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Editorial Note

The significance of the "errors and omissions" item in the United States balance of payments (which has assumed relatively large proportions in the last few years) was recently brought up for renewed discussion by a memorandum written by Hans J. Dernburg of the New York Federal Reserve Bank. This article gave a historical review of the "residual item," together with a discussion of its various possible components. A subsequent article written by J. H. Adler, also of the New York Bank, was directed to a more specific thesis: namely, the relation between hidden capital movements and the "errors and omissions" figure. Since the Adler view is a controversial one, we have reproduced it herewith, together with a further discussion and comment by Miss Jaffy of the Board's staff.

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CLANDESTINE CAPITAL MOVEMENTS IN BALANCE OF PAYMENTS ESTIMATES John H. Adler

The exceedingly large amounts recorded as "errors and omissions" in the balance of payments statements of the United States in 1947 and 1948 1/ have been interpreted in various quarters as indicative of a substantial volume of hidden capital movements to the United States, apparently induced by a desire to evade exchange controls and taxation, or to avoid losses through exchange devaluation. It is the purpose of this note to show that technically there is little quantitative relationship between the volume of capital flight and the amounts shown as "errors and omissions" in the balance of payments statements.

It is a truism that theoretically there is no room for "errors and omissions" in balance of payments statements, since all entries under "receipts" (both from current account and from capital transactions) give rise to a corresponding entry or series of entries under "payments" (whether on current account, capital transactions, or both). Because balance of payments estimates for each item are compiled from data that are statistically independent, however, they result in "errors and omissions," which represent the difference between the sum of all individually estimated receipts and the sum of all payments. The point is that "errors and omissions" is the only entry in balance of payments estimates that is not estimated individually but is a derived figure. It is simply the residual of a mathematical operation.

The "proof" that there is no connection between the size of hidden capital movements and the amount of "errors and omissions" can be best presented in the form of four different "cases" of transactions giving rise to an increase (or decrease) of hidden claims of foreigners against United States residents, including financial institutions.

Case One: Foreign exporter A (of country A) agrees with importer B (of country B) that he will underinvoice his shipments of merchandise. Importer B consents either to hold in trust the difference between the invoice value and the real sales value, or to turn the difference over to a

1/ $1,004 million and $1,242 million, respectively. Cf. Walther Lederer, "International Transactions During 1948," Survey of Current Business, March 1949; pp. 14-18; also Survey of Current Business, June 1949, pp. 4-7, where revised figures for 1948 are shown.

third resident of country B nominated by foreign exporter A. The "true" value of the merchandise is, say, $1,500, but the invoice shows only $1,000. In the statistics of country A exports of $1,000, and in country B imports of $1,000 are recorded.2/ When payment is made the deposits of A's bank with its correspondent in country B increase by $1,000.

In the balance of payments estimates of country A the increase of exports is shown under "receipts for goods and services."3/ The increase in the deposits of bank A with its correspondent in country B is reported as an "outflow" of short-term capital. In country B the balance of payments estimates show under "payments for goods and services" an increase of imports of $1,000; and under "movements of foreign short-term capital" an "inflow" of $1,000, reflecting the increase of "liabilities to foreigners" of the banking system of country B, due to the increase in the deposits of bank A in country B.4/

Thus the balance of payments estimates of both countries are "in balance"--no error or omission occurs. The difference between the (false) invoice value and the "true" value of the shipment, i.e., $500 which represents the amount of the hidden capital flight, is "lost" in the goods and services estimates of both countries, as well as in their capital movement estimates. It does not appear anywhere in the balance of payments of either country, and, therefore, has no bearing on the size of "errors and omissions."5/

A variation of this case is a hidden capital movement, arranged through the overvaluation of exports from country B to country A, with importer A paying an amount in excess of the agreed-upon cost of the exported merchandise and exporter B holding the excess payment for importer A.

Case Two: A resident of country A (where prohibitions against capital exports exist but can be easily circumvented) purchases from a bank in country A currency of country B and deposits the proceeds of this transaction in a bank in country B. If his account in country B is reported--as it should be--as a "foreign account," liabilities of country B to foreigners remain, in the aggregate, unchanged, since the account from which the transferred funds were sold

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2/ Unless the customs authorities decline to accept the invoice value and determine the "proper" valuation by administrative decision.

3/ The terminology of the American balance of payments and capital movement estimates is used throughout this paper. The example assumes the American practice of reporting periodically changes in "liabilities to foreigners," i.e., preparing direct estimates of capital movements.

4/ Alternatively the payment can take the form of a decrease in short-term liabilities of country A and in short-term assets of country B. The results are the same in either case.

5/ This does not mean, of course, that the hidden capital movement does not affect the balance of payments of the two countries. If initially exports and imports of country A were in balance, the underinvoicing of exports will result in an import surplus. This surplus presumably would be offset by a loss of foreign exchange reserves (an inflow of short-term capital, or a loss of gold). Conversely, country B would record an export surplus, balanced by an outflow of short-term capital, or an inflow of gold. But there is no reason to assume that this would result in an entry under "errors and omissions" in either of the two countries' balance of payments estimates.

decreases, while the private account of resident A increases. From the point of view of country B, no change that would ordinarily be reflected in the balance of payments takes place unless a statistical distinction is made--presumably in separate statistics on capital movements--between liabilities to foreign banks and liabilities to "other" foreigners. In that case liabilities to foreign banks decline, while liabilities to "other" foreigners increase.6/

Case Three: Case Two gives rise to an addition to "errors and omissions" in the balance of payments of country B only if the transfer of the funds of resident A is made, not to his own account in country B which is reported as a "foreign" account, but to an account of his own or of a resident of country B (a dummy), which account is reported as a domestic account. Actually, no change in the balance of payments has occurred, but the statistics will record a capital inflow into B (since bank balances reported as "foreign" have been reduced) to which there is no offset. Thus the transaction gives rise to an entry under "errors and omissions."

Case Four: This case is the same as Case One; except that the importer B, in country B, deposits the difference between the invoice value and the true value of the merchandise purchased from A, in an account under A's name.7/ As a result, an increase in country B's reported liabilities to foreigners takes place which is shown in the balance of payments statement as an inflow of foreign capital. This payment to a foreigner is not offset by an increase in imports from, or other current transactions with, foreign countries, and, therefore, results in an addition to "errors and omissions."

The four cases show that only the third and the fourth types of hidden capital movements give rise to an entry under "errors and omissions." But the two types of transactions differ in one important respect. While in the third case "errors and omissions" offset a deficiency of receipts from foreigners, the fourth case reflects an unaccounted payment to foreigners. Or to put the same proposition in different terms, the third case represents a drain on the supply of currency of country B available to country A; in Case Four an unexplained addition to the supply of B currency available to foreigners occurs. If the volume of transactions of the third type is of the same order of magnitude as that of the fourth type, the resulting "errors and omissions" cancel out, because in one case the "errors and omissions" are positive, in the other negative.

6/ But from the point of view of the banking system, and more specifically, of the foreign exchange control authorities of country A, a decline in its foreign exchange holdings takes place if the resident fails to report his newly-acquired foreign exchange holdings. Since ex hypothesi this is a clandestine transaction, based, say, on faked bills of lading, resident A, of course, will not report. Thus a discrepancy between the international payments and receipts of country A arises which will result in an "unexplained" decline in visible foreign exchange holdings--and in an addition to "errors and omissions."

7/ For practical purposes, it would be necessary also to give A's foreign, or any other foreign, address; otherwise the banking institution would fail to report the deposit as a foreign liability.

In 1947 and 1948, "errors and omissions" in the United States balance of payments always represented a drain on the supply of dollars.8/ That seems to indicate that whatever hidden capital movements are included in "errors and omissions" represent transactions of the third type, or more precisely, the difference between transactions of the third and fourth types. The question then arises as to the importance, in practice, of the third type. It appears to be of importance only if resident A, who acquired at one time dollar balances and held them under his name and address, is afraid that the exchange control authorities of his country may discover his "hoard"; and he, therefore, chooses to "cloak" his dollar holdings by transferring them to a dummy in the United States.9/ It may well be that during the postwar year these "unrequited" transfers of funds from foreign to pro forma American ownership were of some quantitative importance, but for two reasons their significance must not be exaggerated. In the first place, foreign funds that were "frozen" by the United States Treasury in the course of the war could be unfrozen only through a certification procedure normally involving the exchange control authorities of the foreign national owning the dollar funds. Thus a pro forma change of ownership was in many instances prevented. Secondly, for reasons of convenience, foreign residents may decide to open and maintain accounts in the United States not as United States residents, nor as residents of their own country, but with an address in a third country.10/ Then we have Case Two and no "errors and omissions" occur; the creation of the dollar balance gives rise to an increase in United States liabilities to foreigners, although the liabilities appear in statistics on capital movements with respect to the "wrong" country. There are no reasons to assume that in the last two years large shifts of dollar balances from accounts of "third countries" to American dummy accounts have taken place.11/ But whatever was the magnitude of the cloaking of foreign dollar holdings as United States accounts, it must be realized that it did not represent a real drain on the exchange reserves available to foreign governments, or their exchange control authorities--because the existence of the balances was unknown to them in the first place.

It is questionable whether hidden capital inflow of the fourth type were of major significance. Ever since the fall of 1948, rumors about an impending devaluation of foreign currencies have been abroad. They certainly offered strong incentives to capital flight--which would have to appear as positive "errors and omissions" in the United States balance of payments. As a matter of fact, the positive "errors and omissions" declined considerably in the last quarter of 1948 and in the first two quarters of 1949, but it would be rather farfetched to interpret this as indicating the occurrence of negative entries, offsetting in part the positive amounts.

8/ They are shown with a positive sign in the accounts of international transactions. In the tables showing the "means of financing" of American exports of goods and services they appear with a negative sign (indicating a deduction from the dollar supply available to foreigners).
9/ In the case of security holdings an additional reason would be the discriminatory taxation of earnings of foreigners in the United States.
10/ E.g., a resident of France, giving Switzerland as his domicile.
11/ Particularly since the most important "third" country, i.e., Switzerland, itself was subject to certification procedure.

All this conveys no information whatsoever about the magnitude of clandestine capital movements of the first type, which, it will be recalled, do not enter at all into balance of payments statements. And it appears reasonable to assume that the bulk of current clandestine capital movements takes the form of overvaluation of imports (both of goods and of services12/) or undervaluation of exports. Therefore, it would be wrong to deduce anything about the volume of clandestine capital movements to the United States from the size of the "errors and omissions." Conversely, a satisfactory explanation of the amounts recorded under "errors and omissions" must be sought in balance of payments items other than unrecorded capital movements.

12/ There is hardly an American returning from Europe this year who has not been requested, in one country or another, to accept foreign currencies in return for holding the dollar equivalent of the amounts involved (computed usually at a rate of exchange below the official one) at a foreigner's disposal. If American tourist expenditures are estimated primarily on the basis of travellers' checks cashed, payments on tourist expenditures will be underestimated. As a result the private "hoards" of foreigners will not be reflected in "errors and omissions."

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ERRORS AND OMISSIONS IN THE BALANCE OF PAYMENTS

Florence Jaffy

In a recent memorandum entitled "Clandestine Capital Movements in Balance of Payments Estimates", 1/ J. H. Adler of the Federal Reserve Bank of New York presented the thesis that there is "little quantitative relationship between the volume of capital flight and the amounts shown as 'errors and omissions' in the balance of payments statements." This thesis is contrary to an interpretation frequently made of the balance-of-payments residual, and that assumed in a previous memo by H. J. Dernburg of the New York Bank. The Dernburg memorandum states that "the rather consistent appearance of a credit residual would ..... suggest an unreported inflow of funds, and conversely in the case of a debit residual."

Part I of this memorandum is primarily a discussion of the argument presented by Adler; Part II presents a brief discussion of the reasoning lying behind the more "orthodox" view, and a few suggestions as to what more might be done to resolve the issue. The memorandum incorporates information gained from discussions with staff members of the Treasury and Commerce Departments as well as members of the International staff of the Board of Governors.

Part I

A "residual" in the balance of payments means that the sum of the debit items either exceeds or falls short of the sum of the credit items, and therefore that a balancing entry must be made. Since every transaction has both a credit and a debit aspect, and must therefore be entered in two places, such a residual can only occur because an error has been made in one entry relative to its contra-entry. More correctly, a residual occurs when the sum of such errors in one direction (debit or credit as the case may be) exceeds that in the opposite direction. 2/ A credit 3/ residual in the balance of payments (such as has appeared in the U. S. balance of payments over the past few years) means that there has been either an overstatement of the debit (payments) entries such as imports of goods and services, unilateral transfers to foreign countries, long-term capital outflow, liquidation of foreign balances, and increase in short-term claims on foreigners; or an understatement of the credit (receipt) entries, such as exports of goods and services, long-term capital inflow, increase of foreign balances, liquidation of short-term claims on foreigners, etc.

To point up the question at issue, we may say that a credit residual

1/ In this Review.

2/ Thus a balance of payments statement may balance perfectly and no "errors and omissions" entry may appear in it, and yet compensating errors and omissions may exist in it.

3/ The signs used throughout this memo are those used in the Department of Commerce's standard table, "International Transactions of the U.S."

means an overstatement of imports of goods or services relative to capital inflow 1/ or an understatement of exports of goods or services relative to capital outflow. The question is, therefore: Does this relative over- or under-statement involve absolute errors in the import or export figures or in the capital movement figures, for the most part?

The Adler thesis is that there is no connection between the size of hidden capital movements and the amount of "errors and omissions". We may try to define this statement more accurately. It could be interpreted to mean that there is no positive correlation between the two variables, or merely that the variables, though perhaps positively correlated, are not necessarily in a one-to-one relationship (or something approaching it). The former claim would deny that an increase in the credit residual means an increase to any extent in the volume of hidden capital inflow; this seems too extreme. On the other hand, to claim only that there is not an exact one-for-one relationship would not be claiming very much. It seems more reasonable to interpret his claim as the less specific one that the volume of hidden capital inflow is not in the neighborhood of the credit residual. To prove that this view is correct, Adler would have to show not only that some hidden capital inflows lead to a debit residual, or to no residual, and that other factors beside hidden capital inflows could and do lead to a credit residual; but also that a "substantial" volume of them have these effects. (He need not, on this interpretation, prove that most of them do.)

"Hidden capital inflow" is defined here as an understatement of foreign accumulation of dollar assets, or an overstatement of foreign liquidation of dollar assets.

The Adler presentation runs in terms of "country B" and "country A". Since it is probably that "country B" will be interpreted as the United States by most readers, and since it is difficult to attempt to reach conclusions without investigating concrete cases, this discussion is presented in terms of the United States and a foreign country, with most attention being given to the U. S. side. All future reference to the Adler thesis should therefore be read as "the Adler thesis applied to the U. S. balance of payments".

Case I.

Adler's first hypothetical case is that of an inflow of hidden capital resulting from a foreign exporter under-invoicing his exports to the United States. The difference between actual and invoice value is then held in trust for him by the importer, or in another American name, so that foreign acquisition of United States assets is understated, but the American import is also recorded at the incorrect low value and therefore no residual in the United States balance of payments would result. On the export side, the parallel case would involve overstatement by the foreign importer of his import from the United States. He would then acquire extra dollars from his Exchange Control, and remit it to the American exporter who would hold it in trust for him; if the American export is also overstated to an equal amount, no balance-of-payments residual would appear. It would support the Adler thesis, if it

1/ We have assumed that gold movements and government unilateral transfers are correctly stated. Private unilateral transfers are relatively insignificant.

could be shown, that this type of transaction occurs fairly frequently, in comparison to the case where, other things being the same, the American import or export is recorded correctly.

To judge on this point, recording procedures for U. S. imports and exports must be examined:

On the import side, the dollar value figure used in import statistics is taken from the "import entry" which importers are required to file for imports of all goods worth $100 or over. The "import entry" is based on the invoice and other commercial documents, but must indicate the "foreign value"1/ or the "export value" (whichever is higher) of the imported commodity -- i.e., it must not include insurance and freight, and it may not show actual payment where this differs from "foreign" or "export" value. The "import entry" is also used for Customs purposes, and is checked by the Customs appraisers for accuracy. However, the Customs appraisers are more interested in the accurate declaration of dutiable and especially ad valorem imports than of free or specific duty goods. Since free goods represented 61 per cent of the dollar value of imports in 1947, and goods subject to specific duty were a "substantial part of the remainder",2/ there is a priori reason to believe that underreporting might occur without detection. On the other hand, if it were discovered that the invoice value and the entered value were too low, and the customs appraiser had to raise it, the importer would be subject to severe penalties which might exceed the total duty on a dutiable good, or might even exceed the value of the merchandise itself.3/

There is no empirical evidence available on this matter.4/ The Commerce Department is now understood to be preparing a study of the relation between import statistics and payments for imports. Until results are known,

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1/ "Foreign value of imported merchandise represents the market value or the price, at the time of exportation of such merchandise to the U.S., at which such or similar merchandise is freely offered for sale for home consumption in the principal markets of the country from which exported... The export value is the market value or the price at which such or similar merchandise is offered for sale for exportation to the U.S." (From Section 402 of the Tariff Act of 1930.)

2/ "The Dollar Value in U. S. Import Statistics", George and Weiss, Foreign Commerce Weekly, August 14, 1948.

3/ "Customs Valuation in the U. S.," R. E. Smith, University of Chicago Press, 1948. Page 152.

4/ A prewar study undertaken by the Commerce Department in conjunction with WPA, concerning the relation between recorded values and invoice values on non-dutiable and specific-duty imports, is not relevant to the question at issue. This is due not only to the period covered by the study (1931-1937) and to the fact that no ad valorem imports were included, but also to the fact that a study of this kind could not give any information as to whether, in case of a discrepancy, the invoice or the reported value was the correct one, in the sense of representing the actual payments value. In fact, neither might be correct. A perfectly "correct" entry from the point of view of Customs -- i.e., one that reflected "foreign value" accurately -- need not reflect true payments value at all.

it can only be concluded that, due to the concern of Customs appraisers with revenue collection, and the small share of imports which are subject to an ad valorem duty, there would be ample opportunity for underreporting of imports in United States statistics to the same extent that the foreign exporter under-reports them to the authorities of his own country.

On the export side, export statistics are compiled from Shippers' Export Declarations. The Census Bureau checks reported export declarations to see if they fall within an estimated price range for each commodity. If they do not, the declaration is sent back to the shipper for verification. It does not appear that there is any on-the-spot check of export values. It is not clear how much over-statement of export values could occur undetected in view of this procedure. The Commerce Department recognizes that further study on this question would be useful, and it is understood that if funds were available such study would be undertaken.

Adler's Case I. could actually be broadened to include service transactions (e.g. shipping, tourism, etc.). In all transactions of this type involving a possible hidden capital movement and an offsetting goods or service transaction the crucial question is: does the offsetting transaction get reported correctly? If it nearly always does, there is a presumption in favor of the Dernburg thesis; if it often does not, there is a presumption in favor of the Adler thesis.

Tourist expenditures in the United States balance of payments are estimated by a sampling method, on the basis of answers to questionnaires. If the foreign recipient of the tourist dollars keeps them as currency or uncashed travellers' checks, or deposits them in an account which is concealed under an American name, then an unreported capital inflow has occurred. The tourist who is "sampled" would normally report his full expenditures, thus leading to a credit errors and omissions entry in the U. S. balance of payments. On the other hand, in cases where a portion of the American tourist's expenses is paid by a local inhabitant in return for which the tourist holds an equivalent amount of dollars in trust for the foreigner, it is possible the tourist will not report the amount as part of his expenses. In this case the two errors would cancel out. Another variant is the case where no dollar payments are involved, but the tourist pays travelling expenses by drawing down foreign currency balances owned by him. If the balance were not held through an American bank, the transaction will probably fail to be reflected as a reduction in U. S. owned foreign assets. If the tourist includes his local currency expenditures as part of his reported expenses, a credit errors and omissions entry in the U. S. balance of payments will result.

Errors and omissions associated with an unreported capital inflow could also conceivably occur in connection with military and troop purchases abroad. This subject has not been investigated in detail.

Without a much more thorough study of the statistical reporting procedures for each balance of payments item than has been made by the writer -- and without an exhaustive listing of all possible permutations and combinations of possible transactions (of which only a few have been mentioned here, and even fewer by Adler) -- it is impossible to generalize as to whether Case I. does or does not support Adler's thesis.

Case II.

This is the case of a transfer of dollar balances from one foreigner to another, when both the seller's original holdings and the transfer are fully reported in the United States, although they may be concealed from the foreign authorities. Since neither a hidden capital movement nor an "error and omission" entry is involved on the U. S. side, the case is irrelevant to the issue as regards the U. S. balance of payments.

Case III.

The third case is identical with the second, except that the acquisition of dollars by the foreigner is not reported in U. S. statistics -- e.g. the payment is made into an American "dummy" account. Under these circumstances what is involved is the movement of foreign-owned dollar assets into unreported holdings although there is no actual total capital inflow. That is, it is the case of over-stated liquidation of foreign dollar assets. Thus a residual results, together with the false appearance of a capital outflow. Adler uses this latter variant as his example -- and his sole example -- of a transaction involving a hidden capital movement which leads to a credit residual in the balance of payments.

He minimizes this type of practice on the grounds that (1) Treasury freezing and unfreezing procedures make it unlikely,1/ and (2) a foreigner may maintain his concealed balances in the name of a resident of a third country rather than in the name of a United States resident. In the latter case, of course, there would be no error in the over-all capital inflow figure. In regard to (2), the possibility of this practice does not of course prove that it has occurred very frequently, compared with the maintenance of balances in American name.

There are also other possibilities which Adler does not mention, of movement of foreign-owned assets into unreported holdings (i.e. overstated liquidation.) There may be an outflow of long-term capital accompanied by an unreported inflow of short-term capital (e.g. an American purchase of securities, real estate, or American direct investment, with the proceeds going into unreported foreign holdings). In such cases it is not at all unlikely that the long-term outflow may also fail to be reported. In fact, it is the view of some members of the Commerce Department's staff that in regard to long-term capital movements, the net error is probably an understatement of the outflow. This type of transaction, then, involving long-term outflow and short-term inflow, may well support Adler's case.

1/ "Foreign funds that were frozen by the U. S. Treasury in the course of the war could be unfrozen only through a certification procedure normally involving the exchange control authorities of the foreign national owning the dollar funds."

Case IV.

This case is similar to the first case, in that the foreigner under-invoices his exports, and the shipment is likewise understated in United States import statistics, but it differs from the first case in that the difference between invoice value and actual value is recorded as a payment to a foreign account. This leads to a debit residual in the balance of payments. But since the inflow is not hidden, in the U. S. statistics, it is not an example, as Adler claims it is, of a hidden capital inflow associated with a debit residual. Nevertheless it might be put down as an argument on Adler's side since it does represent the case of a debit residual traceable to factors other than an unreported capital outflow. Adler himself, however, minimizes its significance.

Adler, in concluding, states his belief, without attempting to prove it, that the "bulk of current clandestine capital movements take the form of overvaluation of imports (of goods and service) or undervaluation of exports."

Conclusions.

The conclusions to be drawn from the Adler paper would seem to be the following: -- It has suggested possible transactions that might cause the amount of the credit residual to depart from the volume of hidden capital movement. There is not enough evidence as yet to enable one to draw any conclusions as to how substantial this departure might be, nor has he presented convincing evidence as to what other factors account for a large part of the credit residual. He has certainly not proven a total lack of correlation between the two variables, since he has not shown that the volume of transactions of his suggested types outweigh in importance the volume of other types of transactions.

Part II

The hypothesis that the large credit residual which has been appearing in the United States postwar balance of payments probably reflects a considerable volume of unreported capital inflow rests on the following reasoning:

A. It cannot be seriously doubted that there has been an inflow of flight capital from foreign countries in the postwar period, both on a priori economic grounds, and from evidence gained from personal contacts or experience. Since (1) we are sure there has been "substantial" hidden capital inflow (2) there is a large credit residual in the balance of payments, and (3) transactions are quite conceivable by which such an inflow of funds could lead to a credit residual; it is therefore reasonable to conclude, in the absence of more certain knowledge, that the credit residual reflects to some undetermined but probably significant extent the hidden inflow.

B. In addition to this, it seems reasonable to expect errors and omissions in capital movement items to predominate over errors and omissions in goods and service items because (a) the reporting system for goods and service transactions is probably more complete than that for capital movements; (b) where actual reports are not available, and estimating must be resorted to, it is probably much more difficult to estimate movements of capital than movements of goods or services; and (c) there is a special tendency, in the case of movements of funds, for persons to conceal transactions, while there would be no special motive for overstating imports or understating exports.1/

In regard to A, this reasoning does not take into account the facts that (a) a hidden capital inflow could take forms that do not lead to a credit residual; and (b) the existing credit residual could be due to a number of factors other than hidden capital movements which we also know to exist. Argument B is in part an answer to the latter point: It may be said that for reasons such as those mentioned under B it is unlikely that the credit residual is due to "other factors" than hidden capital flows.

The complete resolution of the issue, of course, depends on measuring quantities which are now unknown -- in short, on eliminating the error and omission residual. Short of this, however, it would be useful to seek information that might throw light on the relative weight to be given to various types of errors and omissions, and of transactions involving hidden capital. It might be that useful information on these matters could be gained through discussions with importers and exporters, bankers, customs officials, etc., or through the type of survey which is now being initiated by the Commerce Department.

The subjects on which more information is needed are not, of course, confined to transactions involving movements of hidden capital, which have been discussed exclusively so far. If these types of transactions do not largely explain the movements in the balance of payments residual, which ones do? It was previously pointed out that a credit residual could also result from an overstatement of imports (of goods or services); or an understatement of exports (goods or services). Overstatement of imports could result from the use of an official exchange rate for converting "foreign value" to dollars, which yields a dollar value higher than the price actually paid by the importer. Overstatement of certain import items might also result from the reporting of U. S. military purchases abroad, including purchases by American troops. The method of import valuation required by United States law has also been considered to lead to a substantial excess of dutiable value over transactions price.2/ Although this effect would have

1/ There are conceivable motives for understating imports, but this practice would not lead to a credit residual. See earlier discussion.
2/ "Customs Valuation in the U. S.," R. E. Smith, pp. 18, 151 ff, 247, etc.

operated ever since our present valuation procedures came into existence, the increased value of United States imports in recent years would tend to magnify this overstatement. Still other types of transactions which could explain the errors and omissions residual are contained in the Dernburg article previously referred to.

In addition to gathering information in regard to erroneous reporting, further constructive steps might be taken in regard to the known gaps in the reporting systems. For instance, the reporting system for short-term capital movements is known to be incomplete. It might be helpful if a sample check could be made of the foreign short-term assets and liabilities of non-reporting institutions, such as savings banks. This would give some indication of the extent to which reported foreign asset and liability figures are incomplete. Such a check might be repeated or possibly extended at some later date, and if done at regular intervals would give some basis for an adjustment to the capital movement figures in the balance of payments.