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APPENDIX A

A Note on Alternative Ways of Presenting the Balance of Payments

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

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

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

1. *The Search for an Organizing Concept*

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

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

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

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

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

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

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

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

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

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

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

Appendix A

TABLE A-1

SUMMARY SCHEMATA FOR ALTERNATIVE WAYS OF PRESENTING THE BALANCE OF PAYMENTS
(billions of dollars)

	I. Based on Concept of "Net International Liquidity"	1958-1959 (average)	1960-1961 (average)
	ITEMS TREATED AS MAKING UP THE "OVER-ALL BALANCE"		
1.	*U.S. payments, recorded*	28.6	31.6
2.	Imports of goods and services	22.1	23.1
3.	Remittances and pensions	.8	.9
4.	U.S. government grants and credits	3.1	3.7
5.	U.S. private long-term capital	2.5	2.5
6.	U.S. private short-term capital	.2	1.4
7.	*U.S. receipts, recorded*	24.5	29.0
8.	Exports of goods and services	23.3	27.6
9.	Repayments on U.S. government loans	.8	1.0
10.	Foreign capital, excluding liquid funds	.4	.4
11.	*Unrecorded transactions net*	.4	— .6
12.	*Balance on items listed above*	—3.6	—3.2
	ITEMS TREATED AS MEASURING CHANGE IN "NET INTERNATIONAL LIQUIDITY"		
13.	Gold and convertible currency holdings of U.S. monetary authorities	1.5	1.2
14.	Liquid liabilities to foreign and international monetary authorities	1.2	1.2
15.	Liquid liabilities to foreign commercial banks and other private or international holders	1.0	.8

(continued)

TABLE A-1 (concluded)

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

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

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

SOURCE: Table B-1.

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

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

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

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

2. *The Concept of International Liquidity*

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

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

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

Alternative Ways of Treating U.S. Liabilities

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

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

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

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

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

Asymmetry in Treatment of Assets and Liabilities

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

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

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

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

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

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

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

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

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

Shortcomings in the Liquidity Concept

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

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

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

[11] See Table 5, Chapter II.

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

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

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

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

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

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

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

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

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

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

The Strategic Role of the Basic Transactions

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

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

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

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

The Tactical Role of the Sensitive Items

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

By their nature, these sensitive items can be made to serve only in a temporary or tactical capacity to alleviate, or to avoid adding to, strains arising elsewhere in the balance of payments. They could not indefinitely compensate a serious imbalance in basic transactions. Indeed, if confidence in the strength of the currency weakens under such conditions, the flow of liquid capital may react adversely and add to the loss of reserves. Even in the absence of such conditions, flows of liquid funds are not to be thought of merely as passive "balancing items." This would tend to be true of official funds (except when central banks or governments are, for example, borrowing for the specific purpose of building up their reserves). But movements of private funds are motivated by many factors, ranging all the way from meeting the needs of foreign customers and acquiring working balances to transfers of idle funds in search of higher yields.

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

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

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

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

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

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

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

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

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

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

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

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

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

RESPONSIVENESS OF SHORT-TERM CAPITAL TO MONETARY POLICY

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

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

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

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

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

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

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

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

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

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

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

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

Responsiveness of Other Capital to Monetary Policy

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

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

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

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

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

Appendix A

TABLE A-2

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

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

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

[a] Preliminary figures.

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

[c] Less than $50 million.

TABLE A-3

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

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

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

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

SOURCE: *Survey of Current Business.*

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

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

"Compensatory Financing" and "Major Special Transactions"

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

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

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

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

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

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

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

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

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

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

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

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

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

TABLE A-4

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

(millions of dollars)

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

(continued)

TABLE A-4 (concluded)

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

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

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

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