The Rescue of The Dollar

By

Wilson E. Schmidt

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Library of Congress Catalog No. 62-22112

Price: $1.00

AMERICAN ENTERPRISE INSTITUTE
For Public Policy Research

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Foreword

THERE IS CONTINUING concern over persistent deficits in the U. S. balance of payments, the international position of the dollar, and the drain upon our monetary gold stock. Economists, bankers, government officials and others often differ sharply concerning measures that should be taken to cope with these problems.

The two AEI studies, *The Rescue of the Dollar,* by Professor Wilson E. Schmidt, and *The Role of Gold,* by Professor Arthur Kemp, analyze the complexities and difficulties surrounding this most important public policy question and give two of the more significant of the differing views on possible approaches to solution.

Professor Schmidt's analysis leads him to favor more or less freely fluctuating exchange rates for the dollar and removal of ties to gold. His study includes analysis of the problems of measuring the deficit in the balance of payments, discusses the difficulties of arriving at its causes, and lays down guidelines for selecting successful and acceptable cures.

Professor Kemp places the emphasis of his study upon monetary aspects of the problem and considers the role of gold in monetary affairs. He believes we should move in the direction of closer gold ties for the dollar and states that although the gold standard is obviously not a solution to all our problems, it is a step in the right direction and even the present links to gold are worthwhile since they may some day allow us to take further steps.

It is the purpose and hope of AEI, in publishing these studies, to give the reader better insight into this most important public policy issue.

THOMAS F. JOHNSON
Director of Research

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THE RESCUE OF THE DOLLAR

MEASURING THE PROBLEM

SINCE 1960, WASHINGTON has been preoccupied with U. S. gold losses. Many different policies have been proposed and actions taken on the grounds that they would help solve this problem. Our gold exports have been used whenever they had the slightest relevance, real or apparent, to support points of view in debates on many public issues. The balance-of-payments difficulties of the United States, with which the gold losses have been associated, have been employed to justify actions which reach deeply and widely into the American economy and our way of life: an unprecedented onslaught by the President on the pricing policies of the steel companies, the denial to overseas servicemen of the company of their wives and children, and higher interest rates, etc.

This study attempts to discuss first the difficulties of measuring the degree of seriousness of the problem because, without some idea of the seriousness, it is hard to shape appropriate policies. It then seeks to weigh the alleged causes of the problem and their relevance to the solutions. Finally, it sets forth some criteria for selecting means to solve the problem, reviews a number of actions taken to determine if they conform with the criteria, and then considers alternative measures.

From 1950 through the early 1960's, the United States has paid substantially more dollars to foreigners through the purchase of imports and through investments and aid abroad than it has received from foreigners through the export of goods and services, through foreigners' investments in the United States, and through their repayment of their earlier borrowings. The rest of the world has employed the excess of dollars to buy our gold and to accumulate liquid assets in the United States in the form of bank deposits, short-term assets, and United States Government bonds and notes.

It is widely understood that these balance-of-payments deficits cannot persist. We do not have an infinite supply of gold to ship to foreigners, and our annual gold production—a mere $55 million in 1961—is insignificant when compared with recent balance-of-

payments deficits and even inadequate to cover our commercial and industrial requirements. We cannot expect foreigners persistently to accumulate liquid dollar assets, at least not at a rapid pace. At some point the ratio between our gold stock and our liquid liabilities to foreigners will become so small that foreigners will fear that we will not be able to convert their dollar holdings into gold if they wish us to do so. In September 1962, by one concept, U. S. liquid liabilities to foreigners stood at $26.7 billion while our gold stock was but $16.1 billion. Less than $5 billion of the gold was available for export without some change in monetary regulations because about $12 billion must be retained in the United States as legal reserve for the notes and deposit liabilities of the Federal Reserve System.

The danger is not to the United States alone but to the Free World as a whole because we, along with Britain, are international bankers for the world. The dollars held by foreigners here are used to finance transactions with the United States (both public and private) and are also kept as reserves to make payments all over the world. The dollar is an international currency and, if it goes awry, the stability of world trade and payments is endangered. Gold is also used today to settle international obligations, and foreign governments hold it as an emergency reserve. It is safe, and it is the traditional reserve. But since it earns no interest, many countries prefer to hold some of their reserves in the form of dollar and sterling assets in order to obtain income on them.

The implications of the problem are more than financial or economic. John J. McCloy, formerly President of the Chase Manhattan Bank and Director of the U. S. Disarmament Administration, reported some time ago the remarks of a foreign political leader:

> . . . in the eyes of the world you are weaker. The Russians beat you into outer space and then to the moon. . . . Now you are losing gold . . . . Is it any wonder then that the Free World is beginning to question whether you can provide the leadership we all so sorely need.[1]

[1] "The Balance of Payments," speech before the Investment Association of New York, December 15, 1959.

Exactly how serious is our international financial position? Unfortunately there is a misplaced preciseness in the measures of the balance-of-payments deficit and in measures of our international liquidity position. The remarks of St. Augustine on time apply: "For so it is, oh Lord my God, I measure it; but what it is I measure I do not know."

Liquid Liabilities

Table I presents the structure and ownership of our liquid dollar liabilities to foreigners according to one measure of them. About $12 billion of the short-term balances are owned by foreign central banks and treasuries. Special attention is focused on the dollar assets of central banks and treasuries because they are the only owners of dollar assets who can *directly* convert them into United States gold. The U. S. Treasury does not do business with others, at least not directly.

Table I

LIQUID U.S. LIABILITIES
(billions of dollars)
SEPTEMBER 1962

By Holder		By Type of Asset	
Private	8.0	Deposits	10.3
Foreign Central Banks and Governments	11.7	U.S. Treasury Bills and Certificates	12.2
International Institutions	4.8	Other Short-Term	1.8
Total Short-Term	24.5	Government Bonds & Notes	2.1
U.S. Government Bonds & Notes*	2.1	Payable in Foreign Currencies	.3
Total	26.7		26.7

* Allocation by holder unavailable.
Totals may not add due to rounding.
Source: *Federal Reserve Bulletin.*

Central banks and governments hold more than $12 billion of liquid dollar assets because they control an indeterminate part of the U. S. Government bonds and notes held by foreigners. Furthermore, major discrepancies in reserves as reported by foreign sources and by the United States suggest to some analysts that a not insubstantial amount of the funds we report as privately held are in fact owned by foreign central banks and treasuries.

Private foreign holders of dollars can threaten the U. S. gold reserve by selling their dollars to foreign monetary authorities. Suppose a large supply of dollars is offered abroad for sale in exchange for foreign currencies, and there is no compensatory increase in demand for those dollars. Foreign monetary authorities will buy the excess supply if this is necessary to prevent wide shifts in the price of their own currencies in terms of dollars, i.e., in the exchange rate. The monetary authorities of most of the advanced countries, except the United States, buy or sell foreign currencies whenever it is necessary to prevent the exchange rate from going outside of the range of 99 percent and 101 percent of the so-called par value, and they often intervene in the market before these support points are reached. Hence, any effort by private holders of dollars to exchange their dollar assets for foreign currencies may shift dollars into the hands of foreign central banks, who *may* then convert the dollars into U. S. gold. If the dollars go to the monetary authorities of Switzerland, France, Britain, the Netherlands, or Belgium, they are very likely to lead to a U. S. gold loss because they tend to convert most of their foreign currency holdings into gold. Others do not.

Another bridge between our gold stock and liquid liabilities to private foreigners stems from the so-called gold pool. Nine countries have committed themselves to supply gold in the London gold market when necessary to keep the price from rising sharply. Reportedly we have committed ourselves to provide $135 million, and, in addition, have apparently made special contributions to the pool when the dollar is under attack. Therefore, if private foreign holders of dollars use them to buy gold in the London market,

thereby bidding up the price of gold, they may draw down our gold stock.

Apart from the effect of the gold pool, the liquid balances owned by private individuals, enterprises, and banks abroad are at least one step removed from our gold stock. A loss of confidence in the dollar by private holders will not endanger the U. S. gold stock unless they switch to gold, unless the dollars end up in the hands of selected central banks which have a policy of converting most of their foreign currency holdings to gold, or unless there is a loss of confidence on the part of foreign monetary authorities as well. While there is no reason to assume that foreign central banks and treasuries will never get cold feet about the dollar, there is no presumption that they will always follow immediately the leadership of the private holders. For example, in the last five months of 1960 when selling pressure against the dollar was high, private dollar holdings fell by over $600 million. Yet the dollar balances owned by official institutions rose by almost $570 million.[2] In sum, one should not lump together our liquid liabilities to official institutions and to foreign private holders without realizing that the threat they pose to our gold stock is not necessarily the same. Of course, the difference is only one of degree.

The liquid dollar balances owned here by foreigners are held for a variety of purposes. Some are held for the interest return, some as a reserve against emergencies, and some are working balances needed to transact the daily business of international trade and investment. The significance of this distinction is that the working balances of dollars tend to be held in this country by the volume of trade that foreigners carry on, though not necessarily in strict proportion. Therefore, the threat of their withdrawal is less than that of balances held for other purposes. Unfortunately, having recognized the dis-

[2] The increase in official holdings did not prevent a gold loss because the deficit in the United States balance of payments provided surplus dollars to foreigners which central banks converted into gold. If central banks had decided to reduce their total dollar holdings, our gold losses would have been greatly magnified.

tinction, nothing more can be said for there is no way of knowing the proportion of the total which serves as working balances.

Any assessment of our liquidity position should also take note of the fact that $4.8 billion of our liquid dollar liabilities are owed to international institutions, chiefly the International Monetary Fund. The bulk of the $4.8 billion consists of non-negotiable, non-interest bearing notes which reflect U. S. Government subscriptions to international institutions.

From the foregoing discussion, it would seem that a reasonable estimate of the potential demands upon our gold stock might be something less than the total of our liquid dollar liabilities. But if this is reassuring, it is so only because we have overlooked some other claims against our gold. The liquid liabilities recorded above do not include short-term debts owed by non-financial U. S. concerns to foreigners, which amounted to $618 million in the middle of 1962, though the data are believed to be far from comprehensive. Nor are uncertain amounts of U. S. currency held abroad, recently estimated at $913 million, included. Furthermore, the sum of our liquid dollar liabilities in Table I includes, among the long-term obligations, only U.S. Government bonds and notes held by foreigners. At the end of 1961, foreigners also owned over $12 billion of U.S. corporate securities and state and local government bonds which are not included. These can be sold for dollars and if the dollars accrue to foreign monetary authorities they can be converted into gold.[3]

Furthermore, the ratio of our liquid assets held by *foreigners* to our gold stock is too narrow a focus; that measure of our liquidity problem implicitly assumes that Americans cannot lose confidence in the dollar, that they cannot, even indirectly, draw down our gold stock. Nothing is further from the truth, as evidenced by Americans' purchases of gold in London in late 1960. These purchases led

[3] This does not mean that these assets are just as liquid as the U. S. Government bonds and notes. Many of the U. S. Government bonds and notes are bought shortly before maturity so they are truly short-term obligations whereas the other assets are not. Furthermore, there is a difference in the certainty of the value of the proceeds of government bonds and corporate securities.

President Eisenhower to prohibit overseas holding of gold by Americans. Even so, a threat remains. If Americans lose confidence in the dollar, they will purchase foreign currencies or assets denoted in foreign currency, hoping to sell them later for dollars when foreign currencies are worth more dollars as a result of the devaluation. That is, if one expects the British pound to cost $3.00 in the near future whereas it costs $2.80 now, Americans will have an incentive to buy pounds at $2.80, hoping to sell them later for dollars at $3.00 per pound. In the absence of exchange regulations designed to prevent Americans from purchasing foreign currencies or assets, a loss of confidence can lead to a shift of American funds abroad. If the monetary authorities receiving the dollars choose to convert them into gold, the flight of American capital would draw down the gold stock. In view of the fact that Americans own liquid assets of $1.3 trillion in the form of currency, deposits, stocks, and bonds, our gold stock shrivels in comparison.

Even if we did employ exchange regulations to prevent such shifts of American funds abroad, extensive damage to the gold reserve could be done through the mechanism known as "leads and lags," which on numerous occasions has multiplied the balance-of-payments problems of other countries during the postwar period in spite of close controls. If the dollar comes under a serious cloud and its devaluation is anticipated, foreigners having to make payments to the United States in dollars will slow down those payments in the expectation that they will be able to obtain the dollars at a cheaper price in the near future; similarly, Americans having to make payments to foreigners in foreign currencies will speed up those payments for fear that the foreign currencies will cost them more in the near future. Hence, receipts decline and payments expand, adding substantially to the pressure on the balance of payments.

Some analysts have sought to estimate a safe level of gold reserves for the United States. For most countries, the common test is some ratio of reserves to annual imports. The United States gold stock at the end of 1961 equalled almost 120 percent of its 1961 imports, which is far superior to the ratio for the rest of the world. On several occasions President Kennedy has noted, in order to show our

strength, that we hold the bulk of the Free World's gold, namely about 40 percent at the end of 1961. But these tests are not appropriate for the United States, or for the United Kingdom, because both nations, as international reserve centers, have extensive liquid liabilities to foreigners while most other nations do not. We must keep reserves to meet occasional withdrawals of liquid assets as well as to pay for our purchases abroad. The British, whose position is more nearly like our own, have gold reserves equal to about one-third of their liquid liabilities to foreigners, but this does not indicate that we could safely reduce our ratio to that level because the British ratio is hardly acceptable: the monetary and fiscal screws have been put to the British economy on many occasions because of balance-of-payments difficulties when domestic economic conditions have required contrary action.

The behavior of American banks is sometimes suggested as a guide. They hold cash equal to about 15 to 20 percent of their deposit liabilities to foreigners. But the position of an American bank is no standard for the United States as international banker for the world because there is no Federal Deposit Insurance Corporation in international banking to prevent runs or a Federal Reserve System to provide liquidity when required.

Assets

The measurement of our liquidity position and the search for a safe ratio of reserves for the United States is complicated by the existence of some assets which, in differing degrees, are viewed as sources of international financial strength. President Kennedy, in his balance-of-payments message of February 6, 1961 listed these assets: the gold in the United States including that portion of it which is required as reserve against the note and deposit liabilities of the Federal Reserve System, our quota in the International Monetary Fund, long-term debts owed by foreigners to the United States Government, and private short-term and long-term assets held by Americans abroad. When foreigners wish to dump their dollars in exchange for their own currencies, we could satisfy their demands for their own currencies without losing gold to the extent that we

could mobilize these foreign assets. Selling these assets for foreign currency or drawing foreign currency from the IMF and using the foreign currency to buy dollars would prevent or at least reduce downward pressure on the value of the dollar in terms of foreign currencies, i.e., the exchange rate. This in turn would lessen the likelihood of gold losses because foreign central banks would not have to absorb the excess supply of dollars in order to keep the exchange rate stable. If they did not have to buy the dollars, they could not convert them into U. S. gold.

With respect to the gold which is required as reserve against Federal Reserve System liabilities, the law permits the 25 percent reserve requirement to be suspended for 30 days and this suspension can be renewed by 15-day periods, apparently indefinitely. A penalty is imposed, however, in the form of a tax which must be added to the rate of interest which the Federal Reserve Banks charge when they rediscount paper for commercial banks. Inasmuch as the System can set the rediscount rate at any level it pleases, it could reduce the rate just enough to compensate for the tax, and there would not necessarily be a shift in U. S. monetary policy on account of the penalty.

While there is no doubt that the President is correct in including among our assets that portion of our gold stock which is held as backing for Federal Reserve System liabilities, it is not quite as good an asset as our "free" gold, i.e., the gold which does not have to be held as legal reserve, for the reason that it is not available without some overt action. The point is not that the authorities might be slow to act but only that they must act, and, in doing so, will call greater attention to the problem, and perhaps thereby heighten fears for the value of the dollar. It is for this reason that various proposals to reduce the 25 percent requirement in order to free gold to strengthen our liquidity position are often accompanied by a caveat that such action should be taken only when confidence in the dollar is high. On the other hand, if confidence is not expected to increase, it would be better not to wait until the reserve falls to 25 percent and the requirement has to be changed at a time of even lower confidence.

With respect to the quota in the International Monetary Fund, from which members may borrow foreign currencies, it is exceedingly doubtful that any precise value can be placed on this asset, as some interpreters have implied. The President, in his first State of the Union Message, undertook to "pledge" our quota rights in the battle for the dollar, but we in fact cannot command our quota from the Fund. The quota is the mechanical basis for determining the conditions under which we may draw foreign currencies from the International Monetary Fund. Under present procedures, the conditions under which funds may be obtained from the IMF depend upon the size of the quota and the amounts of dollars which the IMF holds.

To simplify matters, suppose the U. S. quota is $100, rather than the $4.125 billion which it is in fact. With this fictitious quota, we would, upon joining the IMF, have contributed $25 in gold and $75 in dollars. If the occasion arose to draw foreign currencies from the IMF, the first $25 of foreign currency or the "gold tranche," equal to the amount of gold we initially contributed, could be obtained with almost no questions asked.[4] The next $25 of foreign currency can be obtained, according to present IMF policy, only if we are making "reasonable efforts" to solve our problems. According to the official policy of the IMF,

> Requests for transactions beyond these limits require substantial justification. They are likely to be favorably received when . . . [they] are intended to support a sound program aimed at establishing or maintaining the enduring stability of the member's currency at a realistic rate of exchange.

The question is whether or not the United States Government would (not should) be willing to meet the requirements of the IMF. The IMF, in its transactions with members, has often insisted upon monetary restriction. If the IMF required modifications in our

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[4] The gold tranche of the United States at the end of October 1962 was approximately $1.1 billion. Our gold subscription is $1.031 billion. Our gold tranche equals our gold subscription plus IMF net sales of dollars to other countries.

domestic financial policies, would (not should) our government accede? Would the executive branch be charged with accepting "dictation" by the IMF? The conditions imposed by the IMF have become hot political issues in other countries, and dealings with the IMF can be a political liability to the party in power.

The President also mentioned the debts of Western European governments to the United States Government amounting to $2.9 billion as another asset. In referring to these as an addition to our liquid reserves, the Message implicitly recognized that these cannot be fully counted alongside our free gold stock. None of the debts are callable. All of them involve schedules of repayment which cannot be shifted at the option of the lender. In 1959 and 1961 a number of countries paid up faster than required, but 1960 saw very little advance repayment even though we had a deficit of the same size as 1959 and larger than 1961. The dangers of relying upon advance repayments to help us during a period of difficulty were underscored when the Germans initially made their advance repayments conditional upon a satisfactory settlement of certain assets we confiscated during World War II. Furthermore, the advance repayments to date have greatly reduced the debts to us of Western European governments who are able to repay, so much less help can be anticipated in this way in the future.

Finally, the President also included our private short-term and long-term assets abroad among the defenses of the dollar. Any assessment of the value of the short-term assets must recognize that an unknown part consists of working balances and revolving credits which can be reduced to support the dollar only with damage to our commerce with foreign nations; they are therefore not likely to be withdrawn by their owners. Furthermore, if there is a crisis of confidence in the dollar, it is difficult to see why, short of force, Americans would be willing to convert into dollars that small part of our private short-term assets which is denominated in foreign currency. These foreign currency assets would become more valuable in the event of the devaluation of the dollar because each unit of foreign currency would be worth more dollars; hence, their owners would have every incentive to keep them abroad. The same point applies to our private

long-term investments abroad which now are close to $50 billion. Equally important, about three-quarters of these consist of direct investments, mostly in the form of buildings and machines, which suggests that they are hardly available to meet our liquidity problem.

To sum up, it is difficult to determine the safe level of reserves for the United States, and it is difficult to know what liabilities constitute a true threat to our gold stock and what value should be placed on assets above the free gold that we presently have. As one British banker put it,

> . . . nobody knows what the danger point in reserves is. In our own experience, people have warned that, if gold and dollar reserves fell below a certain level, we would have a disastrous crisis. Yet the reserves frequently have fallen below that so-called danger point and there has been no crisis. What matters is not any figure but what is in men's minds. . . .

This uncertainty puts a premium on finding some device to solve any international liquidity problem of the United States automatically, without the recurrent need to formulate new policies in the face of deficits or to predict the extent to which any specific deficit situation can be allowed to drift without taking firm action. One such device will be considered later.

The Balance of Payments

If there is difficulty in deciding what liabilities to count against what assets in measuring our international liquidity position, there is no less problem in measuring our balance-of-payments deficit. At least seven different measures of the U. S. balance-of-payments deficit have been employed.

Table II displays in summary form the United States balance of payments for 1961. It should be noted that the balance of payments is not a balance sheet of America, nor is it a profit and loss statement for the country. Whereas a balance sheet provides data for a particular *point* in time, the end of a year or a quarter of a year, the balance of payments is a statement of receipts and expenditures in transactions with foreigners *over a period* of time, usually a year or

a quarter. In this respect the balance of payments is like a profit and loss report, but even this analogy fails because the profit and loss statement excludes capital transactions whereas the balance of payments includes them along with international receipts and payments for current production. The balance of payments is perhaps most like the cash flow statements employed by American business, though it includes certain non-cash transactions.

Table II

UNITED STATES BALANCE OF PAYMENTS, 1961
(millions of dollars)

Credits		Debits	
Merchandise Exports	20,321	Merchandise Imports	14,514
Services	7,745	Military Expenditures	2,947
Repayments of U. S. Government Loans	1,274	Other Services	5,462
		Remittances & Pensions	878
Foreign Capital other than Liquid Funds	606	Government Grants & Capital Outflow	4,051
Increase in Liquid Dollar Liabilities	1,719	U. S. Private Capital	3,953
Changes in U. S. Holdings of Gold & Convertible Currencies (+, decrease)	742	*Recorded U. S. Payments*	31,805
		Unrecorded Transactions	602
Recorded U. S. Receipts	32,407	Total	32,407

Source: *Survey of Current Business,* September 1962.

As a first approximation, one can think of the debit entries as reflecting transactions which provide dollars to foreigners while the credit entries reflect the use of those dollars by foreigners. Since the balance of payments is based in theory on a double entry bookkeeping system, the two sides of the balance of payments should in principle be equal. But, in fact, no country keeps books on inter-

national transactions in the manner of a modern corporation. Most of the figures entered into the balance of payments are not exact counts but are estimates of varying degrees of reliability brought together by the Department of Commerce. Hence, the recorded payments to foreigners rarely equal the recorded receipts from foreigners and, since both sides of the balance of payments should in principle be equal, an entry for net unrecorded transactions is introduced to balance the accounts. In 1961, for example, the Government's reporting system caught payments to foreigners equal to $31.805 billion while it picked up receipts from foreigners equal to $32.407 billion, requiring an entry of $602 million for net unrecorded transactions on the debit or payments side of the U. S. balance of payments. U. S. payments may have been understated by $602 million, U. S. receipts may have been overstated by $602 million, or there may have been a combination of errors on both sides of the balance of payments. Hence, the entry for unrecorded transactions is not a measure of the mistake in counting, but only the net mistake.

Turning to the components of U. S. recorded payments in Table II, or the transactions which gave dollars to foreigners, *Merchandise Imports* refers to imports into the United States. *Military Expenditures* chiefly comprise payments to non-residents by the armed services for goods and services for use in the United States or abroad, for use by our own forces, or to be given to allies, and purchases by military and civilian personnel abroad. *Other Services* includes payments by Americans to foreigners on account of interest, dividends, and profits paid to foreigners because they have investments here, expenditures by American tourists abroad, payments for transport in foreign-owned ships, and a miscellany of transactions including royalty payments to foreigners, insurance fees, etc. *Remittances and Pensions* refers to private gifts abroad and private as well as public pension payments. Under *Government Grants and Capital Outflow* gifts and loans to foreigners by the United States Government are recorded, exclusive of military aid to allied nations and without deduction for any repayments to the United States Government of loans made in previous years. Naturally, the interest

received from foreigners is not included in this entry for it is a receipt from foreigners. Finally, *U. S. Private Capital* refers to the net movement of private, American-owned capital abroad. It takes many forms; the chief distinctions are between direct and other investment. Direct investment involves U. S. control of an enterprise abroad while other investment covers all other investment including, for example, foreign bonds and stocks purchased without U. S. control of the institution in which U. S. capital is employed. Within other investment a distinction is drawn between long- and short-term investment with the dividing line set at a maturity of one year.

Turning to the transactions which reflect the disposition of dollars received by foreigners, the rest of the world in 1961 used some of the dollars to buy our goods, which is recorded under *Merchandise Exports.* The entry for *Services* includes precisely the same kinds of transactions reported under services on the expenditure side except that the transactions involve payments to the United States. It is here that one finds the interest, dividends, and profits on American capital abroad which are remitted to the United States. (Profits reinvested abroad in American-owned enterprises are not included either as a receipt or as a capital outflow in the balance of payments.) *Repayments of U. S. Government Loans* are, of course, repayments by foreigners. *Foreign Capital other than Liquid Funds* reflects the net flow of foreign capital to the United States, primarily long term. All of the short-term investments by foreigners in the U. S.,[5] including increases in their deposits in U. S. banks, plus their purchases of long-term United States Government securities are reported under *Increases in Liquid Dollar Liabilities,* i.e., liabilities of the U. S. It should perhaps be emphasized that the data on capital movements in the balance of payments do not indicate the total outstanding investment that foreigners have in the United States or that we have abroad but only the changes in the outstanding investment in the year under consideration which result from capital transactions. Finally, the rest of the world used part of the dollars received from

[5] Except commercial credit granted to the U. S. by foreigners.

the United States to buy our gold which is recorded under *Changes in Gold* along with changes in the convertible currencies owned by the U. S. Treasury and Federal Reserve System, which will be explained later.

Measures of the Deficit

Where is the deficit in the balance of payments? As noted earlier, the two sides of the balance of payments are equal (total debits equal total credits). Therefore, the accounting system does not automatically cast up the deficit. The size of the deficit depends upon which items one wishes to select in the balance of payments to measure the deficit.

In Table III three different concepts of the deficit are displayed, with all transactions above the line for each type of deficit "causing" the deficit and all transactions below the line financing the deficit. That is the balance between expenditures (debits) and receipts (credits) above the line shows a deficit which is financed by transactions below the line. Total debits still equal total credits; the line is drawn so as to distinguish those debit and credit transactions which "cause" the deficit and those that finance it. For each concept of the deficit the line cuts the balance of payments at a different point.

The *overall deficit* is financed by the decrease in the U. S. gold stock plus the increase in our liquid liabilities to *all* foreigners as shown in Table I. It therefore shows the annual change in one measure of our liquidity position discussed earlier. In the words of the chief architect of U. S. balance-of-payments presentations, Walther Lederer of the Department of Commerce, it serves to

> . . . measure the changes in our capability to defend the exchange value of the dollar. 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]

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[6] Paper presented before the American Statistical Association, December 1961.

Table III

UNITED STATES BALANCE OF PAYMENTS, 1961

(millions of dollars)

Credits		Debits	
Merchandise Exports	20,321	Merchandise Imports	14,514
Services	7,745	Military Expenditures	2,947
Repayments of U.S. Government Loans	1,274	Other Services	5,462
		Remittances & Pensions	878
		Government Grants & Capital Outflow	3,940
Foreign Capital:		U. S. Private Capital:	
Long-Term	466	Long-Term	2,481
Foreign Commercial Credits	140	Short-Term	1,583
		Unrecorded Transactions	602
Increase in Liquid Liabilities to Non-Monetary Sector:			
International & Regional Institutions	461		
Other Foreigners	126		
Increase in Liquid Liabilities to Monetary Sector:			
Foreign Commercial Banks	615		
Foreign Central Banks & Governments	652		
International Monetary Fund	−135		
Gold & Convertible Currencies (+, decrease)	742		

International Monetary Fund Deficit ($1,874)

Overall Deficit ($2,461)

Basic Deficit **($416)**

Source: *Survey of Current Business*, June 1962.

The overall deficit does *not* measure what might be called changes in our direct liquidity position because it includes increases in our liquid liabilities to foreigners who cannot directly buy our gold; these liquid balances are a threat to our gold stock only if they are used to buy gold in London or if they are first sold by their holders to foreign central banks who then employ them to buy our gold. As noted earlier, the difference in the threat to our gold stock of liquid liabilities to foreigners who can and cannot buy our gold is one of degree.

The overall deficit also does *not* measure immediate pressures on the value of the dollar in terms of foreign currencies in foreign exchange markets. Suppose the United States pays out more dollars to foreigners than they need to make payments to the United States. The recipients of the dollars, who will wish to sell the dollars for their own currencies because they have no immediate use for them, will offer them at a lower price in terms of their own currency. In order to prevent this excess of supply of dollars from changing the exchange rate significantly, foreign central banks will buy the excess supply of dollars offered on the market. They may hold onto them, leading to increased liquid liabilities to foreign central banks, or may use them to buy our gold. These residual purchases by foreign central banks, at least as a first approximation, measure pressure on the dollar in the exchange markets. The overall deficit differs from this concept of the deficit because it includes changes in the holdings of dollars by foreign institutions and individuals not responsible for maintaining stable exchange rates among currencies. It includes changes in our liquid liabilities to (1) the International Monetary Fund,[7] (2) foreign central banks and governments, (3) foreign commercial banks, (4) non-monetary international and regional institutions such as the International Bank for Reconstruction and Development, and (5) other foreigners.

A second concept of the deficit is that employed by the *International Monetary Fund* in all but the last of its recent annual

[7] Except subscriptions.

reports. It differs from the overall deficit in excluding from changes in liquid liabilities the dollar balances owned by non-monetary international and regional institutions and by "other foreigners," i.e., (4) and (5) above. Thus, it moves in the direction of measuring the change in our direct liquidity position mentioned above as well as the pressure on the dollar in the exchange market.

A third concept is the *basic deficit,* championed by Treasury Secretary Douglas Dillon. It differs from the overall deficit in adjusting the overall deficit by the amount of U. S. private short-term capital exports, the net unrecorded transactions, and foreign commercial credits received by the United States. As the name implies, this concept attempts to display the deficit on account of the supposedly more persistent, less volatile transactions in the U. S. balance of payments, namely, trade in goods and services, aid, and long-term investment. Secretary Dillon wrote to Senator Byrd in criticism of the concept of the overall deficit, that it makes no attempt

> . . . to separate short-term capital movements from the rest of our balance of payments so as to reveal the basic deficit or surplus which represents the hard core of our payments problem. Instead, short-term capital movements are lumped together as part of our overall deficit. . . . The effect of this is to exaggerate the deficit when large outflows of [U.S.] short-term capital take place and to minimize the deficit when inflows take place. You will note that in 1959 our overall deficit was substantially reduced by short-term inflows whereas in 1960 short-term outflows greatly increased our overall deficit. As you know, monetary movements of short-term capital tend to be quickly reversible and are very sensitive to temporary interest-rate situations. Moreover, outflows of short-term capital (which are recorded as a deficit item in the standard table of the Department of Commerce) are accompanied by the creation of a short-term asset to the United States (which is not recorded anywhere in the standard table of the Department of Commerce.) [8]

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[8] *Duty-Free Allowance of Returning Residents, Hearings,* Committee on Finance, U. S. Senate, June 22-23, 1961, p. 119.

The notion is that private short-term exports of U. S. capital are only a temporary drain on the balance of payments and are quickly reversed; their inclusion among the payments which "cause" the deficit, i.e., above the line, therefore gives a misleading impression of the true deficit with which the United States must grapple. The reason for also putting net unrecorded transactions below the line is the belief that changes in these reflect short-term capital movements which are not caught in the Government's data collection system.[9] In offsetting private U. S. short-term capital exports against the increase in our liquid liabilities to foreigners to measure the deficit, the concept of the basic deficit is analogous to that measure of our liquidity position, discussed above, which subtracts our short-term assets abroad from our outstanding liquid liabilities to foreigners.

Spokesmen for the Treasury, when noting the basic deficit, often mention separately the size of any advance repayments of debts owed to the United States Government which we have received. Since we cannot always count on such receipts, they cannot be regarded as persistent and less volatile elements in the balance of payments. In effect, this adds a fourth concept of the deficit. In 1961, advance repayments amounted to $700 million. This led to an *adjusted basic deficit* of $1.1 billion.

Hot dispute surrounds the comparative merits of the overall and basic deficit concepts. The issue turns largely on the volatility of U. S. private short-term capital movements. When the concept of the basic deficit was first given major use in the early part of 1961 the United States was believed to have undergone a major outflow of speculative short-term U. S. capital, the kind that could be expected to return once the crisis of confidence late in 1960 had

[9] For example, if an individual purchases foreign short-term securities through American banks, this will be reported to the Federal Reserve Bank of New York and will become part of the balance-of-payments statistics though only if the short-term security remains in the custody of the bank. But if he deals directly through foreign organizations, it will not. Purchases of short-term securities through brokers are not reported at all.

eased. But subsequent data indicate that very little of the outflow of private U. S. short-term capital in the last half of 1960 took the form of increased claims on foreigners denoted in foreign currency, which is the form the flow would have to take if the investor is to gain from a devaluation of the dollar.[10] Furthermore, it is not at all clear that the claims on foreigners which are recorded as short term are in fact short term; they include loans of a revolving nature by U. S. banks to foreign customers. Finally, the outflow of private short-term U. S. capital in 1961 was approximately the same as in 1960, and most prior years showed net outflows as well. While each individual transaction subsumed under private short-term capital exports may be easily reversed, it is not clear that the total is especially volatile. With respect to net unrecorded transactions, the only thing that can be said is that we know little about them: they may reflect capital movements but they can also reflect errors in the collection of other data as well.

A fifth concept of the deficit is the overall deficit adjusted for so-called *special transactions.* The special transactions are brought below the line, thereby being removed as a "cause" of the deficit. A transaction is considered as special if it is (1) self-reversing, or (2) non-repetitive and large. The purpose of the concept appears to be to get at the trend in the balance-of-payments deficit and to exclude those transactions which disturb the trend. The Department of Commerce, which makes the judgments, has so far identified the following as special transactions: (1) advance repayments of debts owed to the United States Government, (2) U. S. subscriptions to international organizations such as the Inter-American Development Bank, (3) certain short-term capital outflows which had reversed themselves by the time the data were to be published, and (4) large, non-repetitive private long-term capital flows such as the Ford Motor Company's purchase of British shares in its British subsidiary of $370 million in 1960, and others. In principle, a steel strike, which stimulates imports of steel products and retards exports, could be regarded as leading to special transactions because of its

[10] *Survey of Current Business,* March 1961, pp. 20, 24.

temporary influence on the balance of payments, but difficulties in estimating the impact of a strike on the balance of payments virtually preclude this kind of adjustment. Obviously it is exceedingly difficult to obtain a comprehensive measure of the so-called special transactions because it is difficult to know what transactions are in fact temporary, self-reversing, and non-repetitive, or the proper division between small and large. At the same time, something of this nature has to be done if one is to get a sense of the main drift in the balance of payments.

A sixth concept of the deficit is the *exchange market balance* put forward by Walter R. Gardner of the International Monetary Fund.[11] The main thrust of this measure is to estimate the pressure on the value of the dollar in terms of foreign currencies in foreign exchange markets. Hence purchases of dollars by foreign central banks to hold the exchange rate stable plus their purchases of U. S. gold finance the deficit, i.e., they appear below the line. Gardner goes further, however, in adding those intergovernmental transactions which occur in lieu of foreign central bank gold purchases and accumulations of liquid dollar balances. Thus, he adds the advance repayments of debts owed to the United States Government, presumably on the theory that they were made to ease the U. S. balance-of-payments position.[12] Mr. Gardner also calculates a basic deficit which is the same as Secretary Dillon's except that Gardner puts portfolio investments below the line, while Dillon puts them above the line, because Gardner feels that they can shift readily from country to country.

One difficulty with the exchange market balance is that foreign

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[11] "An Exchange-Market Analysis of the U. S. Balance of Payments," *International Monetary Fund Staff Papers,* May 1961, pp. 195 ff.

[12] Gardner also sets any loans we make to other countries for balance-of-payments purposes against our gold exports and certain increases in liquid liabilities held by foreign central banks and governments. He does not include our liquid liabilities to foreign commercial banks on the theory that they are no longer an arm of central banks, as they clearly were in the years of tight exchange control abroad.

central banks shift their holdings of dollars for reasons other than a desire to hold the exchange value of their currency stable in terms of the dollar. For example, the purchase or sale of dollars by a foreign central bank may be designed to or may be the result of efforts to ease or tighten internal credit conditions by injecting or withdrawing central bank funds from the economy. Purchases of dollars by central banks would increase the deficit in the U. S. balance of payments as measured by Gardner, but they need not be associated with an excess supply of dollars on the foreign exchange market. Another difficulty with the exchange market balance, held in common with the overall deficit adjusted for special transactions, is the problem of selecting intergovernmental transactions to be included within the deficit. For example, Germany is stepping up her purchases of military goods in the United States; this results in part from U. S. pressure on the German Government because of our balance-of-payments difficulties but also because of our argument that she can carry more of the Free World defense burden now because of her startling growth. Should all or part or none of these purchases be considered as being in lieu of gold and liquid dollar movements?

If we do not adjust for any such special transactions so that the deficit is measured only by the export of gold plus increases in liquid liabilities to monetary authorities (foreign central banks, treasuries, and the IMF), the resulting *official settlements balance* shows the change in what was termed our direct liquidity position above. A problem with this measure, which also applies to Mr. Gardner's exchange market balance, is that according to some analysts not insubstantial amounts of dollars owned by central banks are held for them by commercial banks so that it is difficult to measure the deficit accurately. This measure also suffers from the fact, noted above, that central bank purchases or sales of dollars may occur independently of the state of the exchange market.

Table IV displays each of the deficits over the last four years. Given the difference in sizes of the deficits and, in some instances, differences in the direction of their shifts between years, it is clearly not a matter of indifference which deficit one elects to close.

Table IV

MEASURES OF THE DEFICIT

(billions of dollars)

	1958	1959	1960	1961
Overall	3.5	3.7	3.9	2.5
IMF	3.1	3.4	3.7	1.9
Basic	3.6	4.3	1.9	.4
Basic, adjusted for Advance Repayments	3.6	4.7	1.9	1.1
Overall, adjusted for Special Transactions	3.5	4.1	3.4	2.6
Exchange Market	3.0	2.7	3.6	1.9
Official Settlements	3.0	2.3	3.6	1.3

Source: *Survey of Current Business; IMF Annual Report, 1961; Economic Report of the President,* January 1962; *IMF Staff Papers,* May 1961. Mr. Gardner was kind enough to provide his estimate for compensatory transactions in 1961 to permit me to calculate the exchange market deficit for that year.

Each one of these measures has merit in the eyes of its proponents. Enough has been said to indicate that a key task in solving the problem, that of defining its extent, is not easy.

THE CAUSES

PROBABLY NO TOPIC in the national debate on our balance-of-payments position has produced more confusion and nonsense than the cause of the deficit.

The Arithmetic Cause

A few writers, to determine the cause, search through the balance of payments for that group of expenditures which most nearly approximates the size of the deficit and labels it "the cause."

The error here is obvious because the groupings in the balance of payments are arbitrary. More importantly, foreign countries do not set aside the dollars they earn from particular types of transactions to purchase our gold or to hold as liquid dollar balances. All of the dollars they earn are a potential claim on our gold stock, and it is fruitless to try to distinguish them. This casts doubt on any assertion that a particular item—imports, aid, investment or what-not—has caused the deficit.

The Chronological Cause

Another approach for determining the cause looks for the major factor increasing the deficit over a period of time. Using some base period, the analyst will discover, for example, that imports have increased in absolute terms more than any other item on the expenditures side and identify imports as "the cause."

One must question whether or not this approach yields a "cause" in any relevant or useful sense. For example, on a Saturday afternoon in the Fall somewhere in America some young man scores the "winning" touchdown in a football game in the last few seconds of play and receives the blessings of the alumni. In a chronological sense, he has caused the winning touchdown. Yet, when the final whistle blows, does he deserve to be remembered longer than other teammates who also scored? If any one of them had failed, victory might have been lost. It is more than good sportsmanship, but logic as well, that demands kudos for the others. One can also ask whether the failure of someone on the opposing team to make a

particular tackle should not also be labeled as the cause. Applying the analogy to the problem of the deficit, does it really make sense to blame the deficit on a particular category of expenditures which has increased most when if any other of the expenditure groups had failed to rise the deficit might not have occurred? And does it make sense to look for the cause only on the payments side when receipts might be increased to prevent the deficit?

The football analogy fails to display one important problem in determining the cause of the deficit. There is general agreement among sports fans on the question of when the football game begins. But there is no clear-cut starting whistle in the chronological analysis of the causes of a deficit because there are no obvious rules for selecting the base period from which to measure changes in payments and receipts. Some analysts search for a "normal" period in the past to employ as a base, but the international economy has been so disturbed by abnormalities both before and after World War II that no "normal" period clearly presents itself.

This is not a merely academic point. In considering the 1958 deficit, for example, it makes a great deal of difference which base period is selected. For example, on the basis of the years 1946 through 1950, 1952, and 1954, the increase in merchandise imports up to 1958 appears to be the major factor increasing our payments abroad. But using 1951 and 1957 as the base, military expenditures are the chief source of increased expenditures abroad. From 1953 to 1955, net private U. S. capital outflows take first place, and for 1956 the blame falls on increases in service imports.

Even assuming that the base period problem could be solved, the chronological approach to the cause of the deficit is remiss in implicitly assuming that a deficit can be caused only by an increase in payments abroad. One can argue, for example, that, when expenditures abroad increase, it is the failure of receipts, perhaps exports, to rise by a sufficient amount which causes the deficit. In an expanding world economy, it is not unreasonable to hope that U. S. exports will show a secular increase, and it would be incorrect, when using the chronological approach, to blame the deficit on a short-fall of exports only when they actually decline.

The Netted Cause

It is frequently argued that the balance-of-payments deficit has not been caused by our being priced out of foreign markets inasmuch as our merchandise exports exceed our imports—in 1961 by $5.4 billion ($3.2 billion if aid-financed exports are excluded). This contention seems to imply that the U. S. price level is appropriate in relation to other countries so long as exports equal or exceed imports. But, if exports just equaled imports, we could not undertake private foreign investment or government aid, nor could we pay for the various service imports including tourism and transportation that we presently demand. Hence, to test the appropriateness of our price level by the balance of trade implicitly gives an inferior status to all other expenditures except merchandise imports, i.e., imports have first claim on export receipts.

A number of net figures of different items in the balance of payments have appeared in public debate. The error common to all nettings is the assumption that some one expenditure has first claim on certain receipts. This reasoning fails to recognize that, at the margin of the disposition of funds, no one type of expenditure is less or more important than another. In the allocation of one's own funds, the last dollar invested, the last dollar spent for product X, and the last dollar spent for product Y all should bring equal satisfaction. If they do not, a rational person will shift his expenditure pattern from those transactions giving less benefit to those giving more, and will keep on shifting until no further net benefit is derived. With all Americans choosing among alternative uses of their funds, including some rather difficult collective choices through the media of their governments, there is no presumption that imports, investment, or aid have first claim on our foreign earnings.

Cause cum Solution

Many discussions of the balance-of-payments problem confound causes and solutions. If imports are isolated as the cause, then cut imports. If aid, then reduce it. If excessive profit margins, force them down. If wage increases, prevent them.

One well-known student of international economics, now an

official of the Kennedy Administration, stated: "If we are to eliminate our foreign deficit, it would seem only reasonable to operate on the causes which have brought it about. Even more pertinent would be to operate on those factors that may in coming years tend to perpetuate the deficit, or even make it grow." Suppose one forecasts his own balance of payments and discovers that, in a chronological sense, it will be thrown into deficit by expenses for an impending surgical operation needed to save his life. Application of the foregoing rule would require the individual to sacrifice his life. Obviously, it would be preferable for the man to cut other expenditures—ones which give him less satisfaction than those necessary for the continuation of his life. There is also no requirement that the "cause" of a deficit be removed in order to solve the deficit. There are many items on the expenditures side of the balance of payments and many on the receipts side as well, and the adjustment of any one of them will suffice to remove the deficit. A dollar is a dollar is a dollar. The cause has no necessary relation to the solution.

If we go beyond the items in the balance of payments to find the cause, as do those who claim that wage increases have priced us out of foreign markets, the same conclusion holds. To offset the impact of wage increases, a large number of policies are available to us: tariff increases, reductions in aid, devaluation of the dollar, export subsidies, and, of course, the retardation of wage increases. All of these may help the balance of payments and the choice among them must rest upon their relative merits.

The Relevance of Causes

The analysis of causes has some value in determining the need for action. If the chronological cause is a temporary factor, likely to reverse itself within the required period of time, no action is necessary—assuming that no other temporary causes will take its place. What is required here, however, is not so much the analysis of the causes of present deficits but a forecast of the causes of future ones.

In determining the need for action, one must forecast not only prospective deficits and sort out the more or less persistent forces from the temporary ones, but one must also establish a time period over which a deficit is tolerable. One purpose of holding gold is to

meet temporary swings in the balance of payments, and if the forces at work are expected to reverse themselves within the required period of time, then there is no apparent need for action.

Unfortunately, forecasting future deficits and the grace period permitted by a nation's reserves is exceedingly tricky. The deficit in the balance of payments is the difference between two very large numbers, receipts and expenditures. A relatively small error in projecting either can multiply the deficit several fold or reverse it completely. The multiplicity of forces bearing on the balance of payments, here and abroad in both the private and in government sectors, is so great that the components of the balance of payments are exceedingly volatile. As one of President Kennedy's task forces stated, ". . . the balance of payments deficit or surplus that will be realized in any particular year is impossible to forecast with any degree of reliability."[1] Note the despairing remark of Sir Donald MacDougall, who has been a close student of balances of payments both here and abroad for many years: "I have come to the conclusion that the only thing which can be said with certainty about any country's balance of payments is that it changes when one least expects it, and often in the opposite direction."[2]

The prediction of the grace period permitted by our gold reserves is no easier. It is difficult to lay down the safe level of reserves or to specify how long the United States can suffer a deficit without serious consequences because it is impossible to specify in advance the threshold of speculative attacks on the dollar. Some students of the balance of payments feel that a deficit is in fact tolerable for the United States over a fairly long period because the rest of the world will need to hold additional dollar reserves (liquid dollar balances) in order to carry on a higher volume of trade as world trade grows. They estimate the required reserves as a fixed percentage of the expected level of trade and subtract that portion of the

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[1] Report by Messrs. Allan Sproul, Roy Blough, and Paul McCracken, January 18, 1961, p. 11.

[2] *The Dollar Problem: A Reappraisal* (International Finance Section, Princeton University), November 1960, p. 64.

reserve requirements that will be fulfilled by new gold production and by non-dollar currencies; the residual is the amount of additional liquid dollar balances that foreigners will require each year, and this is maximum safe deficit. But these estimates involve some admittedly debatable assumptions. Trade may not grow as fast as projected. There is little evidence to support the view that reserves tend to be, or even should be, a relatively fixed proportion of trade. Gold production is by no means steady, and the amount that goes into monetary reserves as distinct from hoarding or commercial uses is extremely variable. And as long as there are several countries performing the role of international banker (particularly Britain) as well as ourselves, there is no assurance that foreign countries will hold the required additions to their reserves in the form of dollars so that we can safely run a deficit.

When one searches for the facts to determine whether or not a deficit is largely or entirely temporary, there are a number of pitfalls. As a rule it is relatively easy to discern certain temporary forces, and consequently these are sometimes given undue weight.[3] While the causes of a more persistent deficit may operate gradually, the temporary forces leap to the eye—the steel strike in 1959 which contracted our exports and stimulated imports, the change-over from piston to jet airliner production which gave a hiatus to our aircraft exports, the slowness of the U. S. Government to increase the subsidy on cotton exports or lower the domestic support price when world prices of cotton fell, collapsing our cotton exports.

To be sure, some of the evidence which suggests a more persistent deficit also is dramatic and swift, but it is often misleading. For example, on the question of whether or not we have priced ourselves out of foreign markets, some commentators respond with a vigorous "yes" and point to evidence that is largely irrelevant. Too often the evidence consists of a few examples, sometimes personal experiences, of sales lost by American exporters in foreign markets. But

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[3] With the benefit of hindsight, it is easy to say that there was probably too much of this in discussions of the balance of payments in 1959.

these individual examples, even when multiplied, prove nothing by themselves for it is in the nature of a dynamic international economy that, at any given moment, some U. S. exporters will find themselves outsold by foreign competition. Comparative advantages, which underlie the pattern of trade, are constantly shifting with technological progress, changes in tastes, and fluctuations in cost and market conditions in particular industries.

A thoroughgoing analysis of the role of prices in changing our balance-of-payments position would require a case by case analysis of each export and import product and each foreign investment decision, comparing changes in the prices and costs of U. S. and foreign outputs. To isolate the role of price, we need to separate out changes in delivery periods, credit terms, sales effort, re-order convenience, and all the other factors which, in addition to price, determine whether or not a deal is concluded. This is an almost impossible task.

Unable to undertake the massive task of individual price comparisons, many analysts turn to price indices to gain insight into the competitive question. But even in the most talented hands, they rarely reveal much. Various price indices—cost of living, wholesale price, and GNP price deflators—all give different results, and no single index is clearly superior to the rest. None is clearly the correct index. The consumer price index does not include the prices of capital goods, which are extremely important in international trade; the wholesale price index involves much double counting of goods at different stages of fabrication; and the GNP price deflator includes the prices of many services which do not enter into international trade. Differences in the items included in the indices by different countries cast doubt on the relevance of the comparisons, and no allowance is possible for shifts in quality and the other factors which bear on the significance of differences in relative price movements. Furthermore, the price indices only permit comparisons of *changes* in prices rather than absolute price differences.

The danger in employing U. S. export price statistics has been underlined by a report of the National Bureau of Economic Research which notes that in 1957

> . . . less than a fourth of finished manufactured imports . . . and less than a fifth of finished manufactured exports . . . were covered in the . . . calculations. The proportions in themselves would not necessarily represent a serious deficiency if the included items constituted an adequate sample for the category. However there is little ground for believing that the sample is representative of price movements for finished manufactured exports and imports. . . .[4]

If the price data yield little, those who contend that wage increases have priced America out of world markets are placed in a difficult position to the extent that the mechanism involves the effect of wage increases on prices. Yet, in admitting the uncertain results of price and wage comparisons, we have surrendered to ignorance only in respect to the cause of the deficit; price and wage reductions, or at least retardations in their increase, may still be employed as a possible solution if desired.

Still another approach often employed to discern shifts in our competitive position is the calculation of market shares held by United States exports. Table V displays these trends for manu-

Table V

U. S. Share in Exports of Manufactures
By Leading Countries Exporting Manufactures

Year	Percentage
1954	25.1
1955	24.5
1956	25.2
1957	25.4
1958	23.3
1959	21.2
1960	21.6
1961	20.6

Source: *Board of Trade Journal, Supplement,* September 29, 1961 and April 20, 1962.

[4] *The Price Statistics of the Federal Government* (New York: National Bureau of Economic Research, 1961), Appendix A.

factured goods. One must be most careful in employing share data, because shares shift for reasons not necessarily related to the competitive position of U. S. exports. By definition, U. S. exports cannot be sold to the United States so if the U. S. domestic market is expanding rapidly, and we therefore buy larger volumes of foreign manufactures, the U. S. export share of world trade in manufactures automatically falls. Furthermore, if there is a recession in one of America's foreign markets in which our exports dominate compared to goods from other countries, the U. S. share of world trade automatically declines even though there is no fundamental shift in the U. S. price position. Finally, U. S. exports seem to be somewhat more sensitive to cyclical fluctuations in foreign markets than the products of other countries so that the market share in any given year does not represent a longer term position. Some of these problems can be avoided by analyzing U. S. export performance in individual classes of products in individual countries; in this way the U. S. position in respect to particular groups of products in particular markets can be compared with that of other countries. This approach has been employed by the Department of Commerce in analyzing shifts from 1954-56 to 1958, revealing a 6 percent fall in the average share.

Another approach to judging our competitive position scraps the commercial tests of prices and market shares. It holds that our products are not competitive *enough* whenever the balance of payments is in persistent deficit. That is, it holds that U. S. prices have to be low enough relative to foreign prices over the long pull to let us balance our accounts. It does not really matter whether our market shares are falling or rising and whether or not our prices are falling or rising relative to foreign prices. Only the test of balance-of-payments equilibrium counts. Conceptually, this is probably the most meaningful test of whether or not we are priced out of foreign markets. Unfortunately it falters in application because it requires a judgment of whether or not there is a persistent quality to the deficit, which, in turn, requires hazardous projections.

THE CURES

THE DEFICITS SINCE 1958 have been considered sufficiently dangerous by both the Kennedy and Eisenhower Administrations to warrant specific governmental action for their removal. Most of the interest groups, in and out of government, have found ways to show that their pet proposals, if enacted, would help the balance of payments. We have been entertained by some suggestions such as the recommendations that we shift to a metric system in order to make our products more attractive to foreigners and that restaurant menus be presented in several languages to attract foreign tourists.

The Requirements for a Successful Cure

Anyone faced with a deficit in his personal balance of payments knows that it can be cured by raising his receipts and/or reducing his expenditures; inasmuch as his receipts are often closely related to his output, a personal deficit is relieved by raising output or reducing expenditure. The same is true of nations.

What a nation produces, or its gross national product, plus the goods and services which it imports equal all the goods and services available to that nation in any given period of time. Part of this sum is sold abroad in the form of exports of goods and services, and these include not only nationally-produced products but components purchased abroad. The other part of the available supply of goods and services is employed domestically to meet the demands for consumption, investment (producer goods, housing, and inventories), and government services; these demands, taken together, we will identify as "national expenditure" to distinguish them from the expenditures by foreigners which lead to our exports. Whatever is produced at home or is imported from abroad must either be exported or employed domestically. Therefore the available supply of goods and services must equal the demand for them by foreigners and residents, i.e.,

$$\text{GNP} + \text{Imports} = \text{Exports} + \text{National Expenditure}.$$

If we rearrange these items, we find that

$$\text{GNP} - \text{National Expenditure} = \text{Exports} - \text{Imports}.$$

This merely says that if a nation exports more than it imports, it must produce more than it spends or uses at home. It also says that if we want to raise exports relative to imports, we must pursue policies which raise GNP relative to national expenditure.

To display the balance-of-payments deficit, we need only subtract the total of imports and net exports of capital (both private and public) from exports. To keep the equation in balance, we subtract net capital exports from the left side as well, and we obtain

GNP — National Expenditure — Net Capital Exports =
Exports — Imports — Net Capital Exports

The balance-of-payments deficit, which is on the right side, is equal to the difference between national output on the one hand and national expenditure (which is the sum of private and government consumption and investment) and net capital exports on the other hand.

This formulation displays both how easy and how complicated the problem of solving a balance-of-payments deficit can be. It is easy because the largest deficit we have suffered to date has been less than 1 percent of our GNP; if we could have diverted into export or import-competing industries only part of our increasing national output, in the amount of less than 1 percent of the GNP, the past balance-of-payments deficits would not have existed.

But three complications become apparent. First, while the GNP grows, so also does national expenditure because the higher level of output brings greater income for our people. They will spend part of this themselves, and the portions they pay in taxes and save are spent, in turn, by governments and investors for the national output. As GNP grows, so does national expenditure, and the trick is to determine how to restrain the growth in national expenditure so that something of the increase in national production is left to improve the balance of payments.

Second, the size of the national output is determined in part by exports and imports. The solution to the balance-of-payments problem is not merely to get the right relationship between GNP and national expenditure which then automatically gives us the desired levels of exports and imports; it is also to get the right levels of

exports and imports to get the desired relationship between national output and spending. The role of exports in affecting the size of the national output is well-known; they rank in importance with purchases of producers' durable equipment as a component of national output. With respect to imports, the relative proportions of national expenditure devoted to domestically produced and foreign goods and services determine how much national output will be produced for home use. If, for example, our prices are too high, so that foreigners are able to penetrate our markets with ease, a larger proportion of national expenditure will be devoted to foreign goods and less to home-produced products; consequently the GNP will be lower than it otherwise would be. The problem is like that of attempting to fill the bath tub from the hot and cold water taps simultaneously with the plug out *and* to do so while maintaining a certain ratio between the water coming in the hot water tap and the water going out the drain. In the U. S. economy, one of the taps is exports while national expenditure is the other tap; the drain is imports. We must pursue the right balance among all three if we are to achieve the level of national output which, in conjunction with national expenditure, gives us the desired levels of exports and imports.

The final complication is that, since the exports of one country are imports of other countries, if we attempt to improve the relation between our exports and imports, which requires us to raise output relative to spending, the rest of the world must change its exports relative to imports, or change the ratio between its output and spending. Thus, the success of our efforts depends upon events abroad as well as at home.

The Case Against Selective Cures

The arithmetic of the foregoing analysis tells us that we can solve our balance-of-payments problem by juggling exports, imports, net capital exports, national spending, and output. But since we are juggling people, instead of balls, the choice of policies depends closely upon what we want for society. If a man has a hole in his pocket, he can stop the drain of coin either by sewing up the hole or sewing down the flap, and it makes some difference to him which policy he adopts.

The objectives of society are manifold: liberty, opportunity, eco-

nomic well-being, etc. The economic objectives themselves are divisible: high employment, high national income, the reduction of pockets of poverty, and a fair distribution of income. In assessing a proposed cure, we must ask not only whether it will right the imbalance in our international payments but whether it will serve, or at least not harm, the multiplicity of goals.

This is not to say the improvement of the balance of payments may not require some sacrifices. The arithmetic of the previous section makes it clear that efforts to solve the problem by expanding exports relative to imports require reduction in the ratio of national expenditure to national output so that we in fact must use at home less of what we produce. This need not require an absolute reduction in our scale of living if national output is rising, only a slow-down in its rate of increase. Clearly, we should seek policies which minimize the reduction in the goods and services enjoyed by our nation, either absolutely or in comparison with the national output, while still solving the balance-of-payments deficit.

On this criterion there is a presumption against selective measures for solving the problem, unless they can be justified on some ground other than their contribution to the balance of payments. For example, suppose we select one export product as the vehicle for the solution of our deficit, and we subsidize its sale abroad to the extent of 25 cents per unit. Presumably the production of that item would expand until costs of production have climbed to shut off the incentive for still further expansion or the price in foreign markets has dropped with the same effect. When the growth of production has ceased, we would find ourselves selling the product to foreigners for, let us say, $1.00 but employing, because the subsidy makes it possible to do so, $1.25 of economic resources to produce the item. At the same time there would be other exports, not subsidized, earning a dollar per unit also but costing only a dollar to produce since they are not subsidized. In such circumstances we would save scarce domestic resources by shifting some of the subsidy to the presently unsubsidized exports. For example, if we reduce the subsidy on the first product slightly so that exports of it fall by $1.00 and provide sufficient subsidy to the other exports so that their total rises by $1.00, nothing would happen to the balance of payments. At the

same time, the fall by $1.00 in the exports of the first subsidized product would free $1.25 of economic resources for alternative employments in the United States while the expansion of the other exports would use up only about $1.00 of domestic resources. There would be a net freeing of domestic resources for alternative uses in the United States. We would have more goods and services at home with the same balance-of-payments condition. So long as the degree of subsidy differs among products, further shifts toward equal subsidies will add to real national income. Hence, selective export subsidies should be avoided as a means of improving the balance of payments.[1]

The same presumption against selectivity is found on the import side. If we were to levy a 50 percent tax on some imported product, presently free of duty, the volume of imports would drop and the price within the United States would rise. If the item cost a dollar exclusive of the tax, the imposition of the tax would cause consumers to give up something worth approximately $1.50 to them, i.e., the price they are willing to pay for the last unit they do in fact buy. At the same time, there would be other imports, free of duty, also costing a dollar but which, if cut, would be of less value to the consumers and thus less burdensome to sacrifice because their value to consumers would be $1.00. If we reduced the tariff on the taxed import slightly to permit an additional dollar's worth of imports while imposing a slight tariff on all other products so that they fell in total by $1.00, nothing would happen to the balance of payments. However, consumers would gain a unit of a product worth $1.50 to them, which is the price they have been willing to pay for the first product, at the expense of giving up a product only worth approximately $1.00 to them. So long as imports are taxed differently, consumers as a whole would gain by moves toward the equalization of

[1] Inasmuch as the capital-intensity of U. S. exports varies among products, this reasoning seems to establish a presumption against Professor Henry Wallich's interesting suggestion that accelerated depreciation be afforded to U. S. export industries. See *Foreign Economic Policy,* Hearings before the Subcommittee on Foreign Economic Policy, Joint Economic Committee, December 4, 1961, pp. 47-48.

taxes. Hence, selective import restrictions should be avoided as a means of improving the balance of payments.

There is also a presumption against measures which are selective as between expanding exports and reducing imports, again with the exception that selectivity is appropriate if justified on grounds other than that of improving the balance of payments.[2] For example, if we do nothing to increase the cost of imports and only subsidize export production, we would soon find ourselves putting $1.50 of resources, with the help of a subsidy of 50 cents per unit, into the production of goods for export which earn $1.00; since we use the dollar earned to pay for our imports, we are employing $1.50 of resources to obtain imports which are, so long as they are untaxed, worth only $1.00 to American consumers. This is hardly economic. Futhermore, competition will require that the things we import without duty which sell for $1.00 would cost, to the extent we produce them in the United States, $1.00 in terms of U. S. economic resources when produced at home, if they are of the same quality. It is hardly sensible to use $1.50 of U. S. resources to produce a product for export to earn a dollar with which to pay for an import costing $1.00 when the import could be produced at home for $1.00. We would save resources for alternative employment without affecting the balance of payments if we reduce the subsidy on exports slightly, thereby releasing resources from export production equal to $1.50, and impose a tariff to decrease imports slightly, using domestic resources equal only to approximately $1.00 in order to replace through home production the imports foregone.

Alternatively, if we do nothing to stimulate exports and only impose import taxes to solve the balance-of-payments problem, we would employ $1.00 of resources to produce exports which earn us $1.00 of export income; since the imports bought with this dollar of income are taxed, they have a higher value to consumers in the United States than $1.00. In effect, we would be employing $1.00 of

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[2] Hence, the frequent statement that we should solve the deficit by expanding receipts rather than cutting expenditures is invalid except possibly when non-selective export stimulation is urged in preference to selective import reduction.

resources to produce exports which bring us goods worth more than a dollar because they are taxed. Obviously, this is a useful exchange, and more of it ought to be done. That is, when we have imposed a duty to reduce the balance-of-payments deficit, exports should be stimulated through subsidies and the restraint on imports through taxation eased (in other words, the selective measure of import taxation is an uneconomic method for solving the problem). In terms of saving U.S. economic resources for alternative uses, the same conclusion prevails. After the imposition of a 50-cent tax on imports costing $1.00, U. S. import-competing production would expand until costs of production in the import-competing industries rose sufficiently to shut off the incentive for further expansion of production. We would find ourselves using $1.50 of resources to produce a unit of a product which we could obtain from abroad for $1.00; it would save resources if we used only $1.00 of economic resources to produce an export product selling for $1.00 to pay for the required import. Because the import tax is an uneconomic solution to the deficit, we should reduce the tax on imports and pay for the consequent increase in imports by expanding exports through a subsidy to them.

In sum, there is a presumption against measures to solve the deficit which are selective as between exports, between imports, and between exports and imports.[3] With this in mind, let us turn to some of the specific proposals for righting our imbalance.

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[3] There is a technical case for selectivity when the elasticities of demand and supply differ among different types of transactions. For example, an equal subsidy to all exports may produce more additional earnings on one product than another because the market can absorb the increased output more readily. But a policy of differential treatment is not likely to produce better results because, in view of the exceedingly dynamic nature of the international economy, the elasticities shift and there is no reason to suppose that government policy could keep up with such shifts; as a result, items which were taxed appropriately at one time would be taxed too much or too little later, offsetting whatever advantage was previously gained. Furthermore, international demand and supply elasticities tend to be high, suggesting that there is little to be gained by differential treatment in any event.

Import Restriction

A number of groups have sought to link their desire for protection from foreign competition with the balance-of-payments problem by urging that U. S. tariff barriers be raised and import quotas be imposed to restrain imports. President Kennedy appeared to accept in principle this role for duties in limiting a deficit when he obtained from the Congress a temporary reduction of the duty-free allowance on goods brought into the United States by returning tourists.[4] And he mentioned gold and the balance of payments no less than three times in a press conference at which he sought to justify an increase in tariffs on Belgian glass and carpets. Allegedly for balance-of-payments reasons, the tax laws have been sharpened against the purchase of reinsurance abroad by American insurers in order to ease the dollar outflow, and a route for a foreign airline into the United States was allegedly denied for the same reason. Clearly, all of these actions fail to pass the test of non-selectivity which is essential for an economical solution to the problem of the deficit. In fact even a general restriction on imports does not pass the test of non-selectivity set forth above. It would work solely by restricting payments—a particular group at that—rather than by also expanding receipts.

Those opposed to tariff obstacles have sought to defend against the protectionists with various arguments, some of them wholly or partly specious. For example, it is suggested that tariff increases,

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[4] The Administration has sought to distinguish this action from tariff increases on the ground that foreign countries have not complained about it; this is a political and not an economic difference. The President supported the move on the ground that the allowance was increased in the postwar period in order to ease the dollar shortage, which condition has now passed. But there were clearly other grounds on which the increase could have been justified, namely the gains from expanded trade, so that the past reason is not necessarily the relevant one.

by reducing imports, will force a decline in our exports inasmuch as foreigners will have fewer dollars to buy our goods. This amounts to saying that every dollar decline in our payments to foreigners will reduce our receipts from foreigners by a like amount. If this is true, it is difficult to see why we ever got into the deficit in the first place for one would suppose that every dollar *increase* in our payments to foreigners would, on the same principle, lead to a dollar increase in our foreign receipts. One might narrow the argument by contending that, if we reduce our imports from countries which impose exchange and trade controls because they are short of dollars, they will be forced further to limit, by means of those controls, their purchases from us. However, inasmuch as the major currencies of the world are convertible (i.e., can be freely exchanged), the foreign country with controls might choose to restrict imports from Germany, employ the marks thereby saved to purchase dollars from Germany, and with these dollars settle the short-fall in its receipts from the United States caused by higher U. S. tariffs.

There is, however, a subtler mechanism which lends credence to the view that import restrictions will not improve the balance of payments. As we raise our obstacles to trade to reduce our imports, we perforce restrain the exports of other nations. This tends to depress their national production and income, prices, and output, forcing a recession or perhaps merely a retardation in their economic growth, which in turn will depress or retard their imports from us; consequently some of the benefit for the balance of payments is lost. The size of this reaction depends upon a host of variables, not the least of which is the counteraction taken by foreign governments to maintain domestic production through monetary and fiscal actions. But unless one has extreme faith in the facility of governments in such efforts, it does not seem likely that they can fully compensate for the fall in their exports to us, and consequently we should expect some loss of export income.

The compensatory effect on U. S. exports is apt to receive added stimulus through retaliatory increases in tariffs imposed by foreign

governments on our exports. This is not merely a case of "you hurt me, so I'll hurt you"; rather it is a codified principle regulating international transactions and hence, a predictable effect of tariff increases. Suppose that a country withdraws a tariff reduction previously granted to other nations in exchange for tariff reductions on its exports. Under Article XXVIII of the General Agreement on Tariffs and Trade, in which we participate through executive agreement with 40 nations, that country must replace it with a tariff reduction on some other item which it imports or other members shall be free to withdraw substantially equivalent concessions on goods exported by that country. There would be little help to the United States balance of payments if we raised some duties and reduced others. Nor would there be a gain for the balance of payments through tariff increases if other countries would then withdraw previous tariff reductions that they gave to our exports. When President Kennedy raised the duties on Belgian glass and carpets and justified it on balance-of-payments grounds, he opened the way for actions under Article XXVIII which virtually assure that tariff increases are not likely to have a net favorable effect on the balance of payments.

Of course, if we were to withdraw from GATT we could avoid the consequences of Article XXVIII, but this is an unpromising course. If our withdrawal as the world's largest trader should collapse the GATT, the fabric of intricate rules and agreements which has restrained and reduced the barriers to world trade would disappear, and we would have to expect some retaliation, perhaps by more than the "equivalent" amounts called for under Article XXVIII.

There remains the possibility, while retaining membership in the GATT, of imposing import quotas because the GATT specifically permits their use for balance-of-payments reasons. To avoid retaliation under the rules of GATT, we would have to obtain a determination from the International Monetary Fund that such quotas were in

fact required for balance-of-payments reasons, but given the Fund's preference for monetary and fiscal adjustments as solutions to payments problems, we could expect great difficulty in obtaining this permission and much pressure from other member countries to avoid quotas.

In any event, the massive application of quotas to our imports is the least desirable method of restraining imports. If imports are in fact restricted by quotas, the limited supplies must be allocated among buyers by licenses. Any broad-scale effort to restrict imports in this manner would require a vast bureaucracy with the power of life and death over individual enterprises, an expansion of the enforcement divisions of the Treasury and FBI to prevent corruption, and endless wrangling in the courts, Congress, and at lunch over who would get what. (The persistent bickering, executive branch hearings, and court battles over the allocation of licenses for the import of oil into the United States stand as object lessons.) The luncheon martini would replace the market as an allocator of imports with presumably less rational results. Government imports would be free of quotas or at least be given preference over private imports, further expanding the public sector's role in the economy, and Washington would wrestle with the problem of whether the quota for Scotch should be raised while that for Volkswagens reduced, a public issue requiring a government decision on whether Scotch is better than Volkswagens for the people.

Import restrictions alone create some direct and indirect effects which are adverse to the balance of payments and which may, under certain circumstances, compensate for any direct benefit achieved through a cut in imports. A representative of a tractor company which exports a very large percentage of its output noted a direct adverse effect as follows:

> Any trade restriction which causes our machinery to be more costly limits our ability to sell abroad in increasingly competitive markets. Whatever increases the cost of a tractor—whether it be zinc in bearings and pistons, alloys used to toughen track shoes, or merely the lubricating oil in the crankcase—reduces our ability

> to merchandise it abroad. I mention these particular components because each has been subject to some sort of import restriction, each by itself seems trivial, but when combined with all of the other small artificial cost increments adds up to a real, if indeterminate, cost increase.[5]

Import restrictions can lead to adverse counter effects in a more indirect way. During periods of high employment, or during periods of unemployment where the unemployed cannot find jobs because they lack appropriate skills and knowledge, the GNP cannot be increased except through the normal processes of growth. That growth does not necessarily help the balance of payments automatically because it stimulates national expenditure as well. (See page 35) Import restriction is apt to cause purchasers to shift their demands to domestically-produced substitutes for the imports which are made less attractive by tariffs or quotas. With national output pressing against capacity, the increased demand for domestically-produced goods can be met only by diverting resources from alternative employments. If spending on home-produced substitutes rises by as much as the fall in imports, so that national expenditure in total remains unchanged, and if national output cannot grow any faster, the resources drawn into production of substitutes for imports can come only from those resources which otherwise would have gone into export production. That is, the balance between GNP and national expenditure is not changed by the tariff, and therefore the trade balance cannot improve despite the reduction in imports. Of course, whether or not this happens depends on the extent to which purchases of domestic products are increased after the import reduction, which is difficult to predict, but it is certainly not obvious that in periods of high employment import restrictions will help. The ultimate solution to the balance-of-payments deficit depends less on what is done directly to items in the balance of payments and more on what is done to control the balance between output and spending in the economy as a whole.

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[5] Testimony of Robert S. Eckley before the House Ways and Means Committee, March 23, 1962.

If imports are restricted in a period when the economy is not pressing against the ceiling, the resources required to satisfy the new demands for domestically-produced substitutes for imports may come from the ranks of the unemployed, and a reduction in exports can thereby be avoided. But this would provide only temporary relief for the balance of payments because, as the economy achieves high employment, some decline in exports will occur as the ceiling on production is approached. If one assumes a persistent quality to the deficit, periods of high employment become relevant in judging the effects of import restriction.

There remains the possibility that the import restriction may lead to the employment of resources which would be unemployed even in periods of high output and national prosperity, in which case the level of exports need not be retarded. But in this instance it is wiser to attempt to shift new industries to the unemployed or the unemployed to new industries. We saw earlier that the removal of a deficit through an expansion of exports and contraction of imports requires a rise in GNP or a decline in national expenditure, or at least its retardation. It stands to reason that the greater the real income of the nation, the easier it will be to slow down the growth in national expenditure through monetary and fiscal measures because fewer absolute sacrifices will be imposed. If the unemployed resources can be diverted to alternative employments by breaking down the barriers to movement, the real national income will be greater than if they were put to work through import restriction because the nation will enjoy the benefits of the gains from trade, i.e., the gain that comes from buying goods in the cheapest market.

Reduction of the Government's Overseas Expenditures

A wide range of actions has been proposed and put into effect to cut the overseas expenditures of the Federal Government in order to ease the balance of payments. Reduction of foreign aid, the substitution of domestic for foreign procurement by the Government in its expenditures, and voluntary and involuntary cuts in the purchases made by government personnel overseas are among the leading techniques. President Kennedy, in his balance-of-payments message, called upon the Bureau of the Budget to establish

> . . . special procedures for analyzing that part of the requests of departments and agencies for spending authority which will involve overseas outlays to insure that our budgetary decisions will be taken with full understanding of their projected impact on the country's balance of payments.

As a result, for the first time in recent history, each agency reported in its budget requests the sums proposed to be spent abroad.[6] Overseas expenditures must pass a higher standard than domestic expenditures in order to gain the approval of the Bureau of the Budget.

These expenditures provide an attractive area for cutting the deficit because reductions can be achieved by executive action while some measures to diminish private payments abroad, such as the reduction of the tourist exemption from duties and increases in taxes on foreign investment, demand the more cumbersome procedures of the Congress. Furthermore, the sums of money are large—over $4 billion in economic aid and $3 billion in military expenditures.

Most of the measures undertaken to date by the Government are in their effects and results the same as tariffs and quotas. For example, the Secretary of Defense late in 1960 directed that contracts for services and supplies to be used abroad should normally be placed in the United States rather than abroad if the cost in the U. S. is estimated to exceed the foreign cost by no more than 25 percent. In July 1962 the differential was raised to 50 percent on a wide variety of goods and services procured abroad.

The significance of the invisible tariff imposed by the Department of Defense can be appreciated by comparing it with the potential effect of the 1962 Trade Expansion Act on the average level of the U. S. tariff. Under that Act, the President has authority to (1) reduce to zero U. S. duties on products in which the countries of an expanded Common Market plus the United States supply 80 percent

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[6] One cannot help but wonder if this gets at the heart of the matter. Additional estimates of the import content of goods produced in the United States for each agency should also be provided.

of the Free World's exports, (2) reduce by 50 percent any duty from its mid-1962 level, (3) reduce to zero duties which are not more than 5 percent, and (4) reduce duties on any tropical agricultural commodity. This unparalleled authority granted to the President is justly regarded as a revolution in U. S. trade policy. However, the invisible tariff imposed by the Department of Defense on overseas purchases of equipment, supplies, and materials offsets, in terms of its effect on the average level of U. S. tariffs, more than one-quarter of the tariff-cutting authority granted to the President.[7]

Inasmuch as the President is not likely to use his authority fully because some imports will be reserved from bargaining for fear of damage to specific industries, the actual offset is presumably larger. Furthermore, the estimate does not allow for the increase in the average level of U. S. trade restrictions resulting from the Department of Defense limitations, in connection with the gold problem, on overseas purchases of services and on construction expenditures

[7] This is, at best, an estimate. The procedure employed was to add Department of Defense purchases of equipment, materials, and supplies in 1960, less petroleum and fresh foods which are not subject to restriction, to total imports in 1960. The resulting figure was compared with customs revenue to provide an average *ad valorem* equivalent of the U. S. tariff in 1960. Using Department of Commerce data on the value of and customs revenue from imports falling under each of the Trade Expansion Act categories, except duties on non-tropical agricultural products for which data were not readily available, a second average *ad valorem* equivalent was calculated assuming that the full powers granted to the President were employed but no change in the 1960 volume of imports ensued. Finally, the revenue which would have been obtained on Department of Defense overseas purchases if the invisible tariffs of 25 percent (on off-shore procurement under the mutual security program) and 50 percent (on purchases of equipment, materials, and supplies except petroleum and fresh foods) had been collected in money was added to the revenue received after implementation of the Trade Expansion Act; the sum, when compared to total imports as calculated above in 1960 gave a third average *ad valorem* equivalent. The three *ad valorem* equivalents provide the basis for the estimate. (The 25 percent differential for off-shore procurement under the mutual security program has been replaced with a prohibition plus *ad hoc* exceptions.)

which bulk almost as large as overseas purchases of equipment, supplies, and materials.

The Secretary of Defense also ordered an end to purchases of foreign products out of non-appropriated funds, chiefly transactions in the post exchanges overseas, with exceptions including one that made it possible to buy Scotch by the shot in a bar but forbade the purchase of Scotch through post exchanges in bottled form. American personnel, after being relieved of the threat that their dependents would be sent home, were asked to do their part through voluntary reductions in local purchases in foreign countries, bolstered by "an intensive education program" which outlines the balance-of-payments position of the United States and the opportunities for cutting expenditures.

The equivalent of an exceedingly high tariff was imposed on foreign automobiles purchased by American overseas personnel when various agencies of the Government announced that foreign cars bought overseas after a certain date would not be transported at government expense for personnel moving to new posts.

Some of these shifts in policy could not be sustained. The restriction on the sale of locally-purchased items in the post exchanges was subject to numerous exceptions soon after it was put into effect and was finally scrapped. This was necessary because local businessmen quickly established operations near U. S. military bases, and wine and beer distributors introduced home delivery service. In some instances the shift of purchases to the local economy was believed to have added to the dollar drain as the local tax and profit requirements of the distributors raised the price over what had been charged when the item was sold through the post exchange. In addition, representations were made by several foreign governments against the prohibition on procurement of foreign goods.

Most of these measures impose higher costs upon government agencies and U. S. personnel, and President Kennedy gave recognition to this when, in announcing the continuation of the procurement policies established by President Eisenhower, he noted that "some increased budgetary cost may be incurred." In August 1961, the Department of Defense shifted procurement of coal and coke

for use by U. S. Armed Forces in Germany to the United States; a White House spokesman was quoted as stating that the 440,000 tons involved would cost $10.8 million delivered to Germany if bought in the United States as compared to $8 million if bought abroad.[8] The Department of Defense also reported that it shifted to the United States in 1961 $71.5 million of procurement contracts for goods to be used abroad which would normally have been placed abroad; the cost was 17 percent greater than the cost if procurement had been made abroad. During the first three quarters of 1962, $77 million of contracts were shifted at an additional cost of 31 percent.

The foreign aid program has come in for major criticism in the balance-of-payments debate, and the Government has taken action designed to reduce its adverse balance-of-payments effects. Many of the opponents of the foreign aid program have singled it out as the cause of our deficit, though as earlier analysis indicated, there is no single cause of the imbalance. The proponents of aid have attempted to defend against the attacks on the programs by noting that the bulk of aid is spent in the United States so that little adverse effect on the balance of payments ensues. For example, the Department of Commerce estimates that out of $4.1 billion of non-military grants and loans in 1961 only $1.3 billion was spent abroad and in 1961 Treasury Secretary Douglas Dillon testified that:

> . . . The preponderant part of foreign aid expenditures will be spent in the United States. Such expenditures, which are accompanied by American exports, have no adverse impact on our balance of payments.[9]

This contention confuses statistics and economics. At first it would seem that if all aid is spent in the United States for shipment abroad, the entries in the balance of payments would not affect the balance between receipts and expenditures. There would be an entry equal to the amount of aid on the debit side and an offsetting sum when the goods are shipped abroad on the credit side under exports; hence,

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[8] *Journal of Commerce,* August 24, 1961.

[9] *International Development and Security, Hearings,* Committee on Foreign Relations, U. S. Senate, Part I, 87th Congress, 1st Session, p. 94.

the difference between payments and receipts, the deficit, would be unaffected whether or not we provided aid. But it is not possible to read the effects of the aid programs off the balance of payments.

Suppose, for example, that the United States enjoys high employment so that its real national output cannot be increased except through growth and that national expenditure grows along with it. Assuming that all aid funds have been employed to purchase goods and services abroad, if they subsequently are used to buy American output solely, either U. S. imports would rise or *commercial* exports, i.e., non-aid exports, would fall, offsetting the favorable effects on the balance of payments of tying aid purchases to the United States. This follows from the assumption that national output and national expenditure are growing in locked cadence: national expenditure absorbs all the increase in output, and the output cannot be increased any faster. The balance between real output and national expenditure is unchanged so that the trade balance does not shift. The increased demand for American goods following the switch of aid purchases to the United States cannot be met except by diverting output from commercial export production or by Americans cutting their purchases of domestically-produced goods and importing more.

Even when the economy is not this tight, it is an error to assume that none of the aid monies spent in the United States have an adverse balance-of-payments effect. The tying of aid to the purchase of U. S. goods and services increases the demands upon the American economy; U. S. prices may be higher as a result than they otherwise would be, which in turn retards commercial exports and stimulates imports. This is even the case where the aid funds are employed to buy U. S. surpluses. To the extent that the reduction of agricultural surpluses makes politically tolerable the continuation of the agricultural support programs, the aid program indirectly diverts resources from alternative employments. (Total shipments abroad under our agricultural surplus disposal program have been $10 billion since 1954 compared to present stocks of $7.4 billion so that, in the absence of the disposal programs, our surplus might have been almost two and one-half times as high.) The U. S. military assistance program, under which we grant surplus military hardware

to foreign countries, finances new purchases by the Department of Defense when the aid appropriation is paid over to DOD for the surplus material.

The value of tying aid is put further in question by the possibility that, after tying, the recipient countries will ask for U. S. aid for projects which they would have financed out of their own dollar receipts from exports; the provision of aid in such circumstances releases their dollar receipts from exports for alternative uses, and the dollar receipts need not be employed for the purchase of U. S. goods but may be expended in other countries. Hence, there need be no net expansion of U. S. exports.

Even though the limitation of aid procurement to the United States does not assure the absence of an adverse balance-of-payments impact, it does not directly follow that aid reductions will assist the balance of payments. To the extent that the Government would increase other expenditures while reducing foreign aid expenditures, national expenditure would rise; unless the national output is thereby increased, the increase in national spending would offset in part or whole the favorable effect on the balance of payments of the aid reduction. An increase in national expenditure is not unlikely in the face of aid reductions because the pressures upon the Government force it to spend all that the taxes yield; and if one of the basic rationales of foreign aid is accepted, namely that it increases our national security, the reduction of foreign aid would require additional domestic military expenditures. As we noted in connection with tariffs, the ultimate solution to the balance-of-payments problem depends less on what is done directly to items in the balance of payments and more on what is done to control the balance between output and spending in the economy as a whole.

After October 1959, the Development Loan Fund, which at the time was a major foreign aid agency of the U. S. Government, began to place primary emphasis on U. S. procurement from funds loaned by it. This action was later extended to a large share of the funds expended by the International Cooperation Administration, and President Kennedy called for an "even closer review" of the programs after he assumed office. In 1961, Treasury Secretary Dillon

announced a target of 80 percent for the proportion of Agency for International Development funds to be spent at home. There are no overall estimates of the additional costs imposed by U. S. procurement under the aid program. But the nature of the effect can be illustrated by the experience of the Foreign Operations Administration, which was the major aid agency in 1953-55, when it decided to finance the purchase of locomotives and railway cars for India's railroads in 1954:

> . . . interest was expressed by the Netherlands, the United Kingdom, France, Belgium, Switzerland, Germany, Italy, Yugoslavia, and Japan, and bids were solicited and received. However, because of the strong urging from U. S. concerns to limit procurement to the United States, agreement was obtained from the government of India that it would procure approximately half in the United States and half in other countries. Additional costs would be borne by FOA. The government of India agreed, in full knowledge of the fact that it would receive only 5,000 cars instead of the 5,000 plus which they could expect for $30 million from world-wide sources. Pursuant to this agreement, an additional $8.5 million was made available by FOA for the extra cost of limiting half the procurement to the United States.
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> After considerable difficulties such as additional allowances in price to insure that U. S. firms used all U. S. made components rather than importing certain parts for assembly, the government of India received 100 steam locomotives and 5,430 rail cars. . . . Had the commodities been bought on the bids as originally received, the government of India would have obtained for the $30 million, 100 locomotives and 11,220 cars, and FOA would have saved $8.5 million . . . for other important aid to India or elsewhere.[10]

[10] Department of State, *The United States Economy and the Mutual Security Program,* April 1959, pp. 27 ff. This publication reports the Department of State estimate that to furnish the same quantity of ICA assistance under U. S. procurement regulations would increase costs between $50 and $100 million per annum. The method of making this estimate is not explained, and it does not cover the additional cost in respect to Development Loan Fund procurement. *Ibid.,* p. 18.

It is clear that the tying of aid forces the Government to reduce the value it receives for each dollar it spends in aid to foreign countries, obliging it to be less efficient in the employment of the taxpayers' money. One of two things must happen. Either appropriations must be increased so that the Government can continue to achieve the level of results desired, or, if appropriations are unchanged, we must accept smaller results. The first requires higher taxes without an increase in the results, the second requires smaller results without a reduction in taxes. Both the proponents and opponents of aid should find little to praise in such policies. Those who favor foreign aid will lament the reduction in real benefits to the recipients of aid if appropriations are not increased to offset the higher costs imposed by U. S. procurement, and those who oppose foreign aid would surely prefer a reduction in both the benefits to the aid recipients and the taxes to finance the aid.

Tied procurement also reduces the effectiveness of the aid program by limiting the range of projects which may be financed with aid funds. The donor agencies are forced to select less favorable opportunities (either in the political or in the economic sense) for aiding foreign countries. Those projects which require the expenditure of large amounts of the currency of the aid-receiving country in order to purchase the resources of the recipient must be de-emphasized. If we buy the currency of the aid recipient with dollars, it is impossible to assure that those dollars will be ultimately spent in the United States so as to give effect to the requirement of tied procurement. And where the aid recipients' normal trade patterns are not with the United States, it is difficult to arrange with local importers for the purchase of U. S. products, financed with U. S. aid, for sale for the local currency needed for aid operations.

Some effort has been made to excuse tied procurement because it applies to government purchases. For example, one banker, while opposed to requiring U. S. procurement for private foreign investment, supported the tying of aid because aid is not a regular commercial transaction. It is difficult to see why this is a reasonable distinction unless governments are not supposed to husband their

resources, an unlikely view for a banker. Another banker supported the tying of aid because he felt it was preferable to a reduction in assistance. Yet the clear effect of such policies must be to reduce the real value of aid to foreign countries unless accompanied by increased appropriations. Only if one assumes that aid appropriations would be cut, in the absence of tying, in order to improve the balance of payments can one logically view tying as an alternative to aid reductions. Inasmuch as there are numerous expenditures, both public and private, which could be reduced to help the balance of payments, this implies that the proponents of aid are unable to defend aid against alternative uses of the nation's resources; tying becomes a subsidy to aid in the public debate.

The press release announcing the decision to tie the loans of the Development Loan Fund stated that:

> . . . There is now a fair presumption that other industrialized countries which export capital goods to less developed countries are in a financial position to provide long-term loans on reasonable terms to assist such countries in their development programs. It has therefore been decided that particularly in financing the foreign exchange costs of development projects and programs the DLF will place primary emphasis on the financing of goods and services of U. S. origin.

The error in the DLF argument is readily seen if the same principle is applied domestically. If we had a rule that whoever loaned or gave away money must also be the source of the things bought with the money, banks would have to become producers of automobiles and all charity would have to be "in kind" rather than money—the Community Chest would only accept "do-it-yourself" products.

Tying U. S. aid to U. S. procurement has been defended on the ground that it would stimulate other countries to provide foreign aid. It was hoped that the shock of the U. S. action and the evidence it gave of our concern for the deficit would induce others to join hands with us in foreign assistance, and that foreign producers of capital goods, now bereft of the markets for their exports financed

by our aid, might pressure their governments to expand their aid.[11] Added aid by other countries would help our balance of payments if (1) some of it were spent in the United States, (2) the aid expanded incomes in underdeveloped countries and thereby increased the markets for U. S. exports, or (3) if it made unnecessary prospective increases in the U. S. aid appropriations. As for the first possibility, Treasury Secretary Dillon, while a member of the previous Administration, stated that:

> . . . For various reasons, whether through export credit facilities or other formally tied financing arrangements, through traditional marketing arrangements, through discrimination against other countries' exports, or through other factors, the bulk of the development financing provided by other industrialized countries is used to buy their own products or those of the monetary area of which they are the center.

While recent reports are incomplete, it appears that aid from other countries has been in fact tied even where the stated policy of foreign governments has been to provide untied aid. Much of the aid from other countries has taken the form of exporter credits and of assistance to particular projects so that the donor country has been able to select projects where, for one reason or another, the donor knew that the aid would be used to buy products from the donor country.

A very small percentage of French aid is provided to countries outside of the so-called franc area; the monetary and commercial arrangements between France and the members of the franc area work to assure that the aid will be spent in France, and in some instances the Government of France is signing agreements which explicitly call for tying aid. The United Kingdom has taken steps to assure that its aid to dependent territories is spent primarily in England, and the bulk of its aid goes to dependent or trust territories and present or former members of the Commonwealth where commercial ties have the effect of tying aid. Even if the new aid expen-

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[11] See Henry C. Wallich, "Government Action," *The Dollar in Crisis,* ed. by S. E. Harris, (New York: Harcourt, Brace, and World, 1961), p. 104.

ditures by foreign countries were truly on an untied basis, those who have doubts about the competitive position of U. S. exports would wonder if even untied aid would bring us much new business.

Furthermore, the effect on U. S. exports depends importantly on where the new aid goes. Experience in our own aid program indicates that when we have moved into areas where there is a lack of on-the-spot outlets and service facilities for U. S. equipment, where buyers are not accustomed to American specifications, and where American firms have not regarded sales effort to be worthwhile, procurement has not gone to the United States. Since the bulk of aid from other countries goes to areas where they have present or past political ties which in turn have cemented commercial relations, we cannot expect their aid to have much impact on our balance of payments.

Nonetheless, it remains true that additional foreign aid by others, even if tied, may assist the U. S. balance of payments by increasing inflationary pressure abroad. Whether or not this is the result depends on the monetary and fiscal policies of those countries increasing their assistance. This underscores the fundamental point that the success of our efforts to improve the balance of payments depends importantly on what happens to the balance between spending and output in other countries.

As for the second possibility, that expanded aid from other countries may stimulate our exports by increasing incomes abroad, the long lead times on development projects plus the inherent slowness of the process of economic growth suggest the increased aid by others is of little immediate value to the U. S. balance of payments.

On the third possibility, namely that aid from others makes increased appropriations by us less necessary, one must assume that we would in fact provide more aid if other countries did not in order to argue successfully that more aid by others helps our balance of payments. Obviously, it is impossible to know what the United States Government would have done in the absence of greater aid expenditures by others. Yet it may be noted that U. S. Government grants and loans to developing countries and multilateral agencies

increased by 50 percent in 1961 over 1959 at the same time that aid from other Free World sources increased 34 percent.[12]

In pressing other countries to expand their aid programs, the present Administration argued in an *aide memoire* to Germany from the Department of State that:

> . . . the outflow of long-term capital from surplus nations, especially to the developing countries, should approach or exceed their export surplus to the world as a whole. This would not only ameliorate the disequilibrium in the international payments situation, but would also help the Free World meet the vital needs and expectations of the developing countries.

As a statement of the condition for equilibrium in the balance of payments this principle is not unacceptable, but, as a standard for determining the levels of aid, it leaves much to be desired. If the export surpluses were entirely matched by deficits of the developing countries, the dogged pursuit of this principle would leave the level of aid entirely in the hands of the developing nations; by internal inflation or the relaxation of their import restrictions, they could create deficits for themselves (surpluses for other countries) which would be financed by the surplus countries through aid.

While it is possible that the principle urged in the *aide memoire* may produce equitable results at any given moment of time, there is no necessary relationship between the standard criteria of ability to pay, such as wealth and income, and the condition of the balance of payments. Very rich, rich, middle-class, and even poor countries all can run surpluses in their balances of payments. The Federation of Rhodesia and Nyasaland has shown a relatively persistent rise in its official exchange reserves for the last decade, yet the people on the average could not be classified as well-to-do by any measure. The balance-of-payments position of a country reflects the relative level of its prices and the balance between output and spending, not the absolute level of its output or its riches. Recognition of this point may be the reason why the same State Department official who handed the *aide memoire* to Germany was quoted a month

[12] Organization for Economic Cooperation and Development.

later as stating that a nation's balance-of-payments position should not be a factor in determining the size of its aid; the payments position should only determine whether a nation can justifiably tie its aid. Unfortunately, the substitute principle is not much better; it amounts to arguing that a nation which is profligate enough to get into a balance-of-payments deficit ought to further waste its scarce resources by diverting its purchases to more expensive markets.

Growth

Not a few discussions of the deficit head the list of cures with the need to stimulate economic growth. President Kennedy contended in his balance-of-payments message that "economic progress at home is still the first requirement for economic strength abroad." A labor union newsletter, which also focused on the need for growth, has suggested that it was no mere coincidence that the deficits first reached serious proportions in 1958, a year of recession.

There is something to be said for this view with respect to long-term investment because capital is apt to move to areas with high profit prospects, i.e., with rapid growth. Yet U. S. direct investment in recent years appears to fall during recessions in the United States and rise during booms. Furthermore, the facts tend to support the opposite hypothesis with respect to the balance of trade. Research at the National Bureau of Economic Research indicates that since 1880 the U. S. trade surplus has tended to increase during domestic contractions and fall during expansions in the domestic economy.[13] Our imports tend to conform to shifts in domestic business activity because a large percentage, presently over half, consist of industrial supplies and materials. For example, any stimulus to housing construction will directly increase imports of lumber, plywood, stone, sand, cement, lime products, glass and others which in 1959 totaled $600 million.

The cyclical behavior of components of the balance of payments does not really tell us much about the relation between growth and the balance of payments because the secular behavior of the deficit

[13] Ilse Mintz, *Trade Balances During Business Cycles,* 1959.

during periods of high and long-term growth may not be the same as during short periods of economic expansion during the business cycle.

Professor Gottfried Haberler is categorical:

> . . . a larger output . . . could not have improved the trade balance unless, contrary to what is generally assumed in modern theory, the marginal propensity to import were negative.[14]

Ambassador John Kenneth Galbraith is not convinced either:

> . . . fairness requires me to guess that some will hold that if the domestic economy is suitably flourishing—if we have high and improving employment and a suitable rate of growth—the balance of payments will automatically take care of itself. Economic health at home means economic health abroad. Unfortunately, prosperous countries, enjoying full employment, can have balance-of-payments problems. And if they must meet, as must we, a heavy burden of military obligations abroad, it is likely that they will.[15]

In respect to a policy of stimulating growth at the cost of inflation, Haberler holds that:

> . . . whatever one thinks of the possibility and advisability of speeding up growth in the short run by prolonging business cycle booms at the price of more inflation, it is difficult to understand how anybody can deny that such an inflationary policy would have made the deficit in the balance of payments much greater. [16]

Professor Egon Sohmen goes further:

> . . . If the nature of the debate [on the merits of price stability vs. inflation] were not so excessively "domestic," it could not be so widely believed that, whatever unkind things may be said about inflation, expansionary policies cannot by themselves cause a ***reduction*** in the growth rate. I do not even want to raise the highly

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[14] "Domestic Economic Policies and the United States Balance of Payments," S. E. Harris, *loc. cit.*, p. 67.

[15] "Some Thoughts on Public Policy and The Dollar Problem," S. E. Harris, *loc. cit.*, p. 92.

[16] S. E. Harris, *loc. cit.*, p. 66.

> relevant question whether the distortions of the price mechanism that are likely to be caused by inflation might not inhibit economic expansion. Rather, following the practice of taking and adding national-income aggregates at face value, I want to call attention to a hypothesis that has yet to be disproved: that inflation in the wake of expansionist policies may (presumably with some delay) lead to a deterioration of the foreign balance of sufficient magnitude to negate whatever stimulating effects these policies may have had on domestic demand.[17]

The mechanism he has in mind is that balance-of-payments deficits are, *per se,* deflationary. That is, if we pay more out than we take in, there is a net decline in spending at home and a reduction of the U. S. money supply.

One of the closest students of the U. S. balance of payments, Edward Bernstein, contends that:

> . . . Unless the specific effects of an increase in U. S. productivity are severely adverse to the payments position of countries in key positions in world trade and payments, the general effects are certain to lead to a strengthening of the dollar payments position of the rest of the world. Indeed, the greater the increase in U. S. productivity, the wider the field over which the increase has taken place, and the more sustained the increase in productivity proves to be, the more likely it is that the general effects will be favorable to the payments position of the rest of the world as a group.[18]

On this view, we should expect economic growth to worsen rather than reduce the deficit.

With an increase in productivity, if money incomes rise, as they are wont to do, no reduction in prices can be achieved to attract foreign purchasers. To be sure, with greater output at unchanged prices, we may be able to take over a larger share of world markets in some lines, but the greater level of money incomes will directly and indirectly lead to higher levels of national expenditure which

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[17] "The Dollar and the Mark," S. E. Harris, *loc. cit.,* pp. 189-90.

[18] *International Effects of U. S. Economic Policy* (Washington: Government Printing Office, 1959), p. 35.

may absorb most of the increase in national output, leaving little to improve the trade balance. Clearly, measures to expand the growth of the United States are most likely to succeed in improving the balance of payments if they do not simultaneously raise national spending by equal amounts and if they permit a reduction in the prices of exports and import-competing products. Growth measures which start by raising national spending are suspect; those that stimulate exports and import-competing production are not. What is required in the face of a persistent deficit is not a general expansion in American output but faster growth in particular sectors, namely export and import-competing industries; if this can be achieved, the growth of the economy will be stimulated, but in sectors which help rather than hinder the balance of payments.

Export Promotion

The present and previous Administrations have fought vigorously to obtain reductions in the barriers against U. S. exports in foreign countries which are a hangover from the days of the dollar shortage when foreign governments were obliged to ration dollars to their citizens by means of import licenses and exchange controls. A large measure of success has been obtained in these efforts, though even more can be done in banishing tariff and other obstructions to our goods in foreign markets. However, no matter how justified further reductions in tariffs against our exports may be, the principle is firmly entrenched in commercial policy that nations must exchange tariff concessions; hence, to obtain benefits for our exports we must offer tariff concessions which, unless they consist of bindings of our duties at existing levels, will increase our imports. There is no assurance that the concessions equivalent in value which are required in tariff negotiations will produce equivalent effects on our exports and imports, and the balance-of-payments consequences are, as a first approximation, problematical. However, tariff reduction may make it easier to deal with balance-of-payments deficits because the expansion of trade increases our real income and makes it easier to restrain through monetary and fiscal policy the growth of national expenditure which is necessary to an improvement in the balance of trade.

Both the present and previous Administrations have sought to improve the government services provided to U. S. exporters, with the present Administration expanding the initial actions undertaken during the Eisenhower Administration. These aids to exporters have included the provision of additional credit on export sales, either directly from the Government or by means of government guaranties of private credit, plus insurance against losses. The Department of Commerce has strengthened its trade information functions to make more information available to businessmen on how to enter foreign markets and where trade opportunities lie. More missions of businessmen have been sent abroad to investigate foreign markets, the trade fair program to display American products abroad has been expanded, trade centers have been established, and commercial representation in the Foreign Service is being improved. The Kennedy Administration also resurrected the E Award of World War II for firms, organizations, and people who stimulate exports.

Many American businessmen have complained that their government has not given them a fair shake in these matters in comparison with the kinds of and extent of services rendered to foreign exporters by foreign governments. But leaving aside this question of fairness, one must be suspicious of these efforts of the Government to help exports as a means of aiding the balance of payments. The measures employed seem to be selective. Therefore, on the grounds of previous discussion of acceptable solutions, they are more costly means of easing the balance of payments than measures which would give equal stimulus to increase all exports and reduce all imports. This is virtually certain to be the case in respect to government measures to provide more credit to finance U. S. exports and more insurance to protect exporters against losses. Not all exporters require additional credit to compete in foreign markets, and not all exporters need insurance against political and commercial risks. Such programs, therefore, provide a selective stimulus. Even the British, who have offered attractive export credit aids to U. K. exporters since 1919, recently have been able to cover, despite vigorous efforts, only 18 percent of their total exports under their credit insurance program.

Selective Monetary Policies

With the strengthening of the European currencies in recent years so that they could make their currencies freely convertible into dollars, the opportunities for short-term capital movements have been greatly increased. Wider investment opportunities, the attraction of interest differentials, and, to some extent, speculation have stimulated such movements. Some analysts have been especially anxious with respect to the effect of short-term capital movements on our freedom to combat recessions in domestic economic activity. The fear is that low interest rates, which are needed to revive economic activity during recessions, may increase payments to foreigners by stimulating outflows of capital if interest rates are higher abroad, adding to the balance-of-payments deficit and leading to the outflow of gold. In such circumstances, the United States faces a choice between the stability of the domestic economy and the stabilization of the balance of payments. The conflict was recognized by the Board of Governors of the Federal Reserve System when it said:

> . . . the general state of credit and capital markets here and abroad in 1961, including the ready availability of bank credit in this country throughout the year, was conducive to outflows of bank credit and of long-term capital. 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.[19]

Conscious of the role of interest rates in stimulating capital movements, President Kennedy in his 1961 economic message included among his measures for economic recovery a plan to reduce long-term interest rates in order to stimulate the economy while checking any fall in short-term rates so as to prevent outflows of capital. In addition, in his balance-of-payments message the President also proposed, as had the previous Administration, that certain laws and regulations be changed to permit the payment of higher returns to foreign central banks and treasuries on their investments or loans to the United States.

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[19] *Annual Report*, 1961, p. 32.

Common to all of the latter proposals was a policy of paying more to foreign central banks and treasuries for their funds than if the same funds were obtained from domestic sources. The authors of these proposals have forgotten the (wrong) lessons of many public finance textbooks that borrowing abroad imposes a heavier burden upon society than borrowing at home; instead, a preference for foreign borrowing is established. But in the long run neither foreign nor domestic sources should have preference. Suppose the Federal Government issues securities to finance a project in the United States. If the securities are purchased by foreigners, the economy loses goods and services equal to the yield we must pay foreigners to attract their funds. If they are bought domestically, in a high employment economy, the economy loses the goods that would have been produced by the capital if it had been borrowed for capital formation by private enterprises. The price private borrowers are willing to pay for capital tends to reflect the productivity of the capital if employed in the domestic economy. Hence, if the price on foreign capital is higher than the price that private borrowers pay domestically, the United States, when it borrows foreign funds, gives up more goods and services than if it borrows at home. Sacrifices are minimized if the borrower obtains his funds in the cheaper market, domestic or foreign.[20]

There is even doubt that higher rewards to foreign central banks and treasuries have much effect on their willingness to hold dollar assets instead of buying gold. The central banks of Britain, Belgium, Switzerland, the Netherlands, and France have held for a decade a relatively high proportion of their reserves in the form of gold rather than foreign currencies, suggesting that when they receive additional foreign exchange they are likely to convert the greater part of it into gold, with little regard for level of interest rates. If, when we have a deficit, these countries are enjoying large surpluses, our gold losses are apt to be greater than if they are not. The decline in gold losses in 1959 compared to 1958, sometimes attributed to the

[20] See James M. Buchanan, *Public Principles of Public Debt* (Homewood: Richard D. Irwin, Inc., 1958), Chap. 6.

higher interest rates in the United States which prevailed after we got out of the 1958 recession, may in part stem from the fact that these countries enjoyed a much smaller share of the gains in international reserves of the rest of the world in 1959 than in 1958. Furthermore, after close study of the data between 1956 and 1960, Robert Gemmill concludes that:

> . . . examination of the practices of foreign countries has shown no evidence that official reserves are shifted from dollar assets to gold (or vice versa) in response to short-term variations in interest rates.[21]

The success of the other portion of the Kennedy Administration proposal, namely to reduce long-term interest rates to stimulate the domestic economy while holding the short-term rates high, is partly in doubt. In all of the postwar recessions in economic activity, the interest rate on three-month Treasury bills has been allowed by the monetary authorities to drop to less than 1 percent, but in the 1960-61 recession it never fell below 2 percent. While the higher than usual rate may have served to keep some capital here that otherwise would have gone abroad, it was not sufficient to reduce the flow of American capital abroad; in 1960 the export of private short-term U. S. capital abroad amounted to $1.3 billion and in 1961 to $1.5 billion. If we accept the Treasury view that the 1961 flow differs from that of 1960 in containing much less speculative capital, it would appear that the flow of capital in response to interest rate differentials actually increased despite the abnormally high short-term interest rate.

As for the long-term rate, in 1960 the average yield on Aaa corporate bonds was 4.41 percent and in 1961 it was 4.35 percent—hardly a significant change. Whether or not the Kennedy Administration could have depressed the long-term rate significantly while maintaining a high floor on the short-term rate is a matter of dispute. The problem is that a decline in long-term rates on U. S. Government securities is, in some measure, likely to induce a shift of investment towards shorter-term securities which would reduce

[21] "Interest Rates and Foreign Dollar Balances," *Journal of Finance,* September 1961, p. 375.

the short-term rate. While there obviously is not a perfect meshing of the markets for different maturities, recent studies make clear the close correspondence between shifts in the short-term and long-term rates on government securities over the cycle which suggests that investible funds do shift from one market to another.[22]

The second doubt that arises in respect to the device of shifting the structure of rates concerns the possibility of compensating international movements of long-term capital. While we may prevent the movement of short-term capital by holding the short-term rate high, downward pressure on the long-term rate may induce a long-term capital outflow by making the United States an attractive place to borrow and a poor place to invest. What we gain on short-term account, we may lose at least in part on long-term account. The international long-term capital market has been so troubled in recent decades that it is difficult to know exactly how sensitive it is to interest rate differentials. But between the first seven months of 1958 and of 1959, when long-term yields rose substantially in the United States, the export of capital through the purchase of foreign bonds fell from $750 million to $350 million. Heavy borrowing by foreigners (other than by the International Bank for Reconstruction and Development) in the United States during the early part of 1962 makes it clear that the U. S. long-term capital market is no longer isolated from the rest of the world, if it ever was.

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[22] "A Closer Look at Interest-Rate Relationships," *The Morgan Guaranty Survey,* April 1961. See also Stephen Axilrod and Ralph Young, "Interest Rates and Monetary Policy," *Federal Reserve Bulletin,* September 1962. The deviations between short and long rates in the Spring of 1961 and in the first part of 1962 as shown on the chart on page 1127 of the latter source would at first appear to suggest that the Administration has been able to break the close correspondence between short and long rates. However, one may argue that the deviation in 1961 was attributable to a change in expectations consequent to the new interest-rate policies of the Administration which were subsequently not borne out as evidenced by the narrowing of the spread. The deviation in 1962 may perhaps be explained by the relaxation of Regulation Q, which had the effect of changing the commercial banks' asset preferences.

A number of other efforts have been made to meet the problem of capital movements. One has been to achieve some international coordination of interest rates. The Organization for Economic Cooperation and Development, whose membership consists of the NATO countries plus Austria, Ireland, Spain, Sweden, and Switzerland, has been viewed by the Kennedy Administration as a vehicle for obtaining this coordination; so has United States participation in the monthly meetings at Basle, Switzerland of the Bank for International Settlements. There are obviously distinct, and probably close, limits to what can be done. So long as the major countries suffer business fluctuations which are out of phase, domestic conditions will compel different levels of interest rates; if, to take the extreme case, interest rates were determined only by the condition of the balance of payments, unwarranted reliance would have to be put upon fiscal policy to achieve domestic stability. Given the cumbersome procedures for altering fiscal policies, apart from the effects of various automatic stabilizers, the task of maintaining domestic stability would be made exceedingly difficult.[23] According to the head of the German central bank, Karl Blessing, the reason why Germany had to employ high interest rates, which sucked in foreign capital, to stem her 1960 boom was that fiscal policy was of little help. The earlier quotation from the Board of Governors of the Federal Reserve System reflects the same point.

Another major innovation in U. S. monetary policy was the decision of the U. S. Treasury, and subsequently of the Federal Reserve System, to intervene in foreign exchange markets for the purpose of affecting exchange rates. The United States had, since the 1930's, intervened only indirectly in the foreign exchange market: it bought and sold gold to foreign central banks and treasuries at $35 per

[23] This is unfortunate because, as Robert Mundell has recently shown at the theoretical level, the only efficient method of meeting the twin problems of deficits and domestic unemployment under fixed exchange rates is to employ monetary policy to defeat the balance-of-payments problem and fiscal policy to meet the unemployment problem. "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability," *International Monetary Fund Staff Papers,* March 1962.

ounce; the United States thus gave assurance to foreign central banks that, when they purchased surplus dollars on the foreign exchange market in order to keep the exchange rate steady, they could readily convert the dollars into gold at a fixed price. This passive intervention has now been complemented with active buying and selling of foreign currencies by U. S. monetary authorities.

Exchange rates between currencies are fixed only in the sense that they fluctuate around a par value—normally within a range 1 percent above and below the par value. Hence, when a U. S. exporter agrees to sell goods to a foreigner for foreign currency, he takes a risk that the value of the currency will differ at the time he receives the foreign currency from the value which it had at the time he agreed to make the sale. If the currency which he is to receive is under fire, he takes an additional risk that the par value may be changed and that the value of the currency will differ greatly from that which prevailed at the time of the sale of goods. To avoid such risks, anyone expecting to receive foreign currency may enter into a forward contract under which he commits himself to deliver to the buyer at a certain time in the *future* a given amount of foreign currency at a price determined *now* with payment to be made for the foreign currency when it is delivered. Another method of avoiding the risk is for the U. S. exporter to borrow, at the time he makes the sale, the foreign currency which he expects to receive when payment is made and sell it for dollars immediately, thus avoiding the risk of exchange rate shifts because he obtains the dollars immediately. He repays the borrowed foreign currency with the foreign currency he subsequently receives in payment for his exports.

Americans who wish to make short-term investments in the U. K., for example, also undergo the risk of exchange rate shifts between the time they buy pounds to make the investment and the time they wish to sell the pounds for dollars to repatriate their investment. If they wish to avoid this risk when they buy pounds in the spot market for immediate delivery in order to purchase British Treasury bills, they may simultaneously enter into a forward contract to deliver the same number of pounds 90 days hence at a price fixed now. If we suppose that the rate of interest on 90-day British

Treasury bills is 3 percent in London while it is 1 percent on U. S. Government bills in New York, it would appear to be profitable for an American to sell short-term investments in the United States and invest the proceeds in London. But if he has to buy pounds in the spot market for immediate delivery at $2.80 per pound and the forward rate on pounds is $2.786, there will be no net gain in transferring funds to London on a so-called covered basis, i.e., with a forward contract to avoid risk. In buying spot pounds at $2.80 and selling forward pounds at $2.786, the American investor would lose 1.4 cents per pound. This just equals the additional interest income which he can gain over a 90-day period when the rate in London is two percentage points higher than in New York. (2% of $2.80 = 5.6¢; 5.6¢ divided by 4 to obtain the yield over 90 days is 1.4¢.)

It should be clear from the foregoing example that if the monetary authorities can change the spot or forward rate or both by purchases and sales of spot or forward currencies, they can affect the profitability of moving capital in or out of the country. In 1961 the authorities acquired foreign currencies for this purpose; incidentally, these are the currencies which are reported along with gold as convertible currencies in the balance of payments, (see page 60). For example, after the increase in the value of the mark in March 1961 from 23.8 cents per mark to 25 cents, there was a widespread feeling that the mark would again be revalued upward. No one was willing to agree in a forward contract to deliver marks in the future at 25 cents because it was anticipated that it would cost more to buy the marks in the future. At one point, it cost almost 4 percent more dollars to buy a mark to be delivered in the future than to buy a mark to be delivered immediately. This meant that German exporters who expected to receive dollars in the future could cover their risk through a forward contract only by accepting 4 percent fewer marks for the dollars they were to receive than would be provided by the spot market.

To avoid this loss, German exporters borrowed dollars in the United States and sold them immediately for marks; they expected to repay the borrowed dollars when they were paid dollars for their

goods. By borrowing in the United States, the German exporters induced short-term capital exports from the United States; by immediately selling the borrowed dollars, they added pressure to the dollar in the foreign exchange market. To stop this, it would be necessary to reduce the loss on forward contracts which German exporters would sustain, i.e., reduce the 4 percent discount on the dollar. U. S. monetary authorities therefore bought dollars forward or, what is the same thing, sold marks forward in order to raise the forward value of the dollar. At one point, they had agreed to supply in excess of $340 million in marks in the future.[24]

In describing the new operations in the foreign exchange markets, the Federal Reserve System's official publication stated:

> Operations in foreign exchange are no substitute for fundamental improvement in the balance of payments. Under appropriate cricumstances, however, foreign exchange operations may help to moderate temporary speculative or other capital flows . . .[25]

The emphasis must be on the word "temporary." If the monetary authorities used these new techniques to meet persistent capital outflows and balance-of-payments deficits, their policies would amount to inaction. The sale of foreign currencies by the Government in the spot market in order to support the value of the dollar amounts to a loss of U. S. international reserves. The sale of foreign currencies in the forward market, in the manner of the German operation, would at best postpone the problem a few months; eventually, the U. S. authorities must provide the currencies which

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[24] One odd aspect of this operation was that at least in part it was necessary because statements emanating from the executive branch left the impression that the United States Government did not think that the mark had been sufficiently appreciated, presumably stimulating additional demands for the mark. If the U. S. Government did not think that it had been sufficiently appreciated, perhaps further increases could be expected. Events such as this hardly strengthen one's confidence in the ability of governments to manage exchange rates satisfactorily. It also serves to emphasize that government speculation can be destabilizing.

[25] *Federal Reserve Bulletin,* March 1962, p. 278.

they have agreed to deliver in the future which either means that they must run down their reserves of those currencies or they must buy them in the spot market for delivery as required, adding to the pressure on the dollar. If the export of capital has reversed itself so that the demand for dollars is strong as capital flows back to the United States, the extra supply of dollars on the market will not hurt. But if the export of capital has not reversed itself, the extra supply of dollars may depress the value of the dollar and lead to gold losses.

The problem then is for the monetary authorities to identify the temporary or self-reversing capital movements. For more fundamental and persistent sources of disequilibrium, policies other than intervention in the foreign exchange market are required. If the authorities intervene in the market when in fact persistent forces are at work, valuable time can be lost in meeting the challenge to the balance of payments. As Paul Einzig, long a student of forward exchanges, has noted, intervention

> . . . may mean that an inflationary boom would fail to receive in good time a much-needed corrective, so that when it becomes inevitable to deal with the problem much more drastic measures would become necessary.[26]

He notes that governments may be forced to change their exchange rates

> . . . by a realization that what they first thought to have been a mere speculative attack without any substance behind it was in fact the manifestation of a fundamental disequilibrium which they are unable or unwilling to correct. Such situations are apt to arise, because it is often difficult if not impossible to be certain for some time whether and to what extent a persistent adverse pressure [by speculators] is justified.[27]

Speculators may be right in their judgment of a currency. They can act as an early warning system of trouble ahead. To clip their wings

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[26] *Dynamic Theory of Forward Exchange* (London: The Macmillan Company, 1961), p. 513.

[27] *Ibid.*, p. 510.

is like cutting a telephone line to the future. Sometimes we get wrong numbers on that line but not always. Professor Milton Friedman, in reviewing the experience of the 1930's, when massive movements of short-term capital occurred, comments that:

> . . . At the time, any speculative movements which threatened a depreciation of a currency (i.e., which threatened a *change* in an exchange rate) were regarded as destabilizing, and hence these movements were so considered. In retrospect, it is clear that the speculators were "right"; that forces were at work making for depreciation in the value of most European currencies relative to the dollar independently of speculative activity; that the speculative movements were anticipating this change. . . .[28]

The same problem of distinguishing those speculative capital movements which are temporary and self-reversing from those which reflect a persistent weakness in the balance of payments arises in respect to the recent expansion of the resources of the International Monetary Fund. Ten countries—the members of the European Economic Community plus Britain, Japan, Canada, and Sweden along with the United States—have agreed to consider short-term loans to the IMF (up to specified amounts) if such loans are required to bolster the resources of the IMF.

The need for new arrangements grew out of the facts that (1) the opportunity for massive movements of short-term capital was greatly increased by the establishment of convertibility among the world's leading currencies and these shifts might lead to requests for currencies from the IMF and (2) the IMF's holdings of these currencies, except for the pound and the dollar which have been weak, have been small. At the end of 1961, the IMF's holdings of the currencies of industrial countries other than the U. S. and Britain were only $1.6 billion. The new commitments of the ten countries add to $6 billion, half from participants other than the United States and the United Kingdom.

The new arrangements to expand the resources of the IMF do not

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[28] "The Case for Flexible Exchange Rates," *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), p. 176.

commit the members either as a group or individually to contribute funds to the IMF when required. Under the voting procedures, if the United States were the potential drawer, any one of the following combinations would be sufficient to defeat a request by the Managing Director of the IMF for additional resources: (1) any four countries, (2) the United Kingdom plus Germany, (3) the United Kingdom or Germany plus France or Italy plus one other participant, (4) all countries except the United Kingdom, Germany, and the United States. Clearly, the decision rests with the members of the European Common Market. In addition, countries do not have to lend if they are in balance-of-payments difficulty even if the vote is favorable. On the other hand, the participants are not entirely free to abstain from contributing when additional resources are needed by the IMF. If ". . . a participant gives notice that in its opinion, based on its present and prospective balance of payments and reserve position, calls should not be made on it, or that calls should be made for a smaller amount than that proposed, the participants shall consult among themselves and with the Managing Director as to the additional amounts of their currencies which they could provide so as to reach the general order of magnitude agreed" to in the voting.

Another element of uncertainty stems from the procedure by which we may draw on the IMF, namely by issuing a non-negotiable note to the IMF. This may be impossible if the public debt were near the legal limit. Inasmuch as the need for resources is apt to arise quickly, if at all, it is not obvious that the ceiling could be adjusted quickly enough to permit use of the IMF promptly.

Still one more monetary measure, which has gained acceptance in high banking circles in the United States, is to drop or at least reduce the requirement that 25 percent of the Federal Reserve System's notes and deposit liabilities be backed by gold.[29] By removing the requirement we could free about $12 billion of gold to meet future deficits and demands for gold by foreign central banks and treasuries.

The United States, Belgium, and Switzerland are the only nations

[29] A bill to this effect died in committee in the 87th Congress.

employing a gold reserve requirement. The usual rationale for reserve requirements such as these is that they force upon a country suffering a balance-of-payments deficit monetary contraction which serves to rectify the deficit. But the U. S. requirement has not served this purpose because the actual reserves have been above the required reserves, and it is a most imperfect device for setting in motion actions to close a deficit because, given the position of the United States as an international banker, our deficits are financed in part by the accumulation of liquid dollar balances by foreigners and not entirely through gold exports. Now that the Government has accumulated foreign currencies with which it may finance a deficit, the link between our gold stock and the deficit is further weakened.

Those who support the reserve requirement as a means of forcing resolute action in the face of deficits would be better advised to demand a rule for monetary policy which made explicit allowance for the total deficit and not just the gold-financed portion. But if it is possible to find such a rule, it might be better simultaneously to drop the gold reserve requirement because it effectively ties up resources. (There is a tale of a small town with one taxicab stand and a pressing shortage of cabs; to remedy the situation the city fathers passed a resolution that at least one cab had to be at the stand at all times, which of course increased the shortage of cabs on the street where they perform their service. If we could find a rule for monetary policy which took explicit account of deficits in the balance of payments, we could then employ gold to serve the function it has today: the settlement of deficits in balances of payments.)

Non-Selective Cures

Most of the measures discussed so far—tariff increases, quotas, domestic procurement in government purchases, increases in the rewards to foreign holders of dollar assets, export promotion and others—all violate the condition for an acceptable cure, namely that the measures taken to rectify a deficit should not provide selective stimuli for the improvement in the balance of payments. All of them either are selective as among payments, as among receipts, or

between payments and receipts, and they therefore impose unnecessary sacrifices upon us in removing the deficit.

Price Level and Exchange Rate Changes

Only two measures pass the test of non-selectivity: those that serve to adjust the overall price and cost level in the United States relative to price and cost levels abroad, and changes in the exchange rate between the dollar and foreign currencies. For example, if we raised the dollar price of foreign currencies, e.g., shifted the rate of exchange from $2.80 per pound to $3.00, either the cost of making payments to foreigners would increase, as in the instance where the payments are made in foreign currency, or foreigners would receive less of their own currency when they exchanged the dollars they gain from us into their own national currencies. Foreigners would have a smaller incentive to sell here, and Americans (including the U. S. Government) would have a smaller incentive to buy abroad. Most importantly, this would be true no matter what the character of the underlying transaction so that the incentives would be non-selective. At the same time, Americans receiving foreign currency from abroad would find it had greater value in terms of dollars while foreigners making payments of dollars to the United States would discover that the dollars cost them smaller amounts of their own currencies. Consequently, Americans would have a greater incentive to obtain foreign currencies by expanding exports, etc., and foreigners would have an increased incentive to buy our goods and services. This also would be true no matter what the character of the underlying transaction. By changing the exchange value of the dollar a stimulus to improve the balance of payments is provided across the board, not only among payments, and among receipts, but also as between receipts and payments.

Deflation of the U. S. price level has the same effect of raising our exports and reducing our imports because it makes U. S. goods and services more attractive to foreigners and to Americans relative to foreign goods and services. The same result is obtained by inflation abroad, which means that the decision to adjust price levels involves some difficult questions of who shall

bear the burden of adjusting the balance of payments. Those who fear the effects on domestic employment and output of the monetary and fiscal measures necessary to reduce our price level will hope that the rest of the world will pursue inflationary policies. If things were left to work themselves out without the intervention of governments there would be a tendency for the surplus and deficit countries to share the burden of shifting price levels because a deficit tends to reduce the stock of money while a surplus tends to increase it. But since governments do not allow things to work themselves out, shifts in the stock of money induced by the condition of the balance of payments can be and are offset by government policies.

Devaluation

If we adopt the approach of adjusting the exchange rate, we do not have to worry about pressing down the price level in the United States; nor would we have to urge inflationary policies upon the rest of the world. Yet this policy is not free of defects either. A change in the value of the dollar would have to be combined with careful spadework to persuade foreign governments not to retaliate in kind, for if they did, the benefit to our balance of payments would be wiped out. That is, if we raised the price of a pound from $2.80 to $3.00, there is nothing to prevent the British Government from selling enough pounds to drive the price back to $2.80 per pound. The incentives for counter attacks by foreign governments would be strong inasmuch as the United States, the world's largest trader, would through its devaluation gain a competitive edge in a wide range of world markets.

Another objection is that the devaluation of the dollar would increase the dollar price of gold. We do not presently tie our currency to foreign currencies but to gold; other countries tie their currencies to ours and to gold. To devalue we would raise the dollar price of gold; so long as other countries did not raise the price of gold in terms of their currencies, each dollar would be worth a smaller part of an ounce of gold and, equally, a smaller amount of foreign currency. But if the major trading countries also devalued their currencies, there would be a general increase in the price of gold.

The major beneficiaries of this would be the Soviet Union and the Union of South Africa for they are the major producers of gold, two rather unlikely candidates for our largesse.

A third objection is that one change in the value of the dollar might lead to anticipations of further changes, which, in turn might induce a speculative capital movement sufficient to draw down our gold stock on a large scale. This might be avoided by reducing the value of the dollar by more than necessary to bring equilibrium to our balance of payments in order to convince the speculators that what is done is done. It could be further avoided by giving, after the exchange rate adjustment, a guarantee to all central banks and treasuries that we would convert all their holdings of dollars into gold at the new price no matter what subsequent changes took place. This could be rather costly should we find it necessary later to shift the rate again. The same objection holds to changing the rate by more than actually required because an excessive adjustment will induce a surplus in our balance of payments which costs us real goods and services, i.e., we ship out more goods and services than necessary to balance our accounts and we therefore accept gold.

A fourth objection is that devaluation of the dollar might retire us from the role of banker for the world. Countries holding dollars would find them less valuable in terms of other currencies and in terms of gold. Would they not be chary of adding to those holdings in the future or even maintaining them? We could devalue the currency only if we were certain that some other country would take up our burden because, under fixed exchange rates, the Free World must have a reserve center if international commerce is to be sustained. That is, some country has got to be willing to allow other nations to hold its currency in the same manner that the dollar is held now so as to provide currency for settling international debts. Reserve centers are not easily created. In a sense, it required two world wars and a great depression before the dollar displaced in part the earlier means of international settlement—gold and sterling.

Finally, it may be objected that an exchange rate adjustment is an act of bad faith toward those who hold dollars rather than gold

and that it will adversely affect the image of America abroad. These are compelling objections but most of the alternatives are not much better. Which hurts the prestige of America more over the long pull: a *once-for-all* devaluation or *persistent* tariff restrictions, import quotas, reductions in the real amount of foreign aid, export subsidies, etc.? The Belgians complained bitterly, with the support of the rest of the European Economic Community, when the President raised duties on their carpets and glass. A number of the countries where we stopped procurement for our post exchanges protested, as did several nations when we reduced the duty-free allowance for U. S. tourists. In his annual budget speech, the Minister of Finance of Nigeria, where the United States Government is clearly making a major effort in the battle for Africa, stated:

> . . . I cannot refrain from expressing my keen disappointment at the change of policy of the United States Development Loan Fund when, towards the end of last year, it was decided that, except in exceptional circumstances, loans could only be made on the basis of their being tied to United States exports. I think the House will appreciate that under a condition of this sort it becomes very difficult for the Government to decide the extent to which it can take advantage of such offers, particularly if it means that Nigeria cannot obtain the goods she needs in the cheapest available market. It is also quite illogical for countries which express a belief in the wisdom of multilateral systems of trade and payments to tie capital exports in a way that is a complete negation of a declared multilateral policy. We in Nigeria I believe have shown by our actions that we are prepared to pursue liberal multilateral policies in our international trade. We look to other countries for them to reciprocate.[30]

Price level stability or even deflation, so long as it does not produce unemployment, probably gets the highest marks in terms of our image abroad.

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[30] Budget Speech by Chief The Honourable Festus Sam Okotie-Eboh, April 4, 1960.

Unpegged Rates

Some of the problems with devaluation can be avoided or mitigated while employing exchange rate adjustments to solve the balance-of-payments problem if we do not fix the exchange rate at a new level but allow it to seek its own value. Under this arrangement, the problem of the balance-of-payments deficit, at least as we know it, would disappear. The price of the dollar in terms of foreign currencies would fluctuate, like any unregulated price, to clear the market. The unpredictable and dizzy forces converging on our balance of payments would not move our gold but only the exchange rate.

Strange as it may seem, a policy of doing nothing would solve the balance-of-payments problem. An unpegged rate can be achieved if the United States refused either to buy or sell gold at a fixed price and if the Treasury and the Federal Reserve System ceased to buy and sell foreign currencies in exchange for dollars. In those events, there would be nothing to fix the relationship between the dollar and foreign currencies. Furthermore, there would be no need for the United States to retain any gold (or foreign currencies) in order to stabilize the dollar in terms of foreign currencies. The monetary authorities might wish, however, to retain small amounts of gold and foreign currencies so that they could prevent sharp shifts in the exchange rate by selling foreign currencies in the market from time to time. But since they would not be obliged to prevent all shifts in the exchange rate, as under present arrangements, they would require smaller reserves of gold and foreign currencies than we presently have.

Some countries conceivably might wish on their own initiative to stabilize the value of the dollar in terms of their own currencies. To do this, they would have to sell dollars whenever the value of the dollar was rising in terms of their own currencies and buy dollars whenever the dollar was falling. Even though these countries were fixing the exchange rate, they could not harm the U. S. balance of payments because, if the dollar were weak, they would be obliged to accumulate dollars so long as they wished to stabilize the rate. They could not convert the accumulated dollars into U. S. gold.

With unpegged rates we would expect the value of the dollar in terms of foreign currencies to shift with changes in the U. S. balance of payments. The international economy is always subject to change as is our own domestic economy. In the years ahead we must anticipate alterations which sometimes throw our balance of payments into deficits and sometimes into surpluses, and the exchange rate would vary to remove these.

How would unpegged rates meet or mitigate some of the problems raised by devaluation?

First, foreign governments could not wipe out the effect of our devaluation on the balance of payments by counter-devaluations of their own so as to leave the exchange rate unchanged. This follows from the fact that the unpegged rate would shift until the market was cleared.

Second, while devaluation of the dollar would threaten to wreck the Free World's international monetary system because the dollar would no longer be useful as a reserve currency, an unpegged rate is much less likely to bring down the international financial system. Our gold stock is roughly equal to the volume of dollars held by foreign central banks and treasuries. Because we would no longer need the gold we could exchange it for the dollars they presently hold at $35 per ounce; consequently, the rest of the Free World would have approximately as many reserves as it has now and, because we would no longer need reserves, the Free World's reserve position would be unchanged.

Third, while a devaluation might lead to anticipations of further devaluations which would cause speculative movements of capital that would further draw down our gold stock, an unpegged rate need not. If we devalue the dollar to a new fixed rate, speculation against the dollar is relatively costless because the speculators can be reasonably sure that, if the rate is changed again, the dollar will be devalued again. But, with an unpegged rate, the exchange rate can go up or down. Suppose that the current unpegged rate is $3.00 per pound and that a speculator buys pounds on the hypothesis that each one will soon be worth $3.10. He hopes to sell the pounds later for a 10-cent profit. But if the rate in fact shifts to $2.90,

he would suffer a 10-cent loss. Contrarily, if we devalued the dollar now to a fixed rate of $3.00 per pound, speculators could buy pounds whenever the dollar looked weak with assurance that the pounds they buy would not be worth less than $3.00 and conceivably, if the pressure on the dollar is strong enough to cause the Government to change the exchange rate, the pounds they buy may be worth more than $3.00.

Fourth, while devaluation would blemish our image abroad and would be regarded as an act of bad faith by those persons who held dollars instead of gold, an unpegged rate may suffer less of these disadvantages. We could continue to sell gold for dollars at $35 per ounce until the last ounce is gone and then the rate would become automatically unpegged. While it is problematical whether or not we would have enough gold to meet all of the demand for it, at least we would be cutting the gold value of the dollar only when the cupboard was bare, and therefore in a situation where we had no choice, rather than at a time when further efforts might have preserved the gold value of the dollar and our gold stock.

Furthermore, with an unpegged rate, we could pursue the domestic economic objectives of price stability and high employment at all times without regard to the balance of payments. In the years ahead we have to expect that economic forces here and abroad will sometimes throw our balance of payments into surplus and sometimes into deficit. With unpegged rates we would not have to restrain domestic employment and force down prices during periods of deficit in order to right the balance of payments. Nor would we have to accept inflation and excessive labor shortages in order to remove surpluses in the balance of payments. While the opportunity to achieve stable prices and high employment through an unpegged rate is an extremely valuable aspect of a policy of unpegged rates, the effect of obtaining these goals on our image abroad is also worth noting.[31]

[31] Canada's persistent unemployment after 1958 while she employed an unpegged rate and her subsequent decision to shift to a fixed rate are taken by some analysts to display a failure of unpegged rates. However, Professor Harry G. Johnson argues that the trouble lay in the failure of the monetary

Finally, in view of the difficulties, outlined at the beginning of this study, of defining the size of our liquidity and balance-of-payments problems and because it is exceedingly difficult to predict the course of the balance of payments, the automatic removal of deficits through exchange rate fluctuations would obviate the difficult task whose completion is the *sine qua non* of the solution to a deficit under fixed rates, namely its prediction and measurement.

What are the objections to unpegged rates?

One line of argument holds that if we unpeg the rate we would remove the balance-of-payments constraint on the Government to avoid inflation. It would seem, however, that politicians are more concerned about gold exports than the balance-of-payments deficit. Unfortunately, gold movements are a poor measure of the deficit and they are therefore a misleading measure of the need for discipline. An unpegged rate would provide a far more sensitive indicator of the need for action because it would immediately reflect excess supplies of dollars on the market. Furthermore, those persons concerned with the need to avoid inflation overlook the fact that, under a pegged rate, we must accept inflation whenever our balance of payments is in surplus if we are to facilitate the balance-of-payments adjustment process.

A second line of argument against unpegged rates holds that speculation in the exchange market will induce excessive shifts in the value of the dollar in terms of foreign currencies which will add undesirable risks to international trade and investment. Against this it should be noted that we want shifts in the exchange rate in order to adjust the balance of payments. Only if the speculators are wrong in their judgments do they do a disservice. That is, not every shift in the exchange rate is bad—only those that move it away from equilibrium. Inasmuch as it is difficult to know what the equilibrium rate is at any given time, it is difficult to test whether speculation has consistently helped or hindered movements toward equilibrium

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authorities to take advantage of the freedom of action afforded by the unpegged rate. See his *Canada in a Changing World Economy* (Toronto: University of Toronto Press, 1962), Chapter 7.

rates. What evidence there is on this question is either not conclusive or tends to support the view that speculators have been correct. It may also be noted that international traders and investors can reduce the risks of excessive exchange rate fluctuations by entering into forward contracts, though only at a cost.

It is conceivable that if we adopted an unpegged rate, the rest of the Free World would follow. If the rest of the world joined us in unpegged rates, no shortage of liquidity for the international economy could occur to cause world-wide deflation as has been anticipated in some quarters. Governments would not have to hold reserves of gold and currencies except insofar as they wished to undertake stabilization operations in foreign exchange markets. And an increase in the demand for particular currency to be employed by private holders as a working balance would be promptly met through an adjustment in the exchange rate.

In addition, if the underdeveloped countries would go along with us, they could remove the exchange and trade controls made necessary by their weak balance-of-payments position. Since these controls protect the growth of inefficient industries, their removal, by providing more international competition, would set in motion more rapid economic development. Given our political interests, this is of no small moment.

Gold accumulation costs the Free World real resources. Can we not devise less costly methods of monetary management? It is unfortunate that the Free World finds it necessary to devote resources to dig gold out of the ground in distant places, transport it to the United States, and then bury it in a large hole named Fort Knox—with the added expense of protecting it against Acts of God, man, and nature, not to mention the cost of counting it whenever anyone decides to shift its location. World gold production, exclusive of the Soviet Bloc, exceeded $1 billion annually between 1957 and 1961. If an alternative set of monetary arrangements could be found, the Free World would save substantial resources.

Perhaps more importantly, if the Free World could establish an alternative monetary mechanism without gold, such as unpegged rates, we could end our annual gifts to the Soviet Union. Over

the last five years, the Free World has bought annually an average of more than $240 million in gold from the Bloc. The Communists have used the monies received to buy goods and services from the Free World, and we gained gold in return which could not be eaten, worn, slept on, or shot back. We gave, in fiscal year 1961, less economic aid to every other country in the world except India and Korea.

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