to act in this case and I am inclined to think that possibly this committee might influence that decision if we make up our minds, based on the expert testimony of people from the administration as well as competent outside witnesses.

But I think this is something that we can discuss a little later. If the administration doesn't commit themselves and is open to our influence and recommendations, perhaps this committee can have more influence on this Executive decision.

Senator MILLER. It is an Executive decision, but it is then our duty to recommend legislation on this, and I don't think the people should get the impression that we are working at cross-purposes here or dividing up into separate camps without some cross-fertilization.

I think we will do our utmost to work together on this, but nevertheless I think the usual approach has been for the executive branch to come out with something, just like they do in the annual committee report, and then we take over from there and make our comments and recommendations.

Senator PROXMIRE. Well, I think this morning, Senator Miller, we should have Mr. Lederer proceed, and we will be happy to discuss this with you shortly.

At any rate, Mr. Lederer is here this morning as an independent, competent economist and not as a spokesman for the administration.

Mr. LEDERER. The statement I have here is an abstract of a longer paper I would like to submit for the record if the committee so desires.

First, I should like to emphasize that the Review Committee has done a very creditable job analyzing our work, the methods we and other agencies are using to obtain the figures, and the improvements that may be required to make the data more reliable.

Senator PROXMIRE. Could I interrupt once more to ask if this large document here represents your comments on the balance of payments transactions?

Mr. Lederer. Yes.

Senator PROXMIRE. And we also have your prepared statement. We would appreciate it if you could highlight your statement in your testimony and we will include your comments in the record, too.

(Mr. Lederer's "Comments", the document referred to, appears in the appendix.)

PREPARED STATEMENT OF WALTHER LEDERER, CHIEF, BALANCE OF PAYMENTS DIVISION, OFFICE OF BUSINESS ECONOMICS, U.S. DEPARTMENT OF COMMERCE

Mr. LEDERER. Thank you. It should not be surprising that those of us who have for many years worked in that field were quite aware of the problems we are facing and we are very thankful for receiving support in our efforts to do a better job.

I do not think that statistics on foreign transactions incorporate more uncertainties than many other statistics, nor do I think that our data are much less accurate than comparable data of other countries. That should not preclude the need for improvements, however, and—what may be even more important—the need to preserve the quality of the data we now have through periodic comprehensive surveys which serve as benchmarks for estimates based on less comprehensive information obtained currently.

I will not go into the data-collection problems now, but shall be glad to answer any questions which may be raised. Since the major interest of the public, and the Government, seems to be concerned with the conceptual problem of measuring the balance on our foreign transaction, I will address myself principally to that problem.

I should like to stress again, however, that the conceptual problem absorbs only the smaller part of the report of the Review Committee, and concentrating here on the conceptual problems should not be interpreted to mean that I consider the other parts as less important.

It is, however, the conceptual problem where we have some disagreement. I might say here that I have the feeling that most of the time my analysis of the balance of payments based on the data we have on our international transactions and on related economic developments, both in the United States and abroad, does not differ fundamentally from that of Dr. Bernstein (although that may not apply to all of the other members of the Review Committee).

The problem is—whether we like it or not—that both policy officials and the public want to have a more easily understood measure, perhaps one that becomes available before a careful analysis can be made.

This is a very unsatisfactory situation. Very often it turns out that whatever figures one uses to measure the balance has to be analyzed and has to be qualified, and only after that has been done, can one really know what has happened.

However, I recognize that these figures are used and have to be used very often for quick policy decisions, and thereafter one has to try to make them as reliable as one possibly can.

So, this should not, by any means, reduce the emphasis on the later analysis, but occasionally one does not have sufficient time for that.

There is a need, therefore, to select among the many figures that appear in balance-of-payments compilations those on which attention should be focused first, although the first impression may have to be modified by more or less extensive qualifications.

The next point I would like to stress is that I have no intention of either overstating or understating the balance-of-payments problem relative to other economic problems about which we are concerned.

The policymaking officials have to find the balance between the various economic and other problems they are dealing with, and if

there are competing interests, they have to make the decision of what should receive priority.

As for myself, I do not believe that the balance of payments can be improved only at the expense of economic growth, reduction in unemployment, or other desirable economic goals. On the contrary, I think the two aims can, and in fact, have to be combined for either one to be achieved.

There are, of course, expenditures we have abroad to meet certain political goals. It is not for me to judge whether they are desirable or not. Whatever the expenditures are, they together with all other foreign transactions influence our balance of payments.

This means, as I see it, that the interpretation of the balance of payments should not be influenced by the concern of the analyst, whether balance of payments problems and related policies conflict with other public or private policy goals. I do not believe that such concerns have motivated the members of the Review Committee, but I am afraid that other people have indicated preference for the concepts of the Review Committee, precisely because its balance is smaller, and has shown quite significant improvement between 1962 and 1964.

The analysis of the balance of payments should indicate whether—as the Review Committee says—things are "going well or badly" (p. 101 left, Review Committee Report), or one might add: getting better or worse, and this should be judged from the point of view of the balance of payments itself.

What the Review Committee wants to measure is the pressure on the dollar in exchange markets and it proposes to do that by focusing on the changes in U.S. official monetary reserves and in dollar holdings or other claims on the United States by foreign official monetary agencies as they appear in the records of U.S. banks.

The committee believes that these items in the balance-of-payments compilations provide a reasonable measure of these pressures, because whenever such pressures occur, monetary authorities have to intervene in the exchange markets either to supply the excess demand or absorb the excess supply of foreign exchange arising from private or other official transactions.

I do not believe that we can be satisfied merely to record the events that occurred at the time pressures have occurred in the exchange markets, but that we should look ahead, and examine whether any given pattern of foreign transactions can be sustained in the longer run or whether policy actions may be required to correct that pattern.

I believe that we should bring such developments to the attention of the responsible officials and the public at a time when correcting actions can still be undertaken with some chance for success, rather than when events which we want to prevent have already occurred. In other words, balance of payments analysis should be more than a historical record.

Next, I do not believe that the assumptions underlying the concept of the Review Committee are close enough to current realities to be useful for analytical purposes.

1. Monetary authorities are not likely to be always passive factors in the exchange market. They set up policy goals, and in pursuing them, they may purchase and sell foreign exchange even if there is no pressure in the exchange market.

Controls over foreign exchange operations, particular capital transactions, are quite extensive, and there are hardly any countries where one can find a foreign exchange market where private decisions are free of such controls. In most countries the authorities want to limit foreign exchange expenditures, in order to build up reserves or to prevent their decline; in some they are more concerned with the prevention of undesired foreign exchange inflows, particularly through capital transactions. In still other countries the authorities are concerned with preventing a dilution of their control over their economy, particularly when it is exercised through credit operations.

I do not believe, therefore, that one can determine once and for all which transactions are autonomous, which compensatory, or which transactors are autonomous in their decisions, and which enter the market only in response to the decisions made by others. I do not believe that there is a scientific way to make this distinction, and I do not believe that it is necessary or useful in the analysis of the balance of payments.

2. A rise in foreign official dollar holdings should not be construed as a sign of weakness in the position of the dollar, any more than a rise in foreign private dollar holdings.

If foreign official monetary organizations hold dollars, it must be assumed that, all in all, they want to hold the dollars, although some may refrain from purchasing more gold in order to reduce the strain on U.S. reserves. Otherwise, they would exchange the dollars against gold. They hold dollars because—and as long as—they have confidence in the stability of the exchange value, convenience, and absence of restrictions in the use and transfer of dollars, and because—and as long as—the income they receive on dollar assets is in excess of whatever they consider to be a compensation for any risk they may take in holding dollars rather than gold.

Precisely the same considerations apply to private foreign holdings of liquid dollar assets. Liquid dollar assets yield less than similar assets in most other countries. If foreigners hold them, it is primarily for their liquidity, not as an investment for the income they can obtain.

Private dollar holdings abroad are a part of the monetary dollar supply held by foreigners, usually supplementing those held by official agencies, in many instances under their close supervision, and sometimes to take over the function of official reserves, where the authorities cannot, or do not meet the function of a central reserve holding agency upon which private business can rely for its foreign exchange needs.

During the postwar period, particularly since 1958, foreign official dollar holdings have risen much more, and far more steadily than foreign private dollar holdings.

3. Pressures in the exchange market can be met by other means than selling and buying foreign exchange in the spot market. Such pressures can be met by operations in the forward market—and that has been done extensively, more so than indicated by the Review Committee.

To reduce the pressure from an excess supply of dollars, our, or foreign, authorities can purchase dollars in the forward market, which would increase the incentives for those holding dollars to keep them

longer than they would have done otherwise. This would appear in the statistics as a rise in liabilities to foreign private accounts.

Forward commitments of our authorities and those of foreign countries do not appear in the balance of payments data. Forward support transactions hide the balance of payments developments if the balance is computed on the basis of the concept of the Review Committee, but it would not affect the balance reflecting changes in all liquid liabilities, which I prefer to use as a base for analysis.

4. I believe the Review Committee has not given sufficient attention to the implication of the use of the dollar as an international medium of exchange and reserve asset, both by official and by private agencies abroad.

(*a*) The dollar is used extensively for payments by foreigners to other foreigners probably more so than for payments to the United States. These dollar transactions may be between residents of the same foreign country or they may be between persons of different countries. In the course of these transactions, dollar balances in U.S. banks can be shifted between foreign official and foreign private organizations.

The balance on the international transactions of the United States, computed on the basis of the concepts by the Review Committee, would be influenced by such shifts. The answer to the question of whether things are better or worse for the United States would be affected by transactions which take place between foreign countries or sometimes between foreign official agencies and private residents of the same country.

By implication, our balance of payments policy would also be affected by such transactions. I do not believe that this is appropriate. We should be concerned with changes in the total of all liquid dollar liabilities, and that is what we reasonably can expect to influence through policy actions. But after the dollars have been transferred to foreign accounts, we can do very little to influence shifts of these balances between foreigners resulting from transactions with each other.

(*b*) Since the dollar is used as a medium of payments in international transactions and as a reserve by foreign banks for credit extensions, dollar holdings by private people, businesses and by banks can be of concern to foreign monetary authorities.

To hold down inflationary pressures in their countries, foreign monetary authorities may want to tighten credit, and limit the expansion of the money supply in their country. If their residents then substitute dollars for their own currency, and their banks extend loans in dollars rather than in their own funds, this can frustrate the official policies abroad.

It should not be surprising that the authorities which have that experience take actions by which they hope to reassert their control. Such actions would have to be designed to prevent a rise in the dollar holdings of their residents, particularly banks. This, they assume, can be achieved only by actions by the United States to reduce capital outflows, and an effective way to stimulate the United States to take such actions is to purchase gold.

Thus, I believe, foreign monetary authorities are not only concerned with the dollars they happen to hold. They are also con-

cerned—precisely because the dollar is used abroad as a cash asset—with dollars held by the private sector in their economies.

This concern by foreign monetary authorities was perhaps the major reasons for the recent rise in foreign purchases of gold following the large increase in dollar assets held by foreign banks, particularly in Europe. I do not believe, as Dr. Bernstein has stated, that these purchases reflect a relaxation, made possible by the improvement in our balance of payments, of a previous restraint on gold purchases which foreign central banks had imposed on themselves to avoid an undue disturbance of the international monetary system.

The foreign gold purchases started to rise during the last months of 1964, long before the recent improvement in our balance of payments had set in. Therefore, if we are concerned with changes in our reserve assets, we also should be concerned with out liquid liabilities, but just as foreign monetary authorities are concerned with dollar assets of their private residents, we should also be concerned with the corresponding liabilities to foreign private residents.

(*c*) The Review Committee recommends that data on liabilities to foreign organizations reported by U.S. banks should be used to measure changes in dollar assets and other claims on the United States by foreign monetary authorities.

Dollar assets of foreign monetary authorities are, however, considerably larger than data from U.S. banks indicate. We have attempted to use foreign data (published by the International Monetary Fund) to arrive at figures representing dollar holdings of these foreign authorities, and find that their holdings based on their own figures, exceeded at the end of 1964 the figures obtained from U.S. sources by nearly $3 billion. Figures on foreign official holdings based on foreign sources were about $18.3 billion, while U.S. sources reported $15.5 billion.

I have a table in my longer report, on page 27, where these figures are given in more detail.

From the end of 1958 to the end of 1964 foreign sources reported an increase in dollar holdings of their monetary authorities of $8.5 billion, while U.S. sources indicated an increase of $6.3 billion, a difference of $2.2 billion, or more than a third.

A large part of the discrepancy between United States and foreign data on dollar holdings of foreign monetary authorities arose during the year 1959 and 1960, but there were also major increases in the difference in 1963 and in 1964.

The discrepancy is due to the fact that foreign official organizations do not have to hold their dollars on deposit or in custody accounts in U.S. banks. They can also hold their deposits in foreign banks, particularly British, Swiss, or Canadian, or they can deposit their dollar funds in foreign branches of U.S. banks.

If foreign official organizations receive checks drawn against U.S. banks, say in payment for a U.S. import, and they deposit that check in a London bank, they will acquire a dollar balance in that bank. The London bank will transmit the check for collection to the United States, and thus will acquire a deposit balance in a U.S. bank. When the U.S. bank reports liabilities to foreigners it will show an increase in liabilities to a private foreign bank, not to an official organization. That will be the case also if the London bank is a branch of an American bank.

Thus foreign official dollar holdings cannot be measured from U.S. figures as the committee suggests, and U.S. figures cannot be used to determine whether or not there have been pressures on the dollar, even if that were otherwise possible or useful.

It is equally important to understand that a very considerable part of the dollar balances which our banks attribute to foreign private banks and other private holders really belong to foreign official agencies.

5. The concept of the Review Committee opens up opportunities for financial operations which would obscure balance of payments developments. The possibility of transferring official support operations to the forward market has already been mentioned.

A similar effect on the statistical data could be obtained by inducing foreign official organizations to transfer their dollar accounts from U.S. banks to their foreign branches or to foreign banks. The deficit, as measured by the Review Committee, could be wiped out for many years by gradual transfers to foreign banks of the $15.5 billion of liabilities to foreign official accounts reported by U.S. banks for the end of 1964.

In setting up a measure for the balance on international transactions, one must take into consideration that it is not only an analytical tool, but also a suggestion of various policies which would help to improve the balance. Special care must be exercised, therefore, that the measure minimizes the possibilities for operations which affect appearances more than real conditions. I believe that the measure of the balance which we have been using lends itself much less to such operations than the balance recommended by the Review Committee.

In view of all these and many other factors affecting U.S. dollar liabilities to foreign private accounts, as reported by U.S. banks, it should not be surprising that the changes in these liabilities were rather erratic.

What is more important, however, is that these erratic movements also made the balance, as measured by the Review Committee, rather erratic, much more so than the balance we are now using. Being more erratic, of course, makes the balance of the Review Committee much less reliable and much more difficult to analyze in order to determine the movements of the longer run trends.

The Review Committee claims that a rise in foreign private dollar balances should be interpreted as a sign of strength of the dollar. If so, it would be a sign that this strength is very variable, indeed, and most unreliable. The annual variations in these liabilities during the period from 1958 to 1964 averaged as high as $900 million.

What is more, however, is that during that period in each of the two instances when U.S. banking liabilities to foreign private accounts increased—i.e., in 1959 and 1961—that increase was followed in the next year by a sharp deterioration of the balance, as measured by the Review Committee.

The same development can be observed recently as the sharp rise in liabilities to foreign private accounts in 1964 was followed by a deterioration in the balance, based on the Review Committee's concepts, during the first quarter of 1965.

Furthermore, that deterioration in 1960, 1962, and again in 1965 did not consist merely of a shift in liabilities from foreign private to foreign official accounts, but consisted of a decline in our reserve

assets which affects our financial position much more immediately, because the changes in reserves are less sustainable in the longer run than those in liabilities.

Thus, a decline in our balance, as measured by the Review Committee, resulting from an increase in liabilities to foreign private accounts should not be interpreted as a sign of strength in our balance of payments, but as a rather reliable sign of impending reserve losses.

I am afraid that the signals, which policymaking officials and the public would receive from the changes in the balance on our foreign transactions measured on the basis of the concept of the Review Committee, are not only unreliable; on the basis of our experience during the last 8 years, they seem to be outright misleading.

Changes in reserve assets are included in measuring the balance on foreign transactions from which analysis starts, because it is believed that a decline in reserve assets cannot be sustained in the long run.

I am in favor of including, also, changes in all liquid liabilities—not just liabilities to foreign monetary authorities—for the same reasons, although I recognize that the statistical data have to be adjusted to allow for changes in liabilities which reflect dollar balances that are not freely disposable by their foreign owners, and that a certain amount of growth in both official and private dollar holdings should be considered sustainable to meet the foreign requirements for internationally acceptable monetary assets arising from the normal expansion in international transactions. Mr. Chittenden has already mentioned some of these points.

The most important example of foreign dollar balances which may be considered to be not freely available to their owners are compensating balances which banks require as a condition for extending loans. Such balances may vary from bank to bank, and borrower to borrower, and statistical data on the amounts involved do not exist.

The problem created by this practice affects not only the balance of payments, as I prefer to measure and analyze it, since such balances are also withheld from official accounts, even on loans to nonofficial borrowers, they may also affect the balance as measured by the Review Committee.

Furthermore, compensating balances create a problem in the concepts and statistics of such important economic data as the domestic money supply, banking liabilities subject to reserve requirements, and the costs of borrowing. If data on compensating balances were developed, they would help to improve all of these statistics, and they should also be used in balance of payments compilations and analyses.

Informal inquiries indicated that such balances on foreign loans may average around 15 percent of the amounts loaned. If that were so, the balance, as we measure it, would have to be reduced in 1963 by about $200 million and in 1964 by about $300 million. The amounts are too small to have a significant effect on the interpretation of the balance of payments changes in that period. The total would be down, but the movement for that year would probably not be very much.

Somewhat more complicated is the problem of the need by foreign countries for an increase in internationally acceptable monetary assets to facilitate the normal growth in world trade and other international transactions. The requirements do not depend on the increase in

turnover alone. They depend more on the amounts of reserves official and private organizations and persons want to hold, and this, in turn, depends on the chances they have to borrow funds to meet the gaps, and the efficiency with which reserves can be managed.

The need for cash reserves is difficult to estimate even domestically. The difficulty is even greater in estimating the requirements of foreigners for their international transactions. After deriving some estimate, one would have to deduct that amount that may become available from new gold production and Soviet bloc sales, from an increase in sterling balances—if any—and thus derive a magnitude that would indicate the need for additional dollar holdings. Such an estimate cannot be substituted for, however, by reducing the balance as we now measure it by omitting liabilities to foreign private accounts or by netting out some of the U.S. nonmonetary assets against liquid liabilities.

Whatever that estimate is, it may provide some guide in our balance of payments policy. In other words, we do not have to interpret the balance of payments measures to mean that we have to strive now for a zero balance. Under present conditions, as long as there are no other monetary assets to supplement the dollar, we may be satisfied with a rise in liabilities by some magnitude, which should be separately estimated, but which is likely to be considerably smaller than our balance—as we measure it—is not.

This is not, I should say here, a new thought which I am just expressing here at this moment. I said that many times before, such as in the Princeton study that was mentioned earlier.

This problem also affects the balance as defined by the Review Committee. The growth in international business also requires an increase in foreign official dollar holdings, and under present conditions the target of balance of payments adjustments cannot be a zero balance even under the Review Committee concept.

I know that Dr. Bernstein denied that, but I think official reserves have to rise to facilitate a growth in international business just as much as private reserves.

It would be difficult to divide the total of the required growth in foreign dollar holdings between official and private accounts. I would think that an improvement in our balance of payments, indecated by a decline in the rate of accumulation of dollar assets abroad, would induce foreign monetary authorities to absorb a rising share of these dollar balances.

The very important difference between the two measures of the balance—that recommended by the Review Committee, and that used by myself—thus is not that the level of one is more realistic than that of the other. Both levels have to be adjusted.

The difference is in their respective reliability with which they are indicating whether we are moving toward or away from the goal we have set up. And there, I believe, the definition of the balance now in use has proven to be considerably superior.

Senator PROXMIRE. Thank you very, very much, Mr. Lederer.

These have been mighty stimulating and helpful papers. I am going to ask Senator Miller, who has a couple of brief questions to start off and I will have some questions later.

Senator MILLER. Thank you, Mr. Chairman. Gentlemen, I have nine questions here which we would like to have you answer after giving some thought to them.

I doubt if you would like to answer them right off the cuff, so with the chairman's permission, I will give these questions to these witnesses and perhaps in the next week they could provide answers to them, separately.

I would appreciate having their answers in the record.

Senator PROXMIRE. Yes, indeed; I think that would be fine, provided it is acceptable to the witnesses. Give us the answers in writing at your leisure before the record is closed.

(Questions submitted to the witnesses in writing by Senator Miller, and their answers, all subsequently supplied, follow:)

SENATOR MILLER'S NINE QUESTIONS

1. In an article on the Bernstein report in the May issue of the Morgan Guaranty Survey, the Bank states that one effect of switching to the official settlements concept would be to let dollar holdings of private foreigners "slip out of focus." The Bank considers this dangerous because it believes that privately held dollars are likely to be a greater problem than dollars held by monetary authorities. The Bank feels that dollars held by monetary authorities are much less likely to be affected by fear and speculation than are privately held dollars. Do you agree with this view?

2. Do you agree with Morgan Guaranty's position that the official settlements as a summary measure of the deficit would serve as a coincident indicator which would proclaim trouble only after it had already become apparent in the foreign exchange markets and in movements of gold? The Commerce Department's measure, it is said, acts instead as a leading indicator which signals when trouble, not yet apparent, may lie around the corner. Do you agree with this view?

3. The Morgan Guaranty Survey article suggests that our balance of payments statistics could give a more realistic picture of the deficit by netting out of U.S. private short-term capital outflows those foreign held balances of dollars which in practice are not freely usable by their owners. Do you feel that such a practice would be feasible and useful? Have estimates been made of the size of such balances?

4. Can a valid case be made for the argument that a key currency country, such as our own, should be required to use a more strict concept of surplus or deficit that would be provided by the official settlements concept? On what basis can such a case be made?

5. Would the addition of the official settlements concept to our balance of payments data at this time weaken confidence in the dollar abroad? Might it suggest that we are trying to solve the deficit by statistical operations rather than by coming to grips with the fundamentals of our deficit?

6. Should there be an international agreement on the standardization of balance of payments accounting so that all countries use comparable surplus and deficit figures?

7. Have any wrong policy decisions been made because of the way the balance of payments deficit has been defined? In general, Mr. Bernstein and those who appeared with him here several weeks ago felt that mistakes had not been made because of our present definitions.

8. Under the official settlements concept, transactions among foreigners could add to our balance of payments deficit. This would occur if private residents in one country transfer dollars to an official agency in another in payment for trade or other obligations, or if within a foreign country dollars are transferred from a private holder to the monetary authorities. Is it reasonable to record such transactions as deficits—and perhaps adopt restrictive policies on the basis of them—when they had nothing at all to do with U.S. international payments and receipts? Do such transfers necessarily result from weaknesses of the dollar?

9. The balance-sheet position of the United States would be improved if our short-term liabilities could be funded and replaced by long-term debt. But the official settlement concept would not regard it as an improvement in our balance

of payments even if all our liquid liabilities to foreign official monetary authorities were replaced by long-term debt. Isn't this a serious defect in the official settlements concept?

MORGAN GUARANTY TRUST CO. OF NEW YORK,
New York, June 21, 1965.

DR. GERALD A. POLLACK,
Economist,
Joint Economic Committee,
New Senate Office Building, Washington, D.C.

DEAR DR. POLLACK: I'm enclosing my answers to the questions which Senator Miller posed to the witnesses who testified on June 8. I've skipped the first three since they ask for comment on our survey piece, and I am, of course, in full agreement with the views expressed therein.

I've skipped No. 4 since much of my testimony was devoted to arguing that the United States must employ a stricter standard than the "official settlements" measure.

Cordially,

GEORGE H. CHITTENDEN.

ANSWERS BY GEORGE H. CHITTENDEN TO SENATOR MILLER'S QUESTIONS

5. The shortcomings of the "official settlements" concept have been so thoroughly exposed in the discussion of recent weeks that I do feel that psychological hazards would be involved, not just abroad but at home as well, in the official adoption of the concept. Inevitably, some people would conclude that the Government was opting for the Review Committee's method, not because of its merits, but merely because it gave a more pleasing appearance to our payments situation.

6. If one starts from the assumption, as I do, that the United States plays a unique role in the world monetary structure, the Review Committee's emphasis on symmetry in accounting makes little sense. Actually, any technician so inclined would have little difficulty in recasting country payments statistics on a standardized basis when undertaking special analyses. A formal agreement to achieve comparability, even if that were conceded to have some virtue, is scarcely needed.

7. I think we probably have made some errors during the past several years in formulating balance of payments policy. Those mistakes, however, have not stemmed either from deficiencies of data or from the way in which we define our net-payments position.

8. Our bookkeeping should be designed, as it now is, to show how this country's liquidity position is being affected by transactions between U.S. and foreign parties. Transactions between foreigners as such may at times reflect weakness in the dollar, but that certainly is not the case with all such transactions, and the consequence is that the Review Committee's approach would at times give misleading signals as to the status of the dollar.

9. I believe it is important because of the banker status of the United States to distinguish degrees of liquidity in the country's liabilities. The failure of the Review Committee's approach to do so is, of course, a serious conceptual deficiency.

ANSWERS BY HAL B. LARY TO SENATOR MILLER'S NINE QUESTIONS

1. The point made in the Morgan Guarantee Survey article overlooks essential differences between foreign central banks and private parties. Under a system of stable exchange rates, central banks must absorb any excess of dollars offered for their own currencies in the foreign exchange market. They have no choice, if they are to keep the exchange value of their currencies from rising above the prescribed limits. Depending on their usual practices and current preferences, they may use part or all of these newly acquired dollars to buy gold from the United States. Or they may do so subsequently. Conversely, if the pressures in the foreign exchange market are reversed with a change in the U.S. balance of payments, foreign central banks will have to make good from their own reserves any deficiency in the supply of dollars coming on the market. Again, they have

no choice, if they are to keep the value of their currencies from falling below the prescribed limits.

Foreign private parties are not required to do any of these things. If they buy or sell dollar assets, it is not out of any obligation to support existing exchange rates but rather for business reasons (including relative rates of return, the cultivation of good business relations, and protection of the value of their assets). Indeed, transfers of private funds for these purposes may add to rather than relieve the pressures with which the central banks have to contend.

If, instead of thinking about the usual characteristics of official and private funds, one focuses on what happens in the event of a speculative crisis, both types could, of course, prove volatile. This would also be true of some foreign "long-term" investments here, such as holdings of U.S. stocks and bonds, which are not treated as "liquid" in the Commerce Department's definition. And it would also be true of some domestically owned liquid (and other) assets, which total far more than foreign claims on us and do not figure in the current balance of payments at all. It is, however, one thing to say that our monetary authorities must be alert to all these contingencies in framing their policies, and quite another thing to say that the selection of certain foreign claims as "liquid" provides a proper basis for defining the deficit.

2. Once again, we cannot ignore that foreign private acquisitions of "liquid" dollar balances—and other assets—in one period could be followed by shifts of these funds into official holdings of dollars or gold in a later period. But the expression "leading indicator" (developed by the National Bureau of Economic Research in its business cycle studies) suggests a fairly regular sequence of events whereby the balance of payments deficit is larger on the "liquidity" concept in one period and then larger on the "official settlements" basis in a later period. Our balance of payments history so far does not seem to give much support to this usage, and, as in the fable, premature and exaggerated warnings may serve no constructive purpose. It seems to me that the term "leading indicator" is subject to much the same criticism as the term "sensitive indicator," which I discussed in my testimony on June 8.

3. This suggestion would probably yield some marginal improvements in the application of the "liquidity" criterion, judged by its own logic. But I think that it would not go very far. Can one identify balances held here by foreign commercial banks as a counterpart to the foreign collection business which they handle for American banks? Against what would such balances be "netted out"? How would one "net out" the dollar reserves which foreign insurance companies must hold against their business in this country? The suggestion also points to much more basic difficulties in the "liquidity" concept. What is "freely usable" depends on how anxious the owners are to liquidate their holdings, and attitudes in this regard are subject to change. Moreover, assets which may not be "freely usable" overnight may very well become liquid within the time span over which currency crises usually drag out.

4. At first blush it seems obvious that a key currency country should be stricter in its statistics—and in its policies—respecting the balance of payments than other countries. Amost everyone finds it easy and plausible to say so. And yet I am not sure that this is really true. Any country, even one without significant external liquid liabilities, can experience a severe exchange crisis or a prolonged loss of real resources, if a weakening of confidence in its currency leads to a flight of capital. In brief, all countries have currencies; all currencies are potentially subject to attack; and all holders of that currency, regardless of where they live, are potential participants in such an attack. The effects may be more serious, relatively speaking, for a very poor country than for a rich one, or for a nonkey currency country than for a key currency one. In either event, I do not think that the case is strong for preferring a definition systematically yielding a larger deficit over a definition yielding a smaller one, or vice versa. There are advantages and disadvantages either way, as indicated in my written statement, and it is better to try to rule out such subjective considerations in trying to determine the most appropriate statistical practice.

5. My expectation is that in 1965 the present "liquidity" criterion will show a smaller deficit, or at least one not much larger, than the "official settlements" measure. If so, the first will also show a much greater improvement than the second. Some of the improvement on the "liquidity" basis will be spurious, reflecting both the deliberate and the unintended wiping out of offsetting claims and liabilities of U.S. banks and companies. This year may therefore be a good

time to introduce the new concept and to contribute to a better public understanding of our international position.

6. I would hope that we could get rid of some of the more disturbing asymmetries and discrepancies in our practice compared with the practices of other countries, but I suspect that a good deal more study would be needed before deciding whether or not international standardization is possible.

7. I suggest in my written statement that, if we set our sights by the $3 billion deficit measured on the "liquidity" basis for last year, we risk applying our new controls on capital movements too severely and indiscriminately, at the cost of bringing undue pressure on a number of weaker countries and of increasing demands for financial aid from the U.S. Government. A lesser but still disturbing aspect of the new controls is that, in order to satisfy the demands of the "liquidity" criterion, we may confuse shadow and substance; that is, some of the corrective actions stimulated by the program may serve to reduce foreign liquid claims on us but without any corresponding real improvement in our international position.

If we think of the situation as it evolved before February 10 of this year, my chief concern about the effects of the "liquidity" definition would be that it may have contributed to an exaggerated impression of financial profligacy on the part of the United States, making it more difficult to obtain cooperation from some countries and, in late 1964 and early 1965, leading to self-fulfilling expectations that controls would have to be imposed on the continued flow of U.S. investments abroad.

8. It seems that in both of the cases mentioned foreign private holders have decided to reduce their holdings of dollars and that the dollars offered on the foreign exchange market have been acquired by central banks. From the evidence given, this would be a change in our international position analogous to a sale of foreign holdings of corporate shares and would be appropriately reflected in an increase in our deficit.

9. Surely, both the "liquidity" approach and the "official settlements" approach would treat the transaction in question as a special government transaction and not as a real improvement in our balance of payments. The distinction made in the question between our international balance sheet and our international balance of payments is important: It is the first but not the second that would be improved under the conditions stated.

ANSWERS BY WALTHER LEDERER TO SENATOR MILLER'S NINE QUESTIONS

1. The following figures show the total amounts of liquid liabilities to foreign official organizations and to private foreigners since the end of 1958 as reported from U.S. sources.

[In millions of dollars]

	Liquid liabilities to foreign official organizations		Liquid liabilities to private foreigners	
	Amounts outstanding at end of year	Change during year	Amounts outstanding at end of year	Change during year
1958	9,146		6,367	
1959	10,038	+892	7,657	+1,290
1960	11,039	+1,001	7,631	−26
1961	11,770	+731	8,375	+662
1962	12,681	+911	8,359	−16
1963	14,353	+1,672	9,205	+846
1964	15,472	+1,119	11,014	+1,098

The figures clearly indicate that the changes in the liabilities to foreign private banks and other foreign private accounts are much more erratic than those in foreign official accounts.

2. The data following show that U.S. reserve assets fell sharply in the years 1960, 1962, and 1965 following a relatively large rise in liquid liabilities to foreign private accounts in the preceding years 1959, 1961, and 1964.

[In millions of dollars]

	Changes in U.S. reserve assets	Changes in liquid liabilities to foreign private accounts
1959	−771	+1,290
1960	−2,143	−26
1961	−606	+662
1962	−1,533	−16
1963	−378	+846
1964	−171	+1,809
1965	−842	+170

3. The exclusion from U.S. liquid liabilities to foreigners (including both official and private accounts) of balances which in practice are not freely usable by their owners (such as compensating balances held against loans provided by U.S. banks) would be desirable. This requires, however, a definition which would be statistically measurable, and the development of statistical reports to obtain the necessary data. At this time neither a sufficiently precise definition, nor the corresponding data are available. A rough estimate of the net increase in compensating balances included in foreign dollar balances would be as follows (in millions of dollars):

1960	$120
1961	190
1962	75
1963	200
1964	300

The balance on foreign transactions measured by changes in reserve assets and all liquid liabilities may be reduced by these amounts.

A large part of these compensating balances are included in dollar deposits by foreign official organizations. The argument that such balances should be deducted from U.S. liabilities to foreigners also applies to the measure of the balance on U.S. international transactions as measured by the Review Committee.

Other adjustments, particularly liabilities to Canadian banks which are tied to U.S. deposits in these banks, also require conceptual clarifications, and probably statistical data not now available.

4. If the United States would not be a "key currency country"—i.e., if the U.S. dollar would not be used abroad as a medium of exchange, and public and private reserve asset—foreign holdings of liquid dollar assets would, most likely, have remained quite small. Since the United States under such conditions would have had to balance its foreign transactions by drawing on its reserves, it would have been forced to adjust its foreign transactions at a much earlier time in order to avoid large reserve losses. Measures would have to be taken to keep reserves at a level considered necessary to bridge temporary gaps between receipts and payments on trade and other transactions, and for various emergencies. Nearly all countries attempt to keep reserves for such purposes.

The United States has to keep reserves, however, also, because the dollar is used for monetary functions abroad, and its acceptance by foreigners as a monetary and reserve asset is contingent upon the ability of U.S. monetary authorities to guarantee its convertibility into gold or other currencies at stable values and without restrictions. Since the dollar is accepted and used for such purposes not only by foreign official organizations but also by foreign private business, the U.S. monetary authorities have to keep reserves, also, to provide sufficient assurances to foreign private dollar holders. Or, to put it the other way around, the United States has to watch the relation between its reserves and its liquid or monetary liabilities held by all foreigners.

5. If the "official settlements" concept would really be appropriate for the analysis of the balance of payments of the United States it should be adopted. There would be no reason to fear that the change in statistics would be misinterpreted as an attempt to substitute a statistical for a real solution of our balance

of payments problem. The danger in adopting the "official settlements" concept is that it suggests a continuing and major improvement in our balance of payments situation from 1962 to 1964, and that it would lead to the conclusion that major actions to improve the balance further are not needed at this time. In fact, it would be very difficult to obtain support for such actions, both within the Government and from the public. The lack of actions, or in the rescinding of actions to improve the balance of payments already taken, could result in a weakening of confidence in the dollar.

6. The International Monetary Fund and the Organization for Economic Cooperation and Development are attempting to standardize balance-of-payments accounting among their member countries. The two organizations cooperate closely in that task. These efforts have had considerable success, but they have also brought out the difficulties that are involved.

The different countries have different systems of collecting data on their foreign transactions because these data are frequently obtained as byproducts of other administrative operations, which vary considerably among different countries.

Countries differ markedly in their international and internal economic operations and institutions, so that transactions which may appear to be similar can in reality be quite different with respect to their economic significance. For instance, for some countries changes in exports may be a reasonable indication of their changes in foreign exchange earnings. For the United States that does not necessarily apply, because such exports may be financed by Government aid, or by private investments and loans. Short-term assets held abroad by banks in some countries can be mainly very liquid cash assets; in the United States such assets are mainly loans which would be difficult to liquidate. In some countries, the governments have more control over foreign operations and assets of their residents than in other countries.

Transactions between two specific countries may not necessarily appear in their respective statistics on the opposite side of the ledger. Many countries, for different types of transactions, act as middlemen or transit points.

Goods may be consigned by a U.S. exporter to the Netherlands, but may actually go to Germany. A Dutch merchant may have arranged the transaction, and may earn a middleman's commission or profit, but there is no reason why the Netherlands should include such shipments in its imports or exports if they did not enter their country or if their country had no share in producing them.

A bank in, say, the United Kingdom may accept dollar funds from a foreigner and lend out these dollar funds to another foreigner on similar terms. The operation does not affrct the economy (except for the earnings of the bank in that operation), nor the financial position of the United Kingdom.

The country which has the middleman role may not want to show in its statistics these kinds of transactions on a gross basis, as if each side would be unrelated to the other, and each reflect separate aspects of that country's economic activity.

The interpretation of the balance of payments is even more difficult to standardize. A balance of payments pattern that may be sustainable over the longer run in one country may require corrective actions in another. What may appear as a deficit situation requiring correction in one country does not necessarily mean that the corresponding transactions in another should be interpreted as a surplus. In recent years, for instance, Japan borrowed large amounts from banks in the United States and, to a much lesser extent, in other countries. These loans balanced the excess of payments that Japan had on other transactions in part with other countries. Such borrowing cannot be expected to continue, at least not at the previous rate, and earlier or later—the Japanese authorities will have to make some adjustment in the foreign transactions of their country. It does not matter whether one would say that Japan had "a deficit" in its balance of payment measured by net borrowing, so long as the policy implications of that balance of payments pattern are made clear.

On the other hand we cannot consider our banking claims on Japan as an equivalent to our monetary reserves. If third countries have excess dollar supplies and our monetary authorities have to repurchase the excess in order to preserve the exchange value of the dollar, they cannot do so by selling the claims held by our banks on Japan. The latter are not held by the monetary authorities, they are not per se an acceptable medium of exchange, and they cannot be liquidated, partly because they may not fall due, and partly because the Japanese authorities may not have the funds to pay off the amount we may require. Thus we may have to use our reserves to remove the excess supply of dollars from the exchange markets.

In this example the third country would gain reserve assets in an amount equivalent to our losses, but Japan which may not have lost reserve assets may nevertheless have to act to prevent such losses in the future. Taking all three countries together, the adverse balances would exceed the favorable balance of the third country which is gaining the reserve assets. This is not an unrealistic appraisal of the situation; however, the volume of credit has expanded more than the reserve base. This can also happen within an economy and may result in an unstable and vulnerable financial condition. If it develops it should not be hidden by rearranging statistics. It should be corrected to the extent it is desirable by the creation of reserve assets in the amount necessary to facilitate a desirable volume of business activity. This is also the problem in international finance. If there is a need for additional international reserve assets to supplement gold, it would serve us badly to pretend in our balance of payments statistics that all deficits have to be offset by surpluses, and that the problem in international finance is merely a matter of the distribution of reserve assets rather than one of their appropriate growth or sometimes one of overextension of credit.

7. I do not believe that "wrong policy decisions have been made because of the way the balance of payments deficit has been defined", but I believe that wrong policy decisions would have been made if the balance on our foreign transactions had been measured on the basis of the concept of the review committee. According to the review committee, the "balance settled by official transactions improved from −$3.5 billion in 1960 to −$2 billion in 1961, and consequently meaures taken in 1960 to improve the balance of payments could have been relaxed in 1961.

An even larger improvement, from −$3.3 billion to −$2.3 billion occurred in 1963 and a further improvement, to −$1.5 billion occurred in 1964. These changes would have made it virtually impossible to find support for the measures that have recently been taken to improve the balance of payments; on the contrary the pressure to relax restrictive measures taken in earlier years would have been hard to resist.

8. I do not believe that transactions among foreigners, even if they involve transfers of dollars between foreign accounts in U.S. banks, should affect the measure that we set up to indicate whether the balance on our transactions has changed to the better or worse. The purpose of drawing attention to certain items in the balance of payments accounts, such as changes in reserve assets or in liquid liabilities is to advise those responsible for formulating policies, that the foreign transactions have developed a pattern which in the longer run cannot be sustained, and that, in the absence of self-correcting adjustments, policy actions may be required to achieve a sustainable pattern. Shifts of dollar balances among foreigners as a result of ordinary transactions cannot be subject to policy influences by U.S. authorities. It is possible, of course, that dollar balances as a result of transactions among foreigners are shifted to monetary authorities of countries which—as a matter of traditional policy—convert all or a large part of dollar receipts into gold. This may affect U.S. reserves and weaken the ratio between reserves and outstanding liabilities. U.S. authorities would have no power to prevent such shifts. Such shifts should be considered a normal risk associated with the role of an interrnationally used currency. As long as the dollar is such a key currency, the only policy U.S. authorities can pursue is to watch closely the relation of reserves to all liquid liabilities and to keep that relation high enough to meet such risks, so that shifts of dollar balances to gold purchasing countries do not impair the confidence in the continued convertibility of the dollar at stable values.

9. I believe that conversion of some of our liquid liabilities to foreign official organizations into long-term debt would reduce the vulnerability of the dollar. Such conversions would be the same as long-term loans and should be recorded in balance of payments compilations as other long-term loans. If such long-term loans reduce liquid liabilities, this should be considered an improvement in the balance.

There may still be a question, however, whether such a loan was a transaction which is limited in duration and amount. In that case the relief provided by that loan would be temporary, and efforts to improve the balance of payments would have to continue. This should be brought out in the analysis of the balance of payments. One way of doing that is to indicate that the loan was a special transaction, and to compute a balance omitting the loan. The same could be done, however, with any other large nonrepetitive transaction, such as, for instance, extraordinary wheat sales, or on the negative side, extraordinary large private investments, of Government loans.

Senator MILLER. A couple of brief questions now, if I may. Mr. Lederer, you talked about the goal we have set up. What is that goal?

Mr. LEDERER. This is looking to the future. I do not know whether such a goal has been set up, but this is a lack of knowledge, not anything else. I do not know that we have officially set up any particular goal that we should be striving for. I think, however, that some thought should be given to defining that goal.

We have been, obviously, so far away from any kind of reasonable goal that the problem of setting up that goal was not an immediate problem.

Senator MILLER. Do you have any recommendations on what that goal should be?

Mr. LEDERER. No, I think this requires rather careful study, and I don't think it should be determined in a quick and haphazard way.

Senator MILLER. I certainly agree with you, but it seems to me that we do have a problem of defining the goal.

Mr. LEDERER. That is correct.

Senator MILLER. And until we define the goal, it is going to be rather difficult to come to a conclusion on the means of obtaining that goal.

I think you have done a masterful job of pointing out the need for reliability, but that reliability still is going to have to be measured against some goal. Until we know what that goal is, I think it will be very difficult for us to define the means to attain it.

Mr. LEDERER. Yes; the goal depends obviously on some estimate of the rise in world transactions, as Mr. Chrittenden has mentioned before. It depends upon the need for dollars to finance these transactions, to what extent, for instance, other currencies are available or used, say within the Common Market area, within the sterling area.

It depends on some estimate of accommodations which countries have through borrowing from the IMF, and from other sources, so there are many variables involved and I could not at the moment say quickly what a reasonable target would be.

The other problem is, of course, that some people may very well feel different about that at the moment. The dollar supply abroad is higher than what we would like to see, and so, for a time, it may well be appropriate to have a goal in our own balance of payments policy, which is somewhat lower than the longer goal would be.

Senator MILLER. I would like to just ask one last question and ask for brief replies from each of you witnesses.

The point has been made that we should develop some measurement as to determining whether things are better or worse. In the concept of what is better or worse, how important is it that we take into account the outflow of gold problem? In other words, I detect that certainly the first and last witnesses are not concerned about a zero balance.

Suppose we had a zero balance, would we have an outflow or could we have an outflow of gold problem?

If we could, it might be that the zero balance with an outflow of gold problem would not be as good for the national interest as a very favorable—I mean, as an unfavorable balance of payments situation with no outflow of gold problem.

Would each of the witnesses care to comment on that?

Mr. CHITTENDEN. Would you like me to start, Senator Miller?

Senator MILLER. Yes.

Mr. CHITTENDEN. I think it is a good question and a difficult one to answer like most good questions.

It seems to me it is altogether possible that this current year or for at least a good part of this current year, we could have, as our balance is now measured, equilibrium accompanied by continued and sizable gold losses, which in effect would be the meeting by this country of perhaps overdue, obligations that have been accumulated through previous years.

It is hard to say how such an occurrence would be interpreted, whether it would be interpreted as a sign that we were doing better or worse. But, in fact, gold losses affect public opinion and attitudes, even as a reading of a different situation which gave us a worse looking appearance, might do.

The loss or gain in our gold stocks obviously has an effect on market opinion. Its treatment statistically must be realistic. The facts are there.

Senator PROXMIRE. Mr. Lary?

Mr. LARY. I think this question points toward the awkward choice which seems to be looming up in our international financial policy. It is implicit in the question that we may need to achieve enough of a surplus to at least stop the gold losses, if not to reverse them.

The dilemma, as I see it, is that we may, through the corrective measures that have been taken, run the risk of putting more pressure on countries in a relatively weak position, which includes most countries outside the Common Market, than would be consistent with their economic welfare or with our own. We don't want to cause the stagnation or a depression that would go against our own exports and have other adverse repercussions.

On the other hand, the risk is that we may not go far enough to satisfy some of our most severe critics and, more to the point, our creditors in European central banks. It is difficult to maneuver in these circumstances.

I think that this question also has a geographic focus. In this dilemma we would do well to study the possibilities of bringing corrective measures to bear with maximum effect on the surplus countries. A dollar saved there is worth much more to the balance of payments than a dollar saved in any other part of the world.

I might add this; That even this possibility may require a certain amount of patience as against strong and hasty action, because the development in France, in particular, seems to me to bear watching. I would say that as of a year or more ago, France opted, putting it crudely, for a strong currency as against a strong economy. I don't think this is a choice she can live with very long. A new expansion in France will do a great deal to relieve pressures that we have been feeling against us.

Mr. LEDERER. I think Senator Miller has asked whether, whatever we set up as a reasonable target of a balance, whether this could be maintained if it would involve a sizable outflow of gold. Is that the interpretation?

Senator MILLER. You could so interpret my question, I think.

Mr. LEDERER. I think the answer to that is "No." And I did indicate in my paper that we could sustain for some time a rise in liabilities of some magnitude, but not a decline in gold.

Senator MILLER. I was going to come back to you and ask you how much that sum is.

Mr. LEDERER. That is the problem that I mentioned before, and that I don't want to solve it just in a quick manner. Probably several hundred million dollars, maybe somewhere between half a billion and a billion.

But, mind you, this is not a considered judgment. This is now a mere guess and a considered estimate would require a good deal more study. Even then, however, I would like to emphasize again, that this may be acceptable as long as there is no supplementary monetary assets that would supplement the use of the dollar.

I think even, if we would have rising liabilities, say of a billion dollars a year, with steady gold holdings and that would go on for 10 years, that would certainly increase our vulnerability and it may not be a desirable development.

So, the longrun solution would probably be to get some kind of a supplementary monetary asset in the world and there have been many proposals, including many that have been discussed here, and so what I am talking about here is more or less an interim solution as of this moment.

Senator MILLER. Thank you. I thank the chairman very much.

Senator PROXMIRE. Incidentally, it is my recollection that Mr. Bernstein predicted that when we bring our balance into equilibrium, we will suffer a substantial loss of gold and we should achieve the balance very rapidly for that reason. We will suffer the loss because some countries will feel we no longer need their assistance and they won't have to exercise as much restraint as in the past. Some of us got the fleeting impression that maybe we ought not to move to equilibrium, because we will lose a lot of gold if we do. Of course, Mr. Bernstein quickly disabused us of this.

I would first like to ask if it is true, that there is not a single, final, precise answer here. You can't come up with one figure and have it give you an answer that means anything without substantial, sophisticated, discriminating analysis.

Mr. LEDERER. Right.

Senator PROXMIRE. Would you all agree with that?

Mr. CHITTENDEN. Yes.

Senator PROXMIRE. I think your testimony certainly implies that and I think it is a great contribution to us here.

I would like to ask Mr. Chittenden to take first this question.

We explored with the Review Committee the possibility of reporting the balance of payments data without defining a deficit or surplus and reserving an analytical discussion and presentation for separate tables. In response to our question the Review Committee stated that a neutral position would be impractical.

They said:

> The Committee considered this idea, but found it impractical. It is impossible to tabulate international transactions without choosing some method of classifying them and some sequence in which to list them. These choices unavoidably involve analytical judgments, even if every effort is made to hold these to a minimum. For example, almost everyone would put U.S. gold transactions near the bottom of the table, treating them as somehow the result of other transactions.

Now, in your article—we understand you disclaimed authorship, unlike most Senators. We almost always insist on getting credit for

what our assistants do for us. Your "Morgan Guaranty Survey" said:

It is possible to take a completely "neutral" view of these transactions, making no distinction whatever among the impacts that various kinds of transaction within each category have on the country's position.

It seems, therefore, that you do not agree with the Review Committee. Would you like to elaborate on this?

Mr. CHITTENDEN. I think that the statement is simply that "it is possible to"—I don't believe——

Senator PROXMIRE. You don't necessarily recommend this?

Mr. CHITTENDEN. I don't believe that is the intention of that statement. You can be wholly "neutral," but my personal feeling is that that does not serve the public interest in the best possible way.

That implies either an unwillingness or an inability to assess the relative importance of various elements of the tabulation, which I think is——

Senator PROXMIRE. I understand that would be left to a later place.

Mr. CHITTENDEN. A later place——

Senator PROXMIRE (continuing). Later place in the tables; is that right?

Mr. CHITTENDEN. But it is a matter of publishing findings of——

Senator PROXMIRE. One would be neutral just setting forth the fact—separate tables. But you feel the Department of Commerce should come to a conclusion specifying what in the best judgment of the Department of Commerce the surplus or deficit is in the balance of payments.

Otherwise, don't you have a chaotic situation rather than an authoritative official position, even if it might not be the best?

Mr. CHITTENDEN. Well, I think the average man, who is looking for guidance, would be troubled if presented with nothing more than tabulations of statistics without interpretation. He does not have the time himself to make a sophisticated analysis. He looks to the professionals for assistance in that, so that he can use this information intelligently in his own decisionmaking.

I think that the mere tabulation of the numbers without interpretation falls far short of the public need.

Senator PROXMIRE. Let me move on then to something else.

What is wrong with having both the "official settlements" and the present system which would include foreign private dollar holdings? This, as a matter of fact, was the Review Committee's position as a starter.

They went into the "official settlements," but they agreed to wait a few years.

Mr. CHITTENDEN. For a while, perhaps, the two exercises could be carried out beneficially. I think the answer to that comes down to an opinion of whether in fact the "official settlements" approach ultimately provides a better measure.

I think throughout the "Morgan Guaranty Survey" article and in the remarks I have made this morning, it is clear that in our opinion, and in my opinion, that the "official settlements" is not as good as the present method, which happily can be further refined and improved, so I would say——

Senator PROXMIRE. The "official settlements" does have certain advantages and certain disadvantages. For one thing, it has the support of the Bernstein Committee which was an eminent committee of economists competent in the area. It also has the advantage of symmetry; that is, if all countries were included, you would have an aggregate of zero with the net increase in gold production as a plus.

I recognize that the approach that is now used has distinct advantages, too. You think you will ultimately have to make a choice and a choice ought to be made, and you would come down on the side of the present system.

Mr. CHITTENDEN. That is correct. Incidentally, I do not see the merit of symmetry just for symmetry's sake. Even if it could be obtained, which is a difficult thing to do in human and financial affairs, has it any particular value per se?

I feel that the objective of a zero reading in the presently recorded balance of payments is not of paramount importance.

Senator PROXMIRE. I would agree it is not of paramount importance, it is a convenient benchmark, however, to inform people. But when we read the balance of payments as a surplus or a deficit, almost all nonexperts assume the symmetrical and zero basis. We are misled unless we have this deeper understanding which you have expressed this morning.

You all understand it.

Mr. CHITTENDEN. It would be wonderful if we could arrive at a universally acceptable measurement of the figure for our international payments position.

These hearings attest to the very difficulty of realizing such a desirable position or situation.

Senator PROXMIRE. Let me read to you what Mr. Bernstein said when he appeared before us and I asked him about it—I would like to get Mr. Lary's and Mr. Lederer's reactions to this:

> * * * I think those who support the present definition should be asked to estimate the average deficit that could be sustained over a long period without causing serious payments difficulties.
>
> Another advantage of the Review Committee's definition is that it would be symmetrical if used by all countries. If every country used the deficit as the official settlements definition, the sum of the deficits and surpluses of all countries would be zero, except for the addition of gold to monetary reserves.

Now the question, of course, refers to the first statement. Those who support the present definition should be asked to estimate the average deficits that could be sustained over a long period without causing serious payments difficulties.

Mr. CHITTENDEN. The figures cited in my comments are inexact, difficult-to-defend figures.

But based on an increase in world trade, I personally feel that a deficit as presently tabulated on the order of $500 million to $1 billion would be sustainable.

Senator PROXMIRE. Mr. Lary——

Mr. CHITTENDEN. This is not ad infinitum. Conditions sometimes change, and expansion lets down or increases.

Senator PROXMIRE. Mr. Lary?

Mr. LARY. Mr. Chairman, your question, I think, points to a possibly desirable solution to this dilemma. I would see no good reason not to regard the large table which spreads across two pages or more

in the Survey of Current Business as primarily a basic data table without attempting to add it up to a deficit of one kind or other, and to accompany that with a more analytical table which could show the deficit on more than one definition. And, as you may suppose, I would rather favor including the basic transaction type of computation there, too. I think we may be trying to go too far in catering to the kind of demand that was attributed in the Bernstein committee report to a journalist who wanted one figure and one only—with no if's, but's, or maybe's. I don't quite see that that is a reasonable type of demand to be catered to. If the problem is complicated, we are probably doing a better public service if we recognize that it is.

It is like trying to reduce the complexities in Vietnam to a slogan to try to tie the whole balance of payments up into a single deficit.

This would put an extra burden, I think, on Mr. Lederer. He would be obliged to have more figures. It might require a different kind of publication, something supplementary to your Survey of Current Business.

I would think the people to be served are mainly the banks and companies that are active internationally, and perhaps these people should be given a more sophisticated type of analysis than would serve the needs of the journalist.

Mr. LEDERER. On the question of the presentation—and again I am just speaking for myself—I am quite in favor of separating out the tables which provide the data from those which provide the analysis. In other words, I do think that that can be done; not only the basic data, but perhaps, also those data after seasonable adjustments.

The analysis, as I said, and the Bernstein people said, in reality is a matter of judgment, and that whatever figure we present, that, too, is a matter of judgment, and that should be made clear. This is an interpretation by somebody, and somebody else could very well have a different interpretation, and that should be separated and clearly stated. Here are the figures and here is some person's interpretation of these figures and these interpretations, of course, can be expressed in figures, if you have to.

Senator PROXMIRE. Why not add to that an entire interpretive article each quarter, separate from the strictly factual report of the tables?

Mr. LEDERER. As far as I am concerned, that would be fine.

Senator PROXMIRE. Do you want to comment on the second part of it?

Mr. LEDERER. The second question is: How much? That was the Bernstein question: How much of it can be sustained?

Senator PROXMIRE. I think you probably answered that in your testimony.

Mr. LEDERER. I did, to some extent. In the first place, I want to say that Mr. Bernstein somehow or other escaped that question, because he said that his balance could, or would have to add up to zero, and that that kind of a zero balance could then be sustained over the long run.

That is entirely true. That can be sustained from our point of view, that is, from the position of this country; but it is not the sort of thing that can be sustained from the point of view of the rest of the world. And you might say equally well, from our point of view, the

zero balance in the private accounts could also be sustained. What we are worried about is that as long as the dollar is an international currency we do probably need some rise in foreign dollar holdings, and that applies to official as well as private holdings. So, if you talk about an amount by which——

Senator PROXMIRE. Let me just interrupt at that point and say that Bernstein has a little bit the better of the argument at this point, inasmuch as the tendency of the present definition is more conservative and, therefore, would provide for a zero balance when we have, in effect, a favorable balance of payments, and would for this reason be inclined to have a more adverse effect on the holdings of dollars abroad. Is that correct?

Mr. LEDERER. I think it applies to both concepts.

Senator PROXMIRE. It applies to both? It applies a little more strongly against yours. However, I will ask Mr. Lary to help me out on this.

Mr. LARY. I think there is an important qualification to what Mr. Lederer is saying, and again the famous question of symmetry arises. It would be possible for us to have a rise in our dollar liabilities to foreign monetary authorities, and at the same time have an offsetting rise in our official claims in foreign currencies in other countries in a strong position. This seems to me, pending a better solution of the world's monetary problems, a more desirable way in which to move. So, if we had a rise of 100 in our official liabilities and a rise of 100 in our official assets, you would have increased reserves on both sides, and as far as this item goes, would have a balance. Again I say, symmetry here and symmetry in the private balances, and you would be all right.

Senator PROXMIRE. Mr. Lederer?

Mr. LEDERER. This idea of symmetry, in the first place, is statistically not possible on the basis of the way the Bernstein Committee recommends the figures to be collected. Obviously, if a foreign official agency has a dollar balance in a foreign private bank, there is no way we can show that to be symmetrical, and neither would the foreign country.

In other words, if a Swiss bank gets dollar balances from some country, say Spain, and deposits these balances here in the United States, there is absolutely no reason in the world why Switzerland should consider that as being a deficit for itself. This is a perfectly sustainable situation. In fact, the Swiss are making a little bit of money on the way. As long as the Swiss banks can be held—and they are being held—to maintain dollar balances here or elsewhere in the same amount and in the same degree of liquidity as their dollar obligations, this is perfectly all right for Switzerland.

Senator PROXMIRE. Let me just zero in on what is really the crux of this thing, and again quote from Mr. Bernstein's testimony about our concern with the claims of foreign commerce banks and other foreign private claims. He says this:

> I think the argument that these dollars can get into the hands of the monetary authorities is certainly hypothetically true. It simply does not conform to the behavior of the last 20 years. As I have said in my statement, from 1945 to 1964 there were only 2 years in which private holdings of dollars declined. This includes periods of the greatest stress for these foreign countries, when they were desperate for dollars, when they had complete exchange control. It includes periods when there were great doubts about the strength of the dollar. Never-

theless, except in 1948 and 1960, when private holdings of dollars went down by $26 and $65 million, they actually rose in every single year.

By contrast, Senator, there are other holdings of assets in the United States by foreigners which are much more volatile, and when foreigners, for example, sell their common stocks, the dollars get into the hands of their monetary authorities, unless they are acquired, perhaps, by banks or some other private holder. Well, net sales of U.S. stocks by foreigners were $350 million in 1964. There are a half a dozen years in which there were net sales of such securities, so if we are looking for assets which are volatile, which may be sold by foreigners, and which will provide dollar proceeds that get into the hands of the monetary authorities, here are foreign assets that are much more likely to result in dollars getting into the hands of the monetary authorities. Nevertheless, such transactions are put in the capital account of the balance of payments.

And I think all of you would agree they should be in the capital account and should not be here.

How do you answer the Bernstein argument that the private claims that you are including now in your present definition are not volatile and do not represent, on the basis of experience, the most serious threat against our gold, or represent an element that really should be included on the basis of experience?

Mr. LEDERER. In the first place, if you compare the privately held liquid dollar funds with those held by foreign official organizations, you will find that the dollar funds held by foreign official organizations have not declined either. They have risen continually over the postwar period, and what is more, they have risen much more steadily than the privately held liquid dollar assets.

So, the question is not so much whether private funds are volatile, as against other transactions or stockholdings or something like that. The fact is that official dollar funds have also risen very steadily, and the question is why are we concerned about these things at all? Why aren't we merely looking at our gold reserves and stop worrying about liabilities? And it isn't as to whether liabilities are official or private. In fact, we could worry less about official liabilities.

Senator PROXMIRE. No. 1: We agree the official claims have to be seriously considered. Nobody says they should be disregarded; that's quite true.

Mr. LEDERER. That's true.

Senator PROXMIRE. As far as practice in other countries on the other hand—am I right or not—the practice in other countries is not to include, as we do, private claims of foreign banks and others in determining their settlements balance.

Mr. LEDERER. I should say that the countries that we should be talking about are the ones which have extensive international banking operations, and these are the only ones.

Senator PROXMIRE. Yes.

Mr. LEDERER. Those countries which have such banking operations generally net out all or certain of their assets against their liabilities, but they do not distinguish between liabilities to foreign private organizations and liabilities to foreign official organizations. No country that I know of does that. They can net out their assets against their liabilities because their assets essentially are of the same type as their liabilities, and the foreign monetary organizations force these banks by persuasion or otherwise, but force them quite effectively, to hold a balanced position.

In other words, if Swiss banks have dollar liabilities, the Swiss National Bank would see to it that they have equivalent dollar

assets in the same magnitude and in the same liquidity; and if there is a withdrawal of these dollar deposits by other countries, which they hold in Switzerland, then the Swiss banks are more or less forced to liquidate their own dollar assets so that the dollar liabilities of the Swiss banks are not a potential drain on the Swiss National Bank. The Swiss National Bank has seen to that, and if I am wrong, Mr. Chittenden can correct me here.

What we have in this country is an entirely different situation. Our banks have very few foreign assets which are similar in nature to their liabilities. Our liabilities, I should say, are almost exclusively deposits and liquid investments in the money market. We do have some foreign assets of that type. But what our banks are holding is very, very small.

Our banks, as far as I know, hold abroad in cash assets something in the order of a quarter of a billion dollars. Our liabilities—and these are cash liabilities—are $25 billion. That is the difference.

Senator PROXMIRE. Give me those statistics again.

Mr. LEDERER. Our banks hold in cash assets abroad something of of the order of a quarter of a billion dollars, as far as I know.

Mr. CHITTENDEN. For their own account, that's right.

Mr. LEDERER. Our liabilities are $25 billion. That means that our banks in effect do not hold cash reserves against foreign liabilities, cash reserves which are foreign assets.

They hold against their foreign liabilities the same kind of domestic cash reserves that they hold against their domestic liabilities, and that means in turn that any claim on our liabilities by foreigners must be met ultimately by the official reserves which this country is holding, since the banks of their own do not have the equivalent type of cash reserves.

This is a situation which is quite different from what we have elsewhere; and if we had the same kind of situation that say, either the Swiss or the British, or whoever it is, has, I think we would do precisely the same thing they are doing. We have no conceptual disagreement with them on that point, but I think the Bernstein committee does have a conceptual disagreement because the Swiss would never show a dollar liability to a foreign official organization as a deficit for Switzerland, and I don't see any reason in the world why they should, as long as they keep equivalent dollar assets.

Senator PROXMIRE. It is my understanding that, from 1950 to March of 1965, U.S. short-term banking liabilities to private foreigners, rose $7.3 billion, while U.S. short-term claims on private foreigners rose $6.2 billion. The $7.3 billion contributed to our deficit or liability balance. The $6.2 billion was not offset against it. This is certainly hard for a layman to understand, or even just a plain, ordinary, everyday banker who is not involved in international transactions.

In other words, we count the claims against us. We don't count our claims against them. And may I just interrupt at this point to ask Mr. Chittenden, why he goes along with that?

Mr. CHITTENDEN. I don't believe that you'll find on the record that I do.

Senator PROXMIRE. You think we should count our claims?

Mr. CHITTENDEN. On a selective basis, Senator Proxmire, and I have suggested some areas of selection in my paper, this morning, and on previous occasions, and I think, Mr. Lederer——

Senator PROXMIRE. We would count the claims by foreigners against us, without the selection or discrimination? We would count our claims against them on a discriminating and select basis?

Mr. CHITTENDEN. Again, I think we must because I am persuaded the United States and its currency are unique in the overall picture. We are in a different position from the Swiss and all other countries, with the exception, of course, of Britain. What has seemed strange to me—and I am just expressing the puzzlement that you yourself expressed—is that the more business this country does in carrying out its role in international finance, in the role of international financier for the world, the worse our balance of payments looks because our claims, which are counted as debits, go up. As the countervailing liabilities, which are below-the-line financing items, go up, we wind up with a set of figures such as Mr. Lederer mentions, $25 billion of liabilities against a hard core of realizable counterclaims of $250 million which we don't even use as offsets.

Senator PROXMIRE. This is great to hear you say this because I never thought I would live to see the day when the administration, under the new Great Society was more conservative than the House of Morgan. Here we have the Morgan Guaranty, the pinnacle of conservatism and success and soundness in the American financial community, expressing a more liberal position than the Department of Commerce in this particular area.

Mr. CHITTENDEN. I believe that is a statement of the facts as I have related them, and a reflection, at least, of my feelings on the subject.

Senator PROXMIRE. Mr. Lary, do you want to comment? Then we will get back to Mr. Lederer. Mr. Lary wanted to comment on this point.

Mr. LARY. Mr. Chairman, I am worried about the line of argument just expressed by my colleagues on the panel. In its ultimate logic, it would seen to be saying the United States should cease to be an international center. I think that would be a very serious loss. Where else in the world can banks and businesses keep liquid funds with equal assurance?

Senator PROXMIRE. I'm sure that would be the farthest thing from the mind of Mr. Chittenden or Mr. Lederer.

Mr. LARY. I'm sure it would be. I think there is an inconsistency in what we are saying in addressing ourselves to the statistical problem, and what we are really thinking about the position of the United States. There are good reasons why foreign assets here should appear to be liquid even though, in the mass, they would be less liquid than when one considers the criteria applicable to this or that particular consideration.

Certainly, gold is a costly thing to hold, even though some prefer it. For those who want to keep their funds active internationally, where can they go? Do they want to hold them in France or Germany, who have strong positions for the moment, but have had great political and monetary turmoil. I think we have to recognize that the position of the United States is unique in this regard.

May I supplement that by saying that I think there is an unduly restrictive concept of liquidity in offsetting $25 billion of liabilities against $250 million of assets. It is perhaps true that, if you wanted to liquidate overnight, $250 million might be the most

instantaneously available. But if you are thinking of problems and policies that allow more time and a more careful approach, there are a lot more items that would come in, including claims expressed in dollars as well as those in foreign currencies.

Senator PROXMIRE. Yes. But first, Mr. Chittenden said it should be selective. Secondly, it seemed he said equal things should be offset against each other. It seems most logical that we should count the foreign claims that our banks have which are at least of equal strength and validity, and so forth, thereby getting a net that makes the best sense we can make out of the situation.

Mr. LARY. I don't think we should be too limited in the definition of liquidity we attribute to these items.

Senator PROXMIRE. I see. Mr. Lederer, I think we have taken the ball away from you, and it is your ball.

Mr. LEDERER. If we really look at the claims that American banks have, we will find that the great bulk are loans. They are not cash assets. They are not at all the same things as our liabilities. They are loans.

And, now, just as a general proposition, if you look at a bank statement in itself, you would, of course, compare the deposit liabilities of the bank against its cash assets and not against its total assets, because total assets and total liabilities always have to be the same. You have to make a certain selection.

What is it that you want to watch in a bank itself? A bank would extend loans, yes, if they have the reserves to do so, and in extending loans, they will increase their deposits. There is a certain ratio that a bank would want to watch, and Mr. Chittenden, I am sure, would agree that his superiors at the top level of the bank are watching that kind of a ratio.

Now, what we are doing is, really, not so very much different. Our banks have loans abroad, but they have very little in the way of cash assets. And what is more, these loans are not to the kind of countries where you can recall these loans. The major part of these loans are very much frozen in.

Just to give you here a few figures for the end of last year: Our banks had assets outstanding abroad—these are so-called short-term assets—of $7.4 billion. Out of the $7.4 billion, Japan accounted for $2.6 billion; Latin America accounted for $2 billion, and other underdeveloped countries for over $1 billion, so that the total of all countries where you would not have much chance to pull back all the funds added up to over $5.8 billion out of the $7.4 billion. In other words, these are, for all practical purposes, for the country as a whole but not necessarily for each individual bank, rather long-term loans.

Senator PROXMIRE. Would it be possible to make any selective analysis of this? I'm sure some of the loans which have gone to Japan, for instance, which I would not consider by any means an underdeveloped country, but probably is the best developed country in Asia, more fully developed than most countries in Europe.

Mr. LEDERER. Right; but you couldn't pull the money back.

Senator PROXMIRE. Are you telling us you can't pull any of those loans back from Japan?

Mr. LEDERER. I would probably say, on balance, relatively little without causing problems over there which, for political reasons——

Senator PROXMIRE. These are short-term loans. Are you telling us these loans are being made to underdeveloped countries with the notion we are not going to be able to liquidate them ever?

Mr. LEDERER. "Ever" is a long time.

Senator PROXMIRE. Liquidate them period.

Mr. LEDERER. These are loans that are continuously renewed. They are made with the understanding that they will be renewed, and these are loans which would be very, very difficult to liquidate, and particularly to liquidate at the time when our monetary authority needed the funds to support the dollar.

In other words——

Senator PROXMIRE. This is the strongest argument I have heard in a long time against the foreign-aid program. If the bankers are giving their money away, why should the Government do it?

Mr. LEDERER. I don't want to go into this, but the same situation——

Senator PROXMIRE. It is very difficult for me to believe that private commercial bankers would make short-term loans to banks in underdeveloped countries, or in other countries such as Japan, which cannot be liquidated. There may be a few exceptions.

Mr. LEDERER. Sure, but the individual bank may very well at times be able to liquidate something provided another banker supplies the funds or provided, as we have seen many times, that the U.S. Government is providing the funds.

Senator PROXMIRE. Aren't you saying that our banks' loans abroad are in the same practical status as those the foreigners make in this country, or claims foreigners have in this country, because these latter, in fact, are not and will not be liquidated en masse.

They haven't been in the past, as Mr. Bernstein said, despite the fact the dollar has been under attack at times and there have been profound stresses in the world.

We have had good experience with these loans by U.S. banks abroad. We have every reason to believe this favorable experience will continue in the future. Foreign banks with claims here are no less likely to liquidate their loans en masse than our banks with loans in Brazil, Argentina or Japan. I should say, based on my experience with such American international bankers as Mr. Chittenden and others, that their loans abroad are likely to be not only sound but liquid.

Mr. LEDERER. I would say that, too. This opens up the much broader question of why are we worried about our liabilities or any of these liabilities at all? Whether it is private organizations, because after all, official organizations too have increased their dollar holdings in this country and have done so much more steadily even than private organizations.

There have been more periods than Dr. Bernstein indicated where we had liquidations of foreign private funds, in the United States, but there were very, very few cases, as far as I know, where we have had extensive liquidations of official funds.

So why worry about liabilities at all? And my answer to that is, it is not because foreigners don't want to keep dollars here and it is not because their holdings of dollars in any way indicates a weakness of the dollar.

On the contrary, it is an indication of strength, and it is strength even if official organizations hold their dollars here. In other words,

you can't say it is a weakness if the Canadians or the Japanese or the Germans hold their dollars here; it is not at all.

The problem is whether this increase in these liabilities is the sort of thing that you can expect to continue. Is that the kind of thing which is sustainable over the long run, and if it is not sustainable, if in effect we cannot expect that foreigners would add to their dollar holdings—say $2 or $3 billion a year—then the question is whether we do not have to change our transactions so that there would not be such an increase, and the next question is when?

Should it be done earlier or should it be done later? Now if it has to be done at some time, maybe not down to zero, as I said before, but to a somewhat higher point, it certainly would be in our interest to do it earlier rather than later, because what these liabilities mean is either one of two things: We can induce foreigners to hold more dollars by paying them higher interest rates, and the more they have. the higher the interest rates would have to go.

The other thing is that certainly the more liabilities we have and the more dollar assets they have, the more I think our freedom of action is being curtailed. You have to look at the British experience and the experiences of other countries. It is simply that if we have to recognize that foreigners can—even if they don't do it now—convert some of their dollar holdings into gold, and if we like to have gold, if we care about that, then that means that our freedom to pursue the kind of policies which we like to pursue is reduced because what we can do will be determined to a certain extent by what foreign dollar holders like us to do or don't like us to do.

And it is this concern, essentially, that we lose in the long run our freedom of action, freedom of policy, that we are affected by conditions over which very often we have no control, that this is the position that should be prevented and prevented earlier rather than later.

It is not that this is a certain point beyond which we cannot go; it is the gradual sliding into that condition.

When the British Government was elected in October of last year, it had promised all sorts of welfare and other programs. Whether we like these programs or not is not the issue. The issue is that there were large sterling liabilities and it was precisely the private foreign holders of these sterling balances who attempted to sell these sterling assets, and, in effect, threatened the monetary system of Britain.

The result of that was that many of the policies that the British Government wanted to undertake had to be abandoned, reluctantly perhaps, but abandoned nevertheless. It had to raise the interest rate to 7 percent. It had to curtail consumer expenditures.

The problem, to me, is whether that is the kind of situation that we want to go into—gradually go into. Or should anybody in my position, at least, say, "Well, if you go into it you have to make the decision, but as far as my function is concerned I should let you know what you are doing."

Senator Proxmire. Let me say that I think everybody who has testified—that the members of the Bernstein Committee—would agree we want to improve our balance of payments situation. Dr. Bernstein made no qualifications about that. He stressed the seriousness of our balance of payments deficit very, very vigorously. We agreed we should act just as promptly and vigorously as possible to improve

our balance of payments situation, and many of us in Congress feel it is the most serious economic problem we have today.

But it is a matter of having statistics as reliable and accurate and responsive to the actual facts as we can get them, so we know precisely what we are doing and we aren't deceived either way by them.

The hour is getting late. I have just a couple of questions which can perhaps be answered briefly. I would like to ask Mr. Chittenden this. Mr. Chittenden, one of the most serious controversies between the members of this committee and the members of the Federal Reserve Board and some of the people in the banking fraternity has been over high interest rates.

We have been told we should have higher interest rates to attract foreign short-term loans, but under the liquidity concept, an inflow of funds induced by higher interest rates would not improve our balance of payments. Does this make sense?

Mr. CHITTENDEN. I don't think it does. And this is why I have pleaded in the past, and here now, in the statement submitted this morning, further urged that there be developed a more refined means of measurement; one that more truly reflects money market realities, one that provides a better assessment of the relative hotness of the tabulated total claims on this country by foreigners.

It is true that higher interest rates here, if sufficiently high to be competitive with interest rates abroad, will induce an acquisition of short-term dollar assets by foreigners. Of course, to the extent that dollars are taken from official holdings and transferred to private holdings, the overall statistics do not change. But do we not, because of the magnetic attraction of interest rates, have a firmer hold on those investments which outsiders place with us for such reasons than we do with respect to funds placed with us without regard to interest rate considerations?

There is no rating of the temperature of this 25-odd billion dollars of claims. This is what I would like to see developed.

I think at times we give the appearance of defeating our purposes when we successfully attract foreign funds to these shores. We come up with a measurement of the international cash inflow which puts the dollar in the worst light, and this does not make sense to me.

Senator PROXMIRE. Do you other two gentlemen agree with that in general?

Mr. LARY. I think so.

Mr. CHITTENDEN. I don't think you can disregard all the claims by any means, because of the fact, as I mentioned, that there are times, perhaps because of interest rate factors, when money does flow out of this country at a rate high enough to foreshadow an increased threat to our gold supply.

As mentioned, I think we are now suffering gold losses that reflect the deficits we have experienced in the last couple of years, most particularly in late 1964.

Senator PROXMIRE. Let me just ask one final question.

This is directed primarily to Mr. Lederer. You other gentlemen are invited to comment if you wish to do so.

In view of the competence of the Bernstein Review Committee and the thoroughness of their study, and it took, I understand, 2 years—how can you account for their precise statement of officially held dollars, when you flatly contradict the accuracy of this statement by

saying "about $3 billion, which our sources report as privately held are really officially owned?"

This is one of the most startling relevations you have given us this morning and it really brings to us very serious questions on the Bernstein report and the confidence that this committee could have in it.

If you say that $3 billion of this is really officially owned instead of privately owned, I think that is a pretty strong indictment of the official transactions definition.

Mr. LEDERER. It is not only——

Senator PROXMIRE. On the other hand, it seems to me it indicts some very competent, able, honest economists whom I am sure you have faith in and regard——

Mr. LEDERER. The thing is that what the figures that I presented meant is, that as far as I can estimate, and there may be some flaws in those figures too, foreign official organizations hold about $3 billion more than what our statistics show. But that is not the whole story either.

Foreign official organizations control many more billions than even that. For instance, of our liabilities to foreign private banks, which are a little over $7 billion—of that amount, well over $1 billion is held by the Japanese banks.

Now, everybody, I think, knows that the Japanese official authorities have a very strong control over the dollar holdings of their private banks, and what is more, included in that billion dollars held by Japanese banks are, in fact, official balances, which are held in branches of American banks in Japan or in Japanese banks.

This may be several hundred million, I don't know the precise amounts.

Then we have—and this is not included in the figures which I have quoted before—the forward operations which have been mentioned before. These place in the private banks, in effect, hundreds of millions—sometimes more, sometimes less—which are effectively controlled by official organizations. So that I would say that of the total of what we show to be liabilities to foreign private organization, probably more than half are either directly owned by or under the direct control of foreign official organizations.

That is roughly the situation, as I see it. Even if one would agree with the Bernstein Committee concept in principle—and I don't think I quite do—but even if I would, the statistics which we have from our side make it absolutely impossible to measure that principle.

Senator PROXMIRE. You think there is such a variation that you not only would get an overall misunderstanding at any given time, but that the trend could be distorted, and would be likely to be distorted quite a bit?

Mr. LEDERER. Yes, very much so.

Senator PROXMIRE. Occasionally you might even get a picture of an improving situation that might be deteriorating and vice versa.

Mr. LEDERER. Yes, very much so.

Senator PROXMIRE. You think that it is really possible?

Mr. LEDERER. Yes. I mean the dollars placed by official organizations in foreign private banks and these forward operations Mr. Chittenden has mentioned; and you may hear more about those perhaps from other witnesses tomorrow.

Senator PROXMIRE. I think this is a sufficiently serious indictment that the committee should request Mr. Bernstein to give us his advice on it and we will do so.

(Senator Proxmire's letter to Dr. Bernstein and the subsequent reply and comments follow:)

JUNE 10, 1965.

Dr. EDWARD M. BERNSTEIN,
President, EMB (Ltd.), Research Economists, Washington, D.C.

DEAR DR. BERNSTEIN: During our hearings on June 8 and 9 on the report of the Review Committee on Balance of Payments Statistics, several criticisms were leveled at the "official settlements" concept which raise serious questions concerning the validity and applicability of that concept. I should like very much to have your comments on the following two points.

(1) The Statistics Subcommittee received testimony that foreign data show dollar holdings of foreign monetary authorities to be $2.9 billion larger at the end of 1964 than is shown in U.S. statistics. We were advised that large amounts of official dollar assets are deposited in foreign branches of U.S. banks or in foreign banks, and that such deposits are reported by U.S. banks as liabilities to private banks. Walther Lederer testified that "The fact that a major part of foreign official dollar holdings is not reflected in U.S. banking statistics on liabilities makes it practically impossible to provide a statistical measure from U.S. sources for the concept recommended by the Committee."

(2) The Subcommittee received testimony that the official settlements concept inadequately measures pressures in the foreign exchange market because it fails to indicate the consequences of forward support transactions. In your testimony before the Subcommittee on May 11, you stated that "* * * the sums involved have never been very large," that $250 million was the largest in any single quarter, and that forward transactions "get reversed after a couple of months." The Review Committee's report stated, "It does not appear that official intervention has accounted in more than a few quarters in recent years for a substantial proportion of the change in foreign commercial bank claims on the United States."

However, Mr. Peter Fousek of the Federal Reserve Bank of New York testified as follows:

"The German Federal Bank and the Bank of Italy have carried out the largest operations of this nature in order to affect domestic liquidity. The German central bank has done so in every year since 1958. In both 1961 and 1962 its dollar placements with German commercial banks, in the form of preferential swap transactions, reached $1 billion. There have been about a dozen quarter-to-quarter changes when these German operations affected the official settlements concept by $200 million or more, including several when the impact was $2 billion or more on an annual rate basis; and very few such periods when there was no effect. The Bank of Italy's placements of dollars with Italian commercial banks through swaps and deposits likewise reached $1 billion. The quarterly swings in the volume of its outstanding placements have not been as pronounced, but they have exceeded $200 million on several occasions, at one time reaching as high as $400 million.

"Official U.S. forward exchange operations have never reached such high outstanding totals. But the impact on quarter-to-quarter changes in the official settlements balance has been large and has exceeded $250 million four times since early 1961 when these operations were first undertaken, and at one time the impact was almost $400 million."

The subcommittee will be very interested in your comments. To enable us to print the record promptly could we have your reply by June 18?

We greatly appreciate the valuable work you and your committee members have done in this difficult field, and are grateful to you, in particular, for the excellent testimony you presented to the subcommittee.

Sincerely yours,

SUBCOMMITTEE ON ECONOMIC STATISTICS,
WILLIAM PROXMIRE, *Chairman.*

E M B (LTD.),
June 21, 1965.

Senator WILLIAM PROXMIRE,
Committee on Banking and Currency,
U.S. Senate, Washington, D.C.

DEAR SENATOR PROXMIRE: I enclose comments on the two points raised in your letter to me of June 10. These comments were drafted by Mr. John E. Reynolds who served as Staff Director for the Review Committee. I am in broad agreement with what he has written and believe that it represents the viewpoint of the committee.

Sincerely yours,

EDWARD M. BERNSTEIN.

COMMENTS ON TWO POINTS RAISED BY SENATOR PROXMIRE IN HIS LETTER TO MR. BERNSTEIN OF JUNE 10, 1965

(Drafted by J. E. Reynolds, Staff Director for the Review Committee)

(1) The Statistics Subcommittee received testimony that foreign data show dollar holdings of foreign monetary authorities to be $2.9 billion larger at the end of 1964 than is shown in U.S. statistics. We were advised that large amounts of official dollar assets are deposited in foreign branches of U.S. banks or in foreign banks, and that such deposits are reported by U.S. banks as liabilities to private banks. Walther Lederer testified that "The fact that a major part of foreign official dollar holdings is not reflected in U.S. banking statistics on liabilities makes it practically impossible to provide a statistical measure from U.S. sources for the concept recommended by the Committee."

This point was dealt with in the committee's report (pp. 117–118) and is discussed also in the answer, enclosed with these comments, to question 21 submitted by the Joint Economic Committee on May 13. Nevertheless, the stress laid upon it in the hearings of June 8 and 9 suggest the need for some further comment.

Use of the official settlements concept recommended by the Review Committee does not require, as Mr. Lederer suggested, that U.S. statistics should measure changes in "foreign official dollar holdings." It requires only that they measure "changes in all U.S. liabilities to foreign official monetary institutions" (p. 111 of the committee's report). The latter can be measured rather easily and accurately.

With the Review Committee proposed to measure differs from what Mr. Lederer understood it to wish to measure in two important respects. First, not all of the U.S. liabilities that the committee would treat as settlement items are denominated in dollars. Some are denominated in foreign currencies (e.g., most of the so-called Roosa bonds). The fact that these are foreign-currency liabilities, rather than dollar liabilities, does not alter the fact that they are liabilities of the United States. They are counted by the foreign official holder as reserve assets, and as claims on the United States, and Mr. Lederer himself treats changes in them as settlement items.

Secondly, some "foreign official dollar holdings" are not liabilities of the United States. In fact, the $2.9 billion referred to by Mr. Lederer is an estimate, not of foreign official dollar claims on the United States, but of foreign official claims on other foreigners. The fact that such claims do not appear in the U.S. statistics represents neither a defect in the statistics nor an obstacle to the use of the official settlements concept.

It is sometimes argued that the dollar-denominated claims of foreign monetary authorities on other foreigners should be added to their claims on the United States in order to arrive at a true measure of U.S. liabilities to foreign monetary authorities. But in fact, the two items are not additive. To a large extent, the dollars deposited by one foreign central bank with a commercial bank outside the United States are then lent and relent to other foreigners and end up either adding to some other central bank's claims on the United States or preventing a decline in such claims that would otherwise have occurred. Similarly, if a foreign central bank decides to withdraw dollars from a foreign commercial bank in order to place them directly in the United States, or to buy gold from this country, then the claims on the United States of some other central bank are likely to be reduced as a result.

It is true that a foreign commercial bank may sometimes attract dollar funds from a foreign central bank for the purpose of using them directly in the United States rather than for relending to other foreigners. But this is not the usual case.

It probably does not account for a large proportion of Mr. Lederer's $2.9 billion, and is certainly not "major" in relation to U.S. liabilities to foreign official holders of nearly $16 billion at the end of 1964. And even in this case, the foreign commercial bank involved should not be regarded as a purely passive intermediary to be netted out of the statistics. It will normally enter into a transaction of this kind only when the constellation of interest rates and lending opportunities make the transaction profitable.

(2) *Official intervention in forward exchange markets.*—The Review Committee had before it the published information on the forward exchange market operations of the U.S. monetary authorities and the German authorities. No doubt Mr. Fousek has somewhat fuller and more systematic information on a quarterly basis. Nevertheless, the facts he cites do not demonstrate that such official operations have dominated the changes in foreign commercial bank claims on the United States.

It should be noted, first of all, that the overall payments deficit fluctuates considerably from quarter to quarter, however it is measured. The average quarter-to-quarter change in the seasonally adjusted "balance settled by official transactions," as shown on page 121 of the Review Committee's report, was about $350 million, and there were changes of more than $400 million in 7 of the 23 quarter-to-quarter intervals. Similarly, the "balance on regular types of transactions" showed average quarter-to-quarter changes of about $290 million in this period, with changes of more than $400 million on six occasions. Clearly, policies and appraisals of underlying trends should not and do not swing back and forth with every swing in the overall deficit. They are made over longer periods.

Even if the forward operations cited by Mr. Fousek had a 1-for-1 effect on the balances held in this country by foreign commercial banks, it is not clear from Mr. Fousek's evidence that they would have dominated the behavior of such balances in a majority of quarters. They would certainly have had much smaller relative effects over longer periods of several quarters. And they would have had only a minor effect on the $4 billion increase in foreign commercial bank holdings over the whole period since 1958.

In fact, it is most unlikely that official forward exchange market intervention has anything like a one-for-one effect on commercial bank holdings. As noted on page 116 of the report, a foreign bank, "given the offer of a favorable forward rate, might do at that rate not only whatever additional business the rate induced but also some business that it would have done in any case."

The Review Committee recognized that the effects of official forward operations complicate the analysis of foreign commercial bank behavior. But on the broad question whether changes in foreign commercial bank claims on the United States should all be regarded as settlement items, or all be placed above the line as ordinary capital flows though deserving of special scrutiny, the Committee found the latter treatment more appropriate.

It may be noted that Mr. Fousek prefers to avoid this question of how to classify changes in foreign commercial bank balances. He would prefer to make "appropriate adjustments" in the present concept, including adjustments for foreign private working balances, compensating balances, and "liabilities that arise out of the intermediary role of foreign commercial banks." And in the end, he would not choose a single concept of the deficit or surplus, but would prefer "a presentation organized in such manner that the various major components can be readily observed and put together in a manner that will be most useful to the analyst." The Review Committee was sympathetic to various suggestions of this kind, but found them impracticable. Therefore it did have to face the question of how to classify foreign commercial bank claims.

Do you gentlemen want to comment at this time?

Mr. LARY. I would like to comment. I don't know just what Mr. Lederer means, how broad his meaning is, when he says that such a large part of our liabilities to foreign commercial banks is under foreign official control. But I would suggest that even here, too, Mr. Chairman, the situation is no longer as different as it was before February 10, because we have seen the possibilities for the administration here also to exercise influence on the flow of U.S. funds to other countries.

In that connection, may I just say once more that the line of analysis pursued by Mr. Lederer turns on the eventuality of a great inter-

national liquidation, a scramble to undo positions, and the real question, the more current question, is: How do you improve the balance of payments from one period to another?

This you cannot do just by drawing back funds from Latin America or Japan or other areas, which may be hard to liquidate easily, but you can do it by slowing down the outflow. A striking illustration of that is given in the current program. Last year, American banks placed abroad $2½ billion in short-term and long-term loans. The objective under the voluntary program for this year is to keep the flow between $500 and $600 million. There will be some offsetting effects, to be sure, but the figures illustrate my point that one has to be concerned about the ability to influence the rate of flow in considering how to improve the balance of payments, rather than concentrating on what happens in case of international liquidation.

Senator PROXMIRE. Mr. Lederer wants to say something.

Mr. LEDERER. I just want to say one word about this, and I think this is precisely it.

I fully agree with Mr. Lary.

Senator PROXMIRE. He is shaking his head.

Mr. LARY. If he agrees, I have slipped up.

Mr. LEDERER. The problem, as I see it, is precisely to control the outflow of funds and not get into action only when foreign private organizations sell their dollars to foreign official institutions. That is the point which is too late, because at that point we have very little control. It is exactly the point where Mr. Lary says, "The policy actions should be undertaken" and this is why we define the balance as we do.

Senator PROXMIRE. Mr. Chittenden.

Mr. CHITTENDEN. Just a brief comment, Senator Proxmire.

Your question was whether these statements we have made, particularly with reference to the uncertainty surrounding recorded official holdings of dollars, and the large discrepancy that Mr. Lederer has pointed out between the $18.3 billion and the $15.5 billion figures, do not constitute a serious indictment. This in fact is an indictment of the Bernstein Committee's report in this one especially critical area. At the very least, the use of the official settlements approach presupposes that official holdings of dollars are identifiable.

The point I'd make is that it is impossible and misleading to distinguish foreign official from foreign private holdings of dollars. Beneficial ownership is often obscure—most particularly since foreign ownership of dollars is subject to manipulation, if you will, rendering analysis uncertain.

I think we mean these comments—I do, at least—to be directed to the basic question of the wisdom of the Bernstein Committee findings.

Senator PROXMIRE. Thank you very much.

I have learned a great deal this morning and I am sure the record is certainly enlightened by your testimony and excellent papers and responses to questions.

The committee will reconvene tomorrow to hear Professor Angell of Columbia University, Peter Fousek, Assistant Vice President of the Federal Reserve Bank of New York, and Richard Holton of the University of California at Berkeley.

The hearing stands recessed until then. Thank you very much.

(Whereupon, at 1 p.m. the hearing recessed, to reconvene the following day, Wednesday, June 9, 1965 at 10 a.m.)

APPENDIX

Comments on the Measure of the Balance on Foreign Transactions Recommended by the Review Committee [1]

(By Walther Lederer, Chief, Balance of Payments Division, Office of Business Economics, U.S. Department of Commerce)

A. GENERAL PRINCIPLES OF ANALYSIS

There is general agreement that any measure indicating improvements or deteriorations in the balance of payments and the size of the balance of payments problem is a matter of analysis of the data on foreign transactions. The double-entry bookkeeping principle used in the balance of payments compilations implies—by definition—that the totals of all credit and all debit entries are equal. The figures on the total of all transactions do not show positive or negative balances.

To obtain a measure indicating improvements or deteriorations in the international transactions certain figures have to be selected and which figures should enter into that selection depends (*a*) upon the purpose for which the analysis is being made, (*b*) a judgment of what standards these purposes require, and (*c*) a determination of the data which can best indicate whether international transactions in the aggregate move toward or away from these standards.

The selection of the standards and of the data measuring actual performance in terms of these standards will, in turn depend upon certain assumptions which are made concerning various factors affecting economic developments in general, and various types of international transactions more specifically. These assumptions should not, however, pertain to motivations of those engaged in the transactions, since there is almost no possibility to determine such motivations, and to develop statistical systems reflecting opinions concerning such motivations. (This point is also supported by the Review Committee on p. 1041 although—as will be shown later—the concepts recommended by the Review Committee are based on definite assumptions concerning motivations.)

There is also general agreement that no single figure can meet all analytical purposes and policy needs. Careful analysis requires the use of many data, and whatever data are selected to start an analysis, have to be supplemented by others in order to determine whether progress is made toward the chosen standard of performance.

B. THE CONCEPTS USED BY THE REVIEW COMMITTEE

I agree with the Review Committee that balance of payments statistics and analysis are "essential to an understanding of economic processes and events, policy formulation by the Government, and the evaluation of Government policy by the general public." The Review Committee proceeds to say that the tool would be most useful if it would show "the closest measure of the pressure on the dollar in the exchange market." The standard chosen by the Review Committee, therefore, is the absence of pressure in the exchange market. The best measure of the movement toward or away from the point of no pressure in the exchange market can be obtained, according to the Review Committee, by adding changes in U.S. official reserve assets, and in U.S. official and U.S. private liabilities to foreign official monetary organizations.

The explanation of the reasons for measuring the balance in our foreign transactions in this manner may be found in the following paragraphs (p. 2, right column):

"In the present international financial system, the key demarcation in international transactions is between those of the monetary authorities and all other

[1] The views expressed in this paper are entirely those of the author, and in no way purport to reflect those of the Office of Business Economics, the Department of Commerce, or any other part of the U.S. Government.

transactions. Leading countries have established fixed parities for their currencies and have undertaken by international agreement to maintain exchange rates within prescribed margins of those parities. The monetary authorities use reserves to prevent a decline below this limit and acquire reserves to prevent a rise above this limit in the foreign exchange value of their currencies. In effect, the monetary authorities fill the gap between the private demand for and the private supply of foreign exchange, and the size of this gap, measured by the transactions of the monetary authorities, provides the most useful starting point for balance of payments analysis.

"In U.S. statistics, the transactions of the monetary authorities, which may be termed 'reserve transactions,' are shown by changes in the reserve assets of U.S. monetary authorities and changes in all U.S. liabilities to foreign monetary authorities. The large prepayments of official debts to the United States in recent years should also be regarded as official settlement items, undertaken to avoid a drain on reserves. Thus, the main measure of deficit or surplus should be the balance financed by official settlements, the latter comprising reserve transactions and debt prepayments."

The measure of the balance recommended by the Committee is called by it "Balance settled by official transactions." To avoid misunderstandings of the term it should be made clear that "official transactions" does not mean transactions by U.S. official agencies with official agencies of foreign countries. This balance includes all purchases and sales of U.S. reserve assets by U.S. monetary authorities from, or to residents of foreign countries as well as residents of the United States, and all purchases and sales of dollar assets by foreign monetary authorities from, or to private U.S. or private foreign residents. The measure excludes, however, changes in either short- or long-term debt obligations by official monetary organizations of the United States to foreigners which are not considered monetary authorities, although similar types of liabilities to foreign official monetary organizations are included.

C. PRINCIPAL OBJECTIONS TO THE MEASURE OF THE BALANCE ON FOREIGN TRANSACTIONS OF THE UNITED STATES RECOMMENDED BY THE REVIEW COMMITTEE

The principal objections to that concept and the analysis of the statistical data based on it are as follows:

(1) Monetary authorities are not likely to be always passive factors in the exchange market; they set up policy goals, and in pursuing them, they may purchase and sell foreign exchange even if there is no pressure in the exchange market;

(2) A rise in foreign official dollar holdings does not indicate a weaknes in the demand for dollars;

(3) Pressures in the exchange market can be met by other means than selling or buying foreign exchange in the spot market;

(4) Changes in foreign official dollar holdings are affected not only by transactions between the United States and foreign countries but also by transactions within and among foreign countries;

(5) Large and varying amounts of dollar assets of foreign official organizations are held in foreign private banks (including foreign branches of U.S. banks) and thus are not reflected in the data on liabilities to foreign official organizations reported by U.S. banks;

(6) The measure does not allow for balance of payments improvements through the sale of long-term obligations to foreign monetary authorities;

(7) The measure proposed by the Review Committee shows much more erratic movements than the balance measured on the basis of the "liquidity" concept, and the concept preferred by the Review Committee not only is less useful as a policy tool, but is more likely to be misleading;

(8) The concept provides the opportunity for financial operations resulting in shifts of foreign dollar assets from official to private accounts which would conceal balance of payments developments;

(9) The concept suggests that the balance of payments is favorably affected by a rise in liquid liabilities to foreign private persons or enterprises even if this rise involves the payment of higher interest rates and the growing loss of freedom of policy formulation and actions by public authorities as well as private business and persons in the United States;

(10) The concept suggests that there is a symmetry in international balances of payments when, in fact, the aggregate of national policy goals of all countries reflect a need for a growth in aggregate reserves. The need for the

creation of an international medium of exchange and reserve assets supplementing the dollar (or substituting for it) and the need for international cooperation becomes more evident, if the international accounting systems recognize frankly that improvements in the reserve position of one group of countries do not necessarily have to be offset by deteriorations in the reserve position by all other countries, and that, therefore, balance of payments interests of the various countries do not necessarily have to be opposed to each other.

In the following paragraphs the principal arguments against the analytical concept recommended by the Review Committee are provided in more detail.

(1) The Committee recommendation implies that all changes in foreign official dollar holdings are the result of foreign monetary authorities using reserves only to prevent the value of their currency from falling below the limit permitted under the Bretton Woods Agreement and acquiring reserves only to prevent the value of their currency from rising above that limit.

It is correct that the Bretton Woods Agreement requires monetary authorities to keep the value of their currencies on the spot market within a fixed range around the agreed parity and that monetary authorities have to purchase or sell international reserve assets to accomplish that task.

It is wrong and unrealistic, however, to draw the conclusion that:

(*a*) Foreign monetary authorities purchase or sell reserve assets only when the value of this currency reaches the outer limits of the range within which they are permitted to fluctuate. Actually, there is very little correlation between movements of currency values on the market and changes in the reserves of the countries involved. This indicates that monetary authorities very frequently (in fact, more often than not) purchase and sell reserve assets while the exchange rates are well within the permissible limits, and sometimes irrespective of their movement within that range. It thus appears that movements of exchange rates even within that range are influenced to a large extent by other policy goals and operations of the monetary authorities, and not by private market forces alone. The attached chart published in the monthly issues of the Statistical Bulletin of the OECD illustrates the point. It can be seen that only in rare instances were reserve assets purchased by foreign countries when their exchange rate was at the maximum of the permitted range, or sold when it fell to the minimum. The chart gives the impression that exchange rates either were kept at levels determined by specific policy considerations and that the demand and supply of foreign exchange on the market were equalized at those levels rather than at the margins, or that purchases and sales of reserve assets are made for other reasons than merely equalizing supply of and demand for foreign exchange arising from transactions by others than the monetary authorities.

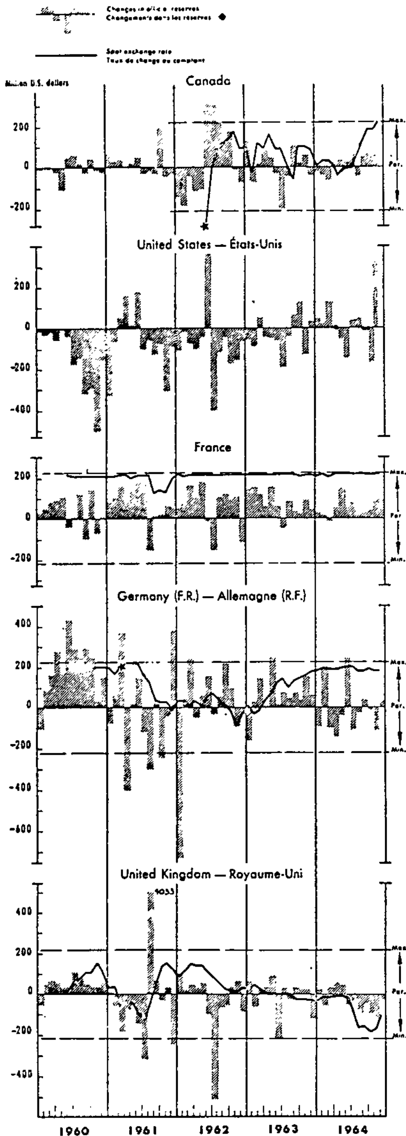
(*b*) International exchange markets abroad are largely markets where private businesses are free to purchase and sell foreign exchange and the exchange rates are determined by the size of private demand and supply for foreign exchange and that monetary authorities enter the market only to absorb the excess supply of foreign exchange when its rate declines to the low point of its permissible price range, or to sell foreign exchange to meet the gap between demand and supply at the high point of its permissible price range.

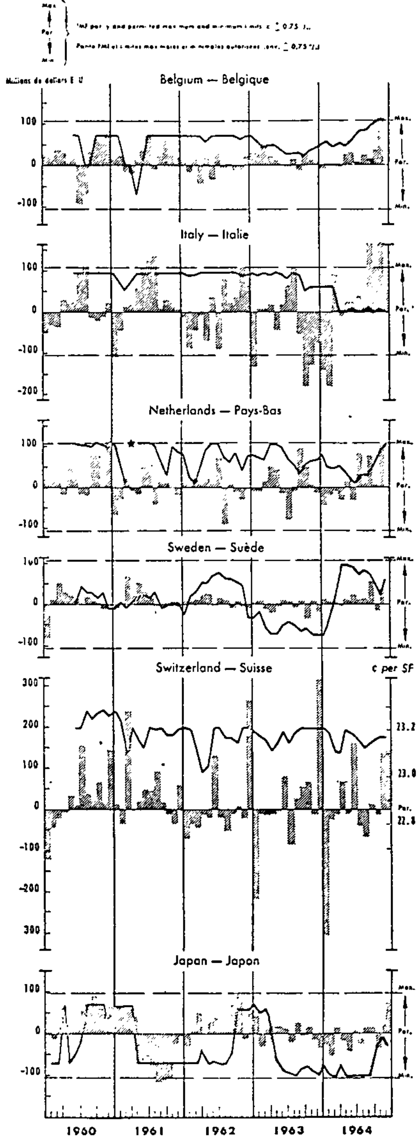
It is highly unrealistic to assume that monetary authorities merely fill gaps in the supply of, and demand for, foreign exchange, and that their role in the exchange market is largely compensatory while private transactions are autonomous. On the contrary, it is more realistic to assume that in the modern world, monetary authorities, except when they are affected by an initial shock of a rapid change in the foreign exchange market, or when they do not have the institutional facilities to pursue monetary and credit policies within their country, purchase and sell foreign exchange not only to maintain the exchange value of their currencies, but also to achieve other policy goals and to that extent are autonomous agents in the market. Such policy goals include the achievement of foreign exchange reserves which they consider adequate for their country, the expansion and contraction of monetary liquidity in their own country, and the reinforcement of various types of direct controls which their governments attempt to exercise over their economy.

To meet such policy goals monetary authorities and governments interfere in the market through restrictive measures applying either to all transactions or to capital transactions only. There are very few countries where foreign transactions are completely free of some sort of restrictive regulation. In some countries, monetary authorities interfere in the market by varying incentives or subsidies, for instance by selling or lending dollar assets to their banks on terms which are

- 8A -

Official reserves and spot exchange rates
Réserves officielles et taux de change au comptant





★ New parity established

◆ For the changes in reserves the scales for the right-hand side are double those for the left-hand side.

★ Établissement d'une nouvelle parité

◆ Pour les changements dans les réserves l'échelle de la partie droite est égale au double de l'échelle de la partie gauche.

more attractive than those obtainable in the open market. This is equivalent to a subsidy to the banks to induce them to purchase or hold more dollar assets than they otherwise would do. In some countries, monetary authorities have borrowed or purchased dollars from their own banks on favorable terms in order to avoid drawing down their official reserves.

Only in the rare instances, where monetary authorities are satisfied with the level and movements of their reserves and where they do not use foreign exchange operations to pursue economic policies within their own countries, can one assume that they limit themselves to compensatory transactions in the exchange markets. In all other instances, where monetary authorities have effective policy instruments, it would be more realistic to assume that changes in private holdings of foreign exchange are dependent upon official policy decisions, rather than that changes in official holdings are dependent on supply of and demand for foreign exchange resulting from private decisions, as is implicit in the assumptions underlying the concepts used by the Committee.

The Review Committee (on p. 115r) says that this argument applied largely to the early postwar period, and that "at that time precisely because of the strict controls the assets of foreign commercial banks in the United States were small. The huge increase in such holdings in recent years has come largely as a result of relaxations of exchange controls, and foreign commercial banks now move funds about rather freely for their own account."

It may be important in this connection to point out, that during the 5-year period from the end of 1959 to the end of 1964 dollar liabilities to foreign commercial banks increased by about $2.5 billion, including about $1.4 billion in 1964 alone. Of the $2.5 billion, about $930 million, or 37 percent accrued to Japanese banks which were, and still are, under rather strict controls by their authorities. About $230 million accrued to banks in less-developed countries, most of which are also closely supervised.

European banks increased their holdings by $880 million, less than those of Japan alone, and a very large part of that amount reflects dollar assets which were deposited in them by foreign official organizations. The remainder of about $500 million accrued to Canadian banks and reflects partly deposits by U.S. residents and partly by residents of other countries, possibly also their official agencies. It is most important in the analysis of the balance of payments of the United States to keep in mind that the international transactions of the United States are with all areas of the world, and that it cannot be assumed that conditions and institutions all over the world are similar to those in the more developed countries of Europe.

The Review Committee (p. 115r) agrees that banks (apparently in Europe and Canada) "are often still subject to general regulations, which may be changed from time to time, e.g., requirements that they maintain a balanced spot and forward position in foreign currencies. * * * but the presence of regulations should not determine how the affected transactions are to be classified in the balance of payments." What is in question, however, is not the classification, but the interpretation of the data, and an interpretation which is based on the unrealistic assumption that foreign private dollar holdings are determined solely by private business considerations, must *ipso facto* also be unrealistic.

In setting up concepts for the interpretation of balance of payments data the substantial regulatory powers of the monetary authorities in most of the foreign countries over the foreign exchange operations and holdings of their banks and other residents should be recognized. It is correct that currencies in the major European countries have been made convertible in the late 1950's, and that more recently this step has also been taken in Japan. In most of these countries, however, convertibility was provided for foreign residents only, while defensive restrictions continued against capital exports by domestic residents. In other countries, e.g., Germany and Switzerland, defensive measures have been applied against capital imports.

Where monetary authorities exercise strong control over foreign exchange assets and policies of their banks, it cannot be assumed that the authorities are merely passive agents in the foreign exchange markets.

Where monetary authorities are able to keep exchange rates stable, and to supply foreign exchange without restrictions, and where that condition is expected to continue, foreign exchange holdings by private business is generally small. Where that condition does not exist, private holdings of foreign exchange assets are large, because private business has to absorb the function of the monetary authorities of holding foreign exchange assets. Of the total dollar liabilities to foreigners other than banks and official organizations amounting to about $3.9

billion at the end of 1964, Latin America accounted for $1.6 billion and other less developed countries for nearly $0.5 billion. Dollar holdings by Western European business were only $1.4 billion, or less than those of Latin America, and those of Canadian business were less than $400 million.

Liquid dollar assets held in the United States by private business (other than banks) in Latin America comprised at the end of 1964 about half of all such dollar assets held in the United States by that area. For Europe the share of private business (other than banks) was only 10 percent.

(2) A rise in foreign official dollar holdings does not indicate a weakness in the demand for dollars. Foreign monetary authorities do not have to hold the dollars they acquire. They can acquire and hold other reserve assets, particularly gold and at any one time there are important differences in degree between countries with respect to the preference of their official organizations for gold or for dollars as reserve assets. When they increase their dollar holdings, it must be assumed that they prefer dollars to gold (or at least that they want to refrain from purchasing gold in order to avoid unfavorable repercussions on U.S. gold reserves). Dollar reserves of foreign official monetary organizations are usually kept in income yielding assets. While for most countries income obtained from them may not be a major amount in terms of their balance of payments, it can be quite important in the budgets of central banks or other official organizations. It cannot be assumed, however, that considerations for income would outweigh those for liquidity or stability in the exchange value. In that respect, motivations governing dollar holdings by official organizations are not fundamentally different from those of private organizations with respect to their holding of liquid dollar assets, particularly since income on liquid dollar assets is smaller than income on similar types of assets held in most of the other currencies or countries.

If the private foreign demand for dollars were weak because the continued stability of the exchange rate or free convertibility were questioned, it cannot be assumed that foreign official organizations would want to increase their dollar holdings. Weakness or strength of the dollar must be assured to affect official as well as private demand for dollars; it does not seem realistic to assume that—except for short periods and minor amounts—the official demand for dollars can move in opposite direction from the private demand.

The argument by the Review Committee that "the massive buildup of foreign bank claims over the past 6 years represents a genuine inflow of private capital" (p. 117r) and therefore reflects an "autonomous" demand for dollar assets can be applied even more convincingly to foreign official dollar holdings. They have risen by much larger amounts, and much more steadily than foreign private holdings. It does not seem to be a valid argument that private dollar holdings reflect an autonomous demand while official dollar holdings do not.

(3) Purchases and sales of foreign exchange by the monetary authorities in order to keep foreign exchange rates within the permissible range do not have to be made on the spot market but can also be made on the forward market. Only purchases and sales on the spot market, however, affect the official holdings of foreign exchange as recorded in balance of payments statistics. When foreign monetary authorities want to prevent their currencies from rising above their permissible limits, instead of selling them on the spot market and acquiring dollars, they may purchase dollars and raise its price and sell their own currency on the forward market. With such operations they make it more attractive for their own banks and residents to hold or to purchase dollars rather than selling them, and thus to induce a rise of the spot market rate for the dollar above the lower limit. Thus a weakness of the dollar would appear to result in a rise in private rather than in official holdings.

The Review Committee agrees that this is a "troublesome case" (p. 115 r) with respect to the applicability of its concept. The examples, given in its report, of forward operations and special inducements provided to foreign banks to hold dollars indicate that such practices have been widespread, and the charts on foreign currency assets of German banks indicate wide fluctuations, some of which may have been induced by official operations. The Review Committee also agrees that "there is no way of ascertaining statistically the effects of forward exchange operations" (p. 116 r). Nevertheless it questions on page 117 (left col.) "whether the portion [of foreign exchange holdings of banks affected by official forward intervention] is so dominant so much of the time as to justify placing below the line all changes in foreign commercial bank claims on the United States."

The Committee has concluded that "this would not be the appropriate solution. It does not appear that official intervention has accounted in more than a few quarters in recent years for a substantial proportion of the change in foreign

commercial bank claims on the United States. Furthermore there is a decisive longrun argument for putting commercial bank claims above the line."

It may be noted that the Review Committee agrees that the effects of forward operations cannot be measured but nevertheless comes to the conclusion that they have been important only in a few quarters. If these were the quarters when the balance, as measured by the Review Committee, has shown major improvements, that measure would have given misleading impressions, and policy signals.

It is not sufficient that a measure is correct in the long run, it also has to be so in the short run. Balance of payments statistics are needed as an indicator of shortrun developments because many situations require quick actions by policy officials. It is important, therefore, that the need for actions is recognized as early as possible, not after a longer run trend can be observed.

What is even more significant, however, is that official authorities would be led to believe that by intervening in the foreign exchange market through forward rather than spot transactions, the balance of payments would in fact, and not only in appearance, be improved. The danger is not only that the authorities could hide the situation and deceive the public, they could even deceive themselves. A concept that could have such consequences is not just weak as a tool in the analysis of the historical past, it can be rather dangerous in its function as a policy guide.

(4) The concept by the Review Committee implies that the exchange market for dollars reflects only foreign dollar receipts and dollar requirements associated with foreign transactions of the United States; i.e. the U.S. balance of payments. This assumption is not compatible with the fact that the dollar is an international currency which is used in transactions between residents within the same foreign country and between residents of different foreign countries. In some countries, such as Germany and Italy, monetary authorities purchase and sell dollar assets to regulate the liquidity of their banking system. This is the equivalent of open market operations in this country, but dollar assets are used to supplement the relatively small supply of locally issued marketable debt obligations.

If the foreign central banks want to reduce the facilities of their private banks to create credit in their own currency, they would sell dollar assets on the spot market and repurchase them on the forward market. This would make it more attractive for the private banks to hold dollar assets and thus reduce their facility to acquire domestic assets. The rising price on the forward market would also make it attractive for those receiving dollars from foreign transactions to hold them, and thus reduce the supply offered on the exchange markets. The private banks would sell less dollars to the monetary authorities and thus would not build up their reserves. If those who require dollars purshase them directly or indirectly from the central bank, bank reserves would tend to shrink, and bank lending facilities would be reduced. Thus a decline in foreign official dollar holdings, and a compensating rise in foreign private dollar holdings would not indicate (as the concept favored by the Committee would suggest) an increased strength in the position of the dollar as a result of favorable shifts in the balance of transactions by the United States, but rather a shift in the internal economic policies abroad. In fact, dollar purchases in the forward market may be undertaken by foreign countries to counteract inflationary pressures that may arise from a surplus in their balance of payments. In that case, as indicated above, the rise in private foreign dollar holdings would reflect a weakness rather than strength of the dollar in the exchange market.[1]

If all liquid liabilities are included in the measure evaluating the developments of the balance of payments of the United States, it is not distorted by such transactions: an increase in total liabilities would signal a warning, a mere transfer from official to private balances or vice versa would be neutral.

[1] The following tabulation shows the amounts of dollars (in millions) involved in swap arrangements by the German Bundesbank with German private banks. These transactions may have been undertaken to support foreign exchange rates, influence the liquidity of German private banks or for other reasons. Similar transactions were undertaken by other countries in even larger amounts.

End of period	Amounts outstanding	Change during period	End of period	Amounts outstanding	Change during period
1958	78	+78	1964 I	96	+96
1959	178	+100	II	147	+51
1960	401	+223	III	91	−56
1961	284	−117	IV	89	−2
1962	33	−251	1965 I	240	+151
1963 I	20	−13	May	250	+10
II	----------	−20			
III	----------	----------			
IV	----------	----------			

Source: Monthly Reports of the German Bundesbank, May 1965, p. 131.

Alternatively, the foreign banking authorities could raise the minimum reserves which their banks are required to hold in the central bank. This would induce the banks to sell to their central bank dollar assets which they would draw from their own holdings or would obtain by borrowing abroad. This method, in contrast to that described above, would result in an increase in foreign official holdings. Actually foreign central banks may find it difficult to employ this method, as long as foreign private banks are able to obtain additional dollar resources through loans from the United States.

The Review Committee (p. 115r) discusses the latter operation, and concludes that a tightening of the foreign credit market by foreign authorities which would result in the transfer of liquid dollar assets from foreign private banks to foreign official agencies should be interpreted as "an outflow from the United States of foreign private (bank) capital" and that "this is precisely the sort of adjustment that the foreign country would be striving for if it were coping with a payments deficit."

It is clear that this comment does not apply to the operations through the forward market described above. In that case, the foreign central bank would attempt to sell foreign exchange assets which would be the opposite of what "it would be striving for if it were coping with a payments deficit."

Even in the latter case it is important that the intervention in the exchange market would be originated by the foreign official banking authorities, and would not be the result of changes in the demand for, or supply of dollars due to transactions with the United States (although it may induce an increase in the supply of dollars through new loans by the United States). Even if it is the "adjustment that the foreign country would be striving for if it were coping with a payments deficit," it does not mean that the similarity of actions must reflect a similarity of causes. In fact, there were many cases when foreign countries were attempting to restrict internal credit when they had a surplus in their balance of payments.

There may be some question of whether such policies are effective or desirable, but that is not the issue here. The fact is that interventions in the foreign exchange market, by foreign banking authorities through tightening of reserve requirements or open market operations in liquid dollar assets are not necessarily undertaken in response to balance-of-payments developments in their own countries or in the United States. Consequently, it does not seem appropriate to interpret shifts between foreign private and official accounts in U.S. banks in a manner which would suggest that the United States should adjust its balance-of-payments policies, so long as the total of foreign dollar holdings is not increased. What should be watched in the analysis of the U.S. balance of payments is the rise in total foreign dollar holdings, even if it occurs in private holdings.

The foreign policy of dampening inflationary pressures by inducing private banks to hold larger dollar assets may not be successful, however. Because the dollar is an international medium of exchange, a rise in the dollar supply held by foreign banks creates the base for an expansion in dollar loans provided by them and thus has the same effect on foreign economies as a rise in reserves in their own currencies; a rise in dollar deposits held by foreign business and persons in foreign or U.S. banks has the same effect as a rise in their domestic money supply. Dollar credit and dollar deposits thus can frustrate credit and monetary policies by foreign monetary organizations. Foreign monetary authorities which are concerned with the size and changes in their domestic liquidity, therefore, have to be concerned also with dollar holdings of their private residents. They cannot easily neutralize a net inflow of dollars. They can be expected to take steps to limit it. The recent gold purchases by foreign central banks and governments

seems to have reflected not only a concern with the size of their dollar holdings relative to their gold reserves, but also an attempt to restore their control over their own credit and monetary system by inducing the United States to take measures which would stem the increase in liquid dollar holdings by their private residents.

Thus, because the dollar is used abroad as a medium of exchange, a reserve asset, and a medium for extending credit, an increase in foreign private dollar holdings, not only in official holdings, may induce foreign purchases of gold and thus affect our international reserves.

Since a rather large volume of transactions between foreign countries are conducted in U.S. dollars, dollar balances are transferred between foreign accounts. No data are available on the volume of these transactions, but since trade and other transactions between foreign countries (even excluding trade within the sterling and French franc area) are several times as high as foreign transactions with the United States, the dollar transfers between foreign accounts are likely to be considerably larger than the dollar transfers between U.S. and foreign accounts. Such transfers can affect the distribution between foreign official and private accounts and thus the balance on our foreign transactions, as defined by the Review Committee.

Whether acquisitions or losses of liquid dollar assets by foreign countries accrue to official or to private accounts depends to a considerable extent upon the policies of the official organizations in the various countries and the institutional facilities they have to execute them. In some countries the official organizations will attempt to absorb as large a part of the foreign exchange inflow as possible, in others they may permit, or even induce, private persons and enterprises to hold foreign exchange, and in still others they may attempt to obtain foreign exchange acquired by their residents, but do not have the facilities to succeed.

If the concepts of the Review Committee were used in formulating balance of payments policies of the United States, transfers of dollars from a country in which liquid dollar assets are held primarily in official accounts to a country where they accrue to private accounts would result in policies appropriate to a balance of payments surplus; if the net movements of dollars were in the opposite direction the policy would have to be shifted to one appropriate to a balance of payments deficit. Thus our policy would be influenced not only by our own foreign transactions, but also by those among foreign countries, provided they follow different policies with respect to foreign exchange holdings of their residents. To minimize our deficits we would have to attempt to strengthen the trading position of those countries which permit private holdings of foreign exchange and weaken the position of those concentrating their foreign exchange resources in their official reserves. This may mean favoring those countries which have sufficient foreign exchange reserves over those where the authorities are anxious to raise them, which could be contrary to our customary policy.

The Review Committee seems to acknowledge some of these difficulties, but states (p. 115r):

"As a matter of practical experience, shifts of dollar funds among countries with widely different foreign exchange holding patterns do not seem to have been a major element in either the shortrun or longrun behavior of foreign commercial bank claims on the United States."

It does not supply any evidence to support that conclusion, however.

(5) By recommending that liabilities only to foreign official organizations as shown in reports by U.S. banks be included in the measure of the balance, the Review Committee neglects the fact that large amounts of foreign official dollar assets are deposited in foreign branches of U.S. banks or in foreign banks. These foreign branches of U.S. banks or the foreign banks send the dollar checks which they had received from foreign official organizations to their head office or to other U.S. banks and thus increase their own deposits in the United States. The U.S. banks will report these deposits as liabilities to private banks. If foreign banks transfer these dollars to other foreigners, the latter would appear in U.S. bank records as the owners of the accounts. It is thus possible that some dollars are indirectly transferred from one official account to another.

At the end of 1964, the total of foreign official dollar assets (excluding those held by the Soviet bloc) amounted to about $18.3 billion or $2.9 billion more than the amounts shown in U.S. statistics. The biggest rise in the difference between U.S. and foreign records of official dollar reserves occurred in 1959 and 1960 and another large increase took place in 1963 and 1964.

From the end of 1958 to the end of 1964, the rise in foreign official dollar holdings was roughly $2.2 billion or one-third higher than would appear on the basis of U.S. records. These $2.2 billion equal about 60 percent of the $3.6 billion increase

in liabilities to foreign private banks. While it may not be quite true that all of the $2.2 billion are reflected in the dollar holdings of foreign private banks, it would be safe to assume that a very considerable part of the liabilities to foreign private banks are indirect liabilities to foreign official organizations. The data are shown in the following tabulation:

Foreign official dollar assets estimated on the basis of foreign sources (International Financial Statistics) and U.S. liabilities reported by U.S. sources

[In billions of dollars]

	Foreign sources	U.S. sources		
	Foreign official organizations [1]	Foreign official organizations	Foreign private banks	Other foreign residents
Position at end of 1964:				
Western Europe	10.9	9.2	3.3	1.4
Japan	1.6	2.7	------	(2)
Canada	1.6	3.4	------	.4
Latin American Republics	1.6	1.3	0.4	1.6
Other countries	2.6	1.8	0.5	.5
Total	18.3	15.5	7.15	3.9
Changes in total during:				
1964	1.4	1.1	1.4	.4
1963	2.1	1.7	.5	.4
1962	1.1	.9	−.1	.1
1961	.6	.7	.6	.1
1960 1959	3.3	1.9	1.2	(2)
End of 1958 to end of 1964 [3]	8.5	6.3	3.6	1.0

[1] The figures are still subject to revisions. They are based on total foreign official exchange holdings as reported in the most recent issues of IFS, adjusted for sterling holdings reported by the Bank of England, and for foreign exchange holdings of other than dollars reported by countries of the French franc area. The data are also adjusted for changes in the net gold position of the BIS.

[2] Negligible.

[3] Differences may be due to rounding.

The deposits of dollars by foreign official organizations in European banks are a major part of the dollar resources of the Euro-dollar market. These deposits (and some from other sources) enable these banks to lend dollars to other foreigners, and thus increase dollar assets and liabilities abroad to a multiple of the original dollar deposits they have received.

The Review Committee on page 117 r states:

"While official transactions in Euro-currency markets do pose some difficulties of interpretation, these do not appear to be decisive * * *. The decision of a British bank to hold dollar assets in New York as cover for its liabilities (to foreign official institutions) is, in any case a private business decision; the bank could have sold those dollars for sterling or invested them in some other form. Nationality of residence ought to take precedence over nationality of currency in balance of payments classifications, and generally does so. The fact that obligations of one foreigner to another happen to be denominated in U.S. dollars does not make them U.S. obligations. It is not the pyramided aggregate of such claims, but the nonduplicated claims on the United States that matter."

This comment misses the point. The total of liabilities to foreigners as measured on the basis of U.S. banking records is not pyramided, but these records do not provide the source to determine the ultimate ownership of the dollars. If the committee believes that pressures on the exchange markets for dollars can be measured by changes in dollar holdings of foreign official organizations, such a measure—even it it were otherwise possible—would have to be based on data for such holdings. U.S. banking records on liabilities to foreign official organizations alone—as the table indicates—are too far off the mark to be useful in that respect. In fact, for the period 1958 to 1964 the change in U.S. liabilities to all foreigners ($10.9 billion) comes nearly as close to the change in foreign official dollar holdings ($8.5 billion), as the change in liabilities to foreign official agencies reported by U.S. banks ($6.3 billion). For the period 1958 to 1963 the change in liabilities to all foreigners ($8 billion) is considerably closer to the change in foreign official dollar holdings ($7 billion) than the change in U.S. liabilities to foreign official organizations, as recorded by U.S. banks ($5.2 billion).

Whether foreign central banks and other official organizations responsible for holding and administering foreign exchange reserves hold their dollar assets directly in U.S. banks or in their foreign branches or in foreign banks will not affect their policy with respect to gold purchases from the United States. The fact that a major part of foreign official dollar holdings is not reflected in U.S. banking statistics on liabilities to foreigners makes it practically impossible to provide a statistical measure from U.S. sources for the concept recommended by the committee. If the concept were accepted there is a danger that balance of payments developments would be misjudged, as the developments in recent years indicate. Use of the data on foreign dollar balances estimated on the basis of foreign sources would raise the deficit as measured by the Reveiw Committee from $6 billion during the 2 years of 1959 and 1960 to about $7.4 billion, from $2.3 to $2.7 billion in 1963, and from $1.5 to $1.8 billion in 1964.

Furthermore, and much more serious in its consequences, is the likelihood that the committee's concept is interpreted to mean that a transfer of foreign official dollar assets to U.S. banks is a weakness in our balance of payments, transfers to foreign banks reflect strength. This would suggest that the balance of payments can be improved by inducing foreign official organizations to shift their dollar assets from U.S. banks to foreign banks including foreign branches of U.S. banks.

A balance of payments concept is not only an analytical tool. It is also a guide to policy operations. There is great danger in the Committee's concept that it becomes a guide to achieving favorable but ineffective appearances of our balance of payments rather than a guide suggesting the need for actions to achieve real improvements.

(6) Another shortcoming in the Committee's concept is its failure to allow for the possibility of monetary organizations assisting each other through long-term loans. If such loans were provided to the United States and would result in an exchange by foreign authorities of liquid assets for nonmarketable long-tern obligations, the Committee would not record that transaction as an improvement in our balance of payments. If the same type of obligations had been sold to foreigners other than monetary authorities—even at less favorable terms—and had been paid for with funds previously held by the foreign official organizations, the Committee would record the transaction as having a favorable effect on the U.S. balance of payments. Thus the Committee, in effect, recommends that long-term borrowing abroad—even by U.S. monetary authorities for the purpose of obtaining foreign exchange resources—should not be done from foreign central banks or such government agencies which the Committee would consider monetary organizations, but should be done from others, even if such loans would have to be more expensive to obtain the funds.

(7) The difficulties associated with the interpretation of balance of payments developments on the basis of the concept used by the Review Committee become apparent in the relatively large fluctuations in the balance as measured by the Committee. These fluctuations considerably exceed those in the currently used balance on "regular types of transactions."

An examination of the data in table 2, page 5 of the report shows three periods of major improvements in the Committee's balance since 1958: 1959, 1961, and 1964. In all of these three periods the "improvement" in the balance coincided with a rise in private dollar balances. It is noteworthy that both the 1959 and the 1961 "improvement" (according to the Committee's concept) was followed by a substantial deterioration in the next year. A deterioration probably would have happened also in 1965 if it had not been for the President's balance of payments program, and the related actions taken by banks and nonfinancial corporations. The balance for the first quarter of 1965 computed on the basis of the Committee's concept was, in fact, less favorable than that for any quarter in 1964 and the deterioration was even larger if measured from the average of the year 1964.

The deterioration in the balance as measured by the Review Committee in the years following a sharp rise in liquid liabilities to foreign private accounts did not take the form of a rise in liquid liabilities to foreign official accounts, but of a more-than-average decline in U.S. reserve assets. Over the period 1959 through 1964 the average annual decline in reserve assets was $0.77 billion. In 1960 reserve assets declined by $1.7 billion, in 1962 by $0.9 billion, and in the first quarter of 1965 alone by $840 million. With reserve assets lower than liquid liabilities, a decline in reserve assets is more serious than a rise in liabilities.

The figures would suggest that rather than considering a rise in liquid liabilities to foreign private accounts as a sign of strength for the dollar—as the Review

Committee does—such a rise should be viewed as a strong signal of danger to the official reserves.

The signals to policymakers provided by the concept of the Review Committee are, therefore, not only unreliable, but—on the basis of experience during the last 6 years—likely to be misleading. They suggest improvements in the balance of payments when in fact deteriorations are to be expected.

In that respect the interpretation of balance of payments developments based on the concepts of the Review Committee compare unfavorably with that based on a measure of the balance which includes liabilities to foreign official as well as private accounts.

Misinterpreting the movement in the balance is much more serious than possible uncertainties concerning its absolute level. As will be pointed out in subsequent sections of this paper, and as has also been done in my earlier Princeton paper, there are several reasons why under current conditions the target for balance of payments adjustments may not be a zero balance, but should allow for some rise in foreign dollar balances, both private and official. The magnitude of this allowable rise is uncertain; however, it depends on judgment and cannot, at present at least, be expressed in firm figures and included in balance of payments compilation.

This consideration, as will be pointed out, does not only apply to the "liquidity" balance, however. It also applies to the balance recommended by the Review Committee. Under neither concept can the absolute level of the balance be considered a firm measure of the amount of adjustment that has to be achieved at any one time.

D. BASIC ASSUMPTIONS UNDER THE "LIQUIDITY" CONCEPT

The assumptions and principles used in the analysis of balance of payments developments as published in the Survey of Current Business, and explained by me in various articles, are believed to be closer to reality than those used by the Review Committee, and thus provide also a better tool in the formulation of public policy. The principal assumptions are as follows:

(1) While it is correct that governments and central banks intervene in the exchange market to meet gaps between private demand and supply of foreign exchange in foreign exchange markets, in most countries they also pursue policies of their own which require purchases or sales of foreign exchange and gold. Such policies involve the exercise of influence over private transactions, sometimes by the imposition of restrictions (including "moral suasion"), sometimes by the creation of special incentives or subsidies. The policies themselves, and the means by which they are executed, vary from country to country.

It would be difficult to define whether private transactions induced by official agencies in order to accomplish what otherwise the official agency would have to do are autonomous or compensatory. This applies not only to transactions actually undertaken, but also to transactions which were not undertaken because of official restraints.

Further, even in a free market, compensatory actions will be undertaken by private business to even out temporary movements of exchange rates around the established parity, provided there is general trust that the established parity rate will be maintained by the monetary authorities.

Consequently, it is unrealistic to assume that transactions by monetary authorities are always compensatory in the exchange market, while all other private or public transactions are always autonomous. There is no scientific way to predetermine on the basis of type or transactor, the transactions which are always either compensatory or autonomous, or even to decide for specific transactions whether the credit or the debit part is the autonomous, or the compensatory side of the transaction. It is not valid, therefore, to designate certain types of foreign transactions or the transactions of certain transactors, such as monetary authorities, as those which "finance" all other types of transactions. There is no single valid way to "draw a line," and to designate certain items to be "above," and others to be "below the line" as the Review Committee attempts to do.

(2) The U.S. dollar, far more than any other currency, is used as a medium of exchange not only in transactions between the United States and foreign countries but also in transactions, both private and public, among foreign countries and sometimes within foreign countries. It is also used by private business and persons, as well as Government agencies (including central banks) abroad as a reserve asset, and frequently as a medium of denominating and extending credit.

This is illustrated by the following quotation from the "Ministerial Statement of the Group of Ten and Annex prepared by Deputies," Annex – 19 (quoted from

Ninth Special Report to the President and to the Congress by the National Advisory Council on International Monetary and Financial Problems, April 1962–June 1964, U.S. Government Printing Office, 1965; p. 70):

"While the report focuses on official liquidity, private liquidity is also of importance to the international monetary system and to official liquidity. Traders' credits and working balances in foreign exchange are an indispensable part of the day-to-day transactions of private traders and investors; and foreign exchange held by commercial banks as working balances plays a role as a secondary reserve asset alongside official reserves in many national banking systems."

(3) The significance of the choice of method to analyze the balance of payments is not merely its success in recording and explaining past developments. Any interpretation of the balance of payments, particularly if it focuses on certain types of transactions as an indicator of improvement or deterioration, will serve as a guide to private and public policies to improve or at least to prevent a deterioration in the balance.

Consequently special care has to be exercised in the selection of these types of transactions to minimize the possibility of stimulating changes in the methods of transacting foreign business which merely change the appearance of the balance of payments without changing the more fundamental facts.

For instance, if the balance of payments analysis draws a sharp distinction between long- and short-term loans, so that a rise in the amount of short-term loans outstanding is considered an offset to a decline in reserve assets or an increase in liquid liabilities, the suggestion is made implicitly that the extension of short-term loans does not affect the balance of payments and that a switch from long- to short-term loans, even if the latter are expected to be renewed is desirable. Likewise, if changes in liquid dollar assets held by foreign private banks or persons are not included among the items by which the balance is measured, as the Review Committee recommends, a transfer of dollar balances by foreign official organizations from private U.S. banks to their foreign branches or to foreign banks is encouraged because such a transfer would reduce the liabilities to foreign official organizations as recorded in U.S. statistics, and thus appear as an improvement in the balance. For the same reasons operations by official agencies in the forward market would be encouraged relative to operations in the spot market.

Whatever measures are chosen to analyze the balance on foreign transactions, the possibility of "window dressing" has to be minimized, therefore, to avoid deception which would merely postpone and frequently raise the costs of policy actions needed to achieve real improvements.

E. GUIDING QUESTIONS FOR BALANCE OF PAYMENTS ANALYSIS

The concept used by the Balance of Payments Division is based on the fundamental question of the purpose of balance of payments statistics. The Committee also raises that question and says (ch. 1, p. 13r): "Statistics and analysis are essential to an understanding of economic processes and events, and hence to decisionmaking, whether by private citizens or by national governments." That implies that the analysis should be focused on those developments which require attention by those responsible for decisionmaking at a stage of these developments when there still is an opportunity to make meaningful policy decision. The concept used by the Balance of Payments Division in the analysis of balance of payments data is designed to meet these criteria.

Next, it has to be decided, whose need to make decisions should be considered, and what policy goals are involved. The answer is that the analysis should be focused on the needs of those authorities within this country who are responsible for the "maintenance of stable and orderly exchange rates" (p. 141). These policy goals, as the Review Committee also stresses (p. 141), cannot be separated, however, from other policy goals, in particular the orderly development of the domestic economy, which requires that international transactions do not reduce or overstimulate domestic business activity or unduly disturb the prevailing level of prices.

The question is, therefore, whether a given pattern of international transactions is sustainable from the point of view of these policy goals over the longer run or whether policy actions are required to change the prevailing pattern into one that is sustainable. If the pattern is not sustainable, analysis should draw attention to that condition as early as possible so that policy actions can be taken. Otherwise its usefulness to those responsible for policy actions is considerably reduced. The question is, therefore, to determine those patterns which usually are not sustainable, although from time to time other patterns which also may not be sustainable over the longer run should receive proper attention. Clearly, this

analysis is a matter of judgment, and to be effective such judgement needs to be adjusted to changes in the significance of transactions and the institutional environment in which they take place.

F. TRANSACTIONS REQUIRING SPECIAL ATTENTION

(*1*) *Changes in reserve assets*

Sales of reserve assets by the monetary authorities are not sustainable over the long run because they are limited in amount. They may be tolerated, however, in controlled and specific amounts if the current holdings exceed the amounts which under given conditions are considered desirable. They may also be tolerated within safe limits if the sales are associated with reversible transactions (such as a temporary increase in inventories of imported goods), so that within a foreseeable time and without the need for further policy actions reserves can be expected to be replenished again.

If the supply of reserve assets were infinite we would not be concerned if they had to be paid out. Neither would we have to be concerned about weaknesses of our currency in the exchange market. What matters is not that such weaknesses develop, but that the means to compensate for them are limited. It does not matter, however, whether the loss in reserve assets was due to weaknesses in the exchange rate or to other reasons. A foreign monetary authority can obtain the dollars with which it purchases gold from us by interfering with the market and limiting the amount of dollars available to its residents. It may purchase gold by using dollars it had obtained through voluntary sales by its residents and may do so because of traditional policies, concern for the exchange value of the dollars, concern for economic developments within its own economy, or for political reasons.

Gold may also be sold by the United States to private persons abroad (indirectly perhaps, but nevertheless) in order to keep the price of gold in the principal foreign gold markets within certain limits. About $100 million a year are currently sold to domestic purchasers for industrial purposes. No matter to whom and for what reasons gold is sold, it represents a decline in our holdings of reserve assets, which must be considered as a development which cannot be sustained in the long run. The Review Committee also includes all sales of reserve assets into the balance that needs to be focused on, but by doing so it is inconsistent with its concept, because such sales are not necessarily associated with settlements between official monetary organizations, and the decline in our reserves does not necessarily correspond to an increase in foreign reserves.

(*2*) *Changes in liquid liabilities*

(*a*) *The use of the dollar as an international monetary asset.*—Nearly all countries analyze their balance of payments on the basis of changes in their official reserves. Their international transactions are generally not settled in their own currencies and their currencies are not used in transactions among other countries. This does not apply to the United Kingdom and the United States, and the fact that the United States dollar and the British pound are used as international media of exchange and reserve assets is the essential reason for analyzing the balance of payments of these countries on a different basis from that applicable for the rest of the world. To use the same criteria for all countries would clearly be based on the quite unrealistic assumption that all currencies play the same role in international transactions.

The currency of the United Kingdom is used in international transactions and as a private and official reserve asset mainly by the sterling area and some other countries with which the United Kingdom has relatively close economic relations.

The United Kingdom and those countries which use sterling as a reserve asset also use dollars as reserve assets, and a large part of their transactions are paid in dollars. Thus the United Kingdom has international monetary assets in dollars and monetary liabilities in sterling. This is reflected in its balance of payments compilation which focuses on the balance between its reserve assets including dollars and its liabilities which are mainly in sterling.

The United States is in the unique position of having its currency used throughout the world as money in transactions between foreign countries and to some extent within foreign countries, as reserve assets for private business and official organizations and as a base for credit extension by banks. In contrast, the United States itself hardly at all uses foreign currencies in its foreign transactions, and holds only very small amounts of "convertible currencies" in official reserves. (Even these "convertible" currency holdings by the Federal Reserve System and

the Treasury are not freely usable in transactions with third countries as is gold. Foreign currency assets are not used as reserve assets by private U.S. businesses and persons, quite in contrast to the way dollars are used and held abroad. (Cash balances held by the weekly reporting member banks in foreign banks early in 1965 were around $250 million, and that amount has increased by only about $100 million over the last 3 years.

This role of the dollar abroad, and the very limited role of foreign currencies here makes the international position of the United States quite different from that of other countries. This has to be reflected in the analysis of the balance of payments of the United States. If it were not, the analysis would not be realistic.

(*b*) *The long-term growth in foreign requirements for monetary dollar assets.*—Liquid dollar assets are held abroad principally as monetary assets or near monetary assets. Such assets include demand and time deposits in U.S. banks, and such private and Government securities which mature within relatively short periods (generally within 1 or 2 years), and which have a rather broad market in the United States, so that they can be liquidated at any time with a minimum risk of a loss in value. Time deposits can usually be liquidated before their maturity although this may involve loss of interest.

Liquid dollar assets yield less than assets in most other currencies. Thus they are held because of their superior liquidity and wide acceptance as a medium of exchange rather than for the income that they yield. They are not investments in the sense of an asset which is purchased primarily for its yield. The Committee considers private, but not official foreign holdings of liquid dollar assets primarily as investments, but this is not a proper evaluation of the characteristics of these assets relative to other foreign and domestic assets, and the purpose for which they are held.[2]

Transferring liquid dollar assets to foreign residents thus increases their holdings of monetary or quasi-monetary assets. The question is whether a balance of payments pattern which includes a continuing increase in such holdings can be considered a pattern which can be sustained regardless of the size of the increase, and thus would not have to evoke concern, or whether it may have to be considered a pattern which cannot be sustained, and thus requires correction through policy changes.

To the extent the dollar is used and needed in international transactions throughout the world, it can be assumed that a growth in such transactions would require an increase in foreign dollar holdings. If a 4-percent annual growth in international business would require an equivalent rise in foreign monetary assets, the total of foreign gold, dollar, and sterling assets would have to rise by about $2½ billion a year. If official gold reserves would be increased through sales of newly mined supplies and sales by the Soviet bloc by about $1 billion (which is more than had been obtained from these sources during recent years), the remaining foreign requirements for official and private liquid reserve assets amounting to about $1½ billion, could take the form of either dollar accumulations or gold purchases from the United States, assuming that foreign holdings of sterling would expand only by minor amounts and that currencies of other countries are not being used to supplement the U.S. dollar and the British pound.

International monetary assets do not have to increase in the same proportion as the volume of international business, however. Working funds can be used more intensively, particularly as banking operations become more efficient. Reserves do not have to rise as fast as the volume of business if opportunities increase to use credit to meet temporary cash shortages, and, of course, if business activities become more stable and coordinated so that cash shortages are less likely to appear. Furthermore, the amount of gold entering official reserves is likely to increase as the supply of dollars abroad tightens relative to the demand and confidence in the dollar as a reserve asset strengthens.

Thus it would be difficult to estimate the additions to foreign dollar holdings that would currently be required to facilitate a satisfactory rate of growth in international business at reasonably stable prices, but it is likely that the percentage increase in foreign dollar holdings could be somewhat smaller than the rate of increase in the volume of transactions. The demand for additional dollar holdings to meet the rising volume of business comes from foreign official agencies as well as private business. The argument that this demand should be deducted

[2] The view that liquid dollar assets held in foreign private account are essentially monetary assets is also shared by Ministerial Statement of the Group of Ten, Annex sec. 36, p. 73, quoted above. "* * * the initiative already taken toward strengthening the multilateral character of the international monetary system by bringing within the review and appraisal processes of multilateral surveillance the various elements in international liquidity—*whether of a private or official character* [italic supplied by the author of this paper] available or created for the financing of surpluses and deficits."

from the measure of the deficit in the U.S. balance of payments applies therefore to the currently used concept which includes changes in all liquid liabilities in the balance as well as the concept recommended by the Committee which includes only liabilities to foreign official organizations. Since the distribution of the additional dollar holdings between foreign official organizations and private holders depends largely upon the balances of payments of foreign countries, and their internal arrangements and policies, one cannot estimate the required increase for official holders or private holders separately. An allowance should be made for a growth in foreign dollar holdings required to meet the monetary demand of a growing world economy, but that allowance can be made only for the total amount and deducted from a measure of the balance which includes the change in liquid dollar holdings by all foreigners.[3]

(c) *Limitations in the foreign demand for liquid dollar assets.*—There may be a question, however, whether a rise in foreign dollar holdings, even in that magnitude could necessarily be sustained over the long run.

The dollar is accepted internationally as a medium of exchange and a reserve asset by foreign official organizations as well as private business not only because of the large share in world production and commerce held by the United States, and because of the freedom with which it can be used, but also because of convertibility by foreign official organizations into gold at stable rates. This is also the basis for the acceptability of the dollar as a private reserve asset abroad, because the dollar can at any time and within a narrow price range be converted into local currencies and reserve assets.

If foreign dollar holdings would rise simultaneously with a rise in U.S. gold holdings, confidence in the continued convertibility of the dollar into gold could be maintained, and—assuming that foreign dollar holdings do not rise faster than the volume of international business—the process could be sustained. If the liabilities do not exceed the gold reserves by too large an amount, it may even be possible that they could rise faster than gold holdings as long as the ratio between them does not decline. Under such conditions the balances on U.S. foreign transactions, as defined by either the concept used by the Balance of Payments Division or the Review Committee could show small "deficits," and either measure would have to be qualified to indicate an approximate amount which may be considered as target for policy purposes.

Even if the rise in liabilities does not exceed the requirement of the growing volume of world business transactions, but occurs simultaneously with a decline in U.S. reserve assets, it cannot be expected to be sustainable, however, because confidence, by official as well as private holders of dollars, in the continued ability of the United States to convert the dollars into gold is likely to decline.

A decline in confidence would affect not only the additions to the foreign dollar supply but impair also the usefulness of existing dollar balances held abroad. A rise in foreign dollar holdings under such conditions could be detrimental rather than helpful to the expansion of world business. In the long run the increase in foreign requirements for an international medium of exchange would more successfully be met through the development of another form of international money, rather than through an increase in foreign holdings of liquid dollar assets, unless there were also a rise in U.S. reserve assets in amounts sufficient to preserve confidence that convertibility of the dollar remains unimpaired.

A rise in U.S. liquid liabilities used as monetary and reserve assets abroad is even less sustainable if it exceeds the requirements for such assets at any given level of business activity and prices. A rise above that magnitude can have one of the following results:

(i) It can lead to a rapid decline in the price of the dollar on exchange markets with the result that the excess supply is sold to monetary authorities. The authorities may sell the dollars which exceed their own requirements for gold.

Even when monetary authorities do not pursue a more or less fixed policy with respect to the composition of their reserves, and even if they do not lose confidence in the dollar, they may convert some of the dollars they receive into gold. Purchases of dollars from their banks increase the reserves of the banks and thus expand their lending facilities. If the monetary authorities of these countries are concerned about inflationary pressures within their economies they may try to hold down the rise in bank reserves by selling dollars or other liquid assets back to their banks. This can be done by lowering the spot price of such assets, or by entering into forward purchase agreements at higher prices. Since these

[3] Ministerial Statement of the Group of Ten and Annex sec. 19, p. 70: "* * * over time, the probable need for growth of private liquidity should be taken into consideration along with the needs for official resources."

operations tend to be expensive, and often are effective for only short periods of time, foreign authorities have also attempted to reduce capital inflows through direct measures, for instance by limiting interest paid on foreign funds deposited in their banks (even to negative rates), or by requiring banks to maintain higher reserves on foreign than on domestic deposits. Germany has imposed withholding taxes on earnings on securities held by foreign residents.

(ii) The excess dollar supply may be used by its foreign holders as monetary assets and spent or lent to others in lieu of, or in addition to, their own currency. This, as has been indicated earlier, would tend to frustrate monetary and credit policies by the foreign monetary authorities and governments, particularly if they are attempting to restrain inflationary pressures. Their reaction can be expected, as indicated above, to increase pressure on the United States by purchasing gold. Thus even if the excess supply of dollars is initially not sold by foreign private holders to their monetary authorities, they may nevertheless increase their gold purchases. The sharp rise in gold purchases starting in the last quarter of 1964 and accelerating in the first quarter of 1965 can probably—at least in part—be attributed to the reaction by foreign central banks and governments to the large rise in dollar assets by foreign private banks and other holders. These considerations by official authorities and actions related to them do not fit into the concepts used by the Review Committee, because they are based on the assumption that the role of these authorities in the foreign exchange markets is limited to filling gaps arising between demand and supply of foreign exchange in private transactions. These recent events indicate again how deceptive it would be to rely on these assumptions.

(iii) Even in those countries where central banks and governments are relatively ineffective in maintaining the internal and external value of their currency and in supplying foreign currencies to those who want to purchase them, a rise in dollar holdings by private enterprises and persons—and the major part of dollar holdings by foreign nonfinancial enterprises and persons appear to be in such countries—cannot be expected to be sustainable in any amount and for any length of time.

Although it can be assumed that dollars could continue to compete as a reserve asset with the local currencies of such countries, and consequently would not be sold to local banks or the local central banks, they can be exchanged for other foreign currencies, which appear to better meet the requirements of reserve assets. Whether or not that would be done, depends on the confidence of holders in these countries that in spite of the rise in their own, and worldwide dollar holdings, the U.S. authorities will be able to maintain the value and free convertibility of the dollar. Thus dollars held privately in Latin America, for instance, which comprise the major part of dollars held abroad by others than banks, can be sold for other currencies; e.g., Swiss franc. If Swiss banks sell the dollars to their central banks, the major part would probably be converted into gold.

A decline in confidence may not necessarily become evident gradually but is likely to appear suddenly, triggered by political or economic events. The same political or economic events may have a different effect on confidence depending on the amount of dollars held abroad relative to U.S. reserves. The larger that amount is, the stronger may be the impact. It will also vary as between those holding the dollars, and is likely to affect official holders less than private holders.

The Review Committee states that a rise in dollar holdings by private foreign banks, enterprises, and persons should be considered a sign of strength of the dollar. The same should apply to a rise in holdings by foreign official monetary agencies although the Review Committee considers the latter a sign of weakness. The question should be whether private holdings are more likely to be sustainable in the longer run. Unless that question can clearly be answered in the affirmative, the Review Committee's analysis can result in a dangerous illusion, as the recent experience with the British pound sterling illustrates. The run on the pound was made by foreign private holders, not by foreign official holders. In reviewing the history of the sterling crisis in the last months of 1964 the Economist of December 12, 1964, states (on p. 126 1): "Since * * * Britain has never managed significantly to strengthen the intolerable international banking balance sheet with which it emerged after the war, so that its ratio of quick assets to quick liabilities has remained consistently between 1 to 3 and 1 to 4, this currency system has itself been a major ingredient in the succession of sterling crises."

The ratio of quick-dollar liabilities to quick assets available to U.S. monetary authorities is currently slightly between than 2 to 1. We may be advised by the British experience, however, to keep its further rise to a minimum. It would be an illusion, however, to improve that ratio by excluding from it quick liabilities to foreign private holders.

(iv) In order to prevent excess liquid dollars from being sold by their private foreign holders to the monetary authorities of their own or of other countries, and to discourage foreign official holders of dollars from exchanging them for gold, the United States can raise interest rates. This may compensate foreigners for the rising risk they are taking in holding increasing supplies of dollars while U.S. reserves decline or at best do not expand. If the foreign dollar supply continues to rise relative to U.S. reserve assets the price paid to foreigners for holding the dollars would also have to continue to increase. According to the Review Committee a rise in private foreign dollar holdings should be considered as an indication of strength in the balance of payments and not a situation which requires correction. This concept is based on the assumption of passivity on the part of monetary authorities in the exchange market which implies that a rise in interest rates must be the result of developments in the private capital market alone and not of actions by public authorities to influence the foreign holders of liquid dollar assets. The assumption is not only unrealistic, but can also result in most undesirable consequences, because in the longer run a rise in interest rates resulting from a policy to stimulate the holdings of dollar assets by foreigners could have a retarding effect on domestic business activity. It would also raise the costs to the U.S. balance of payments by raising interest paid to foreigners. And finally it would reduce interest in corrective actions which are inevitable, but would become more difficult the longer they are postponed.

(3) Other transactions which may not be sustainable

Although the analysis of the balance of payments—first of all—should take into consideration changes in official reserve assets and then those in liquid liabilities, there are sometimes developments in other transactions or in the economy in general which have to be taken into account.

(*a*) Advance repayments of foreign debts to the U.S. Government may be an example. Such repayments do reduce the amount of liquid dollar holdings abroad, and may also reduce foreign purchases of gold. They do, therefore, provide relief to the net cash position of the United States. Since the amount of loans outstanding, particularly in countries that otherwise would accumulate the dollar or purchase gold, is limited more or less to the loans they had received in the early postwar period, such repayments can only provide temporary relief to the balance of payments, and should be considered to be not sustainable. It is preferable, therefore, to consider such transactions in an intermediate category, between the changes in reserve assets and liquid liabilities, and the other transactions.

The Review Committee also recommends that advance debt repayments be included among the transactions by which the balance on foreign transactions is measured. The major differences between the concepts used by the Review Committee and those used in the analysis published in the Survey of Current Business are as follows:

(i) The Review Committee restricts such transactions to those between governments (p. 119) while the concept used in the Survey would include also advance repayments received by the United States on loans extended to foreign borrowers which are not governments. This broader concept has the advantage among others of relieving the compiler of data from the need to decide how repayments of loans by foreign government-owned enterprises or loans guaranteed by foreign governments should be treated. A large share of U.S. Government loans would fall into these categories. The broader concept also includes sales to foreigners of foreign debt obligations held by the Export-Import Bank to either the debtors themselves or to third parties abroad.

(ii) The Review Committee restricts such loan repayments to those which have "been specifically arranged for the purpose of financing an international payments surplus or deficit" (p. 119). This restriction imposes upon the compiler the burden of determining the motivations of those engaged in the transaction, not only of those in the United States but also of those abroad. Such determinations are always open to dispute. Furthermore, the Review Committee also requires that such repayments be considered as part of the balance if they are made to "finance a foreign surplus" not only a U.S. deficit. The foreign surplus could, of course, be the result of the debtor country's transactions with other countries, rather than with the United States. In fact, the United States at the time in question may not have a deficit, and, therefore, may not require or welcome such repayments.

Other types of transactions which have to be watched, whether they are sustainable, include depletions of inventories of imported goods, particularly food

stuffs and industrial materials for which domestic demand can be expected to be relatively closely related to domestic business activity, incomes or population. A continuing rise in liabilities for imports may also arouse concern. Thus an improvement in reserves obtained by reducing such inventories or by deferring payments for imports should not be considered an improvement in the balance of payments; stable reserves under such conditions hide a deterioration.

On the other side, reductions in reserves resulting from an increase in such inventories should not necessarily be considered as a deterioration in the balance.

Such changes are difficult to measure, however. They can only be indicated by more or less close estimates. For that reason it is preferable to include them in a qualitative rather than a numerical or tabular analysis of the balance of payments.

Advances on sales of military equipment by the Department of Defense have a complicated and mixed history which made it necessary to consider them as special transactions. They are also made in relatively large irregular amounts which makes it easier to analyze changes in the balance of payments without them. When such payments were received from Germany in large amounts, particularly in 1959 and 1960, they exceeded the amount of orders actually placed. The funds were placed in a special interest-earning Treasury account from which they could be withdrawn again. Thus, these deposits were treated in balance of payments accounts as liquid liabilities such as foreign holdings of marketable Government securities. These payments by Germany seem to have been facilitated and influenced by the budgetary and balance of payments surpluses of Germany at that time.

In the latter part of 1961 negotiations were conducted with Germany to increase German payments to the United States for military equipment to an amount approximately equal to U.S. military expenditures in Germany. At the same time it was arranged that the amounts accumulated in the Treasury account be used only for military purposes. Thus about $470 million which had been in that account at the end of 1961 were shifted from liquid to nonliquid U.S. liabilities from then on, as advances were received or deliveries were made, nonliquid liabilities were either raised or reduced. Receipts on that account continued to be subject to negotiations, however. Until recently, new advances considerably exceeded deliveries of military goods, and for that reason the question could be raised whether the rise in liabilities should be considered in the analysis of the balance of payments as a development which could be sustained over the longer run. Although these liabilities were not liquid or monetary liabilities, and therefore not included in the measurement of the balance, it nevertheless seemed consistent with a cautious interpretation of the data to call attention to these transactions by including them as "special" transactions. As deliveries approach cash receipts, the need for such treatment may disappear, however.

Finally, but as important as any other aspect of balance of payments analysis, is its relation to the state of the domestic economy. Stability in reserve assets and in liquid liabilities while domestic business activity is shrinking relative to productive capacity should not be interpreted as no change in the balance of payments. If a rise in business activity would raise imports and dampen incentives for exports without being compensated in the capital account (excluding the items by which the balance is measured) a stable balance of payments would merely hide a potential deficit. Such a situation should not be considered to be sustainable in the longer run, and its correction would require precisely the same measures as if a deficit in the balance of payments had actually occurred.

The size of the deficit under such conditions cannot be measured on the basis of actual transactions, however. Perhaps an attempt should be made to estimate on the basis of various assumptions, and historic relationships a "full employment balance of payments" somewhat analogous to the estimates of a full employment cash balance in the Government budget. This is clearly a complicated analytical task, which would, however, help materially in understanding the balance of payments developments at any particular time, and provide a better guidance to Government policy than is now possible. It may be pointed out here, however, that the need for this type of approach is more clearly indicated by the analytical approach of examining whether a given balance of payments pattern has moved toward or away from one that can be expected to be sustainable over the longer run, than by the approach recommended by the Review Committee of measuring the gaps in the supply and demand for foreign exchange arising from transactions of private business and nonmonetary official agencies at given rates of exchange, even if that were possible.

G. MAJOR ARGUMENTS AGAINST INCLUDING CHANGES IN LIQUID LIABILITIES TO FOREIGN PRIVATE ACCOUNTS IN THE MEASURE OF THE BALANCE ON FOREIGN TRANSACTIONS

1. The measure exaggerates the deficit

"Because of bookkeeping rules followed by Government statisticians, the magnitude and the nature of the U.S. balance of payments deficit have been placed in the worst possible light." [4]

The argument is illustrated in the National City Bank Letter (and in other places) by this quotation: "When an American deposits $100 in a bank abroad, the transaction is recorded 'above the line' as an ordinary capital outflow; but when a foreigner deposits $100 in a U.S. bank, the transaction is recorded not as an ordinary short-term capital inflow—side by side with U.S. capital outflows—but 'below the line' as one of the means through which the U.S. balance of payments is measured and financed." [5]

The Review Committee (p. 108r) makes a similar statement "Thus any inflow of foreign private capital into U.S. bank deposits, commercial paper, or Treasury securities has been treated as a settlement item that helps to finance the deficit on ordinary transactions, rather than as an ordinary capital inflow that helps to reduce the deficit. Outflows of private U.S. capital, on the other hand, all go above the line as ordinary transactions, and swell the deficit."

To determine the interpretation of such transactions under the concepts preferred by the Review Committee and under the "liquidity" concept both their credit and debit side has to be shown. Thus, if an American deposits $100 in a foreign bank, it results in a transfer of $100 from the account of that American in a U.S. bank to the account of the foreign bank in that U.S. bank. This transaction consists of an increase in U.S. assets abroad and in foreign assets in the United States or, which is the same, in U.S. liabilities to foreigners. Under the concept of the Review Committee the transaction would be recorded as follows:

Outflow of private U.S. capital	−100
Inflow of private foreign capital	+100
Balance	

Under the "liquidity" concept it would be recorded:

Outflow of U.S. private capital	−100
Increase in liquid U.S. liabilities	+100

which would be interpreted as an adverse balance of 100.

If the $100 balance in a U.S. bank were transferred by the foreign bank to its own or some other country's central bank or other official organization it would be recorded by the Review Committee as follows:

Outflow of private foreign capital	−100
Inflow of official foreign capital	+100

which would be interpreted as an adverse balance of 100.

The same transaction under the liquidity concept would be assumed to cancel out thus showing a balance of zero.

There are several problems connected with the analysis of this example of a transaction.

(1) It can be seen that the analysis under the concept of the Review Committee and under the liquidity concept results in the same measure of the balance if the U.S. deposit abroad is matched by a foreign official deposit in the United States. Even under the Review Committee concept the U.S. private asset is not offset against a U.S. liability provided the latter is to a foreign official organization. The problem therefore is not whether foreigners obtained the deposit in U.S. banks as a result of a deposit by an American in a foreign bank, by a long-term investment by an American abroad, as a payment for U.S. imports or any other transaction. The decisive question for the Review Committee is whether the dollars are or are not transferred to an official organization. The decisive question under the liquidity concept is whether the total of liquid (i.e. monetary or near monetary) dollar assets held by all foreigners is changing.

Under either concept privately held assets are not the equivalent of assets held by those official organizations which are responsible for the maintenance of the exchange value of the currency and the international reserves. If the balance of payments were analyzed to measure changes in international monetary assets and

[4] First National City Bank of New York, Monthly Economic Letter, April 1965, p. 45.
[5] Ibid p. 46.

liquid liabilities of all residents in a country the transaction would, indeed, cancel out, whether or not the dollars are held by foreign official organizations. Under neither concept is the analysis focused on the monetary assets of all residents, but only on such assets held by certain residents, namely, the official agencies.

Under the liquidity concept, however, attention is drawn to the pattern of international transactions at the time when liquid liabilities are rising, which in this example would be the outflow of U.S. capital, while under the concept of the Review Committee attention is drawn to the sale of liquid dollar assets by foreign residents to their monetary authorities. The liquidity concept thus makes it possible, that policy actions are directed toward a reduction in such outflows of U.S. capital, while under the concept of the Review Committee they would be designed to prevent the sale of dollar assets by foreign private holders to foreign official holders. Drawing attention of policy formulating officials to the first stage of the operation, not only makes it easier for them to act, since presumably they can influence domestic residents more effectively than foreign residents, but also gives them an earlier and additional opportunity to prevent such capital outflows to affect our monetary reserves.

(2) If foreigners increase their liquid assets in the United States not through transfers of dollar deposits from a U.S. account, but from a foreign account held in U.S. banks, the transaction would appear in the balance of payments compilations as follows:

Increase in foreign dollar account A	+100
Decrease in foreign dollar account B	−100

Under the "liquidity" concept these changes cancel out.

Under the concept of the Review Committee, however, distinction is made between foreign dollar accounts belonging to official monetary organizations and those belonging to other foreigners. If A is a private account and B an account of an official monetary organization, according to the concept of the Review Committee, the transaction would result in a surplus for the United States, and if A were an official monetary organization, the transaction would result in a deficit. This applies to transactions between residents of the same foreign country and to those between residents of different foreign countries. Thus, according to the concept of the Review Committee the balance of payments of the United States can be affected by transactions in which the United States is not a partner, as long as payments are made through transfer of funds between bank accounts held in the United States. According to the "liquidity" concept such transactions are not treated as transactions by the United States, but among foreigners, and thus have no effect on the balance.

(3) Privately held assets abroad can, in principle, be offset against liabilities under the liquidity concept, if the dollar balances were not freely usable by the foreign holders, but tied to the holdings of U.S. assets abroad. This would happen in cases of swaps of deposits between banks for "window dressing" purposes at the end or middle of the calendar years. It also happens in October and November when Canadian banks want to build up their U.S. dollar assets and induce U.S. corporations to deposit funds with them. If these transactions could be measured, appropriate adjustments could be made in the liquid liabilities. In any case, these transactions are more or less smoothed out in the seasonal adjustments. Compared with window-dressing transactions in the form of transfers of dollar balances between foreign private banks and official organizations which tend to distort the balance as measured by the Review Committee, those affecting the "liquidity" balance are relatively small.

Compensating balances which foreign borrowers have to hold under loan agreements with U.S. banks should not be considered liquid liabilities. Such balances cannot be drawn on. This problem also affects the measure of the balance preferred by the Review Committee, because such balances are not acquired as a result of compensatory operations of official agencies in the exchange market, and because the foreign monetary agencies do not have them, de facto, at their disposal. In some cases, foreign official balances are earmarked even for loans to foreign banks and productive enterprises, particularly if they are effectively controlled by the official agencies.

Compensatory balances are not always provided by the recipients of the loans or other foreigners having balances in the lending bank. They may also be provided by U.S. parties at whose request the loans have been provided. This would apply to loans to foreign subsidiaries of U.S. corporations, and sometimes also to loans to other foreigners, even to foreign governments.

The problem of compensating balances is not limited to the balance of payments. It also affects other statistics, particularly the measures of the domestic money supply, and such regulatory and accounting concepts as the relation of bank reserves to deposit liabilities. It also affects the measure of the costs of loans, and thus of the effective interest rate.

There are no data on compensating balances. If such data were available not only balance of payments statistics could be improved, but many other economic statistics as well.

Compensating balances vary between borrowers and banks, and over time according to changes in the demand for loans and in lending facilities of the banks. For foreign loans such balances are believed to be generally lower than on domestic loans. On loans to borrowers in Europe compensating balances may be less than on loans to other borrowers. Informal inquiries indicated that the average may be around 15 percent. The practice of earmarking such funds applies to short- as well as long-term loans and to acceptance credits.

Assuming that compensating balances have been set aside only from foreign balances (which would tend to overstate the amount) and that the rate was about 15 percent, the amount by which the balance on U.S. foreign transactions, measured by the "liquidity" concept could be reduced would be (in millions of dollars): 1960, $120; 1961, $190; 1962, $75; 1963, $200; 1964, $300.

With these adjustments the liquidity balance and the balances on regular transactions would change as follows:

	1960	1961	1962	1963	1964
Liquidity balance:					
Before adjustment	3,881	2,370	2,203	2,644	2,761
After adjustment	3,761	2,180	2,128	2,444	2,461
Balance on "regular" transactions:					
Before adjustment	3,918	3,071	3,605	3,261	3,053
After adjustment	3,798	2,881	3,530	3,061	2,753

The improvement in the balance on "regular" transactions from 1962 to 1964 would appear somewhat larger after the adjustment for compensating balances than before, but the differences are too small to change the interpretation of the developments significantly.

II. The measure is not symmetrical

On the surface it seems reasonable to assume that a balance of payments surplus of any one country should be offset by an equal deficit in the aggregate of the balances of payments of all other countries.

This would be correct if the balance were defined to include the changes in the total amount of international monetary assets and liabilities of all residents in each of the various countries, and if, for these monetary assets which are physical products, such as coins or gold bars, it were assumed that their stock cannot be changed by new production or destruction, and for those monetary assets which are debt obligations, including bank deposits, that an increase is offset exactly by an increase in monetary liabilities. After monetary debt obligations have been created, an increase in the holdings of such assets by one country would be matched by a decline in holdings by another country. A contraction of such assets would be offset by a corresponding contraction in liabilities.

This symmetry does not exist in the real world because the stock of physical monetary assets does change. Furthermore the focus of balance of payments analysis is not on the changes in monetary assests and liabilities of all of a country's residents but only on those changes which cannot be sustained if the monetary authorities are to continue to maintain the exchange value of their country's currency.

Setting up balances of payments of various countries according to a symmetrical format may be desirable in order to relate positive and negative balances of the various countries, but this is not only impossible because certain of the postulates stated above do not exist, but it would also fail to meet policy requirements in each of the countries concerned.

The following examples may illustrate these points:

(*a*) Monetary gold reserves are increased by official acquisitions of newly mined gold, so that the stock of monetary gold is rising in some countries without an equivalent decline in others. The United States is currently reducing its monetary reserves by about $100 million a year through the sale of gold to domestic industry, which is not offset by an equivalent rise in reserves of other countries.

Shifts of gold between official monetary organizations of a country and private persons and enterprises are recorded as surplus or deficit for that country even according to the Review Committee's concepts notwithstanding that these balances are not matched by opposite balance of other countries.

(*b*) Shifts from official to private holders of dollars held abroad are treated by the Review Committee not only as a deficit abroad but also as a surplus for the United States. The treatment under the "liquidity" concept would be the same as in the case of a shift in gold holdings.

The Review Committee argument for treating the two cases differently is that gold is an asset without being any one country's liability, while currencies constitute also liabilities of the countries issuing these currencies and assuming responsibility for their exchange value and their continued usability as a medium of exchange and reserve asset. Thus, if residents of country A shift their cash holdings from their own currency to dollars the transaction could be interpreted as a rise in the relative strength of the dollar in the exchange market, and this should be reflected in the U.S. balance of payments. A reverse transaction consisting of a shift in the cash holdings of private residents of country A from dollars back into their currency and a corresponding rise in official dollar holdings in that country would be interpreted as a weakening in the market position of the dollar.

This argument seems plausible. This interpretation implies, however, that a weakening of confidence in the currency of country A by its own residents of those of other countries would be a desirable development from the point of view of strengthening the balance of payments of the United States, as long as that development results in a change from official to private dollar holdings. If such a development could be induced by policy actions, we should attempt to promote such policies.

Actually, we do the opposite. We are cooperating with governments and central banks of other countries to prevent distrust in their currencies, and thus preserve foreign official reserves, even if they consist of dollars. This policy is well founded. Essentially it implies that a major shift of foreign private cash holdings from foreign currencies into dollars whch are withdrawn from foreign official reserves is an indication of a weakening in the position of these currencies, rather than of a rising strength in the position of the dollar.

The need for international cooperation is based on the assumption that the weakness of a major currency may undermine the international payments system, and thus ultimately also affect confidence in the dollar itself. In effect this policy implies that a shift of dollar holdings from official to private reserves is comparable in its effect to a shift of gold from official reserves to private hoards.

If balance of payments compilations are to serve as guide to those responsible for policy formulation, the concept under which both types of transactions are interpreted in the same, although asymmetreical, manner is likely to be more in tune with the general goal of achieving a balance of payments pattern that can be maintained over the longer run, than the concept preferred by the Review Committee.

(*c*) The Review Committee recommends that each country report as deficit an increase in banking liabilities to foreign official organizations, but not in banking liabilities to foreign private organizations. Even if the figures were available to follow that recommendation, the following example shows that balance of payments reports based on this concept may present a wrong guide to the monetary authorities and that it is most unlikely that they would accept this guide.

The following example may illustrate the case:

1. U.S. travelers spend dollars in Spain.
2. The dollars accrue to the monetary authorities of Spain.
3. The monetary authorities of Spain deposit the dollars in a Swiss bank.
4. The Swiss bank increases its deposits in New York.

According to the Review Committee:

1. Spain should show a surplus.
2. Switzerland should show a deficit.
3. The United States would be in balance.

If the Swiss authorities make and enforce a rule (as most countries do) that their private banks maintain a reasonable balance in their foreign assets and liabilities, not only with respect to amounts but also with respect to their respective liquidity, there is no reason to assume that such transactions by the Swiss banks could not be continued without adverse effect on Swiss reserves or on the Swiss economy. Switzerland would not, and should not, evaluate such transactions as creating a deficit in its balance of payments, and initiate the type of policies

which would be necessary to eliminate a deficit. If Switzerland shows its transactions to be in balance, however, the surplus of Spain would not have an offset, and the international symmetry would not materialize.

According to the "liquidity" concept the United States would record a deficit which would match the surplus of Spain. This would seem to be the appropriate analysis, since in this example, the chain of transactions started out with expenditures by U.S. tourists in Spain. It would also provide the proper guide to policy-making officials since only the economies of the United States and of Spain would be affected, certainly not the economy of Switzerland, except for a small income from interest rate differentials which it would earn from that type of transaction.

The Review Committee says (p. 117r): "that it is not clear that the Committee's version of the official settlements concept misstates the facts. It is a [Swiss] bank, not a U.S. bank, that has incurred a liability to a foreign official institution, even though the liability is denominated in dollars. The decision of the [Swiss] bank to hold dollar assets in New York as cover for its liabilities is, in any case, a private business decision; the bank could have sold those dollars for [Swiss francs] or invested them in some other form. Nationality of residence ought to take precedence over nationality of currency in balance of payments classifications."

Of course, the Committee would not misstate the facts, but it would employ an interpretation of these facts which would not only be useless but also misleading to those interpreting international economic developments, and to those who have the responsibility of taking policy actions to keep foreign transactions in a pattern which over the longer run can be sustained.

(*d*) Symmetrical presentation of the balance on foreign transactions, as recommended by the Review Committee to be adapted in balance of payments presentations of the United States as well as of other countries would require that transactions between foreign countries paid in dollars be reflected in the figure measuring the balance on the international transactions of the United States if dollars are transferred between the official account in one foreign country and a private account in another.

Thus, if a payment by country A to country B is made through a transfer of dollar balances from an official account in country A to a private account in country B, the U.S. balance of payments should show that transaction as a surplus, and the opposite movement as a deficit. The Review Committee supports this concept on the ground that there has been a change in the market value of the dollar reflecting a change in the desire by foreign private persons and enterprises to hold dollars. In reality no development of that type may have taken place in either of the two countries involved in the transaction. What happened was that dollars were transferred between countries which differ with respect to the distribution of liquid dollar assets between private and official accounts, but that the conditions governing that distribution were not changed in either country.

The Review Committee (p. 115r) says that "acquisitions by foreign central banks of claims on the United States, and declines in foreign private claims on the United States do indeed represent transactions with this country." This reflects the fact that a transaction of that type in the balance of payments of the two countries would appear as follows:

COUNTRY A		COUNTRY B	
Imports from B	−100	Exports to A	+100
Decline in official dollar holdings in the United States	+100	Increase in private dollar holdings in the United States	−100

The change in dollar holdings is interpreted by the Review Committee as a transaction with the United States. If the dollar holdings of both foreign parties are in accounts of U.S. banks, statistics collected from these banks would reflect the transaction as a shift between foreign accounts. The question is not whether such transfer of funds are recorded in U.S. statistics, but rather how they should be interpreted. The case may be illustrated by a simple domestic transaction. If a sale is paid with a Federal Reserve note, the Committee would interpret it as an investment by the seller in the Federal Reserve System and a corresponding disinvestment by the buyer. Similarly, if a sale is paid by a check drawn on the buyer's bank B, the Committee would interpret the transaction as a disinvestment by the buyer in his bank B and an investment by the seller in the same bank B. When the latter deposits the check in his own bank S there would be an investment

in bank S and a disinvestment in B. This does not seem to be a meaningful interpretation of the transaction. Both the seller and the buyer have for various reasons selected the bank in which they keep their accounts. That was the occasion when they made the investment decision. Each could revise his previous decision by shifting his account to another bank. That is not involved, however, when the buyer uses his funds to pay for his purchases. The resulting shift of funds was not due to decisions involving shifts of investments by any single person, but due to trading transactions between different persons.

Presumably, showing a favorable or unfavorable change in the balance of payments of the United States as a result of transactions between third countries would also suggest that U.S. policies should be influenced by such developments. While a change in U.S. policies may affect the total net outflow of dollars, or change incentives for foreigners to hold dollars, it cannot be expected that it can affect trade and other transactions between foreign countries, nor should U.S. balance of payments policies have that as an objective.

Symmetry in balance of payments accounting as recommended by the Review Committee is not only unattainable, it should be rejected for a country such as the United States, whose currency is widely used in transactions within and between foreign countries. Balance of payments compilations based on that concept, may not only be irrelevant, but could have rather undesirable effects. In contrast, in compilations based on the concept, that the analysis of the balance of payments should be started from the changes in reserve assets and in all liquid liabilities, transfers of dollar assets between foreign countries would cancel out, and the policy implication is that the total dollar supply abroad needs to be watched rather than its distribution over which we have no control.

(*e*) As indicated earlier, and shown in greater detail in the appendix, foreign countries in their own balance of payments publication do not follow the concept of the Review Committee. Most countries focus on their reserve assets, although their policy officials may not necessarily be guided solely by this single item. Some of the countries whose banks are more extensively involved in international transactions, particularly as middlemen in international capital movements, also include the net foreign exchange position of their banks in the balance, with liabilities including both official and private accounts.

In general, the central banking authorities exercise considerable control over the banks with respect to this net position. This policy provides a reasonable assurance that banks are able to meet foreign claims on them from their own foreign resources and that when the occasion arises they in fact do so. Thus foreign liabilities of the banks are not likely to become claims on the reserves of the monetary authorities.

The principle underlying the balance of payments presentation of these countries is quite compatible with the "liquidity" concept. The difference between these countries and the United States in the application of that concept reflects the real difference in the type of foreign assets and liabilities of our banks as compared to theirs. The foreign assets of our banks are not matched in size or liquidity with their foreign liabilities and there is no control over their net foreign position. The liabilities are largely dollar deposits which for banking policy consideration are a part of their total deposit liabilities, and these are covered by the usual domestic reserve assets. They do not hold reserve assets abroad. Foreign assets are almost exclusively loans which do not qualify as "cash" assets. Furthermore, unlike in most foreign countries, the official agencies supervising banking activities have no authority to force banks to meet their foreign obligations first by drawing on their foreign assets.

The reserves for deposit liabilities of U.S. banks to foreigners (omitting compensating or other tied liabilities which may not require reserves) are, therefore, for all practical purposes the reserves of the monetary authorities, since the banks' own foreign cash assets are quite small (as was mentioned earlier) and probably needed in day-to-day transactions.

The net foreign position of U.S. banks with respect to their liquid assets and liabilities (with the possible exception mentioned above) is almost identical with the amount of their foreign liabilities.

Thus the measure of the balance on foreign transactions under the "liquidity" concept is much closer to corresponding measures used abroad, than the measure of the balance recommended by the Review Committee.

III. Data on liquid liabilities to all foreigners are less reliable than those on liabilities only to foreign official organizations

The Review Committee says (on p. 111r) that "there are reasons to suppose that changes in the (errors and omissions) result in large measure from changes in private capital flows that are not reported." While it is possible that there are major movements of private foreign funds that are not reported, it is more likely that these would consist of purchases and sales of income yielding assets such as stocks or real estate. It is rather unlikely that foreign residents who some time ago have shifted their investments to the United States in order to avoid political perils, currency depreciations, or restrictions on their use, have kept their funds in demand or time deposits or limited their investments to Government bills and similar quasi cash assets.

These uncertainties affecting the size and movement of all liquid liabilities are likely to be very small compared with the errors in the analysis of the balance of payments based on the Review Committee's concept, that can arise from the difference of dollar balances held by foreign monetary organizations according to their own reports, from those reported by U.S. banks. As was pointed out earlier, that difference at the end of 1964 was close to $3 billion, and has grown since 1958 by approximately $2 billion.

IV. Liquidity is difficult to define

What constitutes liquid assets is sometimes difficult to decide, as the character and use of assets changes. However, such decisions are made continuously by accountants, bank supervisory authorities and financial analysts. The major difficulties arose from newly created Treasury securities, but the way these securities were treated in the published balance of payments compilations was widely accepted.

In contrast, the distinction between monetary authorities and other foreign official organizations remains difficult. The example of the purchases of special U.S. bonds by Canada in connection with the Columbia River power development is important. These securities, amounting to $204 million, are nonconvertible, nonmarketable securities which were sold to the Canadian Government to absorb the major part of the funds paid by a group of U.S. utilities to British Columbia in connection with the development of Columbia River power facilities. The bonds will come due in installments to coincide roughly with the needs for the money to finance the construction activities. These bonds were not included in Canadian reserves and they were not included in our measure of the balance of the United States.

The Review Committee, however, decided that these bonds should be included in the U.S. balance, presumably on the ground that they were sold to the Canadian Ministry of Finance, which also holds Canada's international reserves and thus may be deemed to be a foreign monetary authority.

Another example are the sales of corporate securities by the British authorities. These securities are administered by the same Government agency that also holds the British reserves. To use the concept of the Review Committee, it would have to be decided whether the securities are held by the monetary authorities of the United Kingdom. If the answer is "Yes," the United States would have had a deficit when these securities were originally taken over from their former private owners, but there would be no deficit when they are sold by the British authorities, and the proceeds deposited in U.S. banks. If the answer is no, the United States would have the deficit now, when the securities are sold.

Thus it is far from true that the balance as measured by the Review Committee is less beset by uncertainties of evaluation and interpretation, than the balance as measured under the liquidity system. The opposite seems to be more likely.

V. The distinction between private foreigners and private U.S. residents is too sharp

The Review Committee makes the following statements: (On p. 109 1.) "The Balance of Payments Division draws too sharp and artificial a distinction between private foreigners and private U.S. residents, and it fails to distinguish between private foreigners and foreign monetary authorities." (On p. 110r.) "The motivations that affect private behavior operate similarly for both private residents of the U.S. and private residents of foreign countries." (On p. 109 1, continued.) The Balance of Payments Division "implies that U.S. reserve assets are needed to protect the dollar only against withdrawals of foreign holdings, whereas historical experience demonstrates that outflows of domestic capital typically play a leading role in payments deficits and speculative runs on a currency. On the other hand, the Balance of Payments Division concept implies

that all foreign holdings represent an equal threat to the reserves, whereas in fact only foreign monetary authorities can directly draw down U.S. reserves."

There are several important differences from the point of view of the balance of payments between a foreign and a domestic resident. The U.S. resident most likely derives his income in the United States, and his expenditures are largely in the United States. That means that legally he must accept payment of obligations owed to him in dollars, and he may pay most of his obligations in dollars, since the dollar is legal tender in the United States. For the foreigner his currency is legal tender.

The American does not use foreign currencies for internal domestic transactions, and rarely in foreign transactions. The foreigner uses dollars sometimes in his domestic transactions; e.g. he may borrow and repay in dollars, and quite frequently he uses dollars in his international transactions with the United States as well as with other countries. He also uses dollars as an optional reserve asset, and he does all that because he assumes that he can convert dollars into his own currency whenever he so desires, and at a reasonably fixed rate in terms of gold. He does that because he considers the dollar not only a very convenient monetary asset, but also a very trustworthy asset. This, of course, applies also to foreign official agencies. If the foreign resident loses confidence in the continued convertibility and stability of the dollar, he will switch to the use of alternative (although at the present time less satisfactory) media of exchange and reserve assets because the obligations to him and his own obligations to others are generally in his own currency. When that happens foreign monetary authorities will be under pressure to switch to gold. It is most unlikely, and in fact has rarely happened, that private sales of dollars because of a decline of confidence in the future of the dollar will be compensated for by an increase in official dollar holdings.

The American resident neither has that option nor does he have the incentive to acquire other currencies so long as his total dollar holdings do not exceed his cash requirements in his business or household. If he were worried that the foreign exchange value of the dollar would decline, he may want to convert the excess of his cash holdings into another currency which he expects to appreciate against the dollar. If he wants to protect himself against rising prices within the United States he may change his cash or other assets into investments such as stocks or real estate, which are also likely to rise in price. The foreign holder of liquid dollar assets is not likely to exchange these assets for U.S. stocks or real estate, because presumably he wants to have liquid assets, and if not in dollars then in another currency.

The domestic problem lies largely in whether cash holdings exceed working capital requirements. Some of that excess could be used to purchase foreign assets if the incentives to do so increase. Whether these incentives increase gradually or suddenly, the difference in reaction would be one of degree rather than in the underlying reason.

What we then have to watch in safeguarding our balance of payments—and ultimately our international reserves are these elements:

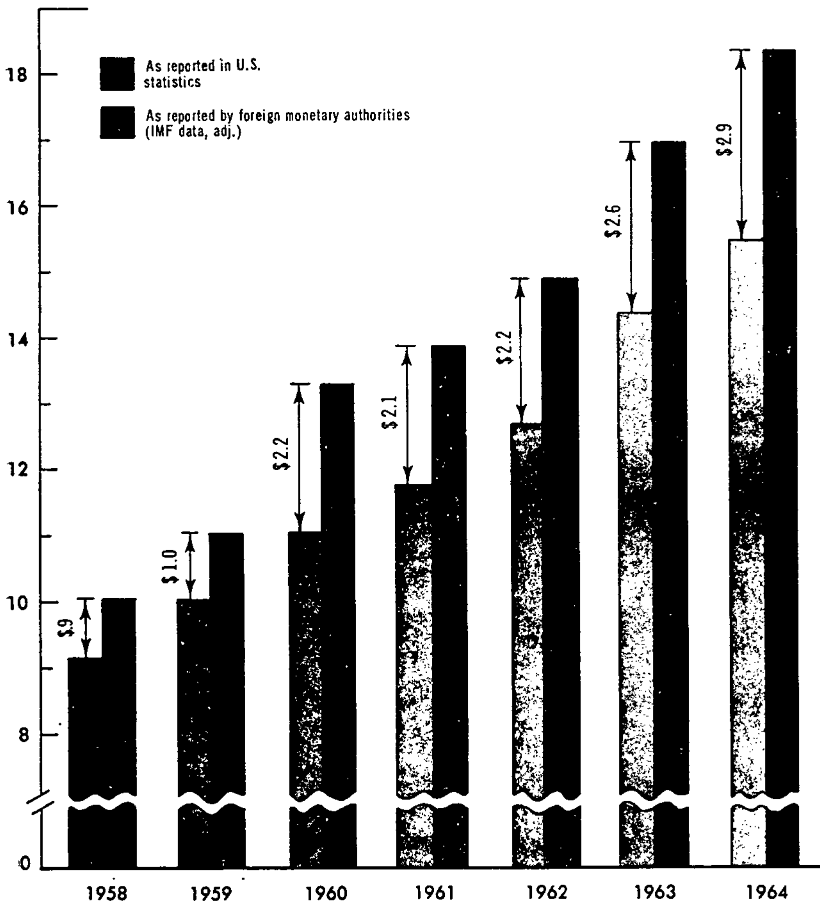
First, our own domestic liquidity relative to domestic requirements. This is a ratio, which we can influence by changing either of the two magnitudes; that ratio, in turn, has to be considered in relation to the corresponding ratios in foreign countries.

Second, the liquid dollar assets held abroad relative to foreign requirements. In that ratio we can influence only the net outflow of liquid dollar assets.

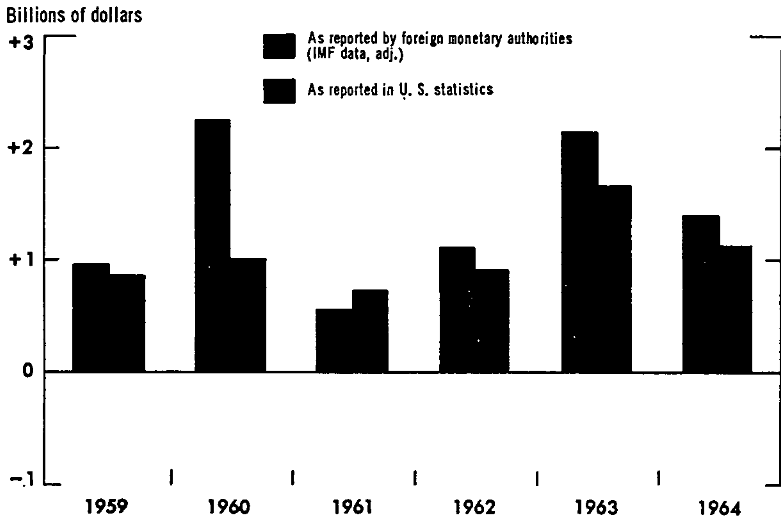
Third, of course, changes in our monetary reserves, which we can influence only through the offer of paying higher interest rates to induce foreigners, private as well as public, to hold more dollars than they otherwise would, or by refraining from actions which may—in foreign opinion—increase their risk of holding dollars.

Watching the balance of payments involves step 2, but the real effort must be directed toward improving the more basic conditions indicated in step 1, although the pertinent statistics do not appear in balance of payments compilatious.

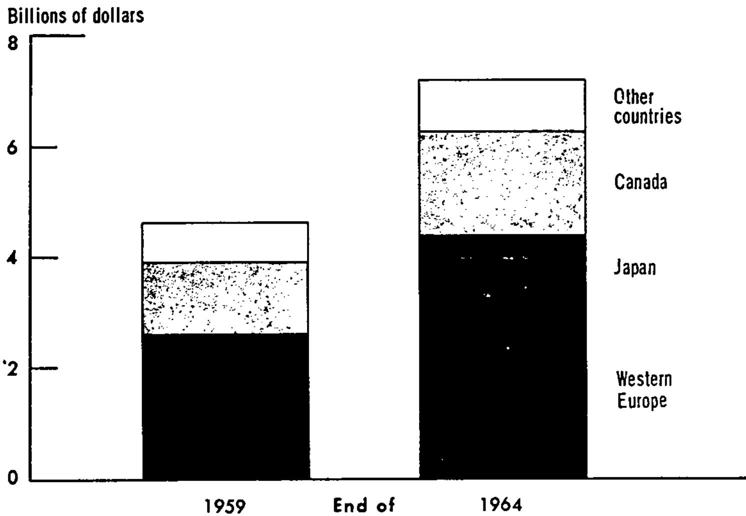
FOREIGN OFFICIAL HOLDINGS OF U.S. DOLLAR RESERVE ASSETS, 1958-1964, YEAR ENDS

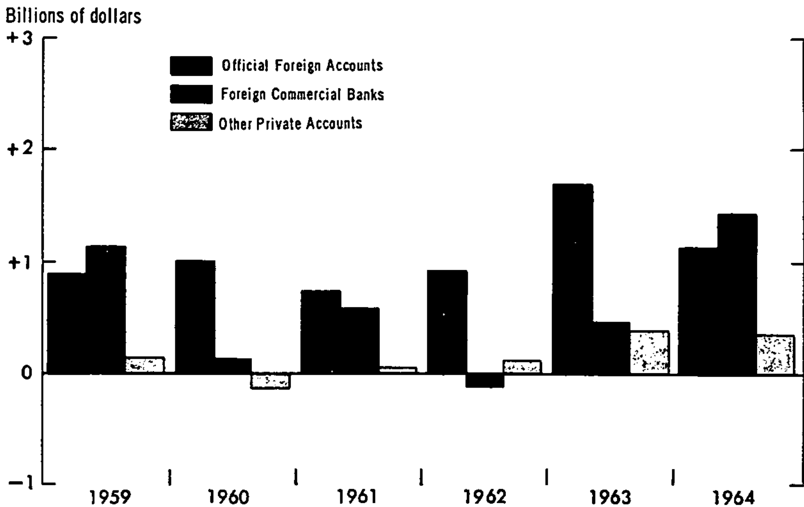


ANNUAL CHANGES IN FOREIGN OFFICIAL HOLDINGS OF U.S. DOLLARS



DOLLAR HOLDINGS OF FOREIGN COMMERCIAL BANKS,
(AS REPORTED IN U.S. STATISTICS)





PRESENTATIONS OF BALANCE OF PAYMENTS ACCOUNTS BY LEADING FOREIGN COUNTRIES

(By Samuel Pizer, Assistant Chief, Balance of Payments Division, Office of Business Economics, U.S. Department of Commerce)

A review of the balance of payments accounts prepared by a number of leading countries shows that while they conform to a relatively standard arrangement for current transactions and longer term capital, they reflect a variety of individualized treatments of short-term or monetary accounts. A summary of the official accounts issued by these countries (United States, Canada, United Kingdom, France, Germany, Italy, Netherlands, and Japan) is given in table 1. That table attempts to follow a framework not distorting unduly the individual country accounts, but some of the relatively minor variations have had to be consolidated in order to keep the list of items reasonably brief.

In addition to these standard accounts, several countries prepare rearranged accounts to bring out special features of their accounts, or insert memorandum items permitting alternative summarizations. Still other arrangements are published by the International Monetary Fund, including an "analytic presentation" summarized in table 2.

The variety of the presentations used by these countries is a reflection of the fact that they have different views, but more important, that they have different monetary relationships with the rest of the world and that the foreign assets and liabilities of their banks have differing characteristics and purposes. It is perfectly clear that there is no standard "European" measure of balance of payments surplus or deficit; also, monetary authorities use as a policy guide those elements of their balance of payments accounts that affect the whole liquidity situation of their countries, rather than a single item such as reserves held directly by the authorities.

A brief review of the presentation of each of these countries may bring out the differences and similarities:

Canada: The Canadian statements do not exhibit a "balance" as such, but are structured to call attention to the change in official reserve assets. Canadian commercial banks hold large amounts of foreign assets but these are closely matched by foreign liabilities, and the net foreign position is kept within narrow margins. These banks act as intermediaries in short-term capital markets, being relatively liquid on both sides of their accounts. The Canadian balance of payments accounts therefore enter only changes in the net position of the banks, and

treat these changes as commercial transactions rather than as monetary movements.

Since Canada does not have significant liabilities to foreign monetary authorities, and its banks maintain a balanced foreign position, there would be no justification for the adoption by Canada of measures which emphasized these accounts, they would clearly not be appropriate. However, the Canadian authorities must have regard for their forward foreign exchange position which may be large at times but is not reflected in the balance of payments accounts.

United Kingdom: The United Kingdom has adopted a "balance of monetary movements" which consists of most of the external assets and liabilities of commercial banks and the reserve holdings and liabilities of the Government. As explained by the Bank of England[1] "The common feature of the items in 'monetary movements' * * * is that, from the point of view of the owner or creditor, they all represent money assets having a sufficient degree of liquidity to be regarded as a means of settling international debts." Obviously, the items under this heading have differing degrees of liquidity. On the liability side the United Kingdom is in the same position as the United States in that holdings of its currency are for the most part regarded as liquid reserves by the holders, both private and official, subject to liquidation on demand. As to assets held by United Kingdom banks, these are generally in more liquid forms than those held by U.S. banks, notably with respect to the large amount held as U.S. dollar claims in the United States and Europe.

Although the United Kingdom issues data on liabilities to foreign central monetary institutions, these have not been treated differently in the accounts from similar liabilities to others. The largest holders would be monetary authorities of the overseas sterling countries. In the issue of the Bank of England Quarterly mentioned heretofore, an experimental reformulation of the accounts along lines suggested by the Review Committee was worked out. This would make no significant difference in 1963, but would make large differences in earlier years. The Quarterly makes the following comment:

"Other, perhaps more fundamental, problems of classification arise in the application of this method. Nonofficial sterling balances, although their changes are treated as autonomous, are often compensatory in their behavior. So far as the overseas sterling area is concerned, the sterling holdings of commercial banks reflect seasonal and cyclical developments in trade; a rising trend of trade brings a rise in working balances; the acquisition of sterling funds purely as an investment (which would properly be an autonomous movement) is less important. On the other hand, official holdings may rise or fall for investment reasons, and are thus not always purely compensatory.

"Perhaps it would be fair to say that the concept of compensatory official financing is not easy to translate into a group of items which can be selected from the available statistics and which can retain the same components in all periods, but that it is a useful and enlightening approach to employ on occasion in the right context."

France: In the French accounts a balance is indicated that includes official monetary reserve assets as well as the liabilities and assets of commercial banks. The changes in the position of the commercial banks have not been particularly significant; on balance the banks have been net borrowers of short-term funds (including Euro-dollars presumably) so that including their balances tends to offset somewhat the extent of the increase in officially held assets in recent periods. In recent years the French accounts also include a supplementary measure of balance reflecting the large advance repayments of postwar debts.

Germany: The German standard statement drew attention particularly to the last line, which is the change in the Central Bank monetary reserve assets and some minor liabilities. However, the accounts also show separately the change in credit institutions' foreign exchange position. The latter is especially important for Germany, because the Central Bank uses as a very important tool of monetary policy its ability to induce German banks to vary their holdings of dollars and other liquid foreign assets under a type of swap agreement with the Central Bank. Consequently, there is no doubt that the German authorities use the combined change in Central Bank and credit institutions' foreign exchange positions as the best measure of the "balance" in German foreign accounts. In effect, much of the change in one part of this balance is matched by an offsetting change in the other.

[1] Bank of England, Quarterly Bulletin, December 1964, P. 278.

Since Germany (as well as nearly all other countries) has no significant liabilities to foreign monetary authorities, there would not be a measure of official settlements that differed greatly from the change in gross reserve assets of the German monetary authorities. The Germans certainly would not take this alone as a reliable indicator of changes in their international liquidity position.

Italy: The standard Italian statement does not show a "balance" as such, but is so drawn as to call attention to changes in reserve assets of the central monetary authorities and of private monetary institutions. Italian banks are in somewhat the same situation with respect to their liquid international position as the German banks discussed above. Italian banks have had large changes in their employment of short-term funds borrowed in the Euro-dollar market and changes in these liabilities are taken into account by Italian authorities in analyzing their reserve change. In 1963, for example, the deterioration in the Italian balance of payments would be measured not only by the drop in official reserve assets (table 2) but also by the large increase in net foreign borrowing by Italian banks.

Netherlands: In the Netherlands accounts, a measure of surplus is shown which includes reserves of the Netherlands Bank and the net foreign position of commercial banks (though the latter may be selective). This formulation is very similar to that used in other countries where the commercial banks are significant borrowers of liquid funds as well as holders of foreign exchange. Of course, the specific mix of various kinds of liabilities, and especially assets, may vary significantly among these countries, requiring analysis of detailed data not provided in the balance of payments accounts themselves.

Japan: The balance of payments accounts of Japan are issued in the standard IMF format, which does not draw a balance but focuses attention on accounts of the central monetary institutions and other monetary institutions. Japanese commercial banks have, of course, been major borrowers in the United States and in the Euro-dollar market. Consequently, a combined balance of the type shown in table 2 is probably generally employed as a measure of changes in liquidity, although there may be some question about the inclusion of all of the foreign assets of the commercial banks.

United States: A measure of balance in the U.S. accounts as given in the "standard" (rather than analytical) presentation, is shown in table 1. The principal features are that it includes all liquid liabilities to all foreigners, but that short-term foreign assets of commercial banks are not included among reserve assets.

The inclusion of all liabilities is on the same grounds as in the British case; the dollar is an internationally held reserve asset, and though foreign holdings may be expected to grow along with the growth of world trade and payments they may also be withdrawn on demand. No other countries (except perhaps Switzerland) need have this concern about foreign holdings of their currencies.

The exclusion of short-term foreign assets of commercial banks from reserve assets, though they tend to be taken into account by other countries, reflects the specific nature of these assets and the U.S. monetary system. Briefly, the foreign assets of U.S. banks consist primarily of short-term credits rather than cash reserve items, which would be prominent among the foreign assets of many foreign banks. Moreover, U.S. banks are not in the position of borrowing abroad at short term in order to relend the proceeds at home and abroad. Their foreign position is not kept at any necessarily limited balance, and in fact there is no relationship (except for relatively small amounts of compensating balances) between their rate of foreign lending and the rate of increase in their deposit liabilities to foreigners. Moreover, their foreign assets are held as the result of the commercial judgments of the banks, rather than as reserves, or in accordance with monetary policy of U.S. authorities. They have tended to grow consistently, and are not readily reversible.

Of course, these are not all hard and fast distinctions, but reflect an appraisal of the principal characteristics of the assets. Other countries have to make similar appraisals of the types of assets and liabilities held by their banks. In fact, one of the active areas of statistical research abroad is to discover more about the size and type of liquid foreign assets and liabilities held by foreign banks, as a better indication to foreign monetary authorities of the change in their overall international liquidity position. As these data are improved, there will be more consistency in the measures being used in different countries.

TABLE 1.—*Schematic outline of official balance of payments accounts of selected countries, 1963*

[Millions of currency units]

	United States (U.S. dollars)	Canada (Canadian dollars)	United Kingdom (sterling)	France (U.S. dollars)	Germany (deutsche marks)	Italy (U.S. dollars)	Netherlands (guilders)	Japan (U.S. dollars)
Balance on goods and services	[1] 5,685	[2] −557	113	384	[3] 881	−947	924	−734
Unilateral transfers	−2,722			127		290	63	−46
Goods, services, and transfers	2,963	−557	113	511	881	−657	987	−780
Capital account (increase in assets (−))	−5,268	703	−155	15	2,219	−560	−483	571
Government capital	−1,657	7	−105	−429	−1,089	−23	−371	−43
Private long term abroad (assets)	−3,573	−87	−309	59	−1,144	−264	−1,064	−236
Private foreign long (liabilities)	329	693	259	457	4,185	1,214	1,015	743
Short term abroad, banking (assets)	−742	(4)	(5)	(5)	(4)	(5)	−153	(6)
Other (assets)	8	(4)	(5)	−117	[6] −437	−188	188	8
Foreign short term, banking (liabilities)	(5)	40	(5)	(5)	[6] 704	(5)	(5)	(7)
Other (liabilities)	[8] 367	−26	(5)	45	(4)	154	−98	99
Other, not specified		[9] 76	(5)			[10] −1,453		
Errors, omissions, and unidentified	−339	(7)	−111	[11] 128	−528	−35	(7)	45
Balance (increase in assets (−))	2,644	(7)	153	−654	−2,572	(7)	−504	(7)
Official monetary reserves	378	146	58	−856	−2,572	602	−604	−246
Foreign assets of banks	(12)	(12)	(5)	−189	(12)	173	(5)	−438
Banking liabilities to foreigners	[13] 2,266	(12)	[6] [14] 132	391	(12)	477	[6] 100	848
To foreign official accounts	[13] 1,672	(12)	(7)	(7)	(7)	(7)	100	(7)
To other foreign accounts	[13] 594	(12)	(7)	(7)	(7)	(7)		(7)
Miscellaneous			−37					

[1] Excludes military grants.
[2] Includes small amounts of private contributions and $61,000,000 of official contributions.
[3] Includes large private and official unilateral transfers.
[4] Not shown separately.
[5] Below.
[6] Net.
[7] Entry not contained in original source.
[8] Includes certain U.S. Government held liquid liabilities.
[9] Includes net change in foreign assets and liabilities of commercial banks.
[10] Primarily return of Italian bank notes.
[11] Includes net balance of overseas territories.
[12] Above.
[13] Includes marketable or convertible obligations of the U.S. Government held by foreigners.
[14] Net change in sterling and foreign currency assets and liabilities of banks and certain agencies.

TABLE 2.—*IMF "analytic presentation" of monetary sectors of balance of payments of selected countries, 1963*

[Millions of currency units; increase in assets (−)]

	United States (U.S. dollars)	Canada (Canadian dollars)	United Kingdom (sterling)	France (U.S. dollars)	Germany (deutsche marks)	Italy (U.S. dollars)	Netherlands (guilders)	Japan (U.S. dollars)
Commercial bank capital:								
Liabilities	[1] 438	----------	53	391	−287	476	416	848
Assets	----------	----------	−109	−189	860	174	−316	−439
Total	438	----------	[2] −65	202	573	650	100	409
Official monetary movements and related items:								
Liabilities:								
Liabilities to central banks and governments	[3] 1,629	(4)	318	(4)	(4)	(4)	(4)	(4)
Liabilities, miscellaneous or not specified	----------	40	----------	−39	−117	(4)	−26	−226
Assets:								
IMF accounts	30	−86	13	−12	−139	−23	----------	----------
Foreign exchange assets	−113	(4)	50	−217	−1,965	725	−506	−22
Gold	461	−60	98	−588	−658	−100	−72	−1
Total	2,007	−106	479	−956	−2,879	602	−604	−249
Total of above items (not added in IMF tables)	2,445	−106	423	−654	− 2,306	1,252	−504	160

[1] Liabilities to foreign commercial banks as reported.
[2] Includes miscellaneous short-term capital and liabilities to foreign private and nonmonetary sectors.
[3] Includes special U.S. Government securities.
[4] Not shown separately.