The Transfer Gap of the United States

Several years ago I attempted a reinterpretation of the payments deficit of the United States: I suggested that it could most appropriately be explained as a transfer problem. The United States was making financial transfers to foreign countries — military expenditures, government loans, private loans, and direct investment — in amounts which for various reasons it was unable to match with real transfers, that is, with an excess of exports over imports of goods and services. I have argued and defended this explanation in several articles and books (1).

On at least two occasions — in 1962 and 1963 — I offered this hypothesis together with the optimistic prediction that the transfer problem would eventually be solved by monetary expansion in surplus countries, with their rates of price inflation exceeding that of the United States. This prediction has gone sour. But the failure of my prediction does not compromise my hypothesis, especially since it is rather clear why the prediction has failed to come true. The United States, after it had been pursuing a cautious policy of stabilizing the price level for several years, embarked in 1963 on a policy of monetary and fiscal expansion designed to reduce unemployment and accelerate the rate of economic growth. At the same time, the countries with the largest payments surpluses undertook to decelerate their rates of inflation. I am not blaming any of the governments for their policy decisions, though it seems fair to say that all countries went too far in their zeal to do the right thing: the United States overindulged in fiscal ease and the Europeans jammed their monetary

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(1) "Pessimismo del dollaro e oro", *Rivista Internazionale di Scienze Economiche e Commerciali*, Vol. IX (1962), pp. 1108-1119; "Das Transfer-problem: Thema und vier Variationen", *Ordo*, Vol. XIV (1963), pp. 139-167; *International Payments, Debts, and Gold* New York: Scribner's, 1964, pp. 386-395; *Involuntary Foreign Lending* (Stockholm: Almqvist & Wiksell, 1965), pp. 51-57. *The 1968 Economic Report of the President*, Hearings before the Joint Economic Committee, Congress of the United States, 90th Congress, 2nd Session, Part 2 (Washington, February 1968), pp. 399-416.

brakes too tight. I mention this only to explain why I was wrong when I counted on differential rates of inflation to solve the transfer problem of the United States. That problem, after a few years of attenuation, has again aggravated and is now as serious as it ever was.

My aim in this paper is to restate my hypothesis, to offer additional support for it by means of statistical illustration, and to point out why I regard the official prescriptions for removing the payments imbalance quite useless, or worse than useless. Realizing, however, that several alternative explanations of the imbalance have been proposed, I think I should first state my reasons for preferring my own hypothesis.

The Chronic Deficit

There are many ways to define and measure a deficit in the balance of payments. By several definitions, the deficit of the United States started in 1950 and is still very much in evidence. The character of the deficit has changed over the years; for example, during the earlier years it was possible for many to speak of dollar shortage whereas for the last eight or ten years the talk is of a dollar glut. Some interpreters even now protest against the designation of the payments position of the United States as a genuine deficit. Perhaps, then, it would be more judicious to say exactly what kind of statistical arrangement of data is referred to when one says that the payments deficit has lasted now for 18 years. The most widely quoted figures are those published by the U.S. Department of Commerce under the name of "balance on liquidity basis". The deficit in this sense is measured by the decrease in official reserve assets of the United States plus the increase in liquid liabilities to all foreigners.

The statistics of the balance of payments have exhibited deficits so defined in 17 out of the last 18 years (2). For these deficits several explanations have been offered.

(2) Even the one exceptional surplus, in 1957, the year after the Suez crisis, would turn into a deficit if "Errors and Omissions" were put "below the line", that is, treated as a financing item rather than an unrecorded long-term capital inflow.

Alternative Hypotheses

My own explanation is that the large financial transfers of the United States were not quite matched by its export surpluses because, in the absence of sufficient expansion of demand, incomes, and prices in other countries, only painful doses of deflation in the United States or an unwanted reduction in the exchange rate of the dollar could secure the reductions in relative incomes and prices that would be needed to raise the export surplus to the required size. This diagnosis, together with a number of factors which I shall later discuss in detail, does not allow of any optimistic expectations regarding the elimination of the deficit in the foreseeable future.

Other explanations lead to different conclusions. I shall select seven alternative hypotheses for a brief review; they permit or imply an optimistic diagnosis — either that the trouble is not alarming or that it will soon disappear. I shall state each hypothesis in a single sentence and add another sentence to indicate why I reject it.

Hypothesis No. 1: The persistent statistical deficit is not a symptom of disequilibrium, but only a reflection of financial intermediation by American banks to accommodate liquidity-loving savers and investors in foreign countries; everything will be all right as soon as foreign monetary authorities begin to see the light and will consent to accumulate dollars in ever-increasing amounts. — The answer is that the foreign authorities will not accept this interpretation of our deficit, even if we should be willing to accept it (which I am not).

Hypothesis No. 2: The sequence of deficits in the payments balance has been due to a variety of strokes of bad luck, ranging from delays in the introduction of compact automobiles and strikes in strategic industries to sudden upsurges of direct investments abroad; the series of unlucky accidents will eventually come to an end, and balance will be restored all by itself. — The answer is that hard-luck stories cannot be believed after 18 years of deficit.

Hypothesis No. 3: The deficit in the last few years has been the result of unduly lax fiscal policy; the tax increase and budget cut of 1968 will stop the inflation and restore external balance. — The answer is that the removal of the budget deficit was badly needed to prevent the payments deficit from getting worse; but such a disinflationary policy is not sufficient to remove the payments deficit

unless the surplus countries indulge in inflationary policies — which they have no intention of doing and which they, with the exception of France, may be able to avoid.

Hypothesis No. 4: The deficit in the last three years may be attributed to the wage-price spiral turning faster in the United States than in the surplus countries; as soon as the United States succeeds in slowing down the cost-push inflation, its payments position will improve rapidly. — The answer is that the surplus countries are no less anxious to hold down the cost push and (except France) may even be more successful than the United States.

Hypothesis No. 5: The deficit has been due to excessive monetary expansion keeping interest rates unduly low and allowing a high rate of domestic investment as well as huge investments abroad; the Federal Reserve Banks have terminated this policy and one may expect the increased tightness of credit in the United States to improve both its current and its capital balance. — The answer is that the interest differentials in the past reflected, most of the time, the richer flow of savings in the United States, rather than an inflation of credit, and that the present tightness in the United States will not be allowed to continue once the stern fiscal policy, which has at last been adopted, becomes effective.

Hypothesis No. 6: The new balance-of-payments program, announced by President Johnson in January 1968, will reduce the payments deficit by $2.5 billion dollars, which goes far to restore external balance. — The answer is that a reduction of outpayments by $2.5 billion will not achieve a reduction of the deficit by a similar amount, and whatever reduction can be achieved by this program will at best be temporary, since temporary restrictions are unlikely to produce lasting results.

Hypothesis No. 7: The present payments deficit is to a large extent attributable to the direct and indirect effects of the war in Viet Nam; as soon as the war is terminated, the reduction of military expenditures abroad and the reduction of imports due to defense expenditures at home will remove most or perhaps all of the present payments deficit. — The answer is that foreign-aid expenditures may (and should) take the place of military expenditures abroad, and expenditures in the war on poverty should (and will) take the place of defense spending at home; but even if some savings in foreign

outlays can be made, the feedback effects upon our exports may be considerable, so that it would be unrealistic to expect restoration of the external balance from an end of the war.

Tautological Inflation

At least three of the alternative hypotheses listed explain the deficit by pointing to inflation: to excessive fiscal ease leading to a budget deficit, with domestic overspending (demand pull) resulting in higher imports and lower exports; to wage-price spirals (cost push) resulting in prices not competitive enough to produce an adequate export surplus; or to an easy-money policy of the Federal Reserve raising aggregate demand and inducing capital to go abroad. Inflation hypotheses to explain the American payments deficit have been most popular abroad, because they have fitted the complaint about " imported inflation " often repeated in surplus countries. Yet, these hypotheses are unsatisfactory in that they point to the wrong " variables " as the chief causal factors and perhaps also suggest the wrong policies as remedial factors.

I must admit, however, that my rejection of the inflation argument — the thesis that the payments deficit of the United States can be attributed to its excessive monetary expansion — is vulnerable in at least two respects. First, one cannot deny the existence of at least three inflationary periods in the United States during the last 18 years: a demand pull during the Korean War (1950-53), a cost push in the late 50's (1956-58), and again a demand pull in recent years (1965-68); each of these no doubt aggravated the transfer problem. Secondly, some highly respected economists deem it not altogether foolish to hold that *every* payments deficit is " due " to excessive demand in the deficit country, since if aggregate demand were much smaller there would be no deficit.

This second proposition amounts to a near-tautology. A payments deficit of a country can be defined as an excess supply of the country's currency in the foreign-exchange market, and it stands to reason that this excess supply can be removed if the total supply of the currency is " sufficiently " reduced. If a " sufficient " dose of deflation can remove the payments deficit, may one not hold the failure to deflate to be the " cause " of the deficit? This would be a defensible position but, though not " absolutely foolish ", not very

enlightening. To attribute the *emergence* of a payments deficit to an excessive increase in the supply of money and in total spending makes good sense; but to attribute the *persistence* of a payments deficit, which may or may not have arisen from excessive money creation or spending, to a nondecrease in the supply of money and in spending is not good analytic practice.

Incidentally, even if the thesis of " tautological inflation " as an explanation of each and every payments deficit is unsound on logical grounds, it is not inconsistent with the transfer hypothesis, that is, with the position which attributes the payments deficit of the United States to its failure to solve its transfer problem. For, as almost all economists concerned with this subject have stressed, the transfer problem lies in the capacity or incapacity of the economy to produce an export surplus of a size sufficient to meet its transfer commitments *although* the amounts to be transferred have been successfully syphoned out of the income stream of the economy. If its " money flows " have not been appropriately reduced, then one can hardly be surprised if the real transfer, the increase in net exports of goods and services, cannot be accomplished. This failure is therefore " explained " by the insufficient extraction of income or money or buying power from the " pockets " of the people in the country that has undertaken the large foreign commitments.

Whether these are government commitments for reparations, military expenditures, or foreign aid, or private capital movements to foreign lands makes little difference. The amounts transferred must have been taken away from domestic disbursements if one is to expect flows of goods and services to match the outflow of funds. (In lucky circumstances, overexpansions abroad may take the place of the retrenchment of domestic spending.)

It would be easy to show that at no time were net reductions made in aggregate domestic spending in the United States. Hence, it could be said with apparent conviction that the failure to make these cuts was equivalent to inflation of domestic demand. Again, this proposition is not very helpful. One must not forget that transfer theory was formulated in largely static terms, not with reference to growing economies. Under conditions of economic growth, one need not assume domestic spending to be cut absolutely when funds are sent abroad, but only to be increased at a reduced rate. It is hard to know, however, what the warranted rate of increase of domestic disbursements would be when foreign payments

have to be made while the economies concerned, the paying as well as the receiving countries, continue their normal growth (3).

We know from traditional transfer theory that a reduction of domestic disbursements by the exact amount of the financial transfers may not be sufficient to achieve real transfers of the same magnitude. Under certain conditions an extra dose of spending reduction, with the multiple dose of income deflation, would be needed to close the transfer gap at fixed exchange rates. While one could hold that the failure to reduce the rate of increase of domestic spending by an amount commensurate to the outflow of funds constitutes an act of quasi-inflationary behavior, one cannot reasonably take the existence of any transfer gap as an indication of culpable overexpansion. It may be possible to close a transfer gap by deflationary policies; but the failure to pursue such policies cannot in sound analysis be regarded as inflationary policy. In this sense, " tautological inflation " is no better as explanation of a transfer gap than it is of any other type of deficit in the balance of payments.

The Theoretical and Statistical Concepts

For an attempt to provide a statistical test or illustration of the thesis that the payments deficits of the United States can be explained as " transfer gaps ", we need a set of statistical concepts that approximately correspond to the theoretical constructs used in transfer theory. We can never expect that available statistical records will provide precisely what would be needed. Sometimes, however, relatively innocuous manipulations with, or rearrangements of, the statistical data will furnish acceptable substitutes for what would qualify as suitable counterparts for the constructs of theory.

For our present purpose we need, before all, the statistical counterparts for Net Real Transfers, Net Financial Transfers, and the Transfer Gap.

Net Real Transfers

For a statistical computation of the flows of goods and services that may be regarded as " real transfers " one cannot simply accept

(3) To my knowledge, the only analysis of the problem appears in my essay " The Transfers Problem Revisited ", in *International Payments, Debts, and Gold* (New York: Scribners, 1964), pp. 433-446.

either the balance on current account or the balance of goods and services. The current account includes purely financial transfers, and some of the services that are usually shown among exports and imports cannot be regarded as real transfers in the sense of the relevant theory.

The current account includes unilateral transfers to foreign countries. Since the capital account comprises only those financial transfers which change the country's claims on and liabilities to foreign countries, it is quite correct that unilateral transfers, such as donations and pensions, are shown in the current account. For our purposes, however, private remittances and government pension payments to residents of other countries, and government grants, military or otherwise, to foreign countries must be regarded as financial transfers.

If exports of goods and services under military grants are excluded from the statistics of exports, and the grants equally excluded from the statistics of unilateral transfers, one avoids an exaggerated impression of the co-variation between real and financial flows. The inclusion of transfers in kind on both sides of the balance of payments might increase the regression coefficient in the function linking the two variables and thus might give exaggerated statistical support to the theory that the real flows are influenced by independently determined financial flows. We decide, therefore, that we shall omit from our computations the military grants as well as the exports of goods and services under these grants (4).

Military expenditures abroad are usually reported as imports of foreign services. This is not appropriate for our purposes. If we want to examine the " feedback effects " of military expenditures — for example, the increase in exports that come about as an indirect result of increases in the foreign expenditures of the United States — we must treat the military expenditures as financial transfers. We shall, therefore, omit them from the statistics of imports and relegate them to the statistics of financial outflows.

(4) One might think that for the same reasons " tied loans " and the sales tied to them ought to be excluded from the current and capital accounts, respectively. However, there is the possibility, and indeed a strong suspicion, that many of these sales would have been made in any case, so that an increase in sales under tied loans would be a decrease in regular sales. It is therefore advisable to leave both the loans and the sales in the respective accounts.

Earnings from capital are usually reported in the balance of goods and services: the income on investments abroad is regarded as payment for a " capital service " sold to foreign countries. This is unsatisfactory for a test of transfer theory. According to that theory one should expect that real flows are induced by the flow of monetary returns from capital invested. Hence, the earnings of dividends and interest will be shown here as financial transfers; whether these purely financial flows do or do not generate real flows in the same direction is precisely what is to be tested.

To make these rearrangements of the customary presentation of balance-of-payments statistics is not to question the soundness of international convention. These statistics have to serve many different purposes and an arrangement most suitable for one purpose may be quite unsuitable for another. Our present purpose requires rearrangements that can help reported magnitudes to become approximate counterparts of the abstract concepts of a theoretical model constructed for a particular explanatory task. Whether certain transactions change the investment position, indebtedness, or liquidity of the country is not relevant to the transfer problem. But whether certain changes in the international movement of good and services can be explained as the results of changes in the movement of funds, this is what matters in the assignment before us.

Transfer theory assumes that the flows of goods and services will be reshaped through income effects and substitution effects emanating from changes in incomes and prices which, in turn, are engendered by changes in the flows of funds, especially by changes in domestic spending due to financial receipts and payments from and to foreign countries. It follows that, for a statistical test or illustration of transfer theory, we want the balance of goods and services to consist chiefly of such items as are sold and bought out of incomes and at market prices, or at least under conditions that allow income elasticities and price elasticities of supply and demand to come into play.

It should be clear that military expenditures change primarily when the general staff so decides, and this decision is not greatly affected by relative incomes and relative prices at home and abroad. Earnings from capital may be related to changes in aggregate income, but changes in relative incomes and prices at home and abroad will hardly be among the major factors affecting the payment of dividends and interest. Thus, the relegation of these transactions from their

customary places in the balance of goods and services to the balance of financial transactions should be accepted as a reasonable rearrangement.

Net Financial Transfers

Besides the two items relegated from service account to the account of financial flows, the latter is composed of unilateral transfers and capital movements.

Unilateral transfers consist of private remittances, payments of government pensions, and government grants. In order to save space, private remittances and government pensions can be merged, both being rather stable or slowly increasing amounts. A merger of government grants and government loans to foreign countries suggests itself because for the problem at hand it makes little difference whether any repayments can be expected in a distant future. With regard to claims by foreign governments and to flows of private capital the problems are more complicated and some decisions about what to include and what to exclude have to be made. We must warn at the outset that these decisions will inevitably be somewhat arbitrary.

One might presume that movements of long-term capital may reasonably be regarded as autonomous, whereas short-term flows may be treated as induced by other changes in the balance of payments. Such a presumption, however, would be quite wrong, particularly for recent years when (sometimes in order to improve the appearance of the statistical balance of payments) maturities of government securities and bank deposits were doctored to make what was essentially short-term capital be covered by the operational definition of long-term capital. On the other hand, there are liquid dollar holdings of foreigners which, in spite of their legal and institutional form (permitting immediate withdrawal on demand), are to some extent quasi-permanent from an economic point of view. Thus, the distinction between short and long term, if judged by the terms of the contract, is not acceptable as a proxy for the distinction between autonomous and accommodating (5). One should attempt to keep the category of financial transfers strictly apart from the category of so-called " financing items ", that is, from financial transactions designed to absorb an oversupply of (or meet an excess demand for) dollars in the foreign-exchange market. It would be nice to produce a clean account of the financial transactions that are likely to influence the flow of goods and services rather than be influenced by it.

(5) I coined the term " accommodating capital movements " in 1941 and defined it in my book *International Trade and the National Income Multiplier* (Philadelphia, 1943, reprinted New York: Augustus Kelley, 1961), p. 134.

This, unfortunately, cannot be done. The available statistics of the balance of payments do not provide the necessary distinctions and separations. One is always tempted to follow the easiest route and accept what is furnished ready-made, without alterations. The official statistics of the U.S. Department of Commerce treat all movements of American capital as autonomous, that is to say, changes even in short-term foreign assets held by residents of the United States (including banks) are shown " above the line ", not as financing items reflecting other transactions on current or capital account. On the other hand, for movements of foreign capital some finer distinctions are made and certain types are shown as items financing the deficit of the overall balance. However, the distinctions are rather tenuous and certainly not relevant for our purposes.

In my first attempt to support my transfer hypothesis with statistical data (6) I decided to include in the account of financial transfers all movements of American capital and none of foreign capital. The decision to include all " Private U.S. capital, net " — short or long-term, banks or nonbanks — among financial transfers to foreign countries was probably less objectionable than the decision to exclude all movements of foreign capital. In a second attempt (not published) I followed the procedure of the U.S. Department of Commerce and included " nonliquid " claims by foreign holders, but excluded " liquid " claims. The trouble with this procedure is that the " nonliquid " assets held by foreigners comprise also the long-term government securities and the long-term deposits in American banks that are held by foreign official agencies and private banks. Yet, changes in the size of these holdings cannot be regarded as autonomous; they are largely accommodating, induced by conditions in the foreign-exchange market. Hence, they have no place in our account of independently determined financial flows.

On the other hand, it is surely incorrect to regard all changes in the size of liquid, near-liquid, and pseudo-nonliquid dollar assets

(6) See p. 415 of my statement before the Joint Economic Committee of the Congress, cited in footnote 1 on the first page of this article.

as accommodating capital movements. Different motives for holding such assets are probably associated with different implications of changes in their size. The case of official holders, chiefly central banks, may be unambiguous, but for private holders, chiefly trading firms and commercial banks, we ought to distinguish several reasons for increases in dollar holdings: 1) Foreign traders may want to hold larger transactions balances because the turnover in their foreign business (dollars collected and paid) is increasing. 2) Foreign commercial banks may need larger transactions balances because the turnover in their foreign-exchange business (dollars purchased and sold) is increasing. 3) Foreign commercial banks may wish to hold more dollar assets in response to more attractive interest-rate differentials or spot-forward rate margins; they may acquire the dollars by buying them (in the market or from their own central bank), by borrowing them, or by lending to American institutions. 4) Foreign commercial banks may extend more loans to American borrowers at the initiative of the latter. Increases in dollar claims, arising from 3) and 4) are evidently temporary financing, unlikely to go on for very long and even likely to be reversed rather soon. On the other hand, increases in dollar claims arising from 1) and 2) are sustainable; they are flows that can go on year after year, associated with the growth in world trade. These increases in liquid dollar holdings would qualify for inclusion in autonomous financial transfers.

Alas, the international capital accounts cannot be disentangled. Perhaps one could use sophisticated econometric techniques to separate changes in foreign dollar holdings "explained" by growth in world trade from changes "explained" by nongrowth factors; or changes dependent on the *volume* of international transactions from changes dependent on the *balance* of international transactions. The former would be eligible, the latter ineligible for inclusion in the account of financial transfers as autonomous foreign capital flows into the United States. I have not undertaken any such separation and have decided to exclude all changes in assets, short-term or long-term, that are held by foreign official agencies or are liabilities of the U.S. Government or of American banks. I have included only three types of transactions: direct investment in the United States, changes in holdings of American securities other than Treasury issues, and other long-term foreign liabilities of private nonbank residents of the United States. The restriction to these three items in the foreign-capital account will become most significant in the last few years,

especially in 1966 and 1967, when American banks reported increases in long-term liabilities to foreigners (time deposits and certificates of deposits) of almost 1 billion each year, — amounts which I do not recognize as autonomous capital inflows.

The Transfer Gap

The amount by which Net Real Transfers fall short of Net Financial Transfers is the Transfer Gap. As I have said before, the operational concepts used in statistical records, estimates, and compilations do not fully correspond to the theoretical constructs used in the abstract models. We have just seen how difficult it is to separate financial transactions into those that can be regarded as autonomous transfers and those that are merely accommodating, induced by imbalances and financing the gap.

The differences between the statistical transfer gap and the statistical liquidity deficit were alluded to in the preceding section. The chief items accounting for these differences are: 1) errors and omissions, which I do not treat as autonomous financial transfers (7) but which official statistics treat as unrecorded transactions requiring financing (that is, increases or reductions of reserve assets or liquid liabilities); 2) changes in foreign long-term liabilities of American banks and in short-term liabilities of nonbank residents, both of which for the official statistics are "above the line" (that is, not among the financing items) but which I exclude from autonomous transfers; and 3) changes in foreign liabilities of the U.S. Government other than marketable or convertible Treasury obligations, changes which I again exclude from autonomous transfers while official statistics abide by the accepted definitional criterion of nonliquidity.

We should also note a difference between the statistical and the theoretical transfer gap. The latter must distinguish between an inherited deficit, due to any kind of past disturbance (including unclosed transfer gaps) and new changes in the balance of payments due to new financial transfers. No such separation can be made for

(7) "Errors and Omissions" may include wrong valuations in commodity trade, unrecorded services, changes in leads and lags in payments for exports and imports, and unrecorded transactions in short-term or long-term capital. Only the latter would qualify for inclusion as autonomous financial transfers, but their share in Errors and Omissions is probably negligible.

statistical transfer gaps. In theory one can start from an equilibrium position with a zero deficit; can then introduce financial transfers, bringing forth real transfers of somewhat smaller magnitude and leaving a transfer gap of a certain amount in a particular period; then introduce additional financial transfers, which again produce real transfers and perhaps another gap, while the effects of the earlier remittances are causing still further changes in the real flows, perhaps reducing the gap remaining from the earlier adjustment process. Thus, an old transfer gap and a superimposed, new transfer gap can be analytically separated. Empirical research is rather helpless regarding such possibilities; if a transfer gap is calculated for a particular year, there is no way of saying how much of it can be attributed to a lack of adjustment to past events and how much to increased financial transfers of the current year. Regression analysis of the year-to-year data, with or without lag, may serve as a weak substitute for the unlimited possibilities of the manipulations on a model in which all parameters and coefficients are fixed by the analyst's decision.

The most embarrassing vexation in this business is our inability to know which part of a statistical transfer gap is really attributable to unmanageable transfers and which part to entirely different causes. For example, a payments deficit may have arisen for reasons unrelated to financial transfers — say, a rate of income-and-price inflation faster than in other countries, or some shifts in demand — but at the same time financial transfers were made which in the absence of the other disturbances would be fully matched by real transfers. Statistics, nevertheless, will exhibit a "transfer gap". The only saving grace in this connection may be the length of the time series: if deficits persist for a time long enough to make regression analysis meaningful, regressions of real transfers on financial transfers may indicate how much of the changes in the former can be satisfactorily "explained" by the latter, and whether a great deal is missed by disregarding all other factors in the picture.

The Statistics, 1950-1967

We are now sufficiently, or perhaps excessively, prepared to look at the statistical series. All the data for the international transactions of the United States are taken from the *Survey of Current Business*, Vol. 48, No. 6 (June 1968) published by the U.S. Department of Commerce. For the Gross National Product (GNP) series, included in order to allow relevant comparisons, earlier issues were consulted. All figures are in current dollars, not corrected for price changes. It is partly for this reason that comparisons with GNP are needed. For example, the transfer gap may look much bigger in 1967, with $4.8 billion, that it was in 1950, with $3.6 billion. Yet, the gap was only 0.6 per cent of GNP in 1967, but 1.3 per cent in 1950.

The figures shown in Table 1 are in billions of dollars, the figures in Table 2 are percentages of GNP.

Real Transfers, 1950-1967

Exports of goods and services increased from $12.2 billion in 1950 to $38.9 billion in 1967, not counting exports under military grants and earnings from capital. The increase, by 219 per cent, was due to some extent to higher prices — the unit value of exported merchandise increased by 34 per cent during the 18 years — but chiefly to larger quantities. Of the 17 changes from year to year, only three (in 1952, 1953, and 1958) were decreases, the other 14 years were increases. The compounded annual rate of increase over the period was 7.1 per cent for the total value of exports of goods and services.

Imports of goods and services increased from $11.1 billion in 1950 to $34.4 billion in 1967, not counting military expenditures abroad and earnings from foreign capital placed in the United States. The increase, by 210 per cent, was due to a small extent to higher prices — the unit value of imported merchandise increased by 15 per cent — but chiefly to larger quantities. Of the 17 annual changes, five (in 1952, 1954, 1958, 1960, and 1961) were decreases, the other 12 were increases. The compounded annual rate of increase over the period was 6.9 per cent for the total value of imports of goods and services.

The net export surplus, here called Net Real Transfers, varied between $1.1 billion (in 1950 and also in 1959) and $7.4 billion (in 1964). It exceeded $5 billion in five years (1957, 1961, 1963, 1964, and 1965). Of the 17 annual changes, nine were increases, and eight decreases.

A glance at Table 2 reveals considerable stability of exports and imports as percentages of GNP. Exports (excluding earnings from

TABLE 1

GROSS NATIONAL PRODUCT, REAL AND FINANCIAL TRANSFERS, AND PAYMENTS DEFICITS OF THE UNITED STATES 1950-1967

(In billions of dollars)

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
1. Gross National Product . .	284.8	328.4	345.5	364.6	364.8	398.0	419.2	441.1	447.3	483.7	503.7	520.1	560.3	590.5	632.4	683.9	743.3	785.0
Goods and Services																		
2. Exports, excl. earnings from capital	12.2	16.9	16.2	15.0	15.5	17.4	20.9	23.7	20.2	20.5	23.9	24.7	25.9	27.8	31.7	33.3	36.9	38.9
3. Imports, excl. military expenditures and excl. earnings from capital	11.1	13.4	13.3	13.5	12.9	14.4	16.1	16.9	16.8	19.4	19.2	19.1	21.1	22.3	24.3	27.6	32.3	34.4
4. Net Real Transfers [2-3] .	1.1	3.5	2.9	1.5	2.6	3.0	4.8	6.8	3.4	1.1	4.7	5.6	4.8	5.5	7.4	5.7	4.6	4.5
Autonomous Financial Transactions																		
5. Military expenditures abroad	0.6	1.3	2.1	2.6	2.6	2.9	2.9	3.2	3.4	3.1	3.1	3.0	3.1	3.0	2.9	2.9	3.7	4.3
6. Remittances and pensions .	0.5	0.5	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.8	0.7	0.7	0.8	0.9	0.9	1.0	1.0	1.3
7. U.S. Government grants and loans, net	3.6	3.2	2.4	2.1	1.6	2.2	2.4	2.6	2.6	2.0	2.8	2.8	3.0	3.6	3.6	3.4	3.4	4.2
8. Private U.S. capital, net . .	1.3	1.0	1.2	0.4	1.6	1.3	3.1	3.6	2.9	2.4	3.9	4.2	3.4	4.5	6.6	3.8	4.3	5.5
9. Sum of transfers to foreign countries	6.0	6.0	6.3	5.7	6.4	7.0	9.1	10.1	9.6	8.3	10.5	10.7	10.3	12.0	14.0	11.1	12.4	15.3
10. Earnings from capital, net .	3.2	1.5	1.4	1.5	1.8	2.0	2.1	2.2	2.2	2.2	2.3	3.0	3.3	3.3	4.0	4.2	4.2	4.6
11. Foreign long-term capital net, excl. gov't securities and bank debts	0.1	0.2	0.2	0.2	0.3	0.4	0.6	0.4	0.1	0.7	0.4	0.4	0.3	0.3	− 0.1	− 0.3	1.2	1.4
12. Sum of transfers from abroad	1.3	1.7	1.6	1.7	2.1	2.4	2.7	2.6	2.3	2.9	2.7	3.4	3.6	3.6	3.9	3.9	5.4	6.0
13. Net Financ. Transfers [9-12]	4.7	4.3	4.7	4.0	4.3	4.6	6.4	7.5	7.3	5.4	7.8	7.3	6.7	8.4	10.1	7.2	7.0	9.3
Payments Deficits																		
14. Transfer Gap [13-4] . . .	3.6	0.8	1.8	2.5	1.7	1.6	1.6	0.7	3.9	4.3	3.1	1.7	1.9	2.9	2.7	1.5	2.4	4.8
15. Liquidity Deficit	3.5	0.0	1.2	2.2	1.5	1.2	1.0	− 0.6	3.4	3.9	3.9	2.4	2.2	2.7	2.8	1.3	1.4	3.6
Annual Changes																		
16. Net Real Transfers [4] . .		+ 2.4	− 0.6	− 1.4	+ 1.1	+ 0.4	+ 1.8	+ 2.0	− 3.4	− 2.3	+ 3.6	+ 0.9	− 0.8	+ 0.7	+ 1.9	− 1.7	− 1.1	− 0.1
17. Net Financial Transfers [13]		− 0.4	+ 0.4	− 0.7	+ 0.3	+ 0.3	+ 1.8	+ 1.1	− 0.2	− 1.9	+ 2.4	− 0.5	− 0.6	+ 1.7	+ 1.7	− 2.9	− 0.2	+ 2.3
18. Transfer Gap [14]		− 2.8	+ 1.0	+ 0.7	− 0.8	− 0.1	0.0	− 0.9	+ 3.2	+ 0.4	− 1.2	− 1.4	+ 0.2	+ 1.0	− 0.2	− 1.2	+ 0.9	+ 2.4

REAL AND FINANCIAL TRANSFERS AND PAYMENTS DEFICIT AS PERCENTAGES OF GROSS NATIONAL PRODUCT OF THE UNITED STATES, 1950-1967

TABLE 2

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
1. Gross National Product . .	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2. Exports, excluding earnings from capital	4.3	5.1	4.7	4.1	4.2	4.4	5.0	5.3	4.5	4.2	4.7	4.7	4.6	4.7	5.0	4.9	5.0	5.0
3. Imports, excluding military expenditures and earnings from capital	3.9	4.1	3.8	3.7	3.5	3.6	3.8	3.8	3.8	4.0	3.8	3.7	3.8	3.8	3.8	4.0	4.3	4.4
4. Net Real Transfers	0.4	1.1	0.8	0.4	0.7	0.8	1.1	1.5	0.8	0.2	0.9	1.1	0.9	0.9	1.2	0.8	0.6	0.6
5. Military expenditures abroad	0.2	0.4	0.6	0.7	0.7	0.7	0.7	0.7	0.8	0.6	0.6	0.6	0.6	0.5	0.5	0.4	0.5	0.6
7. U.S. Government, grants and capital, net	1.3	1.0	0.7	0.6	0.4	0.6	0.6	0.6	0.6	0.4	0.6	0.5	0.5	0.6	0.6	0.5	0.5	0.5
8. Private U.S. capital, net . .	0.5	0.3	0.3	0.1	0.4	0.3	0.7	0.8	0.6	0.5	0.8	0.8	0.6	0.8	1.0	0.6	0.6	0.7
9. Sum of transfers to foreign countries	2.1	1.8	1.8	1.5	1.8	1.8	2.2	2.3	2.1	1.7	2.1	2.1	1.8	2.0	2.2	1.6	1.7	1.9
10. Earnings from capital, net .	0.4	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6
13. Net Financial Transfers . .	1.7	1.3	1.4	1.1	1.2	1.2	1.5	1.7	1.6	1.1	1.5	1.4	1.2	1.4	1.6	1.1	0.9	1.2
14. Transfer Gap	1.3	0.2	0.5	0.7	0.5	0.4	0.4	0.2	0.9	0.9	0.6	0.3	0.3	0.5	0.4	0.2	0.3	0.6

capital) varied only between 4.1 and 5.3 per cent of GNP, imports (excluding military expenditures) between 3.5 and 4.4 per cent. (It is noteworthy that the two highest "import propensities" occurred in the last two years.) The export surplus (Net Real Transfers) varied between 0.2 and 1.5 per cent of GNP. While these are minute fractions of GNP, their variability is impressive: the high figure is more than seven times the low.

Financial Transfers, 1950-1967

The largest items in the category of financial transfers to foreign countries are military expenditures, U.S. Government grants and loans, and private capital exports. Over the years these three items changed ranks in relative size: government grants held top rank only in the early years (1950-52), were then overtaken by military expenditures, and finally (beginning in 1956) by private capital exports. (Private capital exports would not be in first place if the returns on this capital, the earnings of foreign dividends and interest payments, were deducted. These earnings are not shown in Table 1; only net earnings from capital, those received minus those paid, are entered as transfers received from foreign countries.) The annual averages of these three transfers for the entire period of 18 years were quite similar: $3.1 billion of private capital, $2.9 billion of government grants and loans, and $2.8 billion of military expenditures. The sum of transfers to foreign countries (disregarding earnings from capital and inflows of foreign capital) increased from $6.0 billion in 1950 to $15.3 billion in 1967.

Net earnings from capital, that is, the excess of returns received on American capital placed abroad over those paid on foreign capital placed in the United States, increased from $1.2 billion in 1950 to $4.6 billion in 1967. The increase reflects the investment position

of the United States, steadily improving as a result of the cumulative exports of American capital.

Inflows of foreign private long-term capital — comprising only the three types I have chosen to include — were relatively insignificant in most of the years until 1966, when they suddenly assumed importance. They had been between $0.1 and $0.4 billion in twelve of the 14 years from 1950 to 1963, and even negative, indicating withdrawals, in 1964 and 1965. The upsurge in 1966 and 1967, to $1.2 and $1.4 billion, respectively, is surprising, especially since it was not accompanied, as one might suspect, by a decline in liquid or short-time claims of private nonbank foreigners. On the contrary these claims increased at the same time, as did also the dollar holdings of foreign commercial banks and official agencies.

I should perhaps repeat the warning that some portion of the increases in liquid dollar holdings by private foreigners, banks as well as others, would in the nature of things qualify as autonomous, not accommodating, capital inflows. Only because I was unable to find an easy way of measuring or estimating the magnitudes of these inflows did I feel compelled to exclude them. The exclusion does not, however, vitiate the conclusions which I shall draw from the present analysis.

Net Financial Transfers, as computed from the six items included in Table 1, varied between $4.0 billion (in 1953) and $10.1 billion (in 1964). They stayed at $4.7 billion or below until 1955, were between $5.4 and $7.8 billion in the years from 1956 to 1962 and again in 1965 and 1966, and reached higher levels in three years, 1963, 1966, and 1967, when they amounted to $8.4, $10.1 and $9.3 billion, respectively.

It is usually overlooked that the large increases in financial transfers reckoned in dollars did *not* constitute increases relative to GNP. As we see in Table 2, the year in which the highest fraction of GNP was committed to transfers to foreign countries was 1950, the very first year of the period. At 1.7 per cent, this fraction was equalled only once, in 1957, and never surpassed in any of the other years. The lowest percentage figure is recorded for 1966, the only year when net transfers fell below 1 per cent of GNP. The apparently heavy transfer commitments of 1967 were, at 1.2 per cent of GNP, really quite modest; in only four of the 18 years were the net financial transfers below that figure.

Analogous comparisons for the individual items are also illuminating. The "extravagant" military expenditures in 1967, which shocked the observers at home and abroad, were only 0.55 per cent of GNP less than they had been in eleven of the other 17 years (8). The "lavish" amount of government grants and loans to foreign countries in 1967, which aroused the anger of American businessmen and politicians, was only 0.54 per cent of GNP, again less than they had been in eleven of the other 17 years (8). And private capital exports in 1967 were 0.7 per cent of GNP, less than they had been in six of the other 17 years (8). If the earnings from private capital invested or lent abroad ($6.2 billion in 1967) are set against new capital outflows of the year, it can be seen that all of these outflows, and even more, was paid for out of the returns on past investment.

The Transfer Gap, 1950-1967

Computed in current dollars, the Transfer Gap, in the 18 years shown in Table 1, varied between $0.7 billion and $4.8 billion. The low was in 1957, the year following the Suez crisis, the high in 1967, the year of the monetary overexpansion associated with the escalation of the war in Viet Nam. In only two years was the gap less than $1 billion and in only two years was it more than $4 billion. In the remaining 14 years it varied between $1.5 billion (in 1965) and $3.9 billion (in 1959). Its average size over the entire 18 years was $2.4 billion.

These variations of the transfer gap are very small in comparison with GNP and with the volume of foreign trade. The invariance of the gap is especially remarkable if we omit the last year of the series. From 1950 to 1966, GNP increased from $284.8 billion to $743.3 billion, and the trade volume (exports plus imports) increased from $23.3 billion to $69.2 billion; yet the transfer gap was $3.6 billion in 1950 and only $2.4 in 1966. There was no tendency for the gap to become narrower; indeed, in 1967 it was wider than ever. However, one cannot help being impressed by the stubbornness and apparent intractability of that relatively small shortfall of the export surplus. With the huge increases in GNP and in the volume of foreign trade, why should it have been impossible to squeeze or

(8) In order to make these comparisons, calculations had to be carried out to two decimal places. Table 2 shows the percentages only to one decimal place.

switch another two or three billion dollars worth of goods and services out of domestic and into foreign use?

In Table 1, the officially reported deficits on liquidity balance are shown immediately below the transfer gaps. For several years, the discrepancies between the two magnitudes are conspicuous enough to arouse curiosity and call for explanation. In 14 years the transfer gap exceeded the liquidity deficit, in the other four years the opposite relationship prevailed. The transfer gap is the larger of the two magnitudes whenever inflows of foreign long-term capital are recorded that we exclude from item No. 11 of Table 1, such as foreign purchases, private or official, of U.S. Government bonds (or other Treasury securities of maturities over 12 months) or foreign long-term loans, private or official, to American banks (for example, in the form of time deposits) and/or when errors and omissions are entered with a positive sign and treated in effect as unrecorded receipts (9).

These unrecorded receipts, excluded from the figures entered in Table 1, were chiefly responsible for the transfer gap exceeding the liquidity deficit in every year before 1960. In that year, errors and omissions changed their sign from positive to negative and thus became unrecorded payments or outflows. In the last two years, 1966 and 1967, it was chiefly the increase in foreign official holdings of medium-term U.S. Government securities and of time deposits or certificates of deposits in American banks that made the liquidity deficit appear smaller than the transfer gap (10).

From what has been said before, it should be clear that the transfer gaps were minute fractions of GNP. (See Table 2.) Only in 1950 was the gap above 1 per cent. In the other 17 years the percentages varied between 0.2 and 0.9; this high figure was reached in two years, 1958 and 1959. The gaps in 1965 and 1966 were only 0.2 and 0.3 per cent, and the alarming gap in 1967 was not higher than 0.6 per cent of GNP. I point to these relative mini-gaps not

(9) In 1957, when the balance of payments on liquidity basis showed the only surplus in all 18 years, this was the result of errors and omissions of record height: $1.2 billion of receipts from unrecorded transactions.

(10) The liquidity deficits in 1966 and 1967 would have been much bigger if "foreign official agencies", chiefly central banks, had not chosen to invest large amounts in "long-term time deposits or certificates of deposit" in American banks. Such holdings had been small in earlier years, but in 1966 and 1967 they increased by $793 million and $1,040 million, respectively. Had these amounts been in the usual form of "liquid liabilities", the liquidity deficits would have been that much bigger.

in order to skirt the issue: the problem of adjustment. On the contrary, I believe that a full realization of the proportions involved may help us understand what can and what cannot be expected to contribute to the solution of the problem.

The Parallel Changes in Real and Financial Transfers

In every one of the 18 years did Net Real Transfers fall short of Net Financial Transfers, but the 17 changes of the two magnitudes from one year to the next were ordinarily in the same direction. Financial transfers increased in nine years and real transfers increased in seven of these years; financial transfers decreased in eight years and real transfers decreased in six of these years. (In two of the four years in which real transfers did not move in the same direction as financial transfers — 1951 and 1961 — the gap was narrowing.)

The parallelism in these movements indicates, in my opinion, that the trade balance was surely not sticky or inflexible and that the adjustment mechanism was at work throughout the period, even if the adjustments of the export surplus were not of the size required to close the transfer gap. In several years, the change in real transfers matched the change in financial transfers closely; for example, the increases in 1956 were matched precisely — both were $1.8 billion — and the increases in 1955 and 1964 were more than matched, as net real transfers increased slightly more than net financial transfers. At least once, the matching was accomplished over two years: reductions of net financial transfers by $3.1 billion in 1965 and 1966 were accompanied by reductions in real transfers by $2.8 billion, in the same two years.

To expect complete matching in single years would be to suppose that the adjustment process works without any lags and without any slippage. To entertain such a supposition would be unreasonable. However, be this as it may, the parallelism of changes observed over the period is impressive. If we disregard the first two years and omit also the last year, and thus look at the series only from 1952 to 1966, we find that in 13 out of 14 years the changes were in the same direction. This does not, of course, prove that the changes in real transfers were determined or influenced by changes in financial transfers, but the hypothesis of such an influence is surely consistent with the statistical record. The reverse hypothesis,

posing an influence of the real flows upon nonaccommodating financial flows, would lack theoretical plausibility. There is no theory that would explain or predict that military expenditures, government grants, direct investment, and portfolio investment in long-term foreign securities depend on, and will rise and fall with, changes in the export surplus.

Regression Analysis

The preceding argument, based on simple parallelisms and covariations of statistical magnitudes, is probably too primitive, since more respected techniques are at our disposal. We shall regress Net Real Transfers on Net Financial Transfers (11).

Using the numbers from Table 1, and letting y denote Net Real Transfers and x denote Net Financial Transfers, regression of y on x for all 18 observations yields the equation

$$y = -1.14 + 0.80\,x. \qquad R^2 = 0.64.$$
$$(1.1) \quad (5.3)$$

The numbers in parentheses under the parameters are the T-statistics; they indicate that the coefficient of the x-variable is highly significant at a 99 per cent level of confidence, whereas the constant term is not significantly different from zero at a 95 per cent level of confidence. The coefficient of determination, $R^2 = 0.64$, indicates that 64 per cent of all changes in Net Real Transfers are statistically explained by changes in Net Financial Transfers.

It is apparent that the observation for 1967 lies well off the regression line fitted through the other 17 observations. Using only these 17 observations, from 1950 to 1966, the regression equation becomes

$$y = -1.74 + 0.92\,x. \qquad R^2 = 0.71.$$
$$(1.8) \quad (6.0)$$

As before, the coefficient of the x-variable is highly significant, whereas the constant term is not (at a 95 per cent level of confidence) significantly different from zero. The coefficient of determination, $R^2 = .71$, is higher than for the first equation.

(11) I am indebted to my colleague, Professor Wallace E. Oates, for doing the computations for me.

With the coefficient of the x-variable, 0.92, not significantly different from unity, this equation would support the hypothesis that any increase (or decrease) in financial transfers would be accompanied by almost the same increase (or decrease) in real transfers.

The observation for 1967 is sadly out of line; something must have happened to prevent the adjustment of real transfers to the large increase in financial transfers in that year. Few economists would be at a loss to explain the misbehavior of real transfers in 1967. We reserve our comments for later. But we should report here that, had exports and imports behaved in conformance with the regression equation for the previous 17 years, Net Real Transfers in 1967 should bave been $6.8 billion instead of the $4.5 billion actually achieved.

Explanations and Implications

The results of the regression analysis are surprising. Not even the greatest transfer optimists would have expected to see a regression coefficient as high as that — except perhaps Professor Albert Hahn, the proponent of the "boomerang theory", which holds that, as all boomerangs come back, each and every manipulation of financial transfers will be fully reflected in changes of the trade balance and, hence, leave the balance of payments unchanged.

The fact that, according to our equation, an average of 92 per cent of all changes in the Net Financial Transfers of the United States between 1950 and 1966 was reflected by changes in its Net Real Transfers to foreign countries calls for some theoretical explanations. Moreover, if we believe what we have seen, we must not disregard its political implications. For it means that all policy recommendations by official experts, American and European, and all policy measures adopted by the U.S. Government to remove or reduce the payments deficit by checking and controlling financial outflows have been patently wrong.

Theoretical Explanations

In my testimony before the Economic Committee of the U.S. Congress, in February 1968, I made the following presentation:

> "There are two extreme positions concerning the effectiveness of such a corrective measure. At one end is the opinion that a

reduction of a financial transfer, say by $1 billion, will leave all other items in the payments balance unchanged and merely reduce the financing item, that is, reduce the loss of gold or the increase in liquid foreign liabilities.

"At the opposite end is the opinion that a reduction in financial transfers by $1 billion will reduce the export surplus by the same amount and hence will leave the deficit, and the need to finance it, unchanged.

"I propose to regard the first theory as naive and the second as over-sophisticated; both are wrong. The truth lies in the middle, and whether it comes closer to the naive or to the over-sophisticated theory will depend on circumstances."

I then proceeded to a brief exposition of the circumstances that might determine the outcome. I first discussed the possibility that restrictions on a particular form of financial transfer may lead to offsetting changes in other items within the capital account. For example, a cut in capital exports to Europe may result in an increase in American capital flows to Canada, in a reduction of European investments in the United States, or in withdrawals of European capital from the United States. Substitutions of permitted for prohibited transactions could thus make the imposed controls ineffective. As a next step in the exposition, I assumed that the controls would be effective and actually reduce Net Financial Transfers. The extent to which this reduction would or would not be reflected in a parallel reduction in Net Real Transfers would depend on the effects upon aggregate spending at home and abroad and on the effects which the changes in spending would have upon incomes, prices, imports, and exports in the countries concerned.

The desired objective of the imposition of restrictions on financial transfers is, of course, to remove the deficit. This objective can be achieved only if the export surplus does not decline *pari passu* with the amount of financial transfers. Now, what are the conditions for "independence" of the export surplus from the financial outflow? Just what circumstances would have to prevail for Net Real Transfers to be unaffected by a reduction in Net Financial Transfers? Assume that, because of restrictions imposed, investments planned by an American firm in Europe are either indefinitely postponed or fully financed by funds raised in European markets. To leave aggregate spending in the United States unaffected, it would be necessary that the American firm decide that its own funds

which it had planned to use for its European investments will not be touched. In other words, the firm must refrain from using any of these funds for any other purpose and must build up an idle cash position, not needed and not wanted for anything. To leave aggregate spending in Europe unaffected, it would be necessary that some Europeans can find hitherto idle cash or can persuade their banks to extend new credits enabling them to make outlays in the same amounts as would have been made with the funds of the American firm. Assuming the American firm goes ahead with its plans but finances them with European funds, total spending in Europe can be unaffected only if these European funds would have remained idle in the absence of the borrowing by the American firm.

These are rather strong conditions, not likely to be realized. If they are not realized, then aggregate demand will be affected by the restrictions on capital. There will be more spending in the United States, resulting in larger imports and in reduced efforts to seek export outlets for American products. And there will be less spending in Europe, with the result that imports will be less than they would be otherwise and the export business will be pushed more vigorously. Hence, the restrictions on capital exports from the United States are likely to lead to reductions of the American export surplus on goods and services. The next question is what conditions would have to prevail to cause this impact to be 100 per cent.

Accepted transfer theory, based on income effects alone, does not support the expectation of a 1:1 relation between changes in financial and real transfers. Even if domestic spending in the United States is increased by precisely the amount of funds which the restrictions prevent from going abroad, and even if spending in Europe is reduced exactly by the amount of funds prevented from coming from the United States, income effects, reinforced by multiplier effects, cannot produce complete adjustment of the trade balance to the change in the capital balance. They cannot, at least, as long as the marginal propensities to save and to import are within the most likely ranges. Income effects alone can account at best for trade adjustment of somewhere between 40 and 70 per cent of the effected changes in financial transfers. There is no reason, however, to rely on income effects alone.

Several other factors, besides income effects, may play important roles. 1) So-called "direct effects" of changes in financial transfers may affect purchases from abroad — that is, the recipients of the

foreign funds may immediately use them for buying imports, and the reduction in the availability of foreign funds may inhibit such purchases. 2) Price effects of changes in aggregate spending may redirect the flows of goods and services to conform to the changes in the financial flows. (According to one strand of the classical tradition, price effects should be regarded as more important than income effects.) 3) Induced changes in investment — accelerator effects — may greatly reinforce the income effects, that is to say, domestic investments may change in a parallel fashion with the domestic disbursements affected by increases or reductions of financial transfers. (If the marginal propensity to invest equals the marginal propensity to save, changes in real transfers will completely match all changes in financial transfers.) 4) Monetary policies of the countries may reinforce the automatic effects of changes in financial transfers. For example, the country confronted with increasing financial outflows may restrain domestic spending by tightening credit; countries receiving increased capital inflows may allow the secondary credit expansions to occur which the banks would be induced to undertake; in the opposite case, of reductions in financial transfers, the country with reduced outflows may exercise less restraint, and the country with reduced inflows, more restraint in monetary policy, with the normal effects on the flows of goods and services (12).

Any one of these four factors may cause, or contribute to, full matching of changes in financial flows by parallel changes in real flows. It is difficult to diagnose the conditions actually prevailing and thus to predict the actual outcome at any particular time. Yet, the existence of conditions making for full matching is by no means so unlikely as to cause great surprise at the observations of the 17 years, 1950 to 1966.

A Paradox and Its Solution

There remains a big puzzle, however. If the conditions actually were such that changes in financial transfers from 1950 to 1966 were so promptly matched by parallel changes in real transfers, why then did the transfer gap fail to close or even to get any narrower? (The average gap of the last four years, 1963-1966, was $2.4 billion; the average of the 17 years, 1950-1966, was $2.3 billion; the average of the last five, six, and seven years varied between $2.2 and $2.3 billion.) It seems strange that the "transfer mechanism" should work perfectly for increases and reductions of remittances but not at all for the initial or chronic gap. This is a paradox that cries for an explanation.

(12) For a more detailed explanation of all these factors see Fritz Machlup, *International Payments, Debts, and Gold* (New York: Scribners, 1964) or *International Monetary Economics* (London: Allen & Unwin, 1965), pp. 425-432, and 440-446.

Analogies are sometimes helpful, and I can think of several. Foremost among them is the idea of automatic governors, regulators, balancers, robot controls, servomechanisms, or feedback systems, designed to adjust speed, rotation, flow, level, temperature, pressure, charge, load, voltage, and many other things, working well and accurately — but set at a wrong point, say, two or three notches below the desired magnitude. Alas, this analogy does not tell us why the balance-of-payments or the transfer gap should be automatically controlled by an adjustment mechanism which holds the deficit consistently to $2.3 billion. Why should the mechanism work so well in stabilizing the gap or deficit around this value — forcing the flow of goods and services to change consistently with the flow of funds — but fail to work in reducing the deficit to zero?

The answer may lie in the interference of some "manual controls" with the automatic ones, or of more or less discretionary policies with the undesigned reflexes and reactions or general rules of thumb that are behind the so-called automatic system. Perhaps the payments deficit oscillated with so narrow deviations around a central value because monetary and fiscal policies became circumspect and restrictive whenever the deficit increased beyond the accustomed level, and became more relaxed and more liberal whenever the payments position showed signs of improvement.

In order to attempt some checking of this hunch — I hesitate to call it a "test" of a "hypothesis", because my attempt is too superficial to deserve these names — I looked into the record of behavior of three monetary variables which are determined or influenced by the monetary authorities of the United States: Federal Reserve Credit, Member Bank Reserves, and Total Money Stock. In view of concurrent developments, which may modify the effectiveness of these variables, the amounts of Federal Reserve Credit (holdings of loans and Government securities) and of Member Bank Reserves (held in Federal Reserve Banks) had been adjusted to take account of changes in reserve requirements, and the series of Total

Money Stock (demand deposits at all commercial banks, currency outside banks, foreign demand balances at Federal Reserve Banks, and time deposits at commercial banks, without interbank deposits and deposits of the U.S. Government) was taken to include what is sometimes called quasi-money (13). I then compared the annual changes of these three variables with the payments position of the United States in the same years. Some of the findings merit report and comment.

1. After the first large deficit, in 1950, there was between 1951 and 1957 only one very bad year, 1953, with a liquidity deficit of $2.2 billion. The Federal Reserve Banks engaged in considerable offsetting (by expanding its loans and investments) but did so with sufficient restraint to keep Member Bank Reserves down to a rate of increase of only 0.7 per cent, the lowest rate between 1950 and 1955.

2. The years 1958, 1959, and 1960 were the worst sequence of record deficits: $3.4, $3.9, and again $3.9 billion. The transfer gaps in my computation were even higher.) The reaction of the Federal Reserve System was very late but drastic. In 1960, Federal Reserve Credit was reduced absolutely, the rate of increase becoming —0.6 per cent, and Member Bank Reserves likewise fell absolutely, the rate of increase becoming —0.5 per cent. Neither of these things was done before or after 1960 in the entire period from 1950 to 1967. Total Money Stock increased by only 0.1 per cent, the lowest annual increase in the 17 years.

3. After four years of relatively high deficits between 1961 and 1964 ($2.7 billion in 1963 and $2.8 billion in 1964), 1965 brought relief, with a deficit of only $1.3. The monetary authorities took quick advantage by increasing Federal Reserve Credit by 12 per cent in that year — the highest rate of increase in the 17-year period — and thereby allowing Member Bank Reserves to increase by 5 per cent — the highest rate between 1951 and 1966. Total Money Stock, likewise, increased in 1965 by the record rate for the period, 8.9 per cent.

The three episodes are consistent with the suspicion that some of the more drastic actions of the monetary authorities between 1950

(13) The source for the series used was *Triangles of U.S. Economic Data*, published periodically by the Federal Reserve Bank of St. Louis.

and 1966 served to keep the payments deficits within bounds. The policies of 1953 and 1960 were clearly designed to halt expansion or force contraction of domestic credit and aggregate spending; the policy of 1965 was an extraordinary push toward monetary expansion, at a time when the payments deficit was reduced but far from disappearing.

It is the third episode that suggests an explanation of a "lower limit" to the deficit. If expansionary forces are allowed free rein as soon as the payments position becomes slightly less embarrassing, this is analogous to setting the automatic governor or regulator of the servomechanic system at a nonzero point. This is not to say that there has been a deliberate attempt to prevent restoration of external balance. Far from it; the goal of external balance has, at least since 1960, been one of the "top priorities" of the country's economic objectives — but only one among several. The goals of full employment and faster growth, various targets in the wars on domestic poverty and on hostile foreign powers, and a few other aims, all these compete for first rank in public policy. At a particular moment the government's prime concern will be with that objective which to attain it has most spectacularly failed; but its concern will be diverted to some competing objective long before full success in the previous effort has been achieved. If monetary expansion is thought to be a medicine against unemployment and sluggish growth, though it is toxic with regard to the external payments position, an improvement of that position will entice the authorities to take the toxic medicine long before the payments deficit is cured.

The suggested solution of the paradox rests on a political, not an economic hypothesis; but this should cause no surprise, since all governmental decisions, in the economic area no less than in others, are political. Again, no criticism is implied, for it can hardly be otherwise. One cannot even complain about the weakness, inconsistency, unreliability, or shortsightedness of government, for one may in full rationality argue that the attainment of a chosen end may, after an honest try, appear too costly; if too much of what is also badly wanted, say, a high rate of employment, has to be sacrificed in order to gain complete removal of the payments deficit by means of monetary policy, one must understand the tergiversation on the part of monetary authorities. It is not possible to be consistent in the use of an instrument that is supposed to serve several different

objectives at once. In brief, if deflation of credit, money, incomes, prices, and employment is needed to remove the external deficit of the nation, the deficit will not be removed.

The Off-Year, 1967

While excuses can be made for the monetary authorities' failure to get rid of the payments deficit by means of deflation, the monetary and fiscal behavior of the off-year, 1967, cannot thus be defended. The statistical observations for that year have been found to be far off the regression line fitted for the period 1950 to 1966. The examination of the monetary record yields some data that illuminate the strange behavior of the variables of our main concern in this study.

Perhaps it should first be recalled that the liquidity deficit of 1966 was low enough to tempt the policy makers into continuing a policy of fiscal and monetary ease. They should have been told, however, that conscious window-dessing and inappropriate consistency in the application of inflexible definitions of liquidity (such as classifying near-liquid liabilities as nonliquid) understated the liquidity deficit in a most misleading or deceptive way. (Note that the Transfer Gap in 1966 was $2.4 billion while the liquidity deficit was reported at $1.4 billion.) Whether misled by the supposedly modest payments deficit of 1966 or by other delusions, the Congress and the monetary authorities chose to combine a large budget deficit with a large credit expansion in 1967. While the Congress delayed an urgently needed tax increase, the monetary authorities increased Federal Reserve Credit by 9.3 per cent over the year before and thereby increased total Member Bank Reserves by 5.6 per cent, the highest annual increase in 16 years. Total Money Stock, as a result, increased by 8 per cent, the second-highest rate in the same period.

Not surprisingly, the deficit of 1967 was a whopper. The seriously understated liquidity deficit was "only" $3.6 billion, but the Transfer Gap was $4.8 billion, the biggest ever.

Having designated 1967 as the "off-year", I should warn that this does not mean to imply a suggestion that 1968 will be back in line. The increase in taxes, the cuts in the budget, and the slowdown in money creation probably came too late to halt the price and income inflation and improve the payments position in 1968. The deficit on capital account may be lower than in previous years,

but the surplus on goods and services will probably be much lower too. The inflation has surely had its effects on real transfers, raising the demand for imports and reducing the supply of exports.

Had there been many more years like 1967 in the series of postwar payments deficits, I would not have taken the time to defend the hypothesis that a transfer problem was the source of the troubles. Monetary overexpansion would have been a perfectly good explanation. But 1967 was the exception, not the rule. Even for that year, one can hardly attribute the entire deficit or gap to inflationary policy. Of the statistical Transfer Gap of 1967 — $4.8 billion — one could, on the basis of our regression equation, attribute about one-half to fiscal-monetary inflation and the other half to the chronic transfer difficulty which, at unchanged exchange rates, only net deflation could have overcome.

The Transfer Correlation and Its Policy Implications

If it is correct to regard 1967 (and probably 1968) as exceptional and to assume that, after the inflationary policy of the United States is stopped, things will revert to the pattern observed between 1950 and 1966, important policy implications should be recognized. For, if changes in Net Financial Transfers are almost fully matched by changes in Net Real Transfers, expectations that restrictions on capital outflows and/or reductions in military expenditures abroad will close the Transfer Gap will necessarily be disappointed.

A strong alliance of official, academic, and self-appointed experts has insisted that the payments deficit of the United States can be and will be removed by drastic reduction in remittances to foreign countries. The official experts want to restrict the outflow of private capital, academic experts want to cut or stop military expenditures abroad, and many experts from business and finance want to reduce foreign-aid outlays. I submit that all three groups are wrong if they believe that the reductions which they favor would reduce the payments deficit by even approximately similar amounts. Indeed, if the observed correlation still holds, the exports surplus would decline *pari passu* with the financial outflows, and the gap would be practically unchanged. If the financial transfers were cut to the size of the normal Transfer Gap, the export surplus might disappear altogether — and the gap might survive.

The implication of all this should be clear: the balance-of-payments program pursued by the United States Government, and applauded by the governments of the surplus countries, is useless for the purpose for which it is designed, and injurious to several other matters of considerable economic and political importance.

The Normal Volume of Financial Transfers

The argument in the preceding section was that attempts to correct the payments deficit by restricting financial outflows are misdirected and futile, because a reduction in Net Financial Transfers will cause Net Real Transfers to be reduced, rather than the Transfer Gap. In the remaining part of this paper, however, we shall, for the sake of another argument, assume that the attempt to correct the deficit by restrictions of financial outflow may, after all, be successful in achieving their purpose, that is, in closing the gap by cutting Net Financial Transfers down to the level of Net Real Transfers, a level not simultaneously lowered in the process.

This assumption is not meant to be a retreat from a carefully developed position, but only a device to exhibit another error in the reasoning of the advocates of restriction. They usually overlook that temporary measures have only temporary effects and cannot produce or promote adjustment to long-run forces. I shall argue that the financial transfers to foreign countries have not been abnormally high; that they cannot be expected to be substantially lower in the long run as fractions of GNP and must therefore be expected to increase in dollar volume; and that voluntary or mandatory controls and restrictions, however effective they may be for a few years, cannot reduce the " normal " volume of financial transfers in the long run.

Normal Capital Exports

For many observers the idea of a " normal " volume of capital exports seems to be difficult to accept. The same persons, economists or laymen, who like to talk about all sorts of things as being " structural " or " structurally determined " believe that governments could and should give the flow of capital just about any magnitude or direction they like. Exports or imports of commodities are

recognized among the " sticky aggregates ", in physical volume, in total value, or in relation to national income or GNP, and many " propensities " are accepted as relatively stable and not easily shaped by government edicts — but not international capital movements, and not propensities to lend or invest abroad. These, apparently, can be made to be what the political powers may prefer them to be or, at least, they can be cut down to any size that the powers approve.

I do not like the words " structure " and " structural ", because they are more often misused than used with clear and honest meanings. But when they refer to certain relationships that are not easily altered or influenced and have inherent stability or resilience, the terms are used legitimately. If these terms are applied to such things as ratios of imports to national income (average or marginal, at given relative prices), then I submit that we can with not much less justification speak of a structural level of capital movements among countries with different income per head and different capital endowment.

The United States has more capital per head, more capital per worker, and also a greater supply of new savings per head and per worker than any other country in the world. This relative abundance makes it more than likely that the marginal efficiency of new investment will as a rule be lower in the United States than elsewhere (or would be lower if capital outflows were restricted). This state of affairs implies that, in the absence of prohibitive risks and obstacles, long-term capital will normally flow from the United States to other countries. It is possible, of course, that, for one reason or another, investment opportunities in the United States will at times be more promising or attractive than elsewhere, but — assuming peace and order — such periods will be only relatively brief. The same technological or organizational developments that may at certain times make new investment particularly attractive in American industries will soon thereafter create similar investment opportunities abroad and restore the conditions for capital exports from the United States. One must reckon with this tendency as a persistent force for many years to come.

Capital movements from countries where the supply of new savings is larger to countries where it is smaller, relative to the available supply of human and natural resources, are beneficial to both the exporting and the receiving countries. Some governments do not see it this way, for example, when they have sectional rather

than national or international interests at heart, when they are motivated by meta-economic feelings such as national pride, or when, in choosing between the long view and the short, they impatiently adopt the latter. For the international community, there can be no doubt, general welfare calls for a distribution of the total supply of capital in such a way that the marginal social returns are equalized in all uses everywhere — and this implies capital exports from the country where the sources of new savings are, relative to other resources, the richest.

Acceptance of this proposition does not include specification of any particular order of magnitude or of any particular selection of recipient countries. To speak of the latter problem first, if countries are ranked by supply of new savings per head, nothing can be said a priori about whether those of rank Nos. 2, 3, or 4 will be net suppliers of capital funds or net recipients. Since capital is conveyed in various forms and at various terms, it is quite likely that a country will both import and export capital, receiving direct investment by foreign firms and making direct investment abroad, selling securities, equity as well as debt, to foreign buyers and buying securities from foreign sellers. Thus, even if countries with a large domestic supply of capital may be net exporters, their receiving foreign capital in large amounts would be neither uneconomic nor irrational in any sense.

Again, nothing can be said a priori about the size of net capital exports. One can, at best, examine the historical records and speculate on whether the observed magnitudes and ratios have been the results of accident, of temporary circumstances, or of conditions likely to prevail in the future. Several choices have to be made about the data: should we be more interested in fractions of GNP or in dollar amounts; in the sum of private and governmental capital or in private capital alone; in American capital alone or in the net balance on capital account, American and foreign; in capital exports including reinvestments of earnings from capital lent or invested in the past or in exports of "new" capital, not counting reinvestments of profits, dividends, and interest? On all four questions I decide in favor of the first alternative. I propose to look at ratios to GNP, because dollar volumes alone can hardy give us a long-run norm in a context of growth. I propose to look at the sum of governmental (grants and loans) and private capital (loans and investments), because all these financial resources supposedly come from the same source, the U.S. national income. I propose to focus only on American capital, and to disregard imports of foreign capital, chiefly because these imports amounted to very little until 1966, and the very small figures were rather unstable (even becoming negative in two years). Finally I propose, though rather half-heartedly, for reasons to be explained later, to include reinvestments of earnings.

Capital Exports, 1950-1967

From 1950 to 1967, foreign grants and loans by the U.S. Government varied between 0.4 and 1.3 per cent of GNP; only in the first two years, 1950 and 1951, did they exceed 1 per cent, and the average over the 18 years was 0.54 per cent.

In the same period, foreign long-term loans and investments by private Americans varied between 0.1 and 1.0 per cent of GNP; only in four years, 1951 to 1954, did they fall short of 0.5 per cent, and the overage over the 18 years was 0.7.

Together, capital exports, governmental and private, varied between 0.7 and 1.8 per cent of GNP; only in four years (1953 to 1955 and in 1959) were they below 1 per cent; in another five years (1950, 1957, 1960, 1963, and 1964) they were 1.4 per cent or higher; and the average over the 18 years was 1.2 per cent of GNP.

During the last five years of the period capital exports were restricted, first through the imposition of the Interest Equalization Tax in 1964, then through the introduction in 1965 of voluntary restraints upon loans and direct investments. Although the imposition of mandatory controls early in 1968 may indicate that the previous programs did not do all that the Government hoped to achieve, we were told in repeated statements by the Secretary of the Treasury that the tax on the purchase of foreign securities and the voluntary controls on foreign loans by banks and on loans and investments by large corporations were effective in reducing exports of American capital. Total capital exports, private and official, were only 1.1, 1.1, and 1.2 per cent of GNP in 1965, 1966, and 1967, whereas they had been 1.6 per cent in 1964 and almost 1.4 per cent on the average from 1960 to 1964. One may argue that the capital exports in the early 1960's were abnormally large because this was a period of widening horizons for American corporations, many of whom discovered for the first time the opportunities of foreign investment, especially the new opportunities behind the tariff wall of the Euro-

pean Economic Community. However, though these particular opportunities may be getting exhausted, we should not regard them as so unique and *sui generis* that we could not expect them to be replaced by other attractive outlets in Europe or elsewhere.

If we accepted 1.4 per cent of GNP as the norm for unrestricted capital exports of the United States, we would tacitly accept rather niggardly allocation for aid to developing countries. There has been wide agreement on a simple rule of thumb: the rich nations should be prepared to give 1 per cent of their gross national product for the economic development of poor countries. (This rule has recently been restated by UNCTAD, the United Nations Conference on Trade and Development, with the interpretation that this target indicates the amount the developing countries ought to have left for their use after paying interest and amortization of principal in servicing their old debts.) The United States has averaged only one-half of the target aid and the Congress seems unwilling to continue even this much. If appropriations in future years become more generous and get closer to the target, perhaps in order to emulate the much larger appropriations made by France, Germany, and the Netherlands, we should see normal capital exports to both developing and developed countries exceed 1.5 per cent of GNP.

The notion that the normal rate of capital exports ought not to be financed out of earnings from capital exported in prior years, but to constitute net additions to the resources available to the receiving countries, seems reasonable though unrealistic. On that basis, that is net of earnings received from past loans and investments, private capital exports would have been negative in eleven of the last 18 years, including the last three, 1965 to 1967 (14). Since accumulated investment grows continually, dividend and interest payments increase from year to year and first overtake and eventually dwarf the flow of "new" capital. The idea that a rich economy shares its supply of current domestic savings with less affluent economies implies that new outside resources will be made available to these economies. When earnings from past foreign investment exceed current capital exports, the flow of additional resources from the rich country appears to be negative. If it is to remain positive, the rate of capital exports including reinvestment out of earnings

(14) Calculated from balance-of-payments statistics, *Survey of Current Business*, June 1968.

must increase over the years — until the supply of current savings (relative to other resources) in the countries that hitherto imported capital catches up with that of the rich country.

This proposition, if it is considered plausible, is not an argument for grants, merely nominal interest rates, or continually deferred repayment of loans to developing nations. It is at best an argument for rising targets for aid counted in the conventional way. It may even be countered by an economic argument: if the capital of prior years has been put to good uses, productively invested, the returns on this capital are really part of the resources of the countries that supplied the capital. It is therefore inappropriate to say that the countries that received the capital use their own resources to service their debts or to repatriate profits and principal. There is, however, no use arguing to whom the returns of capital properly "belong", to the user or the supplier. The demand that the capital exports from more affluent to less affluent countries be increasing fractions of GNP does not depend on the answer to that question.

Europe's Need for American Capital

The preceding discussion related chiefly to the capital exports of the richest and the capital imports of the poorest countries. There is, however, a very different question, relating to the highly developed countries of Europe, which "structurally" are probably net exporters of capital but have been "flooded" with American capital. Can it be argued that these capital imports are structurally determined? If not, would not the "normal" outflow of capital from the United States be much smaller?

Several collateral circumstances complicate the answers. There is the temporary attractiveness of direct investment in the European Economic Community in view of the customs union with its protective tariffs against products from outside. There is the "management gap" between European and American industries, which may operate as attraction for capital in joint supply with managerial talent. Perhaps these and similar factors account for the entire flow of funds and no more permanent and fundamental reasons exist for the flow of American capital to Europe. Moreover, the inflow of capital funds from the United States has not been ac-

companied by a transfer of real resources, but to a large extent only by an accumulation of liquid dollar balances. The fact that there has not been real but only a paper transfer suggests to some that Europe had no need for the American funds. A " structural " theory pronounces on relationships in real terms; if no real transfers have taken place and no real resources, therefore, been received, does this not prove that the capital was not really needed?

Such an inference would not be logically sound. From the existence of a Transfer Gap it does not follow that the large financial transfers had no economic function. That the real transfers were not achieved proves only that the adjustment policies of the countries concerned were inadequate. The international flow of goods is directed by international income and price differentials and these differentials can be changed by policies affecting aggregate demand and exchange rates. The richest country can " pull in " real resources from the poorest countries if it expands effective demand vigorously enough; the poorest countries can " push out " real resources to the richest if they deflate enough. Such movements would indicate neither that the rich needed the resources, nor that the poor did not need them.

The question may be differently interpreted. Since Europe did not " miss " the real resources which it failed to receive, but apparently had all it wanted, it evidently did not need them. Perhaps the word " need " confuses the issue, because it suggests a lack or want of something. The point, however, is whether or not the transfer of real resources could improve their optimal allocation. A country with a given endowment of resources and a given supply of current savings, may have a relative abundance or a relative scarcity of capital, depending on conditions elsewhere. An increase in the supply of capital abroad may change a relative abundance into a relative scarcity of capital in a country in which nothing at all has changed (15). In this sense, it does not depend on Europe alone whether it " needs " more capital. As long as marginal yields are greater than zero, all countries could do with more than they have.

(15) Few persons in the United States may admit that the country " needs " more immigration. Yet, as long as labor could earn more in the United States than elsewhere, labor is " scarce " in the United States.

Military Expenditures Abroad and Net Financial Transfers

The series of foreign military expenditures of the United States, expressed as percentages of GNP, shows considerable stability. Apart from the first year of the period covered, 1950, the deviations from the average, 0.57 per cent, were small; the low was 0.4 per cent, the high 0.8 per cent, and in 14 of the 18 years the percentages were 0.5, 0.6 and 0.7.

It does not follow that this has to continue for many more years. Public opinion in the United States is becoming increasingly opposed to the country's role as " policeman of the world ". One cannot expect that the swing from foreign intervention to isolationism will be complete, but there is a prospect of reductions in the share of GNP going to military expenditures abroad.

Several experts entertain high hopes regarding the relief for the balance of payments with the end of the war in Viet Nam. I believe these hopes are exaggerated. What I hope and expect is that destruction will give way to rebuilding, and that this change will reduce military expenditures and increase foreign aid. Raising the appropriations to foreign aid and lifting the restrictions on private capital exports may easily take up all that can be saved on military expenditures.

It is possible that in the future foreign long-term capital will come to the United States to a much larger extent than it has in the past. There may be increasing attractions both in direct and in portfolio investment. One had better not count on such developments, however. In any case, the order of magnitude of such capital imports is not likely to be such as to call for a significant modification of Net Financial Transfers from the United States.

My conclusion is that we must reckon with a long-term norm for Net Financial Transfers of at least 1.5 per cent of GNP, and probably higher.

The Required Net Real Transfers

The Transfer Gap must be closed soon, and there is only one way of doing this safely: by increasing Net Real Transfers to the level of Net Financial Transfers. For, even if one assumes that the latter can be reduced by means of government restrictions, no one can expect that such restrictions can be maintained and enforced

permanently in an essentially free society or that temporary restrictions can have permanent effects, reducing normal outflows to a lower level. If there is something like a normal level of Net Financial Transfers, attempts to reduce them temporarily by temporary restrictions cannot reasonably be regarded as " adjustment measures ". Such measures may at best suppress the imbalance, but cannot remove it.

Real adjustment thus requires raising the level of Real Net Transfers of the United States to 1.5 per cent of GNP, and perhaps higher. With a GNP of about $870 billion expected for 1968, the required surplus on goods and services included among " real transfers " would be some $13 billion, and thus, a huge Transfer Gap must be expected this year. Projecting (not predicting) the increase of GNP at a compounded annual rate of 7 or 8 per cent — one-half real, one-half in price inflation — we may put for the year 1970 GNP at around $1,000 billion and the required Net Real Transfers at about $15 billion. That this would call for very substantial changes in the foreign-trade performance of the United States can best be realized by comparing the targets with the actually achieved figures of recent years: they were $4.6 and $4.5 billion in 1966 and 1967, and they may be even lower in 1968.

Many readers will probably be shocked by my ambitious targets. Yet, my ambition is by no means mercantilist in character; it is only an honest attempt to spell out the meaning of what virtually every economist and politician demands, namely, adjustment to achieve balance in international payments.

Looking at previous years, the Net Real Transfers of the United States have only five times in the 18 years reached or exceeded 1.1 per cent of GNP and have only once, in the exceptional year of 1957, reached the required 1.5 per cent. Thus a " big push " will be needed to do normally what has been achieved only once, thanks to fortuitous circumstances.

No one should think, however, that it would be impossible to achieve the required increase in the export surplus. The statistical Transfer Gap of 1967 was $4.5 billion. About one-half of it was attributable to an inflationary expansion in the United States, accompanied by exceptional slack in the demand from Germany and other European countries. Our estimate of the genuine Transfer Gap was between $2.3 and $2.5 billion. Once the European countries reach higher levels of effective demand and the United States succeeds

in disinflating, the Transfer Gap should be reduced to its chronic level. The present volume of foreign trade of the United States is about $73 billion. An improvement in the balance of goods and services by $2.5 billion would be only 3.4 per cent of the trade volume. To be on the safe side, the improvement target ought to be 4 per cent of the trade volume, in addition to the improvements that should come from the adjustments of aggregate demand in the United States and abroad. If the price elasticities of supply and demand in the foreign trade of the United States are within the ranges calculated by econometric techniques, a reduction of the external value of the dollar by four per cent would do the trick.

Econometricians recently have calculated the price elasticity of foreign demand for American exports to be greater than 3, and the elasticity of American demand for imports to be greater than unity. With all due reservations regarding the accuracy of such findings and the stability of the estimated coefficients, it seems safe to assume that a 4 per cent reduction in the exchange rate of the dollar would accomplish a combined change in exports and imports of at least 4 per cent, chiefly an increase in exports. It goes without saying that this need not mean more American products sold to Europe; with a complex multilateral-trade pattern, it would be naive to ask in advance which countries would buy what American goods at reduced prices.

Exchange-Rate Adjustment

A unilateral reduction in the exchange value of the dollar is impracticable, partly because of its (still uncut) link with gold, partly because the rate for the dollar can never be less than what other countries are willing to pay for it. The proposal that countries with payments surpluses raise the exchange rates of their currencies is impracticable, partly because their governments are unwilling to act deliberately to reduce the competitiveness of their industries, partly because they can never be sure if the appreciation is not too little or too much and whether it would not prove completely wrong within a year or two. Just imagine France would have reacted to her supposedly persistent payments surplus by an appreciation of the franc, just before the enormous cost push of the summer of 1968. This French episode has taught us a lesson.

The point of it all is that a small adjustment of the exchange rate of the dollar can achieve without too much pain what a deflation in the United States could accomplish only with almost unbearable suffering. A deflation that could push extra quantities of American goods into export markets and empty American pockets sufficiently to reduce the demand for imports, together enough to close the chronic Transfer Gap, would be intolerable. But how can the required adjustment of exchange rates be managed?

My prescription is for a widening of the margin of permissible deviations from par values — the so-called band proposal. Under the present rules of the Fund, deviations of exchange rates in the free markets are limited to 1 per cent of parity in each direction. This limitation ought to be changed to permit wider deviations, perhaps 5 per cent up and down. Variations of exchange rates of this order of magnitude would allow the adjustment mechanism to operate on the international flows of goods and services. No government would have to take unpopular action; supply and demand would be allowed to determine exchange rates within the fixed limits; and any variations within these limits would reverse themselves when conditions change.

This is not the place to furnish details for my prescription, to evaluate the arguments of its opponents, or to examine how the very serious obstacles in the way to its acceptance can be overcome. The chief aim of this article was to explain the persistence of the Transfer Gap and to indicate what kind of measures can, and what kind of measures cannot, be helpful in closing it.

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