

An Exchange-Market Analysis of the U. S. Balance of Payments

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FINANCIAL WRITERS in the press, taking their cue from the government publications, are prone to speak of the balance of payments deficit as a simple case of the United States spending abroad more than it receives. They explain that the out-payments have exceeded the in-payments. And the man in the street nods his head. He knows what that is. But does he know how completely arbitrary and inconsistent is the concept of payments that must be used to arrive by this route at the official measure of the U.S. deficit? Let me give some examples. If a foreigner buys a U.S. product, his payment is, of course, recorded as such; but if he buys a U.S. security from a holder in the United States, the payment may or may not be so recorded. It all depends on what security he buys. If he buys the bond of a private company, the transaction is recognized as a payment, but not if he buys its short-term note. In the latter case, his payment is *not* a payment. If a U.S. resident buys a short-term note abroad, however, his payment is recognized as such. So also is his purchase of a foreign Treasury bond. But the foreigner's payment for a U.S. Treasury bond is not a payment even though his purchase of any other type of bond *is*. Similarly, the U.S. resident's acquisition of a deposit abroad is recorded as a payment; but a foreigner's acquisition of a deposit in the United States is not. It is obvious that this payments language is not what the man in the street thinks it is. Whether a payment is treated as such, or is recorded as not a payment, has nothing to do with whether a payment has in fact been made. It is treated as a payment or not a payment according to some quite different concept, which we shall come to after I have presented what might be termed the "exchange-market" approach to the balance of payments and am in a position to compare the official concept with it.¹

As a matter of fact, an economist should know right at the start that there cannot be any difference between out-payments and in-payments in the balance of payments as a whole. It is a double-entry system of

* On December 5, 1960, Mr. Gardner, Deputy-Director of the Research and Statistics Department, talked to a Harvard University seminar that was devoting the semester to study of the U.S. balance of payments problem. His talk represents his personal views and is reproduced here substantially as he gave it. The style of an oral presentation has been generally preserved. The tables, which in December ran only through September 30, 1960, now cover the entire year.

¹ See page 202, below.

accounting, and credits and debits (or payments received and made) must come out exactly in balance in the over-all statement. When we speak of surplus or deficit, we must be referring to a portion only of the balance of payments. We can have a trade surplus or deficit. We can have a similar gap in goods and services; or in the goods, services, and international transfers that make up the current account. A deficit in the current account must always be matched by a surplus in the capital account, and vice versa. All these accounts have their significance for different purposes; but when we speak of the surplus or deficit that moves the exchange rate of a country around and forces the monetary authorities to take financial action to keep it within the support points, we are talking of something much broader. We are talking of the miscellany of merchandise, service, and capital transactions undertaken because of the profit to be made or because of political or other ends that are sought for reasons of their own. If this great aggregate of what might be termed autonomous transactions does not balance out, the exchange rate of the country will be pushed up or down, and the authorities must supply whatever compensatory financing is required to keep the rate from moving outside the support points.² Thus we have autonomous transactions above the line matched by compensatory financing below the line. The compensatory financing may take the form of a movement of reserves, or a drawing on the International Monetary Fund (IMF), or the use of ad hoc loans or other financing for the purpose. It is only as we draw a line of this sort and group above it the autonomous transactions, and group below it the compensatory financing that comes into play only because the autonomous transactions fail to balance, that we see what it is that is pushing the country's international exchange rate up or down and creating an exchange-market problem.

Table 1 shows how the U.S. balance of payments looks when divided between autonomous transactions and compensatory financing. This highly simplified version of the balance of payments covers the last four years—the years in which the exchange-market deficit has assumed serious proportions. This deficit is shown in line F.³ After a substantial surplus in 1957, there was a deficit of \$3.0 billion in 1958, which declined to \$2.7 billion in 1959 and declined further in the first half of 1960. But in the latter half of 1960, the deficit increased again as open-market capital flowed out. Compare with this series of figures

² The support points may be specifically stated (e.g., \$2.78 and \$2.82 for sterling) or they may be, as in the U.S. case, merely the gold points resulting from the practice of the U.S. Treasury of freely buying and selling gold at fixed prices.

³ The term "exchange-market balance" used for item F is short for "autonomous exchange-market balance." It seems hardly necessary to retain the long and formalistic word "autonomous" since the content of the item is clearly stated (i.e., items D + E), and it is immediately followed by the compensatory financing which offsets it.

TABLE 1. ANALYTIC BALANCE OF PAYMENTS OF THE UNITED STATES, 1957-60¹
(Summary form of Appendix Table 2; in billions of U.S. dollars)

	1957	1958	1959	1960 ²	1960	
					First half	Second half ³
A. Market Goods and Services	8.6	5.2	2.5	6.4	2.7	3.7
B. Direct Investment	-2.1	-1.1	-1.3	-1.6	-0.6	-1.0
C. Noncommercial Transactions	-5.6	-6.2	-5.8	-6.1	-3.1	-3.0
D. Basic Balance (A through C)	0.9	-2.1	-4.6	-1.3	-1.0	-0.3
E. Open-Market Capital	0.7	-0.9	1.9	-2.4	0.2	-2.6
F. Exchange-Market Balance (D + E)	1.6	-3.0	-2.7	-3.7	-0.8	-2.9
G. Compensatory Financing						
1. U.S. loans	-0.4	0	0.4	0	0	0
2. IMF dollar assets	-0.4	²	0.3	0.7	0.2	0.5
3. Other official dollar assets		0.7	0.9	1.3	0.5	0.8
4. Gold	-0.8	2.3	1.1	1.7	0.1	1.6
Total Item G	-1.6	3.0	2.7	3.7	0.8	2.9
<i>For comparison with Item G above</i>						
Department of Commerce balancing item	-0.5	3.5	3.8	3.8	1.4	2.4

¹ For a detailed explanation of the items, see pages 206-08: Table 2, with its accompanying notes, and Table 3.

² Preliminary figures.

³ Less than \$50 million.

the deficit as shown by the U.S. Department of Commerce. For this purpose, the signs of the Department's balancing item as recorded in the last line of the table must be reversed. It is immediately evident that, compared with the exchange-market approach, these Department of Commerce figures substantially understate the surplus in 1957 and overstate the ensuing deficit through the middle of 1960. For the last half of 1960, however, they fall short of the full deficit by \$500 million. They indicate that the exchange crisis in the second half of 1960 was produced by a \$1.0 billion increase in adverse pressures on the exchange market, instead of by the \$2.1 billion increase shown in line F of Table 1. The exact nature of the difference will be clearer when we examine the U.S. concept of deficit in more detail later on; but first let us look at the analytic categories "above the line" in the table.

The first line in the table shows a category called "market goods and services." These are the goods and services that private residents of the United States are buying and selling in world markets. The transactions occur in response to profit opportunities, and the monetary authorities can influence them by altering markets and cost levels. Observe that the net balance of these transactions has changed considerably from year to year, although it has always been positive. Monetary policy acts with less immediate force on the direct investment recorded in line B. Investment of this sort by parent concerns in their branches or subsidiaries abroad is largely governed by long-term profit objectives and responds more slowly to cyclical changes, though it is

undoubtedly influenced by them. By way of contrast, the transactions gathered together under the designation "noncommercial transactions" in line C have nothing to do with markets and profit opportunities. They represent private transfers, military expenditures abroad, government aid to foreign countries, and the contractual interest received on the loans involved. They are mainly the fruit of political necessities. Governments may act on them for balance-of-payments reasons—in fact the President's balance-of-payments directive⁴ was aimed primarily at line C; but the action is political and on a wholly different plane from that of monetary policy. Since 1957, this stable group of noncommercial transactions has produced a net debit of about \$6 billion a year—more than enough to absorb the entire net return on market goods and services until the last quarter of 1960.⁵ When the outflow of U.S. direct investment is combined with it, the negative balance is even larger.

I have called the total of these transactions in line D the "basic balance" because they include most of the fundamental and persistent elements in the balance of payments. It is mainly these elements that monetary, fiscal, and political policy must manage to keep in adjustment over the years. The term "basic" is not intended to suggest that *all* the elements that make up this item are stable and lasting in character. As I emphasize later on, divergent phases of the business cycle in the United States and abroad may swell or contract the basic balance; and, of course, special factors, which may not last more than a year or two, also affect it. Moreover, at any given time, trend factors may be at work so that the balance in the years ahead will differ from this year's magnitude. One cannot conclude from the fact that it is in equilibrium at the moment that the equilibrium will necessarily last. All the factors at play in the balance must be analyzed before any forecast can be hazarded. What is meant here by referring to it as a "basic balance" is merely that it is in this area that monetary, fiscal, and political policies must effect the basic readjustments required to keep the exchange-market balance broadly in equilibrium over the business cycle as a whole.

Perhaps the most interesting item in the table is "open-market capital" in line E. It combines items which the Department of Commerce scatters among several different accounts, including the account that finances the balance of payments deficit. As can be seen from Table 2, I have gathered here all those forms of capital movement that can easily shift from market to market—a sort of footloose capital. Government loans abroad, included in item C2 of Table 2, are obviously *not* of this character. Nor is direct investment in line B, because the

⁴ The reference is to President Eisenhower's directive of November 16, 1960.

⁵ In the last quarter of 1960, these two items combined developed a surplus that was greater than the deficit for the first nine months.

parent concern is committed to its subsidiary by ties that cannot easily be broken. And compensatory financing in line G is not in response to market profitability at all; it comes into being solely because the autonomous transactions above the line do not balance. But *portfolio* investments in stocks and bonds can easily be liquidated on organized exchanges and their proceeds shifted from market to market according to where the chance for profit seems greatest. And private short-term dollar balances of foreigners, or U.S. balances in foreign countries, can be moved in whatever direction the best return is to be found. Finally, on the assumption that the fluctuations in net errors in the balance of payments computations largely reflect types of capital movement that escape the reporting system, I have included them also in open-market capital. It is possible that among net errors and omissions there is a relatively stable net credit of as much as half a billion dollars which reflects unreported service receipts, but the substantial *fluctuations* in net errors must largely reflect unreported capital.⁶

I am not suggesting that open-market capital is 100 per cent volatile. Many marketable securities are stowed away in safe deposit boxes where they may lie forgotten for extended periods while the market rises and falls. And a large part of the short-term funds may represent working balances which will be kept where they are irrespective of whether interest rates rise or fall. If it were not for holdings of this character, open-market funds would slosh from market to market like tidal waves in response to modest differentials. As it is, only marginal amounts move. The fact, however, that a marketable security or a short-term balance does not instantly move does not make it any the less an asset that *could* do so at any time. I, therefore, treat all open-market capital as potentially mobile even though only marginal movements occur in response to moderate inducements. The behavior of this group as a whole bears out the expectation that the wide swings back and forth will be found here, the extent of the swing depending on the strength of the inducement.

In 1957, and particularly in 1959, when money rates were relatively high in the United States, the flow of open-market capital, as shown in line E, was inward. In the recessions of 1954 and 1958, when the U.S. money market eased, such capital flowed outward;⁷ and in the summer of 1960, with the money market again easing in the United States and

⁶ If half a billion dollars of net credits were shifted each year from item E3 in Table 2 to item A4, the plus entries in item E (open-market capital) would be reduced, and the minus entries enlarged, but no signs would be altered and the *changes* in the flow from year to year would remain unaffected. The shift of credits to item A4 would, of course, have a corresponding effect on the level of items A and D (basic balance); but the exchange-market balance in item F would remain the same because of the offsetting change in the level of item E.

⁷ The outflow of open-market capital in 1954 (not shown in the table) was \$1.4 billion.

tightening abroad, there was a further sharp outflow. In fact, the story of 1960 is essentially one of a striking improvement in the basic balance overborne by a drastic reversal in the open-market capital flow. The outflow of open-market capital in the second half of 1960 amounted to \$2.6 billion despite the fact that the deficit in basic transactions had been reduced to \$0.3 billion.⁸

If we could trust the improvement in the basic balance to continue, this would be a classic case for taking no other action than to use reserves freely in financing the outflow of open-market capital. The whole history of this item E would indicate that the outflow was a temporary phenomenon. In part, it reflects merely the present phase of the cycle, which has led to easy money in the United States at a time when capital markets abroad have been generally firm. The decline on the U.S. stock market may also have been a factor. And in part it undoubtedly reflects some loss of confidence in the dollar. But the cyclical phase of slowdown in the United States and boom in major countries abroad will pass. With it will go the wide differential in money-market levels. And why should a lack of confidence in the dollar persist if the basic balance is securely established? If that is the case, time will increasingly demonstrate the foolishness of the fears that were aroused. Thus, on the assumption that the basic international transactions of the United States are securely in balance, nothing more is required than to finance without excitement a temporary deficit that will automatically disappear. U.S. gold stocks are ample for the purpose.

But can we safely assume that a sound basic balance is here to stay? There are powerful reasons for believing that that point has not yet been reached. The same divergent cyclical movement that has turned the inflow of open-market capital into an outflow is undoubtedly responsible for a large measure of the improvement in the basic balance itself. U.S. exports have been stimulated by poor domestic markets and strong markets abroad, and imports have been checked by the slowing down in the United States. Just how great the impact has been is hard to judge, for previous periods are rendered almost useless as precedents by abnormalities such as the aftermath of the Suez crisis, the prevalence of rigid trade controls, or other special factors. It seems probable, however, that much of the improvement of \$4 billion in the basic balance in the second half of 1960, compared with 1959, reflects the divergent cyclical impact. If this is the case, one must reckon with a possible adverse influence of several billion dollars on the basic balance as recovery from the present slowdown gathers force.

⁸ If the adjustment indicated in footnote 6 were made, basic transactions in the second half of 1960 would be close to balance, and the figures for open-market capital outflow would be larger.

This is not to say that full recovery in the United States must inevitably create a deficit of several billion dollars in the basic balance. In the first place, an adverse influence of this magnitude would probably develop only if there was a simultaneous recessionary tendency abroad. In the second place, I have not attributed the whole of the 1960 improvement in the basic balance to the cyclical factor. There has undoubtedly been a *trend* improvement as well. If this can be kept going, it may well offset over the next few years the adverse influence on the U.S. balance of payments of a full recovery in the U.S. economy. Needless to say, such a recovery is a highly desirable goal in itself. The problem is to achieve it on a basis of declining costs that will make U.S. industry strongly competitive in world markets.

In theory, the sort of measures that would achieve this goal are not too difficult to visualize. Fiscal and credit policy might be aimed at holding the increase in wages and other factor incomes below the annual increase in national productivity. This would involve no decrease in money wages; but it would permit a moderate reduction in U.S. prices while boom conditions abroad were pushing costs higher in Germany and Japan and other industrial countries. Both lower relative money incomes in the United States and more competitive prices would tend to increase the export surplus. This is the normal way of strengthening the basic balance of payments.

There may be, however, a major threat to the continuance of such a policy. It lies in the unemployment created by monopolistic or semi-monopolistic action on the part of business and of trade unions in the U.S. market. When the monetary authorities aim at maintaining a final demand sufficient to clear full-employment output at a stable over-all level of prices, the forcing up of prices by monopolistic action—either directly or through raising money wages faster than national productivity—will inevitably price goods and labor out of the market. The failure of the post-1958 recovery to reabsorb the abnormal segment of unemployed labor and plant into the productive process, despite a gradually rising level of prices, and the frequent experience of reduced net income even where the volume of sales was increased, suggest that a cost-hurdle may have been created which can be cleared only if prices rise more sharply. And if full absorption of the unemployed is sought solely by fiscal and credit measures that increase demand, the cost-hurdle may be raised again and again. A more rapid rise in costs and prices in the United States than in other major industrial countries will worsen the basic balance in its international transactions. As I have already noted, the near balance that was achieved in the summer of 1960 is precarious and will be affected adversely by recovery in the United States, particularly if it is accompanied at that time by a slowing

down abroad. Therefore, the United States must further strengthen its competitive position, and this means controlling any threat of a cost-push that may be shaping.

Obviously, the problem of maintaining a basic balance will be eased to the extent that the official program achieves a relaxation of the barriers that are still in effect against U.S. exports and, also, to the extent that the outflow in the "political category" (item C) can be curtailed. But it would be unsafe to count too much on such efforts. While they are well worth making, the gains are likely to be gradual; meanwhile, the pressures are building up for increased foreign aid, and for a stronger military posture abroad, on a scale that may easily offset them.

This then is the sort of story that can be told on the basis of the presentation in Table 1. Each category of that table is designed to facilitate analysis. Now I should like to revert briefly again to the official measure of deficit that I questioned at the outset. I then poked a bit of fun at the misleading net payments language as used by the financial writers; but I put off discussing just what the official measure was and what seemed to be the real philosophy behind it. For that purpose, we may take the figures in Table 1 for 1959. For that year, line F shows a deficit of \$2.7 billion. The official U.S. figure is \$3.8 billion.

The explanation of this U.S. figure can best be given in terms of the financing of the deficit, i.e., item G in Table 2 and the balancing item (shown in the bottom line) as published by the Department of Commerce. My items G2, 3, and 4 are included in the Commerce balancing item. The difference between the two treatments lies in the fact that the Department (1) puts into its balancing item below-the-line transactions in short-term dollar assets and U.S. Government bonds held by private individuals, firms, business corporations, and commercial banks abroad, or by international organizations other than the IMF, instead of entering all these items as open-market capital movements above the line,⁹ and (2) puts compensatory transactions in U.S. loans above the line instead of in the balancing item. For example, the Export-Import Bank loan to the United Kingdom (item G1), which was used in 1957 for the same compensatory purposes as the British drawing on the IMF (item G2), is entered above the line in the Department's statement; and the advance repayment of this loan as a result of a British surplus and a U.S. deficit

⁹ When commercial banks act as agent of the central bank, or *de facto* in that capacity, their transactions should be treated as virtually official and included in compensatory financing. In a convertible currency world, however, they are more likely to be in business for themselves. Like other transactors in open-market capital (or, for that matter, like traders in goods and services), they leave the problem of maintaining the exchange rate within the support points to the monetary authorities, whose responsibility it is. A more detailed discussion of the behavior of these balances is included in the Appendix.

in 1959, along with other advance repayments, is entered by the Department above the line rather than as part of the balancing item as in my table (item G1).

It is clear that, in its balancing item, the Department of Commerce has in view something other than to show the deficit or surplus in autonomous transactions and the compensatory financing required to cover it in order to hold exchange rates within the support points. This different focus appears to be a specially defined "reserve ratio." It is the ratio of gold in the hands of the U.S. monetary authorities to (1) foreign short-term assets in the United States plus (2) foreign holdings of U.S. Government bonds. All international transactions that affect this ratio are entered above the line, and the ratio items themselves are entered below the line, irrespective of what their impact is on the exchange market.

The focus on this ratio¹⁰ appears to reflect a concern over the possible withdrawal of liquid foreign assets from the United States should an adverse situation develop—one such as, in fact, led to a heavy outflow of open-market capital in the second half of 1960. Such concern is understandable. But it is clear that the change in this ratio in, say, 1960 is not a measure of the market pressures that were acting on the dollar exchange rate in 1960 and were forcing the monetary authorities into compensatory financing during that period. Rather, it is an indication of how future movements of open-market capital may impinge on the U.S. gold supply in the years ahead. And, for this purpose, the ratio chosen seems to embody only a fragment of the potentialities of the open-market movement. It leaves out the \$11 billion of foreign-held portfolio securities in 1959, most of which are stocks that could be liquidated overnight by orders placed with stock exchange brokers. Of far greater importance, however, is the liquid U.S. capital that can flow abroad as stock markets and interest rates shift or confidence in the dollar weakens. The domestic liquid assets of U.S. residents are immense. Money, time deposits, savings and loan accounts, and marketable U.S. Government securities amount to \$500 billion; in addition, there is the whole range of private securities for which a ready market exists. And extensive borrowing facilities are available. In short, there is virtually no limit to the amount of U.S. funds that could flow abroad if the inducements were sufficient. The picture that the Department of

¹⁰ This U.S. reserve ratio has nothing to do with legal gold liabilities. It includes liabilities to foreigners that are not legal liabilities of the monetary authorities at all—e.g., liabilities of the commercial banks. Moreover, liabilities to individuals, commercial banks, and other business corporations abroad are not payable in gold. Dollars are redeemed in gold only for foreign central banks and governments. But an outflow of open-market capital (or adverse developments elsewhere in the balance of payments) may shift dollars to central banks abroad, which may then convert them into gold.

Commerce balancing item gives of the change in the ratio of reserves to certain liabilities is a picture that touches only the fringe of this potential problem. The greatest possibilities for mischief lie in the very categories that are omitted from the Commerce package.¹¹

The only way in which the United States can successfully keep this open-market capital threat from materializing is to continue to work toward a sound basic balance—the balance shown in item D of Table 1. If it does so, the open-market movement can be trusted to behave. There will always be fluctuations as cyclical business movements, and the monetary policies associated with them, follow different paths in different countries; but these can be handled by compensatory financing. Indeed, the prevailing tendency of open-market capital (cyclical movements aside) may well be inward over the years, since New York is a reserve center and security markets in the United States have a strong attraction for investors all over the world.¹² Most of the U.S. private capital flow to less developed countries takes the form of direct investment (item B); and, although Europe offers some interesting possibilities for portfolio investment, these may not last as Europe's own savings capacity increases and its capital needs slow down.

I have been talking of the importance of achieving a basic balance in U.S. international transactions over the course of the business cycle; but I should not want to leave the impression that I regard the U.S. deficits of recent years as something to be deplored. On the contrary, from a world standpoint, they have been a constructive development.

¹¹ While the deficit shown in the 1960 balance of payments should measure exchange-market pressures in 1960, which is what the deficit shown in line F of my table does, a good case could be made for showing something like the Department of Commerce ratio in a memorandum item. The ratio should relate *total* gold reserves (not just the *change* in the total during 1960) to total readily marketable dollar assets of foreigners. These readily marketable dollar assets would include portfolio securities as well as short-term dollar assets held by foreigners. Such a ratio would at least indicate the potential impact of foreigners' future withdrawals on the U.S. gold supply. There is no accurate way of measuring the potential outflow of U.S. funds in future years, but the fact that such an outflow might far exceed the foreign withdrawals could be noted in connection with publication of the ratio.

It may be thought a somewhat paradoxical feature of this ratio approach that it registers a U.S. deficit when private foreign funds are attracted to this country and a surplus when they are withdrawn—i.e., just the opposite of their impact on the exchange market. But once it is appreciated that the ratio looks to future years rather than to the present year, the paradox is explained; for the inflow of private balances in 1959, though it strengthens the dollar exchange rate in that year, creates the possibility of withdrawals in the 1960's; and, when such withdrawals actually occur in 1960, they reduce the possible scope of future withdrawals and thus strengthen future balance of payments prospects even though they weaken the exchange rate of the dollar in 1960.

¹² This is suggested by the figures for item E over the past decade. It is true that, if \$500 million is shifted from item E3 to item A4 (see footnote 6), any evidence of an inward tendency in item E disappears; but in that case the basic balance is improved by \$500 million. If the shift is *not* made, the prevailing inflow in item E should be taken into account as a separate factor tending to support the basic balance in item D.

They have diverted some of the disproportionately large U.S. reserves to the rest of the world and have helped to build up independent reserves there. They have supplemented gold production with U.S. gold and U.S. dollar balances, thus creating a stronger international situation at the very time when the venture into currency convertibility was being undertaken. It is essential, however, that the world should not get the idea that the United States has lost control over its balance of payments. The time has come to demonstrate that it is master in its own house—that the potentialities of the cost-push do not pose an insuperable problem for monetary policy. Once such a demonstration has been convincingly made, there is no reason why, in the future, there might not be other periods in which a run of U.S. balance-of-payments deficits would serve a constructive end.

APPENDIX

Tables 2 and 3 below are designed to explain more fully the content of Table 1. Some readers may, in fact, prefer to use Table 2 in place of Table 1.

TABLE 2. ANALYTIC BALANCE OF PAYMENTS OF THE UNITED STATES, 1957-60¹
(In billions of U.S. dollars)

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

¹ For a detailed statement of the content of most items in this table, see General Note below.

² Preliminary figures.

³ Under the Anglo-American Financial Agreement as amended, the United Kingdom borrowed \$122 million in 1957 (item G1), paid \$73 million of interest (item C3), and repaid \$49 million of principal (item C2). These amounts are not entered in the U.S. balance of payments statistics.

⁴ Less than \$50 million.

GENERAL NOTES TO TABLE 2

Market Goods and Services (item A) exclude military aid exports (in 1959 military aid amounted to \$2.0 billion). The government transfers involved in military aid are likewise excluded from item C2. Other tied financing, and the goods and services tied to it in such a way as to create a noncommercial package, cannot readily be excluded. It might be possible and desirable, however, to record *all* government aid, including military, in item C2 and to begin the subitems under item C with a new entry, "special aid exports," under which there would be two subitems, (a) "military" and (b) "agricul-

tural surplus disposal." These exports of goods and services would not be included in "market goods and services." At present, only military *aid* exports are excluded from item A. But items C1 and C3 include nonaid goods and services of a nonmarket character, which also are not part of item A. Reinvested earnings on direct investments are omitted since they are not available for periods shorter than a year. See next item.

Direct Investment (item B) is that of U.S. residents only. For foreign direct investment in the United States, see "portfolio securities" (item E1). The data do not include reinvested earnings. This omission offsets the omission under services above (see item ²A).

Government Aid Abroad (item C2) includes noncompensatory loans of the Export-Import Bank of Washington (\$0.3 billion in 1959) and other nonmilitary noncompensatory loans, balances, and grants of the U.S. Government in connection with Mutual Security, agricultural surplus disposal, etc. Repayments of loans are an offset to total aid. Military aid is excluded (see note on item A).

Government Interest Receipts, etc. (item C3) include interest received on U.S. Government loans and net receipts on other government transactions involving embassies, pensions, etc. For convenience, the small receipts of U.S. military agencies are also included here.

Private Transfers (item C4) include immigrant remittances, charitable gifts, and other private transactions involving no quid pro quo.

Portfolio Securities, etc. (item E1) include some loans and other long-term claims. They further include a small amount of foreign direct investment in the United States, which conceptually belongs in item B, but which is somewhat difficult to separate out in the statistics.

Short-Term Liabilities to Commercial Banks (item E2bi) include some U.S. Government securities with a maturity of more than one year.

Short-Term Liabilities to Other (item E2bii) include liabilities to international organizations other than the International Monetary Fund, the Bank for International Settlements, and the European Payments Union/European Fund, as well as liabilities to business corporations, firms, and individuals. Holdings by international organizations of U.S. Government securities with a maturity of more than one year are included.

U.S. Loans (item G1): In 1957, the United Kingdom drew \$250 million of compensatory financing in the form of a loan from the Export-Import Bank; and the U.S. statistics do not enter \$122 million of compensatory financing borrowed net under the Anglo-American Financial Agreement of 1946 as revised in 1957. In 1959, compensatory financing in the form of advance repayments by the United Kingdom, Germany, France, and Mexico on U.S. Government loans amounted to \$435 million.

IMF Dollar Assets (item G2) include (as a debit of \$1,375 million) the U.S. subscription to the International Monetary Fund in June 1959. The gold counterpart of this subscription (\$344 million) is entered as a credit in item G4, and the dollar balance counterpart (\$1,031 million) as a credit in item G2, thus making the net entry in item G2 from this transaction a debit of \$344 million.

Other Official Dollar Assets (item G3) represent short-term liabilities to foreign central banks and governments (including the Bank for International Settlements and the European Payments Union/European Fund) as well as their holdings of U.S. Government securities with a maturity of more than one year.

Department of Commerce Balancing Item equals the sum of items E2b, G2, G3, and G4.

TABLE 3. DERIVATION OF TABLE 2 FROM THE U.S. BALANCE OF PAYMENTS DATA AS PUBLISHED BY THE U.S. DEPARTMENT OF COMMERCE

Item in Table 2	Data for 1959 (million U.S. dollars)	Derived from Following Items ¹
A. Market Goods and Services		
1. Exports	16,225	4
2. Imports	-15,315	14
3. Trade Surplus	910	
4. Net Services (excl. item C)	1,619	5,6,7,10,11,15, 16,17,20,21
Total item A	2,529	
B. Direct Investment	-1,310	32
C. Noncommercial Transactions (excl. item G)		
1. Military expenditures	-3,090	19
2. Government aid abroad	-2,416	28, 38*, 39*, 40
3. Government interest receipts, etc.	249	8, 9, 12, 18, 29
4. Private transfers	-563	26
Total item C	-5,820	
D. Basic Balance (A through C)	-4,601	
E. Open-Market Capital (excl. item G)		
1. Portfolio securities, etc.	-354	33, 34, 35, 42
2. Short-term		
(a) Assets	-89	36
(b) Liabilities to		
(i) Commercial banks	1,359	43*, 44*
(ii) Other	246	43*, 44*, 45
3. Net errors	783	48
Total item E	1,945	
F. Exchange-Market Balance (D + E)	-2,656	
G. Compensatory Financing		
1. U.S. loans	435 ²	38*, 39*
2. IMF dollar assets	261 ²	38*, 44*
3. Other official dollar assets	885 ²	43*, 44*
4. Gold	1,075	46
Total item G	2,656	
<i>For comparison with item G above</i>		
Department of Commerce balancing item	3,826 ³	38*, 43, 44, 45, 46

¹ Numbers refer to lines in U.S. Department of Commerce, *Survey of Current Business*, June 1960, Table 3, pp. 14-15.

² For details of these items, see General Notes to Table 2.

³ Part of item, i.e., the Commerce item is divided among several items in Table 2.

Note on the Behavior of Commercial Bank Balances

As is noted in the text, three factors account for the difference between item G (compensatory financing) and the balancing item of the Department of Commerce statement. They are as follows: (1) compensatory U.S. loans—item G1; (2) commercial bank balances—item E2bi; and (3) other private balances—item E2bii. It seems quite evident that the private balances of individuals or businesses other than banks—item (3) above—are moved about solely to serve the purposes of the owners (i.e., for profit, convenience, etc.), rather than for the purpose of holding the country's exchange rates within the official support points. From the standpoint of exchange-market analysis, they belong where I have placed them, in open-market capital "above the line." It seems equally clear that compensatory U.S. loans (item G1) belong "below the line" where I have put them, although the question whether loans or repayments are compensatory may not be entirely clear in every case, and hence, for statistical precision in the standard table, all compensatory loans might be left in government aid abroad (item C2), but noted separately in a memorandum item attached to the table.

Ordinarily, however it is not in these two categories that the major statistical differences with the Department's balancing item occur. The striking statistical difference comes from the treatment of commercial bank balances. These have been characterized by swings of substantial magnitude. The question whether the swings reflect the market inducements that play upon other types of open-market capital, or whether they are in practice only an extension of the compensatory financing of the monetary authorities, is therefore, of special importance.

In the early postwar period, when full-fledged exchange controls were in operation in most countries and commercial banks handled their foreign assets in accordance with the instructions of the central bank or the treasury, there were strong grounds for assuming that movements in commercial bank balances were part of the compensatory financing operations of the monetary authorities. In more recent years, as exchange controls have been dismantled in the industrial countries and the commercial banks have been free to acquire balances at their own discretion and to seek the best returns, the presumption has shifted. One would now suppose a priori that commercial bank balances would behave like other forms of open-market capital. This presumption is tested in Table 4, where commercial bank balances (item E2bi) are shown separately from the remaining open-market capital items and are placed side by side with official balances (item G3), which, in turn, are shown separately from the other compensatory financing items. This enables one to see at a glance whether, in recent years, movements in commercial bank balances have been similar to the movement of other open-market capital or to the movement of official balances.

TABLE 4. GROUP BEHAVIOR OF COMMERCIAL BANK AND OFFICIAL BALANCES
IN THE UNITED STATES
(Data from Table 2, in billions of dollars¹)

	Item E: Open-Market Capital Movements		Item G: Compensatory Financing	
	E1, E2a, E2bi, and E3	E2bi: Commercial bank balances	G3: Official balances	G1, G2, and G4
1957	0.6	0.1	3	-1.5
1958	-0.9	2	0.7	2.3
1959	0.6	1.4	0.9	1.8
1960	-2.6	0.1	1.3	2.4
Second half of 1960	-2.0	-0.7	0.8	2.1

¹ Some minor differences are due to rounding.

² Less than \$50 million.

In the first two years recorded in the table, commercial bank balances showed little volatility. Money-market rates were relatively firm in the United States in 1957, and open-market capital movements were inward; but the inflow of commercial bank balances was small. Official balances remained virtually unchanged; they would normally have been drawn down in that year since the rest of the world was in deficit with the United States, but this deficit was covered by other forms of compensatory financing.

In 1958, money-market conditions were reversed and so was the flow of open-market capital. It turned outward. But the only response of commercial bank funds was that the small inflow of 1957 ceased altogether in 1958. Official balances, on the other hand, increased substantially because in 1958 the rest of the world developed a large surplus with the United States. In 1959, this surplus continued and official balances continued to grow at about the same rate. Their movement reflected the continuing surplus with the United States rather than the shift from ease to extreme firmness in the New York money market. The money-market reversal, however, found full reflection in the behavior of the commercial banks, which were now operating under conditions of well-established convertibility and greater freedom to respond to profit opportunities. The inducement was particularly strong because the tightening of the New York money market was accompanied by an easing in most of the major money markets of Europe. The change in the movement of private funds, compared with the previous year, was \$1.4 billion for the commercial banks and \$1.5 billion for other forms of open-market capital.

As 1960 progressed, the relationship between the New York money market and major centers abroad again underwent a sharp reversal. The gap was at its maximum during the second half year. If we look first at the year as a whole, we see that the massive inflow of commercial bank funds that had characterized 1959 melted away almost to nothing, while official balances rose by an unprecedented amount because of the enlarged surplus of the rest of the world with the United States. Developments in the second half of 1960 were even more dramatic. During this period of crisis, some \$700 million of commercial bank funds were withdrawn from the United States, while official balances increased by \$800 million. The two types of balance moved in exactly opposite directions, as did the two broader categories of which they were parts. The outflow of commercial bank funds, far from providing compensatory financing, increased the need for it. Thus, the last two years provide unmistakable evidence of the freedom that commercial banks now have to seek the most profitable outlet for their funds in the market—a freedom which they exercise in ways that may intensify the difficulties of the monetary authorities in their efforts to hold exchange rates within the support points. To assume that the commercial banks are still functioning virtually as agents of the central banks today, with little scope for taking advantage of money market differentials, would be quite unrealistic. The record of recent years is emphatically to the contrary.¹³

One other table may be of interest to the reader. Since it has been suggested in some quarters that, notwithstanding the evidence to the contrary, there may be a substantial element of compensatory financing in the movement of commercial bank balances, I have prepared a table to show how this would influence the picture. For the purposes of this table, I have made the quite liberal assumption that there is an element of compensatory financing in the movement of commercial balances equal to half the movement in official balances. The assumption seems liberal because the movements in official balances are 100 per cent compensatory financing. I then record

TABLE 5. THREE SETS OF DATA ON OPEN-MARKET CAPITAL AND EXCHANGE-MARKET BALANCE¹

(Change from preceding year's flow²; in billions of U.S. dollars)

	Open-Market Capital			Exchange-Market Balance ³		
	Omitted ⁴	Included ⁵	Split ⁶	Omitted ⁴	Included ⁵	Split ⁶
1958	-1.5	-1.6	-1.9	-4.4	-4.5	-4.9
1959	+1.5	+2.8	+2.8	-1.0	+0.4	+0.3
1960	-3.2	-4.4	-4.6	-0.2	-1.1	-1.3

¹ From Tables 2 and 4. Some minor differences are due to rounding.

² Increased debits or decreased credits are minus.

³ This is the surplus or deficit financed by the compensatory or balancing item. The financing items, of course, would carry the opposite sign.

⁴ This is the Department of Commerce's treatment as far as commercial bank dollar assets are concerned. Other private short-term dollar assets, however, are here included in "open-market capital" although the Department enters them in its balancing item (corresponding to "compensatory financing").

⁵ Same concept as that in Table 2.

⁶ Assuming a compensatory segment in the movement of commercial bank balances equal to half the movement in official balances, which are entirely compensatory. These assumed compensatory movements of commercial bank balances are deducted from "open-market capital," and hence from the "exchange-market balance," in the columns headed "Split."

¹³ Needless to say, this is a sphere in which more detailed studies would greatly enrich our knowledge of the complex of influences that account for the movement of commercial bank balances. Conceivably, these studies would show that a substantial segment of these movements was still undertaken for the purpose of holding exchange rates within the official support points, even at a sacrifice of the bank's profits. My own belief is that these studies will only serve to show the complex forms that profit calculations can sometimes take. But until such studies are made, the evidence is, of course, not absolutely conclusive.

in the table the story of changes in the flows from year to year as they would look on three assumptions: (1) that the movements of commercial bank balances are *omitted* in toto from the open-market capital movement and placed "below the line," as in the Department of Commerce treatment; (2) that commercial bank balances are *included* in toto in the open-market capital movement, as in my tables; and (3) that commercial bank balances are *split* between open-market capital and compensatory financing on the basis described above. The effect of these assumptions on the statistics of the open-market capital movement and the exchange-market balance is shown in Table 5.

The evidence of this table is unmistakable. Even if one assumes a substantial compensatory element in the movement of commercial bank balances, as in the column headed "Split," the story as told in the column headed "Included" comes far closer to the assumed truth than the story as told in the column headed "Omitted." That is, the story told in my Tables 1 and 2 would be far closer to the correct Exchange-Market Balance than the story told in the Department of Commerce figures, even if commercial bank balances in fact supplied an amount of compensatory financing equal to half that supplied by official balances.

Once again, however, it is necessary to recall, as was done in footnote 11 above, that the Department of Commerce balancing item is designed to alert government officials and others to potential future impacts on the balance of payments rather than to measure the exchange-market impact during the current period. From this standpoint, the very fact that commercial bank balances are now free to respond to interest differentials and other market factors becomes a reason for putting them in the Department of Commerce balancing item. That is, the same interpretation of the behavior of these balances that leads me to include them in my Open-Market Capital item "above the line" leads the Department of Commerce to put them in its balancing item "below the line."