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AND THE
INTERNATIONAL MARKET
FOR LIQUIDITY

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DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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BALANCE-OF-PAYMENTS DEFICITS AND THE INTERNATIONAL MARKET FOR LIQUIDITY

Ambiguity and confusion abound over the international payments position. President Johnson's balance-of-payments message, for example, devotes the first half to stating how strong the dollar is, and the second to proposals for correcting its weaknesses. Economists have been using the term "crisis" to describe the situation for at least six years, during which world trade has expanded virtually continuously. The balance of payments of the United States is puzzlingly in continuous massive deficit, but the foreign-exchange market for the dollar, with sporadic speculative exceptions, evinces no particular sign of weakness. The French, and to a lesser extent the European Economic Community as a whole, express irritation over both the duration and extent of the deficit, and the strength of American corporations, banks and other financial institutions. German opinion is unclear whether capital is scarce or abundant in that country, and whether, accordingly, the long-run normal capital flow should be outward to finance long-term foreign investment, or inward to finance the still large backlog of housing demand.

This paper contends that much of the confusion arises from a mistaken definition of balance-of-payments disequilibrium. It holds that there is no objective problem of the strength or weakness of the dollar, but a possibility of a subjective problem arising and growing by reason of faulty economic analysis, stemming from this definition. Moreover, the change in definition of a deficit proposed by the Bernstein Review Committee for Balance of Payments Statistics,¹ and referred to in the President's balance-of-payments message of February 10, 1965, effects no distinct improvement.

The difficulty arises from confusion between capital movements for

¹ See Edward M. Bernstein, *The Balance of Payments Statistics of the United States: A Review and Appraisal* (special report prepared for the Bureau of the Budget; published in Washington, April 29, 1965).

the purpose of transferring real assets and those which have the purpose of and serve to accommodate national liquidity preferences.

I ignore President deGaulle's animadversions on the subject of gold. The analysis does, however, expose the error in the thinking on international payments of Jacques Rueff, whose thought formed the (distorted) basis of deGaulle's statement.

Definitions

The Department of Commerce or Walther Lederer definition of balance-of-payments deficit, as is well known, is the loss of gold plus the increase in certain liabilities to foreigners: specifically—all short-term liabilities and all United States government bonds and notes, including the non-marketable issues payable in dollars and foreign currencies (the so-called Roosa bonds). In some definitions, prepayments of intergovernmental indebtedness are added. On this basis, the President's balance-of-payments message stated that the deficit amounted to \$3.6 billion in 1962, \$3.3 billion in 1963, and \$3.0 billion in 1964.

The basis for this definition has been explained at length.² It rests not on the solvency of the United States in international transactions but on its liquidity. Net worth can increase from year to year with a deficit, as the current account of the balance of payments, less transfers, is positive, but falls short of the long-term capital outflow and the increase in United States short-term claims on foreigners. It is assumed that the country might be called upon to pay off all its short-term liabilities to foreigners, without being able to draw on any of its short-term claims.

The difficulties with this definition have been widely noted.³ It is

² See, for example, Walther Lederer, *The Balance on Foreign Transactions: Problems of Definition and Measurement*, Special Papers in International Economics, no. 5. (International Finance Section, Princeton University, September 1963); and by the same author, "The Balance of United States Payments: A Statement of the Problem," in S. E. Harris, ed., *The Dollar in Crisis* (New York: Harcourt Brace and World, 1961), pp. 114-136.

Throughout the discussion below, the appropriate treatment of "errors and omissions" is ignored, as if all payments were known, rather than estimated by imperfect techniques.

³ See, for example, Hal B. Lary, *Problems of the United States as World Trader and Banker* (Princeton, N.J.: Princeton University Press, 1963); Robert Triffin, "The Presentation of U.S. Balance of Payments Statistics," in American Statistical Association, 1961 *Proceedings* of the Business and Economics Statistics Section (Washington, 1962), pp. 51-57; and Walter Gardner, "An Exchange-Market Analysis of the U.S. Balance of Payments," *International Monetary Fund Staff Papers* (May 1961), pp. 195-211.

asymmetrical. When banks in two countries buy foreign deposits, each in the other, to acquire an inventory of foreign exchange (perhaps each entering into a contract with the other to sell the foreign-currency assets forward), both countries are in deficit, despite the fact that there has been no capital movement. It draws far too sharp a distinction between United States assets and liabilities. Some claims of the United States on Europe and Japan are highly liquid or transferable to another holder without substantial loss, whereas some minimum amount of working balances in dollars held by the countries of the "dollar bloc," will be held through thick and thin. Where a claim and a liability are closely associated, in particular, it is offensive to common sense to assume that one is a highly flighty and skittish balance likely to be withdrawn, while the other is a turgid frozen asset, which cannot be drawn upon to meet the withdrawal. When an American corporation puts a deposit, for example, in the New York branch of a Canadian bank, which in turn invests the proceeds in the New York call-money market, the United States balance of payments is in deficit on the Lederer definition, despite the fact that there has been no impact on the foreign-exchange market—the funds never having left downtown Manhattan—and that only under the most unlikely circumstances would the Canadian bank go short of dollars by the amount of the deposit, i.e., use the deposit to buy foreign exchange. The pinnacle of absurdity is reached in the case of Japan, where New York banks making short-term loans to that country require borrowers to maintain minimum balances. The deposit puts the United States balance of payments into deficit, while the asset that gave rise to the claim against this country is ignored.

The revision of the Department of Commerce definition, set out in the Bernstein Committee report, continues to ignore assets. The distinction is drawn merely between official short-term claims on the United States and unofficial claims. The deficit is now defined as losses of gold and increases in short-term official claims. It is assumed that private holders of dollars can be disregarded, because they have voluntarily chosen to lend to the United States at short term. By contrast, official dollar holders are considered to be lending to the United States under duress, or at least are much more nervous and more desirous of converting their dollars into foreign currencies or gold than private holders. The Bernstein Committee is understood to have made no change in the treatment of United States claims on foreign countries. These are still regarded as unavailable to meet withdrawals of foreign dollars from the

United States, except, of course, for official United States holdings of foreign exchange which are the equivalent of gold.

This definition has the benefit of reducing the stated deficits of the years 1962, 1963, and 1964. Instead of \$3.6 billion, \$3.3 billion, and \$3.0 billion, respectively, they are \$3.3 billion, \$2.3 billion, and \$1.3 billion, as the President's balance-of-payments message stated. But this virtue is unaccompanied by others. Over a long period, since 1959, the two definitions produce roughly the same order of magnitude of deficit. Theoretically, the distinction between private and official holdings is not a sharp one. From time to time privately held dollars are dumped on the market and must be bought by foreign central banks. Or the Bank of Italy will seek to mop up excess domestic liquidity by selling dollars to the commercial banks under repurchase agreements which remove the exchange risk. While it is true that a good many European central banks have been inching up in their proportions of gold to total reserves, as nervousness over the international monetary mechanism has been maintained at a high level, the holdings of other countries are both substantial and steady. It might be well to make a distinction between the dollars held by the monetary authorities in Canada, Japan, Mexico, Venezuela, etc., on the one hand—which may be said to be in a “dollar bloc”—and those of France, the Netherlands, Spain and Switzerland—which deal only in or are moving rapidly toward gold—with Germany, Italy and Belgium somewhere between. In any event, the distinction between private and official holders is overdrawn. The numbers may be comforting in the short run, but the theory is erroneous.

These remarks about the definition used by the Bernstein balance-of-payments committee have been written without benefit of having seen the report. Publication is hung up for reasons which, rumor has it, stem from the strenuous objections of the Department of Commerce, and the threatened resignation of Department of Commerce officials, if the report is allowed to appear. On the basis of my analysis, the Department of Commerce definition should be discarded, and those who are committed to it must yield intellectual positions or remove themselves. But the Bernstein definition between official and private dollar liabilities of the United States is not the appropriate replacement.

Long-Term Borrowing for Liquidity

Where these definitions go wrong is in assuming that international lending by the United States, at short-term and long, should be trans-

ferred in real goods and services. This is perhaps true of lending under present conditions to the less developed countries, which are interested in real assets, and not in balancing their portfolios among real and monetary assets, nor, within the monetary category, in balancing assets by maturity. But much, perhaps most, of the lending by the United States to Europe, and perhaps a third to a half of United States lending to Canada and Japan, serve an altogether different purpose: they are intended in an over-all economic sense to provide liquidity. The United States is not engaged in exchanging real goods for long-term securities, but short-term monetary liabilities for long-term monetary claims. The country, of course, is not the decision-making unit, and no conscious national portfolio-balancing decision is made. But the effect of private and public decisions is the same. Foreign countries as a whole must be added to domestic institutions as financial intermediaries.

Postulate a country like Germany with a high rate of saving and a high rate of investment. Suppose that the *ex ante* rates of saving and investment will produce an equilibrium rate of national income, which would mean, provided that capital markets were isolated, that the balance of payments was in equilibrium. In the well-known formula developed by Sidney S. Alexander, the foreign balance of a country is necessarily equal to its national product minus its domestic "absorption" of goods and services. From this equation, or rather identity, it follows that the foreign balance must be zero if and when the sum of domestically absorbed goods and services is exactly equal to the total national product.

If the savers happen to have high liquidity preference, and the investors insist on long-term obligations—the capital markets still being isolated—one will find a very high long-term rate of interest and a low short-term rate. Time deposits will yield a low return because they are abundant; bonds will have low prices because the demand for them is far to the left.

Assume then convertibility, and connect up this capital market roughly, if not perfectly, with that in a country where liquidity preference is much lower. Investors who prefer their liabilities funded at long term will borrow abroad. Savers who lose outlets for their savings domestically have no alternative but to lend abroad. The households which save are unlikely themselves to maintain time deposits in New York banks, but the effect is the same. If the savings are maintained with banks, the banks may hold foreign deposits. Or, if the banks are

uninterested themselves in holding foreign assets, the liquid assets held against their quick liabilities to savers must be supplied by the government or central bank, which in turn must hold the foreign assets. The financial authorities may choose to fund these assets into long-term claims on abroad. In either event there will result a long-term private inflow into the country and a long- or short-term capital outflow by the authorities. But the country has a surplus in its balance of payments in no meaningful sense.

The counterpart in the long-term lender is equally not a deficit. A country with low liquidity preference finds it profitable to exchange types of assets with a country with high liquidity preference when *ex ante* savings equals *ex ante* domestic investment in each country.

The result of connecting up European and American money and capital markets in this way can be illustrated schematically. Figure 1 shows solid lines which suggest the structures of interest rates with markets separated. The United States, with low liquidity preference, has short-term rates almost as high as long-term; Europe, with a strong demand for liquidity on the part of savers and a desire of borrowers to fund obligations, has a much steeper profile of rates. When the two markets are joined, assuming perfect mobility of capital, the two structures become identical—the dotted lines. The European structure changes more than the American, in the schematic diagram, because the United States market is larger. Arrows suggest the direction of capital movement—the upward arrows representing lending, which tightens the local market, and the downward borrowing, which lowers rates. The diagram, it should be emphasized, is highly stylized: in the real world, money and capital markets are not perfect and the arrows signify directions of movement, not discrete distances.

Observe that the distinction between official and private holdings of foreign claims in the country with high liquidity preference is a detail of no objective consequence, and one which should not make any considerable difference in the interpretation of the balance-of-payments position. The distinction between private and official institutions in the country with low liquidity preference may be equally or more significant. If this country lends long and borrows short, it makes a difference for monetary policy whether the short lending is to the central bank or to the commercial banks. Member-bank reserves are reduced, of course, when the proceeds of long-term loans in the capital market finally come

to rest as deposits with the central bank. But on balance-of-payments grounds, the distinction is of no interest.

Examples of Long-Term Loans for Liquidity

Professor Triffin's criticism of the gold-exchange standard is that reserves can be added only by new gold production, which is inadequate in some sense which need not be made precise, and through deficits of the reserve-currency countries. Deficits pile up as reserves expand, and ultimately undermine the value of the reserve currency. The system is thus self-destructive.

The point that reserves under the gold-exchange standard can be created only by newly mined (or dishoarded) gold and deficits is formally correct on the definition of deficits propounded both by the Department of Commerce (Walther Lederer) and by the Bernstein balance-of-payments committee. The attempt has been made, however, to show that these definitions were not very helpful—and in fact have been harmful. Some examples of reserve creation through long-term loans may serve to illustrate how these definitions have led to and sustained confusion in this area.

First, take the case of currency swaps between central banks. This device has been used by the United States Treasury, under the leadership of former Under Secretary of the Treasury for Monetary Affairs, Robert V. Roosa, as one of the perimeter defenses. As has been mentioned, the exchange of short-term capital assets between two countries can put both in "deficit," as the increase in liabilities is counted but the offsetting increase in claims is not. The slight redefinition of the balance-of-payments deficit to include monetary authorities' holdings of foreign exchange with gold means that outright, irreversible swaps now create reserves without deficits, but when only gold and short-term liabilities were counted, reserves were created by "deficits" which were not deficits in a significant sense.

Where swaps are undertaken when a currency is under pressure, and one country sells its foreign exchange in the market, while the other holds its foreign exchange, there is of course a real deficit. The liability remains, but the asset is sold. The United States Treasury devised currency swaps mostly as a way to acquire foreign exchange needed to meet a run. But these swaps can take place any time, among two- or multiple-currency centers, to create instant reserves without deficits, except as some irrelevant definition may decree.

Second, consider stabilization loans. The distinction between a stabilization loan and an ordinary loan is, or should be, that under ordinary circumstances a country borrows from abroad to acquire real assets, whereas a stabilization loan is contracted to raise permanently the level of foreign-exchange reserves. The hope of retaining the proceeds of the loan is not always realized, as the Anglo-American Financial Agreement of 1946 demonstrates. But countries do, from time to time, borrow long and lend short, for stabilization purposes, without the borrowers having a surplus or the lenders a deficit, except under the Department of Commerce and Bernstein definitions.

Third, take the question of the reserves of the British Commonwealth, the sterling balances held in London. In the early 1950s there was controversy over whether it was fitting for rich Britain to borrow from the poor colonies and ex-colonies through the mechanism of the sterling-area and colonial sterling balances in London. It was alleged in a series of claims, and denied, that Britain exploited these colonies by borrowing from them.⁴ Balance-of-payments issues were not in the forefront of discussion at the time, and the question did not arise whether Britain had a deficit, and the colonies surpluses, when sterling balances increased. Concern was with the stocks, not the flows.

It was not of course appropriate to regard simply the gross sterling balances of the colonies in London. There were many offsets to these sums, in bank loans, commercial indebtedness, and especially bond issues in London. The claim that countries that had 100 per cent reserves for their domestic money supply, as did many of the colonies, had to achieve an export surplus to add to their local money was wrong. Money could be expanded through long-term borrowing. Sometimes colonial borrowing in London resulted in a transitional increase in the money supply as the government sold the proceeds of the loan to the Currency Board against local means of payment; when local expenditure spilled over into import surplus the money supply was drawn down again, and the increase in claims on London spent to pay for the additional imports. This is the transfer mechanism at work. But money could be acquired through long-term borrowing to finance export projects, the output of which offset rising imports. The balance of payments did not turn adverse; the increase in money supply became part of the long-run struc-

⁴ See, for example, Ida Greaves, "*The Colonial Sterling Balances*," Essays in International Finance, No. 20 (International Finance Section, Princeton University, 1954), and the discussion in the *Economic Journal* for 1953-55 among Greaves, Hazlewood, Niculescu, King.

ture; and the colony borrowed long and lent short to match British borrowing short and lending long. On Department of Commerce terms there was a colonial surplus and a British deficit. On any sensible basis, the balance of payments remained in equilibrium. The colonies acquired liquidity, and paid for it with the difference between the return on short-term assets and the coupon on long-term bonds. Since in London the spread between long and short rates was narrow, the liquidity was acquired cheaply.

Fourth, let us return to the case of two countries, Germany and the United States, with high and low liquidity preference, respectively. Just as the colonies did not lend to Britain by holding sterling, so Germany does not finance the United States. It is claimed, for example, that Europe finances American direct investments in Europe, and it could be held that European holders of dollar balances financed the \$940 million increase in long-term U.S. bank claims on foreigners in 1964. But it can equally well be put the other way: American direct investment financed European holdings of dollars, or long-term bank loans by the United States made possible the liquidity of European money markets.

Direct investment raises another point on which the Department of Commerce statistics are grossly misleading. When Europeans think of direct investment, they inevitably have in mind the large United States corporations with enormous amounts of capital which built efficient factories and make life difficult for their competitors. They fail to realize that the Department of Commerce estimates include inter-company balances in direct investment, and that some of the rise in direct investment in recent years represents nothing more than dollar balances left on deposit in the Euro-dollar market by the European subsidiaries of American corporations to earn $\frac{1}{4}$ per cent more return than would be possible through time deposits in New York. The counterpart to Euro-dollar deposits in London by U.S. firms takes two forms. In one case, the London bank holds short-term assets in New York. The balance of payments shows a deficit on the Commerce (but not the Bernstein) definition. The Euro-dollar balance (direct investment) is ignored, but the London claim on New York is counted. In effect, however, the London bank could be regarded as part of the New York market (like the Canadian bank already discussed). There is no effect on the exchange market, current or potential, since the liability and the claim are linked.

In the other case, the dollar funds are lent by the New York bank to