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Unbalanced International Accounts --
Diagnosis and Therapy*

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An imbalance in a country's international accounts means a persistent unintended change in its net gold and liquid foreign exchange reserves. For practical reasons, this paper will consider imbalance only when it involves a decline rather than an increase in reserves.

Imbalance so defined is a purely monetary concept, a decline in a country's external liquidity. It does not necessarily imply a decline in the country's "real" wealth, abroad or at home.

Diagnosis and therapy of imbalance in general

Imbalance always reflects an excess of total expenditures over total receipts, but it may appear primarily in a country's current accounts or in its capital accounts.

Imbalance in current accounts is, as a rule, due to domestic inflationary pressure, whether or not accompanied by price inflation; or to deflationary pressure abroad or shifts in foreign demand or supply schedules; or to disparities between domestic and foreign price levels, which need not reflect current inflationary or deflationary pressures.

Imbalance in capital accounts may be due to persistent disparities in yield levels, reflecting divergent rates of economic growth or divergent institutions or policies; or to fears of unusual capital losses, frequently caused by dangers of inflation, devaluation, or expropriation; or hopes of unusual capital gains, stimulated, for instance, by expectations of currency appreciation or the effects of protectionist policies abroad.

Whatever the cause of imbalance, therapy must involve either an increase in total receipts to match the increased expenditures, or a reduction in total expenditures to match the reduced receipts, or both. In view of the close relations between domestic and international transactions in a free economy, it is in general neither necessary nor sufficient to confine therapy to actions directly influencing international receipts or expenditures. A direct reduction in foreign exependitures, for instance, would be ineffective if it were offset by a rise in domestic expenditures that would eventually spill over into the international sector.

Whether imbalance should be corrected by raising receipts or by reducing expenditures, is less a problem of theory than of practicability. In the field of current transactions, for instance, raising receipts usually, though not invariably, requires an expansion of output to provide for the necessary increase in exports, while reducing expenditures usually involves a contraction of consumption or investment. In most cases, moreover, care must be taken to prevent an increase in receipts from being offset by a corresponding increase in expenditures, or a reduction in expenditures by a corresponding reduction in receipts.

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In deciding whether to aim primarily at raising receipts or reducing expenditures, at least the following five conditioning factors will have to be considered:

First, the volume of the country's actual and potential reserves, including foreign credit lines and drawing rights on the International Monetary Fund. This volume determines whether the country may choose therapies that are expected to work in the long run rather than in the short run.

Second, the degree of utilization of domestic resources. If resources are fully and effectively utilized,measures envisaging an expansion of output are unlikely to be successful.

Third, the degree of flexibility in the domestic economy. Full utilization of all domestic resources of labor and capital is a rare event. However, resources that are not fully employed can be used for expanding output only if they can be shifted to those sectors in which there is actual excess demand or a potential for a rise in demand.

Fourth, the degree of flexibility in the world economy. If a country's trading partners permit deflation in their economies or raise other obstacles to an increase in imports, the country trying to correct an imbalance will be unable to increase its receipts by expanding its exports. Similarly, if foreign countries keep their capital yield levels unusually high or stimulate hopes of currency appreciation, the country trying to correct an imbalance will find it difficult to stem the outflow of capital, except by direct controls. It was the virtue of the classical gold standard mechanism that it led to expansion in the surplus countries, thereby helping to correct the imbalance of the deficit country. Under present monetary standards, ways must be found to replace that mechanism by conscious international cooperation.

Fifth, other policy considerations compelling a country to modify measures that would be appropriate on purely economic grounds. Such considerations, for instance, may make it impossible for a country to reduce economically unjustified government expenditures, or to curb imports of goods and services or the outflow of capital, or to oppose foreign protectionist or discriminatory policies.

These elementary theoretical considerations will now be applied to the present imbalance in the international accounts of the United States.

Diagnosis of U. S. imbalance, 1958-60

Since the last quarter of 1957, the United States has suffered from an unintended persistent decline in net reserves which, according to the methods of measurement most widely used, exceeded $3 billion annually. Until mid-1960 the source of the imbalance was to be found in the current sector; since then the deficit has also reflected unusual capital movements.

For the period prior to mid-1960, the diagnosis of imbalance in the current sector is not contradicted by the variation in capital flows. In a world of convertible and relatively stable currencies, cyclical changes influence not only the current but also the capital balance. On current account the cyclically weak country tends to have a surplus and the cyclically strong country a deficit; but on capital account it is the cyclically weak country that tends to have a deficit and the cyclically strong country a surplus. Yields both on fixed-interest and on equity investments as well as the prospects of capital gains on equity investments will be more attractive in the cyclically strong than in the cyclically weak country. To some extent, therefore, current and capital balances tend to move in opposite directions during the cycle.

As to causes of the imbalance in the current sector, there has been little if any evidence of absolute or even relative general inflation in the United States since 1957, the last year in which the U. S. balance was in equilibrium.

Foreign demand and supply schedules, however, seem to have changed. Foreign industrial countries have improved their competitive position by catching up with the United States in technology and marketing, and their exports are no longer hampered by an abnormally high domestic demand due to reconstruction needs and lack of financial discipline.

Moreover, a persistent disparity between price levels in the United States and at least some foreign industrial countries has perhaps been created by the devaluation wave of 1949, as Professor Hinshaw suggested two years ago. If this devaluation was indeed excessive in some countries, the resulting price disparity could have remained without effect on the balance of international payments during the earlier period of abnormally high domestic demand abroad. According to this interpretation, it would be futile to look for evidence of unfavorable price or cost shifts in the statistical data for more recent years.

The recent imbalance in capital accounts has been due only in part to the large interest-rate differential between the United States and some, though by no means all, foreign industrial nations. It is difficult to judge, moreover, whether this differential has been larger than can be explained on purely cyclical grounds, and whether the resulting short-term capital movements should thus be considered cyclical and self-reversing, or persistent and requiring therapy.

There have also been some unusual capital flows to Europe, including short-term flows based on expectations of an appreciation of the German currency, and long-term flows connected with the European Common Market. The long-term flow has probably also been influenced by lower tax rates abroad and U. S. tax provisions favoring foreign investment; and by the fact that most if not all European countries have shown much higher rates of economic growth than the United States, and therefore justify hopes of larger yields and capital gains, quite apart from problems of exchange adjustments, discriminatory protection, and taxation.

Finally, a significant part of the capital flow to Europe seems to have been due to misgivings about the future of the dollar as an international currency. This diagnosis is based on three facts: first, about half of the recent over-all deficit has been due to an unusual shift in the balance of unrecorded transactions from surplus to deficit; second, a sizable fraction of the capital outflow seems to have gone to countries such as Switzerland and the Netherlands, where interest rates are not higher than in the United States; and third, an unusually large proportion of transfers to foreigners has recently been reflected in gold purchases from the U. S. Treasury rather than in increases in foreign dollar holdings.

Therapy of U. S. imbalance

In general, countries are anxious to avoid a depletion of their gold or foreign exchange reserves in order to be able to maintain their imports even if their receipts from exports and capital transactions temporarily drop below their international expenditures. As long as the U. S. dollar is accepted as an international means of payments, the United States need not worry on that score. Both the United States and the rest of the free world, however, do need to worry about maintaining the role of the dollar as an international means of payments. This role is based on world-wide confidence in the stable value of the dollar in terms of gold and of the currencies of other leading nations; and this confidence in turn is, at least in part, based on the expectation that U. S. gold reserves will remain adequate, both in absolute terms and in relation to U. S. actual and potential short-term liabilities to foreigners. For this reason, the imbalance in the international accounts of the United States needs therapy even though it may reflect an exchange of investments abroad for gold and short-term dollar liabilities rather than an excess of current expenditures over receipts.

In fact, therapy must aim at more than at restoring the balance-of-payments position of the early 'fifties when the United States had a deficit averaging $1-1/2 billion annually without adverse effect on confidence in the U. S. dollar. At that time, the dollar was generally considered "scarce" abroad and an increase in foreign dollar holdings therefore advantageous and even necessary for the expansion of world trade. The increase in foreign gold and dollar holdings by about $13 billion that occurred in the past three years has put an end to the international dollar "scarcity" and has given rise to a fear of a dollar glut. Therapy must therefore aim at eliminating rather than merely reducing the over-all deficit in the U. S. balance of payments.

This therapy must affect both current and capital transactions. During the past few years so much has been said about the elimination of a deficit on current account that few if any new ideas can be put forward. Since technological progress abroad seems to have played a role in creating the U. S. deficit, it should be obvious that the United States, in spite of its affluence, cannot afford to neglect the problem of continuing to raise its economic efficiency, while guarding against further increases in costs and prices. If it is correct to assume that price discrepencies also have resulted from excessive devaluation of one or two major foreign currencies, the United States should support efforts of those countries to remedy the situation.

Obviously, the United States should try to correct the current imbalance as much as possible by increasing exports rather than reducing imports; with the equally obvious proviso that economically unjustified payments, for instance, on government account, should be eliminated. However, this principle may be affected by three of the five conditioning factors previously discussed.

The first two of them need not detain us. The U. S. gold reserves still are large enough to permit as long a period of transition as can reasonably be expected. They are about twice as large as the short-term dollar holdings of foreign monetary authorities, who alone can demand conversion of their holdings into gold; and they can be further defended, if need be, by using other resources, such as drawing rights on the International Monetary Fund.

Second, an expansion of output is -- unfortunately -- not hampered by the full-employment ceiling since much labor and capital have been unemployed for some time.

Successful therapy requires, however, that economic flexibility be increased both at home and abroad. The presence of rigidities in the U.S. economy is indicated by the persistence of serious unemployment side by side with continued increases in some prices and in wages. These rigidities have been attributed to various factors, such as monopolistic practices of labor unions or of big business. Perhaps more important than either of them is the increasing bureaucratization of business, as shown by the rapid rise in the white-collar staff of manufacturing enterprises. According to Professor Schultze's data, this increase has contributed more to raising the cost of manufactured products than increases in wage rates or in profit margins. Fiscal policy may have to be used to curb Parkinson's First Law in the business world.

However, bureaucratization is perhaps merely a symptom of deeper trouble, of a general rise in inertia and complacency, a subconscious protest against the restlessness of our times. Unless the United States over-comes this tendency, I fear that institutional changes will not suffice to prevent more active nations from outcompeting the United States, and its balance of payments will be confronted with the same kind of problems that some older countries have had to face ever since the first world war.

On the international scene, the need to increase flexibility furnishes obvious arguments against foreign commercial and financial policies that interfere with the required expansion of U. S. exports; against those features of regional organizations that would divert rather than create trade; and against attempts of the United States to correct the imbalance by imposing rigidities of its own, such as restrictions on imports or on capital flows.

The fifth factor, the influence of other policy considerations, is even more important. The most serious, if not the only serious, consequence of a persistent U. S. imbalance would be the decline in the international prestige of the dollar and the resulting threat to the international dollar standard. Therapies that would undermine that standard, such as an increase in the price of gold or other attempts at tampering with the established par value of the dollar, would thus be as bad as the disease.

Moreover, grave as a danger of a collapse of the dollar standard would be, it would not be as disastrous as threats to the preservation of the Atlantic Alliance or to the economic progress of less developed areas. Therapies that might endanger the attainment of these goals are therefore out of the question: changes in foreign trade, foreign economic aid, and foreign military expenditures can be considered only insofar as they do not conflict with basic U. S. foreign policies, even though they may be desirable from a purely economic point of view. Policies requiring foreign aid to be spent on U. S. goods and services, for instance, are acceptable only because they put pressure on other industrial countries to finance their own exports to less developed areas and in this way tend to increase rather than reduce the total funds available to those areas.

The imbalance on capital account might best be corrected by removing the causes of the unusual capital outflow. Insofar as the outflow is due to more rapid economic growth abroad, the obvious therapy is to accelerate growth at home. Insofar as it is due to tax considerations, a revision of fiscal policies and an attempt at equalizing tax rates in the major industrial countries may be in order.

Insofar as the outflow is due to the expectation of appreciation of a major foreign currency, the foreign country should be induced either to have done with that appreciation or to pursue policies that eliminate the need for appreciation. Insofar as it is due to fears of U. S. domestic policies that would endanger the par value of the U. S. dollar, the equally obvious therapy is to prove that these fears are unjustified by continuing to pursue monetary and fiscal policies consistent with long-run financial equilibrium.

A more difficult problem is posed by those capital flows that are due to interest-rate differentials. Under present conditions of currency convertibility and freedom of capital transactions, it is inevitable that a certain amount of interest-sensitive funds will take advantage of such differentials. Whenever these differentials are cyclical, the resulting flows are in principle reversible and therefore would seem not to require therapy. However, large cyclical flows, by their effect on U. S. gold reserves, may create apprehension or even panic before they reverse themselves, and thus lead to accelerated and persistent secondary flows.

This danger cannot be avoided by the actions of any single monetary authority. It would be self-defeating to prevent interest rates from falling when a country was on the verge of recession or stagnation; such a policy would merely hamper economic recovery and growth and thereby induce an outflow of long-term capital. The danger can be avoided, however, if all major countries decide to cooperate in neutralizing the effects of cyclical flows of short-term funds so as to avoid secondary flows. There are many ways in which cooperation could be accomplished, including the use of the International Monetary Fund or the Bank for International Settlements. Some interesting suggestions to this effect have been made recently.

The preservation of the international dollar standard certainly is in the interest of the United States; not so much because of its rather modest advantages for the U. S. banking system as because of its importance for the cohesion and expansion of the international commercial and financial network. However, for the same reason it is as much, or more, in the interest of all other financial and commercial nations. These other nations have the right to expect that the United States will do its part to bring its international accounts into structural balance. The United States, however, has the right to expect that other nations in turn will do their part to help preserve the monetary standard of the free world.

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THE DISCIPLINE OF THE BALANCE OF PAYMENTS: POSTWAR EXPERIENCE IN EUROPE*

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It may be advisable to note at the outset that this paper deals only with western Europe, and that all its references to "Europe" mean western Europe.

There is probably a tendency--arising perhaps from the punitive connotations of the word "discipline"--to think of the discipline of the balance of payments as something applicable primarily (if not exclusively) to countries in actual or potential balance-of-payments deficit. The first two parts of this paper deal with our subject from this point of view. The first part attempts to show that in most of western Europe, what we now think of as the normal balance-of-payments discipline operative against chronic external deficits was in fact operative only to a limited extent during the first half-dozen years or so after World War II, and that the gradual re-establishment of conditions under which that discipline could again operate is for present purposes the main fact of interest about that period. The second part of the paper comments on the operation during recent years of the discipline against chronic external deficits. The third part considers the question of balance-of-payments discipline in situations of chronic external surplus, with particular reference to Germany.

I. Early postwar status of the balance-of-payments discipline

Given the acute balance-of-payments problems of early postwar Europe, the statement that the discipline of the balance of payments was then operative only to a limited extent obviously calls for explanation. To begin with, and speaking for the moment in general terms--without reference either to the early postwar economic policies of European countries or to the extenuating circumstances in which some of those policies were applied--the mere fact that a country struggles to overcome a balance-of-payments deficit does not necessarily mean that it is operating under something that can meaningfully be characterized as a balance-of-payments "discipline." Limited holdings of gold and foreign exchange, and limited availabilities in loans or gifts from abroad, sooner or later must force any country in substantial external deficit to balance its external accounts. Without scorning the salutary effects that having to "scrape the bottom of the barrel" may have on policy, it is relevant to point out that when a country has reached or is approaching the bottom of its external reserves barrel, in many cases what that situation reflects is the absence of balance-of-payments discipline--

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reflects, that is, the failure of the country to follow appropriate policies previously. Clearly, therefore, the concept of the "discipline" of the balance of payments connotes primarily a set of continuing policies, or a set of constraints on policy, rather than the mere fact that a country that has exhausted most of its external reserves must impose corrective measures that for a time at least are likely to be severe.

Secondly, however, the kind of constraints imposed on a country by the need for long-run balance in its external accounts depends in part upon the character of the system of international trade and payments within which the country is functioning. If the system is one of rigorous bilateralism, and of extensive use of quantitative trade restrictions, the country will have to balance its accounts--probably even more narrowly, in fact, than under a liberal trading system--but the resulting constraints on internal policy will pertain largely if not exclusively to the question of aggregate expenditure in relation to aggregate income. On the other hand, the constraints on a country functioning under a multilateral system of relatively free trade must include considerations of economic efficiency as well as of the balance of expenditure. This follows from the fact that a multilateral system of relatively free trade implies international competition. If it is assumed that the system of international trade which is normal for a particular group of countries is a system of multilateralism rather than of bilateralism--which would seem a reasonable assumption regarding western Europe in the present era--the discipline of the balance of payments should be defined broadly as the set of constraints imposed on the internal and external policies of any country by the need to maintain long-run equilibrium in its external balance of payments, under a system of international trade which is largely unrestricted except by internationally-agreed tariffs.

Perhaps it will now be more clear why it was suggested earlier that in most of western Europe the discipline of the balance of payments was operative only to a limited extent during the early postwar years. On the external side, the multilateral trading system had broken down, the international trade of Europe at that time (as in the 1930's) being dominated by quantitative trade restrictions and bilateralism. On the internal side, the continued reliance primarily on direct controls--while probably necessary for a time--hamstrung economic efficiency; and in addition the need for restraint of internal expenditure because of balance-of-payments considerations was either not clearly realized, or not fully accepted. In February 1948 D. H. Robertson, the distinguished British economist, was asked by a group of journalists whether it "would be fair to say that Western capitalism has broken down under the impact of two world wars, and there is very little hope of effective repair." In his reply, Robertson said in effect that what had broken down was postwar economic policy. Specifically he said that "if anything must be said to have broken down, it is . . . the idea that a country dependent on foreign trade can allow a complete divorce between its internal and external monetary arrangements."1/

In addition, there was the Marshall Plan. It would be an exaggeration, of course, to say that the Marshall Plan completely suspended the balance-of-payments discipline in Europe during the years of its operation. Few if any of the aid-receiving countries ever thought they had been allocated all the external aid they needed; moreover it was understood from the beginning that the aid program was temporary. Thus, all the recipient countries were continually under some pressure to balance their external accounts, especially during the later years of the program. As a result of the aid program, however, the levels of economic activity in those countries did not have to be constricted to the point at which import requirements could be met out of export earnings and other normal inflows. Moreover, a perverse incentive was implicit in the way the Marshall Plan was administered: the fact that the amounts of aid extended to the different countries tended to vary directly with the size of their external deficits. The perverseness of this incentive was enhanced by the fact that the bulk of Marshall Plan aid was extended on a free-grant basis. It could therefore have been predicted that at least some of the countries for at least some of the time would act on the assumption that the larger the deficit the larger the aid; and there is not much doubt that this did happen.

All these factors together--the extent of bilateralism and discrimination in international trade, widespread use of direct controls internally as well as externally, the tendency at that time to think of internal and external finance as separable problems, and, finally, the Marshall Plan with its perverse incentive--constitute the principal evidence for the view that during the first half-dozen years or so after the war, only a weakened balance-of-payments discipline was operative against chronic external deficit positions in most of Western Europe. If this view is correct, the most important early postwar European developments related to the discipline of the balance of payments must have concerned the reestablishment of conditions under which a discipline effectively operative against chronic balance-of-payments deficits would again exist. In addition to substantially increased production, which was a prerequisite to recovery and progress in practically any direction, there were three essential conditions: first, the ending of chronic inflation; second, getting rid of the direct controls that tended to frustrate initiative and efficiency; and third, reestablishing a multilateral system of trade and payments that would re-introduce competition from abroad into

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1/ D. H. Robertson, Utility and all That (London: George Allen & Unwin Ltd., 1952), p. 147. It has been pointed out that in August 1947, at the time of the first postwar sterling crisis, the Chancellor of the Exchequer noted with apparent surprise the contrast between the external British deficit that had developed, and the "relative ease of the purely domestic financial position"--this "relative ease" being the product of postwar monetary expansion on top of the suppressed inflation of wartime. (Miroslav A. Kriz, "Gold in World Monetary Affairs Today," Princeton Essays in International Finance, No. 34, June 1959, pp. 27-8.)

each national market. These three things--together with increased output--would tend to make disciplined behavior by the countries concerned both possible and necessary.

At this late date, and before this audience, it seems unnecessary to review in detail the manner in which the prerequisite conditions were established, and a balance-of-payments discipline effective against chronic balance-of-payments deficits was restored; it should suffice to note the key facts. First, while Europe has clearly not been immune to upward pressures on prices during the past six or seven years, in almost all countries the chronic inflation of the early postwar period ended years ago. In addition, although some European governments retain, on a stand-by basis, broad powers for direct economic controls, comparatively little use has been made of such powers in recent years. Finally, we have all seen the gradual evolution of a multilateral trade and payments system in Europe, from the European Payments Union and the O.E.E.C. trade liberalization program of a decade ago to the system of non-resident convertibility and increasing non-discrimination in trade that exists today. This evolution, which had been assisted by the increasingly important work of the International Monetary Fund, has in turn reflected the gradual reestablishment of a general multilateral system of the kind for which the Fund was created.

Although formal non-resident convertibility of European currencies was established only two years ago, its evolution had indeed been gradual, and much of its substance existed earlier--notably after the British decision of February 1955 to support the market for transferable sterling. This means that most of the conditions necessary to a balance-of-payments discipline operative against chronic balance-of-payments deficits have to a considerable extent been present in Europe during the past five or six years, instead of just the past two years. As a result, the period in which the present discipline has been tested is longer than might at first glance appear.

II. <u>The discipline in operation against chronic external deficits</u>

Turning to the operation in recent years of the present discipline against chronic deficits, it is relevant to point out that the effectiveness of such a discipline is evidenced more by the infrequency of infractions of discipline behavior, than by the way in which the infractions that do occur are handled. It is therefore worth noting that chronic balance-of-payments deficits have been rather rare in Europe in recent years.

The French problem of 1956-58 was a case of chronic deficit up to the time when working reserves of gold and foreign exchange were substantially exhausted. From that moment on, it was essentially a test of French ability and willingness to recognize and to accept as a permanent fact of life the balance-of-payments discipline that was then emerging. The French inflation and external deficit of 1956-58 were the result, quite obviously, of expenditure that was excessive in relation to output potential, effected both through large public deficits and private credit expansion. Until the latter part of 1957 the inflation was obscured by absorption through an import surplus rather than by price increases; and for part of the time it had been concealed by manipulation of price indexes to prevent or limit their rise. Corrective action--including two franc devaluations aggregating nearly 30 per cent--was eventually forced by substantial exhaustion of working reserves of gold and foreign exchange, which declined by about $1.3 billion--a drop of two-thirds--from November 1955 to late 1957.

For present purposes, interest centers on the kinds of corrective action chosen, and on the extent to which that action was influenced by awareness of the new balance-of-payments discipline. Antoine Pinay, Minister of Finance in 1958-59, has told of how, after the initial decision in favor of a "surgical operation" rather than "medical treatment" (i.e. a drastic program rather than one that would merely slow down the rate of inflation), a decision was necessary on whether to carry it out in the context of a closed or an open economy. The practical question involved was whether to devalue the currency and reinstate French trade-liberalization commitments in O.E.E.C. and in the European Economic Community, then about to get under way; or to refuse both devaluation and liberalization. Pinay comments that had France followed the latter course, "she would have been forced into a sterile autarchy, and that at a time when almost all Western countries were taking first steps toward convertibility and were seeking new forms of free exchange."[2/] Acceptance of the discipline of the balance of payments as defined in this paper seems implicit in that statement.

Similarly, the Spanish stabilization program of July 1959 reflected some recognition of the dangers in the progressive isolation of Spain from the world economy up to that time. As part of that program, the Spanish government undertook commitments providing for the gradually increased exposure of the Spanish economy to pressures from abroad, in addition to measures of internal financial stabilization. Although there has been some progress in the liberalization of Spanish imports, much remains to be done along these lines.

Between 1954 and the latter part of 1957, Britain faced a series of balance-of-payments problems, beginning with a current-account deficit resulting from an internal investment boom, passing through various intervening strains (including drawings on the central dollar pool by the outer sterling area, and also speculative outflows caused by the Suez crisis in 1956), and reaching a climax in the bear raid of 1957. British acceptance of the principle of balance-of-payments discipline was clearly evidenced during the 1954-57 period, both by her strong internal policy responses to the external drains, and by the fact that Britain went through the entire period without any retreat from trade liberalization as established up to that time. Her successful avoidance of a retreat from liberalization even in 1957 must have stimulated British confidence, and could reasonably be expected to influence her handling of external deficits that might arise in the future. The 1956-57 experience must also have made a deep impression on world thinking as to what can be accomplished by strong policy in situations of that kind. What it showed was that resolute action by the country concerned, with substantial assistance from the International Monetary Fund, could stop a

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2/ Antoine Pinay, "Economic Revolution in France," Foreign Affairs, July 1959, p. 590.

massive speculative attack even in the case of a currency as vulnerable to speculation as sterling.

If a country incurs large and continuing balance-of-payments deficits for a long enough period of time, it will of course lose all its external reserves (including readily available external aid). This fact provides a strong incentive for countries to follow policies designed to prevent long-continued drains on their external reserves. One might reasonably conclude, in fact, that even if the "mechanism of external adjustment" envisaged by gold-standard theory does not exist or is not allowed to operate, the need to avoid exhaustion of external reserves will at some point motivate adjustment semi-automatically; the facts of the case will eventually compel official action to correct the situation. What happened in France in 1956-58 is a clear case in point. The question that now arises is whether there is any compulsion toward corrective action in the case of countries in chronic external surplus.

III. Balance-of-payments discipline in the case of chronic external surplus

The outstanding present-day case involving the question of balance-of-payments discipline against chronic surplus positions is, of course, Germany. Since 1952, official German reserves of gold and foreign exchange have risen from the equivalent of a little over $1 billion to more than $7 billion. This year the official reserves increased by the equivalent of $2 billion through November; the current-account surplus for the year is expected to be substantially less than half that amount, the remainder consisting largely of an inflow of what are essentially short-term funds. Despite various measures to curtail this inflow, it has continued--via channels that circumvent the controls--partly because of the attraction of high interest rates, and partly because there has clearly been some recurrence this year of speculation on a revaluation of the deutsche mark. However, the German authorities have denied any intention to take such action, and for some months they have been concentrating on the preparation of a package of alternative measures for curtailing the over-all surplus, centering in a substantial increase in German long-term aid to under-developed countries to a figure on the order of $1 billion. Part of this program requires legislative approval, and the necessary legislative action has not yet been completed. Even after the program is in effect, some time will have to elapse before its effectiveness can be judged.

A country in chronic balance-of-payments surplus obviously cannot go on piling up reserves forever, because the deficit countries will eventually rebel, and take steps to curtail the drain on their reserves. However, experience shows only too clearly that the piling up of reserves by a surplus country can continue for many years. The main reason for its having done so in the German case stems from the fact that the German economic position has been one not only of chronic external surplus but also of almost equally chronic internal boom. In such a situation, the policies needed for internal balance and the policies needed for external balance are in conflict--or at least they appear to be in conflict--and priority has been given to the problem of internal balance. This has been done through the application of strong anti-inflationary policy, which of course has contributed heavily to the maintenance of the external surplus.

It is true that conflicts of this kind can be eliminated without necessarily sacrificing either objective--that of maintaining internal financial stability, and that of restoring external balance. In debates over the German problem, however, the main issue has not been whether a solution was possible, but whether achievement of a solution necessitated changes in German policy. The official German view has tended to be that economic conditions and tendencies inside Germany will eventually solve the external problem more or less automatically. These conditions and tendencies include such factors as the acute labor scarcity (which may itself remain chronic from now on), the rate of increase in wages in recent years, and the "rising expectations" of the population. The German view has been that the increased demands on resources resulting from these factors would tend to eliminate the external surplus. Many outside observers, on the other hand, have stressed the fact that German officials have for years now been citing various special considerations--including some of those just mentioned--as evidence that the German external position was about to change, so that no change in policy was needed, although in fact the large external surplus always continued. The new German program which has been mentioned reflects official German recognition that some positive action to curtail the surplus now appears to be necessary.

On the question posed a few moments ago, as to whether in situations of chronic balance-of-payments surplus there are any forces compelling action to eliminate the surplus, it seems obvious that if there are any such forces they are not very powerful. Because a balance-of-payments surplus is inflationary, it might seem that a country having such a surplus and wishing to resist inflation would have a strong incentive to eliminate or at least to reduce the external surplus. However, its desire to resist inflation is general, and has no necessary connection with the source or sources of the inflation. If the policy measures chosen are also general, they will tend--as in the German case--to perpetuate the external surplus.

We have seen that much of the postwar European experience with the discipline of the balance of payments related mainly to the reestablishment of an effective discipline operative against chronic balance-of-payments deficits. We have also seen that for some years now a discipline of that kind has been in existence, and seems to have been working. On the surplus side, however, it is much less certain that a balance-of-payments "discipline" exists. There is clearly a question whether a discipline effective against chronic deficits can function properly unless tendencies toward chronic surplus can be held in better check than has been the case in recent years.