FEDERAL RESERVE BANK OF NEW YORK

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Contents

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The Business Situation

Economic activity steadied in the second quarter of 1975, following five consecutive quarters of significant decline. While the gross national product (GNP) in real terms dropped again, the reported decline was negligible and was more than completely accounted for by an intensification in the rate of inventory liquidation. Indeed, the latest GNP data suggest that the longest and steepest postwar recession has finally bottomed out. Although the inventory liquidation may well continue for sometime further, it seems clear that businessmen have been successful in bringing stocks into better alignment with sales. Buoyed by consumption spending, final demand as a whole rose in real terms in the second quarter for the first time since mid-1973. As a result of lower income taxes and increased transfer payments, consumers were able to expand their purchases and at the same time to rebuild liquidity. Elsewhere, outlays on housing stabilized in real terms, but business fixed investment spending continued to decline. Conditions in the labor market improved in July as employment rose and the unemployment rate declined to 8.4 percent of the civilian labor force.

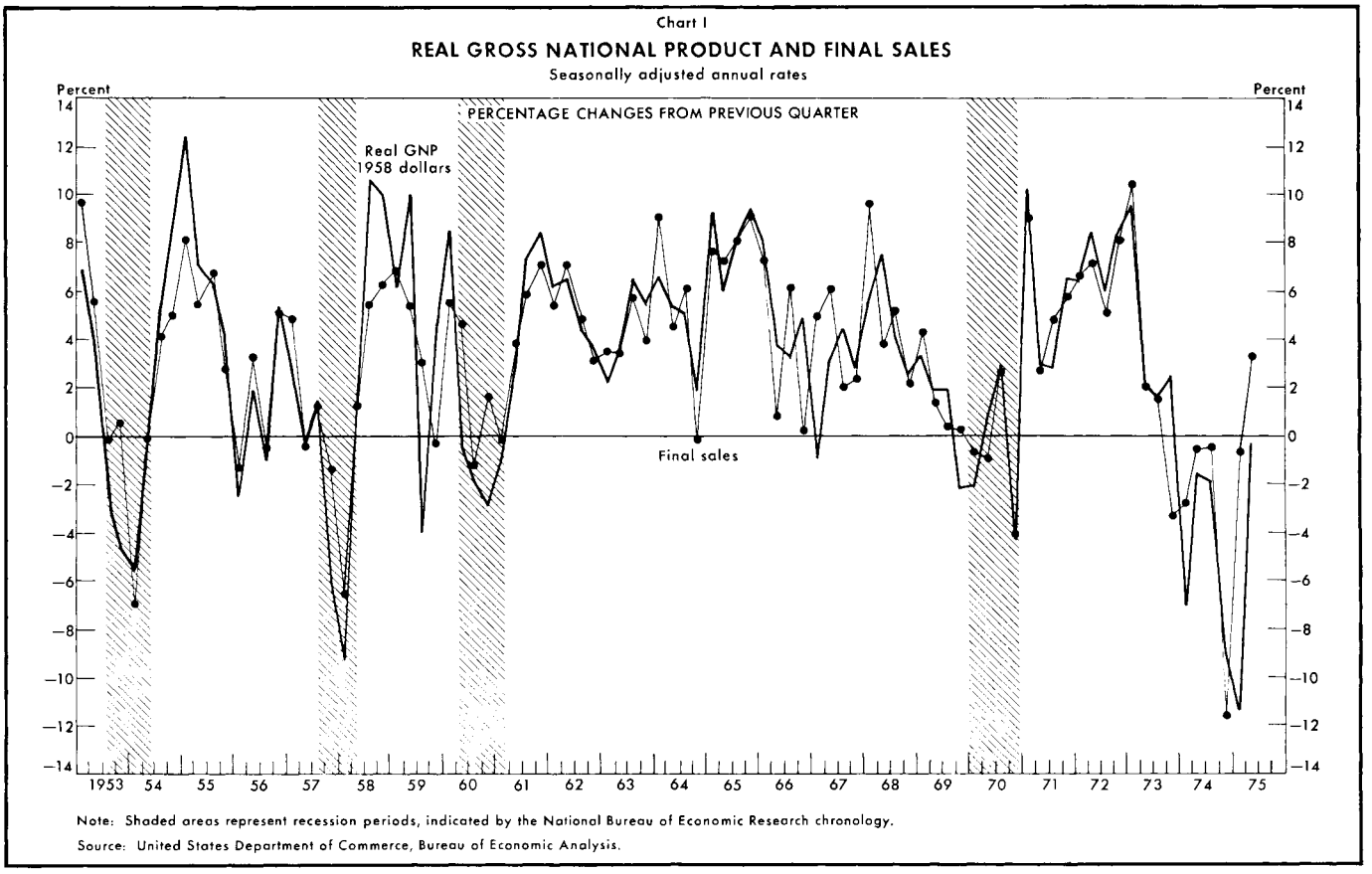
On the inflation front, the latest evidence indicates that the deceleration in inflation which began in the fourth quarter of last year extended into the April-June period. The rate of growth of the fixed-weight price index for GNP—which, unlike other GNP deflators, is unaffected by compositional shifts in output—was 6 percent in the second quarter, 1.5 percentage points below the increase in the previous quarter and the lowest recorded since the fourth quarter of 1972. However, recent and prospective developments cast some doubt on whether this favorable trend will continue. While industrial commodity prices have moderated in the face of mounting unused capacity and inventory liquidation, prices of petroleum products and fuel have recently been climbing at a somewhat accelerated pace. Another discouraging factor has been the recent acceleration in food prices. Moreover, spot and future prices of agricultural commodities have jumped in response to reports of large foreign grain purchases. On the wage front, the latest evidence suggests that the slack in the labor market has begun to dampen the growth of wages. The growth of compensation per hour worked decelerated in the second quarter and, coupled with increased labor productivity, the rate of increase in unit labor costs slowed considerably.

GNP AND RELATED DEVELOPMENTS

According to preliminary data released by the Department of Commerce, the market value of the nation's output of goods and services rose by $16.8 billion in the second quarter, a 4.8 percent seasonally adjusted annual rate of gain. After adjusting for the effects of higher prices, real GNP inched down at an annual rate of 0.3 percent, in sharp contrast to the 11.4 percent plunge in real GNP in the preceding three-month period (see Chart I). On balance, real GNP in the April-June quarter stood 7.8 percent below the peak attained in the final three months of 1973. This is the longest and steepest drop recorded during any postwar recessionary period.

As in the first quarter, the rapid pace of inventory liquidation was the most important depressant on economic activity. Current-dollar final expenditure—i.e., GNP less the change in inventories—rose $31.3 billion, or 9 percent, at an annual rate. In real terms, the increment in final sales amounted to 3.3 percent at an annual rate, the first such gain in six quarters. The increase in real spending resulted from advances in consumer, residential construction, and government outlays that more than offset the drop in business fixed investment.

Preliminary estimates based on partial data indicate that inventory liquidation accelerated to a record rate in the second quarter. In current-dollar terms, businesses reduced their inventories by $33.7 billion, outpacing the very large



$19.2 billion decline in the first quarter. Despite this massive inventory liquidation, the $14.5 billion restraint on GNP expansion was much smaller than the $37 billion drag in the first quarter, when inventory investment swung from accumulation to decumulation. Although the massive inventory correction acts as an immediate depressant on economic activity, in the long run the liquidation is essential for an eventual pickup in production.

In the first quarter, about half of the swing to liquidation was accounted for by real retail auto inventories. In contrast, inventory liquidation in the April-June interval was much more broadly based, with all major categories posting sizable declines (see Chart II). In retrospect, it appears that the inventory correction commenced late in 1974 in the nondurables trade sector and has spread since then to all major sectors of the economy. Thus, in the second quarter of this year, inventory reductions occurred in the durable and nondurable manufacturing, wholesale, and retail trade sectors. As a result of the massive inventory liquidation and the recent pickup in final sales, the ratio of constant-dollar inventories to final GNP sales has now receded from the extraordinarily high level to which it had risen at the end of 1974. While imbalances probably still remain in certain sectors of the economy, especially durable manufacturing, the overall inventory situation is now vastly improved over what it was at the beginning of the year.

There was in the second quarter a marked improvement in final sales, spurred by a sharp rise in disposable income. Consumers' disposable income surged by $63.3 billion in the second quarter, as tax rebates, cuts in tax-withholding rates, and special supplemental social security transfers swelled spendable income. The jump in disposable income stemmed from a $27.4 billion increase in personal income, coupled with a $36 billion drop in personal tax payments. Part of the gain in personal income was at-

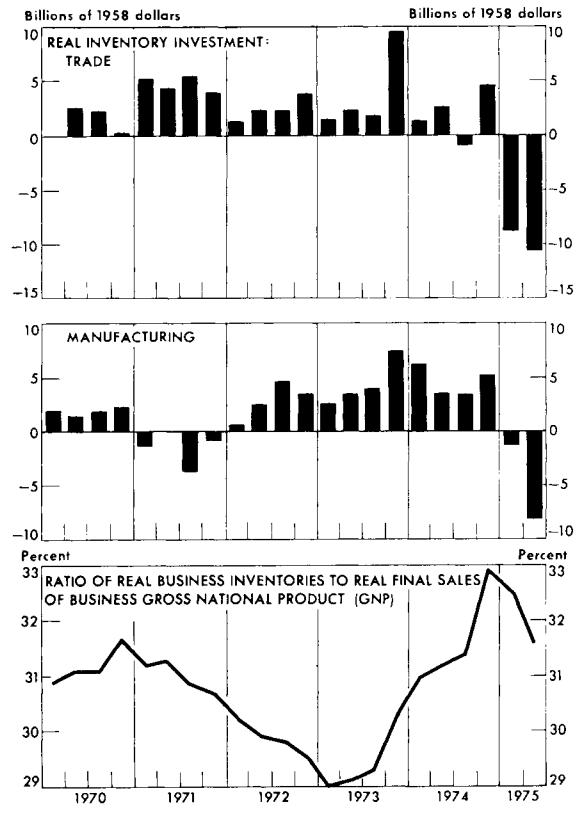
tributable to onetime payments of $50 to social security recipients, while tax rebates amounted to $31.7 billion at an annual rate. Together with an easing in the rate of inflation, real disposable income rose at a 22 percent seasonally adjusted annual rate.

Personal consumer expenditures increased by $24.9 billion in current-dollar terms (see Chart III). In real terms, the gain in personal consumption expenditures was the largest since the first quarter of 1973. With disposable income increasing sharply and consumption spending increasing more moderately, the saving rate soared to 10.6 percent of disposable income, the highest rate of saving since the first quarter of 1946 and well above the 7.5 percent averaged over the previous four quarters. While this accumulated saving is likely to be used initially by consumers to reduce instalment debt and rebuild liquidity, it will at the same time provide a foundation for stronger consumer spending in future months. Moreover, the impact of lower withholding schedules and extended unemployment benefits will continue to be felt in the future, and an 8 percent cost-of-living increase in social security benefits will also boost disposable income. The gain in real consumer spending reflected higher outlays for durable and nondurable goods as well as for services. Real service expenditures increased at a 4.8 percent annual rate. Real spending on consumer durables rose at a 10 percent annual rate in the June quarter, with auto expenditures expanding at a 9 percent annual rate and nonauto spending rising at a 10.5 percent annual rate. Sales of domestically produced cars have edged up steadily in recent months, running at 7.1 million units in June as compared with the 6 million units sold in March. Nondurable goods outlays rose at a 6.3 percent annual rate, the largest increase since the fourth quarter of 1972.

Chart II

REAL INVENTORY INVESTMENT AND REAL INVENTORY-SALES RATIOS IN THE GNP ACCOUNTS

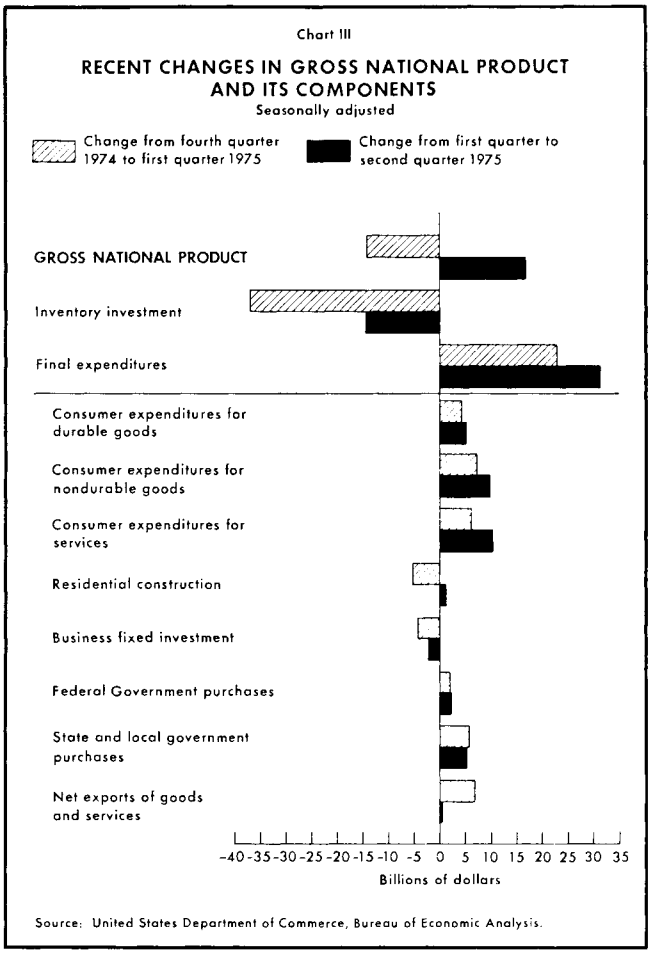
Seasonally adjusted annual rates



Source: United States Department of Commerce.

After skidding for two years, real residential construction spending edged up in the second quarter. To be sure, the increase was negligible, but it nonetheless suggests that the collapse in housing has ended. Most other measures of housing activity confirm the pickup in home building, but the strength of the recovery is still uncertain. Permits to build new homes rose each month of the quarter and, over the quarter, averaged 892,000. While this remains a depressed rate by historical standards, it is 30 percent higher than the first-quarter average. Another encouraging factor has been the improvement in sales of single-family homes. Sales are now at their highest level since May 1974. No doubt the tax credit on purchases of new, previously unoccupied houses is a factor in the sales pickup. On a newly built home of $40,000, which is close to the median price of new one-family homes, the 5 percent tax credit works out to be roughly equal to a 20 percent reduction on a 25 percent downpayment. The ratio of unsold new homes to sales fell in May to its lowest level in nearly two years. Despite the recent upturn of short-term interest rates, rates on time and savings deposits have remained relatively attractive and deposit growth at thrift institutions has continued to accelerate. In June, deposits at savings and loan associations and mutual savings banks rose at close to a 20 percent annual rate. Thus, the outlook for housing remains moderately encouraging, as the increased inflow may lead to further easing in mortgage lending terms.

Business fixed investment declined $2.3 billion in the second quarter, as the drop of $2.6 billion investment in structures more than offset a $0.2 billion increase in producers' durable equipment. In real terms, plant and equipment outlays fell for the fourth consecutive quarter.



In light of the current low levels of capacity utilization, there is little reason to look for a turnaround in spending. Indeed, the most recent Commerce Department survey of capital spending plans, taken in late April and May, indicates such a meager increase in nominal outlays in 1975 that a decline in real terms seems certain. Outlays on new plant and equipment are expected to be only 1.6 percent higher than in 1974.

PRICE DEVELOPMENTS

By virtually every measure, inflation continued to decelerate over the April-June period. Prices of goods and services, as covered by the implicit GNP price deflator, advanced at a 5.1 percent annual rate in the second quarter, down substantially from the 8.4 percent advance recorded in the previous three-month period. In part, however, it appears that the slowdown in the implicit GNP deflator overstated the actual improvement because of the changing composition of output, especially the sizable pickup in the level of auto production between the first and second quarters. The fixed-weight price index, which holds constant the composition of output, improved more modestly, with its annual rate of increase falling from 7.5 percent in the first quarter to a 6 percent rate in the second quarter.

To the relief of consumers, the rate of inflation in retail prices is now running well below the double-digit range. Since peaking at an 11.9 percent annual rate in the third quarter of 1974, the rate of advance of consumer prices has eased considerably. In the second quarter, such prices rose at a 5.8 percent annual rate, the slowest quarterly rate of increase since the end of 1972. This deceleration reflected a sharp slowdown of inflation in the prices of nonfood commodities and services, as well as food. However, it appears that the volatile food component is headed back up. Led by rapid increases in the price of meat, the increase in food prices accelerated each month of the quarter. Nonfood commodity prices rose at a 6.7 percent annual rate over the quarter, less than half of the 13.6 percent rate of increase a year earlier. Service prices in the second quarter rose at a 6.1 percent annual rate, compared with a 9.3 percent annual-rate advance in the previous quarter.

At the wholesale level, prices of industrial commodities continued to decelerate, rising at a 2.6 percent annual rate over the April-June period. This was in sharp contrast to the year-earlier quarterly increase that exceeded 30 percent at an annual rate. The deceleration would have been even more pronounced if power and fuel prices had not begun to rise rapidly again. Unfortunately, the near-term outlook for energy prices is not encouraging. The full impact of import fees of $2 per barrel on crude oil and 60 cents per barrel on refined petroleum products is still to be felt and undoubtedly will add to pressures on energy prices. In addition, energy prices could accelerate even further in the event that either domestic crude oil prices are decontrolled or the Organization of Petroleum Exporting Countries (OPEC) cartel raises its price of oil. Excluding power and fuel, industrial commodity prices rose only at a 2.2 percent annual rate in June. After declining in the first three months of 1975, wholesale agricultural prices increased at a 16 percent annual rate in the second quarter. As a consequence, wholesale prices as a whole rose at a 7 percent annual rate in the second quarter after declining in the first quarter. To a large extent, the turnaround in agricultural prices reflected a jump in the prices of livestock and meat, as prices of hogs and

beef cattle have soared recently.

In July the outlook for food prices was clouded by reports of drought damage to USSR crops and by news that the Soviets were seeking to purchase substantial amounts of wheat and corn from the United States. Despite forecasts of record domestic production of corn and wheat, prices of these commodities have jumped sharply. As of the end of July, the USSR had contracted to purchase 9.8 million metric tons of domestic wheat, corn, and barley. Although it is clear that the increased Soviet demand for United States grain exports will lead to higher prices of corn and wheat, it does not appear that these purchases will precipitate the skyrocketing prices of 1972-73. With the exception of the USSR, prospects for an increase in worldwide production appear good, and production estimates suggest that carry-over stocks in this country at the end of the year will likely be larger than at the beginning.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate that the pace of wage increases has slowed in the past several months. Over the April-June interval, compensation per hour worked, which includes wages and fringe benefits, rose in the private nonfarm sector of the economy at a seasonally adjusted annual rate of 7.2 percent, a slower pace than the 10 percent increase averaged in the previous four quarters. The slowdown in wage gains has also been mirrored in other wage series. Average hourly earnings increased at a 5.1 percent annual rate in the second quarter, compared with an 8.5 percent advance recorded in 1974. However, because movements in this series reflect not only wage changes but also changes in manufacturing overtime and interindustry shifts in employment, a better measure of wage-rate changes is the adjusted hourly earnings index. After adjusting for changes in overtime in manufacturing and interindustry shifts, the gain in average hourly earnings slowed to 6.9 percent at a seasonally adjusted annual rate in the second quarter, the third consecutive quarter of slower wage gains and the lowest rate of increase since the first quarter of 1974. Over 1974 as a whole, adjusted average hourly earnings climbed at a 9.1 percent rate.

Developments reported in the separate survey of major collective bargaining agreements also reveal a modest slowing in the rate of wage increases, although the gains remain sizable. In collective bargaining agreements covering 5,000 or more workers, contracts settled in the second quarter provided for a 9.3 percent annual rise in wages and benefits over the first year of the contract and 7.7 percent annually over the contract life. In contrast, the increases in contracts signed in 1974 averaged 10.7 and 7.8 percent, respectively. For wages alone, settlements covering 1,000 or more workers in the second quarter provided for first-year increases of 9.8 percent, compared with 12.5 percent in the preceding three-month period. Because union negotiators have concentrated on winning large first-year wage increases, the relatively light calendar of major contracts that expire in 1975 should tend to help moderate wage pressures, since most union workers will be receiving the relatively smaller second- and third-year increases provided by agreements signed in earlier years. This tendency is reflected in the Bureau of Labor Statistics' effective wage series, which includes gains arising from current settlements, deferred increases negotiated in earlier years, and additional gains from escalator clauses. In the second quarter, the effective wage rate rose at a 7.8 percent annual rate after advancing 9.4 percent in 1974.

Productivity, as measured by output per hour of work in the nonfarm private economy, rose at a 3.4 percent seasonally adjusted annual rate over the April-June period, the first increase in more than two years. This advance, however, resulted from a decline in hours worked which exceeded the decline in total production. Typically, during the early stages of a cyclical recovery, productivity tends to pick up sharply as producers are able to utilize idle capacity more efficiently without large additions to their labor force. However, some analysts have argued recently that productivity increases in coming months may be subnormal for this phase of the business cycle since durable manufacturing industries may post smaller productivity increases than in typical recoveries. These analysts foresee only a modest recovery in the production of durable goods which ordinarily have bounced back sharply. In any event, the prospect of a moderate increase in unit labor costs this year looks promising since productivity growth, even if sluggish, is still likely to mitigate wage gains somewhat. In contrast, productivity declined continuously in 1974. In the second quarter, because of the deceleration in compensation and gains in productivity, unit labor costs in the private nonfarm sector rose at a seasonally adjusted 3.9 percent, the slowest annual rate of increase since late 1972 and far below the 14 percent advance posted in 1974.

According to the household survey, labor market conditions improved in July as the rate of joblessness fell to 8.4 percent. This was the second consecutive monthly decline and left the unemployment rate at its lowest level since February. Since the unemployment rate in June had been artificially depressed by faulty seasonal adjustment

procedures, it was widely expected that the jobless rate would post a substantial increase in July. Under these circumstances, it seems likely that the 0.2 percentage point decline in July may understate the actual degree of labor market strengthening. Despite this, the unemployment rate remains high by historical standards and, moreover, it remains to be seen if some of the improvement was an aberration. Typically, the unemployment rate tends to lag somewhat behind the pickup in economic activity, since employers expand production initially by lengthening the workweek of their work force without recalling laid-off workers or hiring new ones. In addition, as job prospects improve, this often encourages individuals who have stopped looking for employment to seek jobs, thus tending to swell the labor force and raise the rate of unemployment. Whatever the near-term behavior of the unemployment rate, employment has begun to expand. In July, total employment registered its fourth consecutive increase, advancing by 634,000 workers to its highest level in seven months. The number of unemployed persons fell in July to the lowest level since February. Most labor force groups shared in the improvement in employment; in addition, the number of persons working part time because they couldn't find full-time employment declined sharply in July, dropping by 175,000.

While the household survey points to an increased pace of employment growth, the separate payroll survey indicates a more modest advance in employment. Of course, the household and payroll surveys may diverge because of differences in definition, coverage, sources, and estimation procedures. In July, the survey of nonfarm establishments indicated that employment rose by 88,000 as employment in services, trade, and state and local government expanded. Employment in construction declined slightly but this may have reflected the effects of increased strike activity. Manufacturing employment also dipped slightly, but average weekly hours worked in manufacturing jumped to the longest workweek since November 1974. While the household survey points to a much faster employment growth than the payroll survey, the payroll survey nevertheless suggests that the employment gain was broadly based. The percentage of nonfarm industries experiencing increases in employment rose to 54.9 percent, the highest level in more than a year.

The Money and Bond Markets in July

Both short- and long-term interest rates advanced during July, partly in response to a substantial buildup in the corporate and municipal bond calendars and the belief of market participants that some firming of monetary policy was under way. The sharp rise in yields on the Municipal Assistance Corporation's bonds when they began trading without price restrictions was an additional depressant in the municipal market since it rekindled concern over the financial problems confronting New York City and some other urban areas. During the month, Treasury borrowing also continued heavy, through sizable amounts of new cash raised at each weekly bill auction and through the sale of $1.5 billion of new notes. At the end of the month the Treasury auctioned $5.8 billion of coupon issues to refund August maturities and raise $1 billion of new cash.

In the money market, most rates moved upward in July for the second consecutive month. The rates at which Federal funds traded increased over the month to an average of 6.10 percent. Higher yields were also posted on all maturities of commercial paper and on large certificates of deposit (CDs). In addition, major commercial banks boosted their prime lending rate over the period by ½ percentage point to 7½ percent. This was the first increase in the prime rate since July 1974, when the rate reached a record 12 percent before falling steadily to 7 percent in June of this year.

According to preliminary estimates, the growth in both the narrow and broad money stock measures moderated considerably in July from the very rapid expansion of the previous two months. However, since consumer-type time deposits at commercial banks continued rising sharply, the slowdown in the growth of the broad money stock was less pronounced. The bank credit proxy fell somewhat in July, as declines in Government deposits at member banks and in CDs offset demand and consumer-type time deposit growth.

THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on money market instruments rose further in July, following the sharp advances experienced in the preceding month (see Chart I). As the Federal Reserve absorbed reserves at progressively higher levels of the Federal funds rate, participants became convinced that a firming of monetary policy was under way. For the month as a whole, the effective rate on Federal funds averaged 6.10 percent, an increase of 55 basis points from the comparable figure for June. Rates generally increased ½ percentage point on directly placed commercial paper in July, while most maturities of dealer-placed paper registered a ¼ percentage point gain. The average yield in the secondary market on ninety-day CDs showed considerable fluctuation during July and closed the month at 6.55 percent, up 15 basis points from the end of June. In line with these increases in money market yields, the rate on prime business loans at most money-center banks was boosted in July in two ¼ percentage point steps to 7½ percent.

Business demand for short-term credit remained weak during July, as corporations apparently continued to lengthen the maturity of their liabilities. Over the first four statement weeks of the month, business loans at large commercial banks fell by $1 billion. This compares with increases of $2.7 billion and $2.3 billion over the comparable period in the two preceding years. In response to this weakness, banks allowed a further large volume of their CDs to run off in July. There was essentially no change in the amount of nonfinancial commercial paper outstanding during July when allowance is made for the usual seasonal pattern.

Preliminary data indicate that there was a sharp deceleration during July in the growth of the narrow money supply (M_1)—private demand deposits adjusted plus cur-

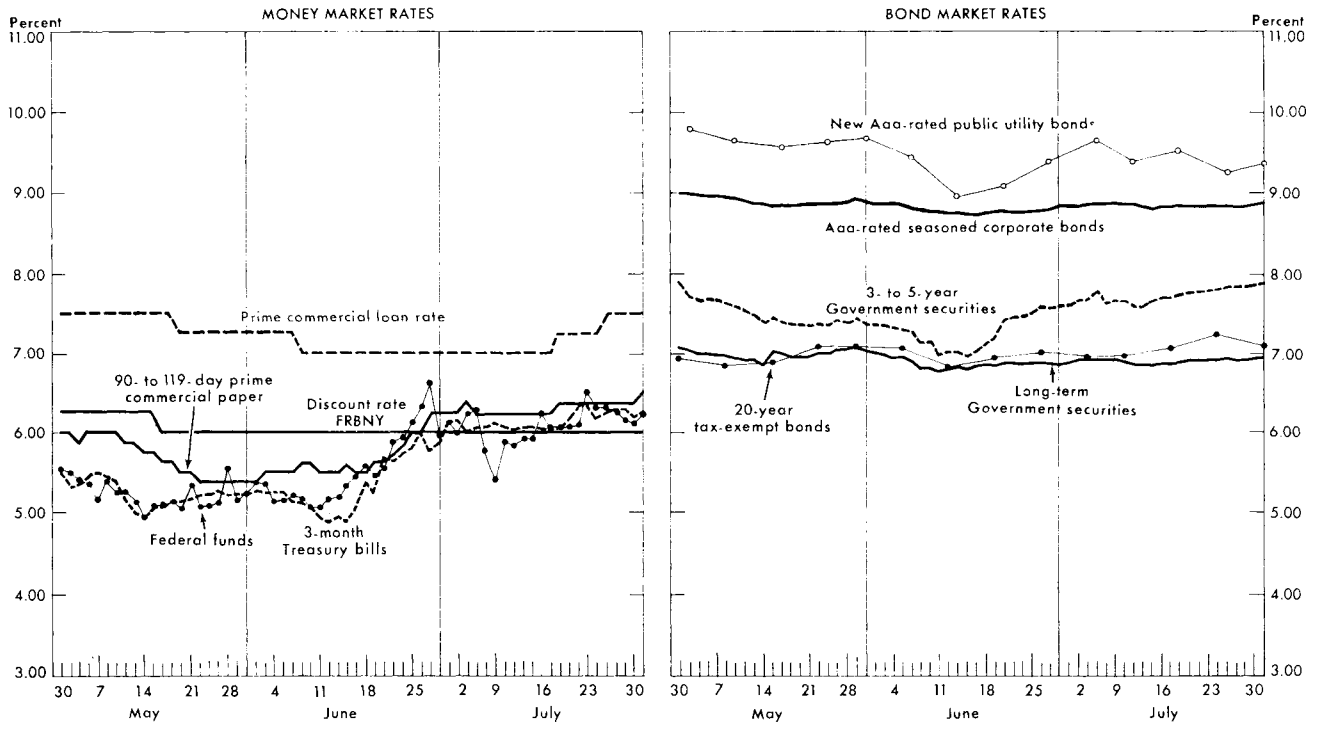
rency outside commercial banks. On an annual basis, the average seasonally adjusted level of M_1 in the four weeks ended July 23 was 1.8 percent above the average for the four weeks ended June 25. Both in May and particularly in June, M_1 had grown at extremely rapid rates, in part due to the effects of tax rebates by the Treasury and special social security payments. As a result, the expansion in M_1 in the four weeks ended July 23 from its average level in the four weeks ended thirteen weeks earlier was a substantial 10.6 percent at an annual rate. Over the latest fifty-two-week span, however, M_1 advanced a moderate 5 percent (see Chart II).

Consumer-type time and savings accounts continued to grow strongly in July, as rates on these deposits remained attractive. The broad money stock (M_2)—which includes these deposits plus M_1—thus grew at an 8.4 percent seasonally adjusted annual rate in the four weeks ended July 23, compared with the average four-week level in the period ended June 25. Over this same period the average levels at commercial banks of United States Government deposits and negotiable CDs declined substantially on a seasonally adjusted basis. As a result, there was a decrease in the adjusted bank credit proxy, a measure which includes all deposits at member banks subject to reserve requirements plus certain nondeposit sources of funds. On an annual basis, the average seasonally adjusted level of the proxy in the four weeks ended July 23 was 5.6 percent lower than its average level in the preceding four-

Chart I

SELECTED INTEREST RATES

May-July 1975



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Prime commercial loan rate at most major banks; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the five dealers that report their rates, or the midpoint of the range quoted if no consensus is available; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa-rated bond of at least twenty years' maturity; daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, Inc., and The Bond Buyer.

week period. Member banks made somewhat heavier use of the discount window during July, when borrowings averaged $386 million (see Table I), compared with $97 million in June.

THE GOVERNMENT SECURITIES MARKET

Yields on Treasury securities increased on balance during July, initially in response to uncertainty about the course of monetary policy and later in response to what participants interpreted as a firming of this policy despite the upcoming August refunding. A lack of significant investor demand was also evident at various times. In addition, the Treasury's large financing needs engendered a cautious tone, given the less than enthusiastic investor interest exhibited from time to time during the month.

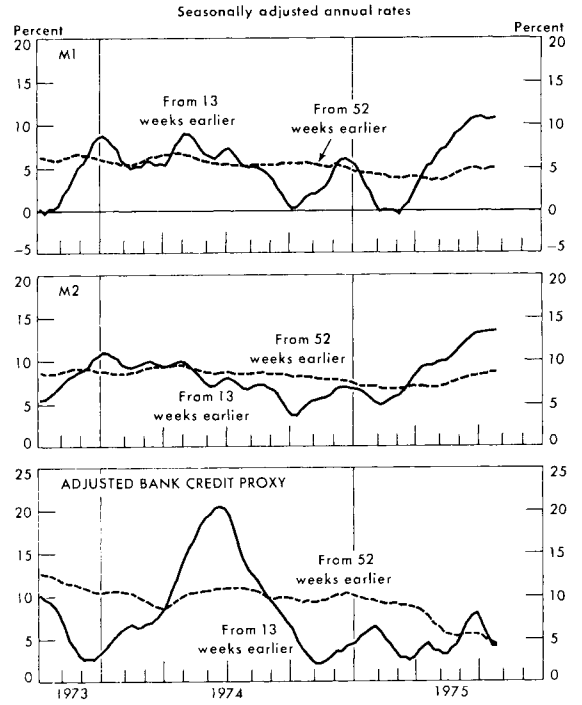
Rates on coupon issues generally edged higher during the first week of the month in light, pre-Fourth of July holiday trading. In the wake of the rise in rates at the end of June, investors tended to wait on the sidelines in uncertainty about the near-term course of interest rates, and some unloading of holdings also took place. Then, in the following week, the Federal funds rate receded from its higher midyear level which had partly reflected seasonal pressures. In addition, declines in M_1 and in business loans, coupled with better than expected demand in the July 14 weekly bill auction, also contributed to an improved tone in the Treasury coupon market at that time. Market participants responded favorably, and yields on notes and bonds moved down over the remainder of the first half of July.

As the month progressed, growing concern developed about investor acceptance of the $1.5 billion of Treasury notes scheduled for auction on July 17 and the terms and amount of the August refinancing which were to be announced after the market's close on July 23. Response to the $1.5 billion of two-year notes auctioned at mid-month turned out to be favorable, with tenders from the public totaling $5.4 billion. The notes were sold at an average yield of 7.52 percent. Following this auction, rates increased in the wake of lackluster secondary market interest in the new notes and in anticipation of the yields which would be required to complete successfully the Treasury's August refinancing. The terms of the refinancing were announced as expected on July 23. To refund $4.8 billion of publicly held notes maturing August 15 and to raise $1 billion in new cash, the Treasury auctioned $3 billion of 2¾-year notes, $2 billion of seven-year notes, and $0.8 billion of twenty-five year bonds at the end of July. Also, the Treasury sold $2.6 billion of notes and bonds at the average price of accepted tenders

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier and 52 weeks earlier. The latest statement week plotted is July 23, 1975.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source. Board of Governors of the Federal Reserve System.

to Government accounts and Federal Reserve Banks, which held $2.9 billion of maturing notes. The public's initial response to the August refinancing was quite favorable. On July 29, the Treasury received $5.6 billion in tenders for its $3 billion of thirty-three-month notes and the average issuing rate was set at 7.94 percent. The following day the Treasury received tenders of more than $3.7 billion for its $2 billion of seven-year notes. The average issuing rate for the notes was 8.14 percent. Investors also tendered $2 billion for the final part of the sale, the $800 million of twenty-five-year bonds which were auctioned on July 31 at an average yield of 8.44 percent.

At the time of the refunding announcement the Treasury also disclosed its projected new cash borrowing for the last half of 1975. It was estimated to be $41 billion,

$3 billion higher than the amount estimated in mid-June. An additional $3.5 billion to $4 billion will be borrowed in late August and early September through issues of two-year and four-year notes, and there will also be additions to the regular bill auctions totaling $3 billion to $3.5 billion between mid-August and mid-September. From then to the end of October, cash needs will be about $9 billion, but no details were given for raising that amount.

Over the month as a whole, the index of yields on intermediate-term Government securities rose 32 basis points to 7.88 percent. However, the index of long-term bond yields rose only 7 basis points to 6.93 percent.

The Treasury bill market responded in similar fashion to many of the factors which affected Government coupon securities during July. Rates moved higher as the month began, in response to the less than enthusiastic bidding in the final weekly auction in June. Although investor interest emerged at the higher yield levels, participants remained cautious because of their uncertainty about the future trend in interest rates. Reflecting this atmosphere, the average issuing rates on the three- and six-month bills at the first weekly auction in July were 19 and 25 basis points higher than a week earlier. Then, over the next several days, rates on bills declined in response to the lower level of Federal funds trading and expanded investor and professional demand. As a result, the average issuing rate on the three- and six-month bills declined by some 15 basis points at the July 14 auction (see Table II), and rates edged even lower following the sale.

After midmonth the tone in the bill market became more cautious, as the rate on Federal funds began to rise and the Federal Reserve absorbed reserves on several occasions. Although some investor demand was evident for selected maturities from time to time, bill rates increased on balance and, over the month as a whole, yields on most Treasury bills rose 29 to 59 basis points.

Rates on Federal agency issues also rose during July, and some new offerings encountered investor resistance. On July 17, two farm credit agency offerings were marketed at yields about 1¼ percentage points higher than were provided on similar issues in June. At these yield levels, the bonds were given a good reception. New securities offered by the Federal Land Banks and the Government National Mortgage Association (GNMA) encountered some initial problems. Early in July the Federal Land Banks priced $464 million of 7½-year bonds to yield 8.20 percent and $650 million of fifteen-month bonds to yield 7.20 percent. The longer bonds sold quickly, but the shorter ones did not because the yield was so close to that on comparable Treasury issues. The GNMA offering on July 15 was also in two parts: $154 million of thirty-year securities yielding

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JULY 1975

In millions of dollars; (+) denotes increase and (—) decrease in excess reserves

Factors	Changes in daily averages—week ended					Net changes
	July 2	July 9	July 16	July 23	July 30	
"Market" factors						
Member bank required reserves	— 466	+ 584	— 306	+ 106	— 25	— 107
Operating transactions (subtotal)	—1,620	+2,471	+1,851	— 667	+ 192	+2,227
Federal Reserve float	— 95	+ 362	— 100	— 294	— 415	— 542
Treasury operations*	—1,538	+2,396	+2,244	— 160	— 449	+2,493
Gold and foreign account	— 31	+ 10	— 32	+ 56	— 22	— 19
Currency outside banks	— 3	— 604	— 220	— 228	+1,188	+ 133
Other Federal Reserve liabilities and capital	+ 47	+ 307	— 41	— 40	— 111	+ 160
Total "market" factors	—2,086	+3,055	+1,545	— 561	+ 167	+2,120
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+1,832	—2,692	—1,600	+ 505	— 128	—2,083
Outright holdings:						
Treasury securities	+ 400	— 360	—1,210	+ 587	— 240	— 823
Bankers' acceptances	+ 8	— 1	+ 4	— 6	— 1	+ 4
Federal agency obligations	—	— 1	—	—	— 1	— 2
Repurchase agreements:						
Treasury securities	+1,184	—2,008	— 298	— 90	+ 126	—1,086
Bankers' acceptances	+ 124	— 152	— 81	+ 11	+ 2	— 96
Federal agency obligations	+ 116	— 170	— 15	+ 3	— 14	— 80
Member bank borrowings	+ 683	— 648	— 21	+ 180	— 129	+ 65
Seasonal borrowings†	+ 5	— 2	+ 3	+ 3	+ 1	+ 10
Other Federal Reserve assets‡	— 156	— 3	+ 43	+ 72	+ 121	+ 77
Total	+2,359	—3,343	—1,578	+ 757	— 136	—1,941
Excess reserves‡	+ 273	— 288	— 33	+ 196	+ 31	+ 179

	Daily average levels					Monthly averages§
Member bank:						
Total reserves, including vault cash‡	35,471	34,599	34,872	34,962	35,018	34,984
Required reserves	35,077	34,493	34,799	34,693	34,718	34,756
Excess reserves	394	106	73	269	300	228
Total borrowings	871	223	202	382	253	386
Seasonal borrowings†	15	13	16	19	20	17
Nonborrowed reserves	34,600	34,376	34,670	34,580	34,765	34,598
Net carry-over, excess or deficit (—)‖	71	226	97	20	79	99

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Average for five weeks ended July 30, 1975.
‖ Not reflected in data above.

8.42 percent and $70 million of twenty-five-year securities priced to yield 8.44 percent. The larger issue in particular sold quite poorly, and yields on both parts rose by 9 basis points when the securities were released from syndicate two days later.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—July 1975			
	July 7	July 14	July 21	July 28
Three-month	6.203	6.045	6.247	6.318
Six-month	6.510	6.344	6.626	6.719
	Monthly auction dates—April-July 1975			
	April 30	May 28	June 24	July 24
Fifty-two weeks	6.400	5.803	6.292	6.782

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

THE OTHER SECURITIES MARKETS

Yields moved higher in both the corporate and municipal markets over the month of July in the face of heavy calendars and some concern among participants as to the near-term course of interest rates. Early in the month there was a decline in both The Bond Buyer index of twenty municipal bond yields and the Federal Reserve Board's index of yields on recently offered corporate securities. However, in response to the pressure of additional new offerings and the increase in short-term rates, the pattern was soon reversed and the indexes rose steadily over most of July.

By far the dominant factor in the tax-exempt market during the month was the $1 billion offering of New York Municipal Assistance Corporation (MAC) bonds. The two-day sale of this issue occurred on June 30 and July 1 and was generally considered successful at that time, although there was reportedly little demand for the bonds among out-of-state investors despite their very high yields. As the month progressed and the bonds remained under syndicate price restriction, speculation arose as to the actual success of the sale. When the bonds were finally freed to trade on July 21, their prices dropped sharply, increasing the yields substantially. Since MAC was planning to raise an additional $2 billion by the end of September in order to aid New York City, its difficulties with the initial sale generated concern about the fate of its future offerings. With some $790 million of New York City notes maturing in August, the municipal market was once again confronted with the depressing possibility of a default by the city.

In contrast to MAC's and New York City's problems, the next largest tax-exempt issue, the New York State Power Authority's $200 million offering of top-rated promissory notes, sold out immediately at midmonth. These consisted of $150 million of 7¼ percent notes due in three years and $50 million of 7½ percent notes with a five-year maturity. Priced at par, the issue provided generous yields when compared with another authority offering a month earlier. Two issues totaling $275 million were postponed during July, and some large new offerings in the last half of the month sold somewhat slowly. However, an improved tone developed as the month drew to a close, in part because of renewed interest in the MAC bonds as signs of some progress in New York City's fiscal problems emerged. The Bond Buyer index rose 22 basis points from the end of June to a record 7.22 percent on July 24 and then declined to 7.09 percent the following week. The Blue List of dealers' advertised inventories fell by $13 million and closed the month at $547 million.

The corporate bond market experienced a record volume of new issues during the first half of 1975, and offerings continued heavy in July, a normally slow month. Most of the large new issues were given a good reception in July, albeit at higher yields. The largest taxable offering during the month was $500 million of International Bank for Reconstruction and Development Aaa-rated debt which was sold on July 9. Almost all of the $200 million of ten-year notes was sold the first day at a yield of 8.6 percent, but the second part of the offering, $300 million of five-year notes paying 8.3 percent, moved somewhat more slowly. The next day brought the marketing of two additional large offerings: $300 million of Standard Oil Co. of California's Aaa-rated debentures and a $250 million Aa-rated package from Ford Motor Credit Co. Both were well received. The thirty-year oil company bonds were priced to yield 8.83 percent, 36 basis points more than a similarly rated oil issue offered a month earlier. The two-part offering from the credit company, $100 million in ten-year notes and $150 million in twenty-five-year debentures, was also attractively priced to yield 8.85 percent and 9.73 percent, respectively. Reflecting the general rise in rates on corporate issues during July, the Bell Telephone Co. of

Pennsylvania's Aaa-rated offering of forty-year debentures was priced to yield 8.8 percent at midmonth, up from 8.65 percent on a similar issue marketed in June. These bonds sold quickly on their first day and were followed by the successful sale of $250 million of eight-year Aa-rated utility company notes yielding 8.46 percent the following day. Corporate bond issues marketed over the remainder of the month were more modest in size and were generally well received. The Board's index of yields on recently offered Aaa-rated corporate securities rose 16 basis points from June 26 to July 17 but then declined somewhat over the remaining two weeks. For the month as a whole, the index showed a 4 basis point rise.

Some record-breaking and unusual developments occurred in the taxable bond market during July. Citicorp successfully marketed a record volume of publicly offered convertible securities during the period, and the American Telephone & Telegraph Company, which normally borrows domestically, reported the placement of a $100 million note with the government of Saudi Arabia. In addition, Standard Oil Co. (Ohio) and British Petroleum Co. Ltd., through a jointly owned subsidiary, privately placed a huge $1.75 billion debt issue to conclude the financing of their 49 percent portion of the Alaskan pipeline. Sohio/BP Trans Alaska Pipeline Finance, Inc., received commitments from some seventy-five institutions for purchase of this record-breaking amount of its 10⅝ percent notes.

Measuring the United States Balance of Payments

By PATRICIA HAGAN KUWAYAMA*

The balance of payments is an important concept, one which significantly influences our understanding of international developments in the United States economy. Each time a new balance-of-payments statistic is released, it is widely interpreted as an indication of how things have become "better" or "worse" in the foreign sector of our economy and as a measure of "strength" or "weakness" of the dollar. Frequently, the figures are reported in more popular media as "the" balance of payments, without recognition of the fact that at least seven different measures are currently in standard use, each designed to illuminate specific aspects of these broad qualitative issues. Indeed, the number is larger than seven if all balance-of-payments measures which are commonly used by professional economists for various types of analysis are included.

The existence of so many international payments "balances", while in some ways inconvenient, should be welcomed as a reminder that there is no single answer to the question whether our international transactions have become better or worse in a given period—nor is there any simple way of determining from any of these balances the prospective strength or weakness of the dollar.

The meaning of several balance-of-payments measures has also changed over the years, along with developments in the international economy and institutions. In the post-World War II period, the liberalization of international trade and capital flows has led to an enormous growth in the scale and sophistication of transactions engaged in by both private and official parties and has blurred many of the distinctions that were once useful. More recently, the shift by industrial countries to a system of greatly increased variability in exchange rates has provided new reasons for a revised approach to analyzing international flows. Another recent change that has added to the difficulty of using the balances stems from the huge accumulations of dollar reserves by the Organization of Petroleum Exporting Countries (OPEC).

The United States Department of Commerce has responded to the changing needs over the years, carrying out two major revisions (as well as many smaller ones) of its official balance-of-payments presentation in the last decade. One of these revisions followed an intensive review of the statistics, commonly known as the "Bernstein Report" [10],[1] in 1965. The second was introduced with the June 1971 issue of the *Survey of Current Business* [12], along with a detailed explanation which is still a standard reference on official United States balance-of-payments statistics and their interpretation. Currently, another review committee of academic, Government, and business economists is considering the questions of whether the official tables should be revised again and even whether publication of traditional balance-of-payments measures should be continued at all.

This article proposes to clarify the analytical differences among major balance-of-payments measures and to explain the usefulness of each in application to present-day policy questions. No attempt is made to identify a single statistic which can be regarded as "the" appropriate balance-of-payments measure for the United States; nor is there any consideration of what should, or should not, be published as an "official" measure. Some recommendations are made to the users of balance-of-payments numbers as to how they can (or cannot) use the statistics in answering specific questions, and major problems of con-

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[1] The numbers in brackets refer to the references cited at the end of this article.

cept and measurement are explored with reference to these applications. Particular attention is devoted to changes in the use of the balances that have been dictated by recent developments in the international economy, including the shift to more flexible exchange rates. In this latter respect, the most important conclusion to be drawn is that the problems of measuring the United States balance of payments in a contemporary setting do not stem mainly from the new exchange rate regime. Most of the problems have existed for some time and reflect the complexity of international capital movements at least as much as the flexibility of exchange rates.

Finally, the discussion which follows emphasizes that, while a proper use of balance-of-payments concepts is a helpful starting point for understanding developments in the international sector of the economy, these measures can never provide answers to important questions by themselves. Even if balance-of-payments statistics were gathered in much more detail than they are now, and even if they are interpreted with a maximum of sophistication, they still only summarize the net flow of transactions between domestic residents and residents of foreign countries. For the United States particularly, this is but part of the story. The widespread use of United States dollars by foreigners in transactions which do not directly involve the United States at all means that American businessmen and policy makers must consider the potential impact on the United States not only of this country's balance-of-payments flows, but also of a variety of other factors affecting the supply of and demand for dollars in international use. Thus, while this article is intended to promote the best possible use of the balance-of-payments statistics, it is not necessarily intended to advocate more attention to these measures; if anything, balance-of-payments measures are probably overused as an approach to international policy analysis and should be supplemented as much as possible by other kinds of information.

DEFINITIONS OF THE BALANCE OF PAYMENTS

The balance-of-payments statistical statement is designed to summarize all economic transactions between residents of the United States and those of foreign countries. It is based on the principle of double-entry bookkeeping: every payment creates a claim or extinguishes a liability, and the corresponding receipt provides an offsetting entry somewhere else within the accounting statement. Thus, the broadest balance—involving all transactions by both private and official parties—should always equal zero by definition.

However, not all transactions between Americans and foreigners are captured in the statistics. Furthermore, because in some cases one side of a transaction fails to be reported, or the two sides may be reported with inconsistent values, the sum of all recorded transactions is never zero. Therefore, there is always one item called "errors and omissions", which is derived as the statistical discrepancy that is found when all recorded transactions are added together. This residual item is usually thought to be composed largely of unrecorded capital items. A review of past statistics will show that it has been large and negative (i.e., representing unrecorded outflows) in periods when the United States dollar was under speculative attack. However, there can be large errors in the reporting of transactions other than capital as well.

The payments balances which are used for analytic purposes all result from separating out one or another subset of international transactions which are thought to have a particular type of significance. A line is drawn below these items, and they are then summed up to obtain a balance of payments which may or may not equal zero. Each definition involves its own division into "above-the-line" and "below-the-line" flows, and the latter of course exactly offset (in some contexts we would say "finance" or "settle") the former. Where the line is drawn depends on the purpose of the analysis. Some balances are intended to measure stable as opposed to ephemeral elements in the current payments picture. Others result from an attempt to separate autonomous flows from the accommodating transactions which authorities undertake in order to defend a given exchange rate. Alternatively, a balance may be drawn to show the net absorption by foreigners of United States domestic product, or the net balance of United States residents' lending to (or borrowing from) residents of other countries. Table I shows some—though by no means all—of the balances that are frequently used to analyze United States international payments: seven different partial balances are encountered as one reads down the table, each one including a broader set of items above the line than the balances preceding it. The following reviews the definitions and measurement of all of these standard balances, starting with merchandise trade and ending with official reserve transactions. Some less standard balances with particular relevance to current circumstances are also mentioned in the course of this article, and statistical illustration of these is provided in Table II.

MERCHANDISE TRADE BALANCE. The balance of merchandise trade is probably the most familiar and well-defined of all payments concepts. The data in Table I give an idea of the shift which the United States trade balance has undergone in the last several years as the result of dollar

Table I

UNITED STATES BALANCE OF PAYMENTS, 1971-74

In millions of dollars; + denotes increase in claims on, or reduction in liabilities to, foreigners

Type of balance	1971	1972	1973	1974
Exports of goods	+43,311	+49,388	+71,379	+ 98,268
Imports of goods	−45,579	−55,797	−70,424	−103,796
Merchandise trade balance	− 2,268	− 6,409	+ 955	− 5,528
Services, net	+ 2,031	+ 479	+ 3,222	+ 9,102
Balance of goods and services	− 237	− 5,930	+ 4,177	+ 3,574
Unilateral transfers, net	− 3,642	− 3,780	− 3,842	− 7,182
Balance on current account	− 3,879	− 9,710	+ 335	− 3,608
United States Government capital flows, net (excluding reserve transactions)	− 2,376	− 1,335	− 1,490	+ 1,118
United States direct investment abroad	− 4,738	− 3,530	− 4,968	− 7,268
Foreign direct investment in the United States	− 175	+ 380	+ 2,656	+ 2,224
United States purchases of foreign securities, net	− 1,113	− 618	− 759	− 1,990
Foreign purchases of United States securities (excluding Treasury issues), net	+ 2,289	+ 4,507	+ 4,055	+ 672
Net change in long-term claims on foreigners	− 780	− 1,550	− 1,366	− 1,560
Net change in long-term liabilities to foreigners	+ 134	+ 743	+ 559	− 515
Balance on current account and long-term capital (basic balance)	−10,637	−11,113	− 977	− 10,927
Net change in nonliquid short-term claims on foreigners	− 2,332	− 1,763	− 5,069	− 14,789
Net change in nonliquid short-term liabilities to foreigners	− 15	+ 221	+ 831	+ 1,840
Errors and omissions	− 9,698	− 1,884	− 2,436	+ 4,834
Net liquidity balance (excluding allocations of SDRs)*	−22,682	−14,539	− 7,651	− 19,043
Net change in liquid claims on foreigners	− 1,097	− 1,247	− 1,951	− 6,113
Gross liquidity balance (excluding allocations of SDRs)*	−23,779	−15,786	− 9,602	− 25,156
Net change in liquid liabilities to private foreign accounts	− 6,691	+ 4,722	+ 4,294	+ 16,782
Allocation of SDRs*	+ 717	+ 710	0	0
Official reserve transactions balance	−29,753	−10,354	− 5,308	− 8,374
Net change in primary reserve assets†	+ 998	− 121	+ 242	− 169
Net change in reserve position in the IMF (secondary reserve assets)†	+ 1,350	+ 153	− 33	− 1,265
Net change in liabilities to official foreign accounts	+27,405	+10,322	+ 5,099	+ 9,808
Balance on all accounts	0	0	0	0

Note: Because of rounding, figures do not necessarily add to totals.

* SDRs = Special drawing rights.

† Excludes revaluations of assets to reflect changes in the par value of the dollar or in market exchange rates.

Source: United States Department of Commerce, *Survey of Current Business* (June 1975).

depreciation and other factors (most notably, worldwide agricultural shortages and the quadrupling of crude oil prices in late 1973 and early 1974). The deficit in trade was largest in 1972, the year following the Smithsonian exchange rate realignment, reflecting what has become known as the "J-curve" effect, in which the initial, adverse impact of devaluation in raising dollar import prices for a time outweighs the slower, desired responses of higher export and lower import volumes. The volume effects, of course, eventually dominated, resulting in a net improvement of the trade balance, at least until the enormous boost in the oil import bill supervened in 1974.

Some analysts have used a special computation of the balance of United States trade, which includes all merchandise except petroleum, to summarize trade developments over this recent period. When this is done, as in Table II, the improvement in "nonoil trade" is seen to continue through 1974. This case provides a convenient example of how a special balance-of-payments definition sometimes comes into temporary use, because events in a particular period make it an analytically useful complement to the standard measure. Another *ad hoc* measure that has been widely used lately, also shown in Table II, is the balance of United States trade excluding not only petroleum imports but also agricultural exports. Adjustments of this kind represent an attempt to abstract two major disturbances of recent years, both of which have affected the United States balance of trade in ways that are largely unrelated to the other adjustments that it has been undergoing.

One reason for the attention that is paid to the trade balance is that it is available more promptly than any other balance-of-payments data: it is published monthly, within about a month of the end of the covered period.[2] Analysis

[2] The trade figures which are published monthly are on a "census basis", which means that they reflect only clearances through Customs. These are not quite the same as the trade statistics which eventually appear in the United States balance-of-payments accounts, as the latter reflect a number of adjustments to the Customs data. The most important differences are: the exclusion from the balance-of-payments data of exports under United States military agency sales contracts (which are included elsewhere in the international accounts), the inclusion in them of imports into the Virgin Islands from foreign countries, and adjustments for various items that are not captured in Customs statistics (e.g., the export or import of ships, of nonmonetary gold, and of gift parcels sent through the mails) or which are considered to be inaccurately valued in Customs statistics. For details of these adjustments for recent years, see the June 1975 *Survey of Current Business*, page 22, Table B1, "U.S. Merchandise Trade, by Principal End-Use Categories—Reconciled to Balance of Payments Basis".

of the trade balance in a short-term framework, however, involves some problems different from long-term analysis. Trade flows are measured by clearances through Customs and therefore reflect the timing of shipments rather than of actual payments. To assess the impact of short-run changes in the trade balance on exchange markets, it is necessary to know how the purchases are financed. Some countries collect trade information on a "cash", or "payments", basis as well as on the basis of shipments, thus providing a useful insight into the trade financing pattern and the changes it undergoes when there is relative interest rate movement and/or currency speculation. In the United States, however, this information is buried within the data on other capital flows.

BALANCE OF GOODS AND SERVICES. The goods and services balance includes net payments for services—such as investment earnings,[3] shipping receipts, fees and royalties related to technological transfers, and so on—as well as trade. This balance corresponds to the "net exports" item in the gross national product (GNP) accounts, thus representing the foreign component of total expenditure for goods and services produced in the United States.[4] The measurement of this balance is fairly straightforward, although some of the items (such as interest payments and receipts) must be estimated by indirect methods, and others are subject to large errors. An important example is the overreporting of United States petroleum companies' overseas earnings in the 1966-73 balance-of-payments statistics; these were later revised on the basis of a special survey conducted in January 1974, with revisions coming to as much as $1.7 billion for 1973.[5] It may be worth noting that many goods and services that are sent overseas are excluded from net exports in both sets of accounts. For instance, shipments under military grants are included within Government expenditures in the GNP statistics and are treated as a special transfer item in the balance-of-payments accounts. This is because these goods and services are regarded as an economic demand by the United States Government rather than as one coming from the foreign sector.

Table II

SELECTED NONSTANDARD UNITED STATES PAYMENTS BALANCES

In millions of dollars; + denotes increase in claims on, or reduction in liabilities to, foreigners

Payments balances	1971	1972	1973	1974
Balance of trade, excluding petroleum imports	+ 1,348	— 1,783	+9,096	+20,534
Balance of trade, excluding petroleum imports and agricultural exports	— 6,438	—11,288	—8,766	— 1,723
Balance on current account, excluding net United States Government transfers	— 1,294	— 6,965	+2,966	+ 2,545
Balance on current account, plus net United States Government capital	— 6,255	—11,045	—1,155	— 2,490
Balance of monetary movements*	—20,683	—12,442	—4,715	— 6,837
Official reserve transactions balance, excluding United States liabilities to OPEC†	—29,300	— 9,500	—4,800	+ 100

* The balance of monetary movements equals the official reserve transactions balance minus changes in United States banks' net short-term international position.

† The liabilities to the Organization of Petroleum Exporting Countries (OPEC) include all recorded short-term liabilities to banks and official institutions in OPEC, plus long-term liabilities to those OPEC countries for which such data are available. These figures represent rough estimates of the required adjustments since they may include some liabilities to nonofficial OPEC residents and may exclude some long-term liabilities to official accounts.

Sources: United States Department of Commerce, *Survey of Current Business* (June 1975). United States Treasury Department, *Treasury Bulletin* (February 1971 to June 1975).

BALANCE ON CURRENT ACCOUNT. The current-account balance includes unilateral transfers to and from foreigners along with the trade in goods and services. These transfers are composed of payments under grants by the United States Government and also pensions and remittances by private citizens to relatives or other persons residing in foreign countries. The balance thus includes all transactions which are "current", in the sense that they are not acquisitions of claims or liabilities *vis-à-vis* foreign residents. The current-account balance has as its below-the-line counterpart the overall "capital account" of the whole economy, and thus one of the contributions of the current-account balance is that it measures the net lending or borrowing position of the entire United States

[3] Reinvested earnings of foreign affiliates other than branches of United States firms (and similarly for foreign investors in the United States) are excluded from the measurement, although in principle they should be included as service receipts. This omission also affects the capital accounts of the balance of payments in that the reinvested earnings are omitted from measured direct investment.

[4] There frequently have been large discrepancies between net exports data appearing in the published United States GNP and balance-of-payments statistics for recent quarters. These reflect the procedures used for approximating items on which information is still missing or preliminary, and differences in the timing of revisions of the two sets of data.

[5] See the June 1974 *Survey of Current Business* [12] for a complete explanation of the changes.

economy, i.e., of all private citizens and corporations together with the Government.

In 1974, the United States current-account balance was seriously distorted by some very large, nonrepetitive special transactions between the United States and India, Israel, and Vietnam. These enlarged the size of the recorded outflows of United States Government transfers overseas by $3.1 billion for that year. Because of this, many economists have at least temporarily preferred to use a nonstandard current-account measure which excludes all Government transfers. As Table II shows, this provides a more realistic (and smaller) assessment of current-account deterioration in 1974.

In more normal years, one of the most criticized faults of the current-account concept in the United States case is the artificiality of the distinction between Government grants and loans. Insofar as some of the latter are more like unilateral transfers than like private loans—in motivation as well as in implication for United States total wealth—current-account surpluses are overstated (or deficits understated) by the conventional measure. For this reason, some analysts prefer to utilize a broadened current-account measure that includes all current transactions plus flows of United States Government capital (see Table II). This balance, it may be noted, is also unaffected by the exceptional Government transfers to India, Israel, and Vietnam in 1974, since all of these transfers were offset by corresponding inflows in the United States Government capital account. Other economists consider this same measure as the narrowest—and most "basic"—definition of the basic balance, one that avoids some of the complicated measurement problems, discussed below, which arise in the attempt to separate basic from other private capital flows in the statistics.

BALANCE ON CURRENT ACCOUNT AND LONG-TERM CAPITAL (BASIC BALANCE). The idea of the "basic balance" is to separate the underlying structural developments in international payments from distorting short-term movements. Included above the line are all current transactions, plus those capital flows which are thought to be mainly responsive to long-term changes in fundamental economic conditions rather than to short-run influences like changes in interest rates or exchange rate expectations. Specifically, the basic capital items are (1) United States Government capital, (2) direct investments by United States corporations abroad and by foreign corporations in the United States, (3) private portfolio investments, and (4) all long-term private loans, defined as those whose original maturity from time of issuance to maturity exceeds one year.

Great difficulties arise in this attempt to identify private capital flows which are motivated by long-term, as opposed to short-term, considerations. More than one motivation may sometimes be involved in a single transaction, and borrowers and lenders may not even know themselves which ones are dominant. This makes the attempt at statistical separation extremely difficult, if not impossible. As an example, one of the most important long-term trends in the United States balance of payments has been the growth of direct investment overseas. However, in any given quarter this trend may be swamped by unrelated short-term movements in the direct investment flows measured by our statistics. If the measurement of direct foreign investment included only permanent additions to capital in overseas affiliates, regardless of sources of financing, this might not be true. But direct investment is measured in part by the flow of funds between parent and overseas affiliates within a multinational firm, and it therefore reflects all kinds of short-run changes in financing patterns. These intracorporate transactions are as interest sensitive as any liquid capital flows, and they may also be distorted by tax considerations and various accounting practices of the multinational firms. An examination of the behavior of the United States direct investment account during periods of exchange market speculation easily reveals how important this distortion of the basic balance can be.

In addition to these problems in the direct investment account, international portfolio flows can also be seriously distorted by short-term fluctuations. In fact, investment in foreign securities has sometimes been an important vehicle for currency speculation. And, finally, the formal maturity of loans cannot be identified with the actual motivation of transactions. For instance, a long-term bond purchased one day before maturity may serve as a short-term asset for the buyer, while long-term financing can sometimes be secured by negotiating short-term loans with an advance understanding that they will be renewed at maturity. Because of this, statistically recorded portfolio flows and so-called long-term private loans are demonstrably sensitive, in aggregate, to short-run changes in interest rates and changes in expectations about relative inflation rates, monetary policies, and ultimately exchange rate relationships.

NET LIQUIDITY BALANCE. The net liquidity balance includes what are termed nonliquid short-term capital flows, along with long-term capital transactions, as above-the-line items. It also includes errors and omissions, as if this item represented only nonliquid capital flows. Tables III and IV summarize the distinction between nonliquid

and liquid private capital transactions as they are currently embodied in reporting practice. As can be seen, the net liquidity balance contains many arbitrary elements. All loans by United States banks, except those to their own branches, are treated as nonliquid, even overdrafts, which must by definition be quickly reversed. On the other hand, all transactions between United States banks and their branches (but not subsidiaries) and between United States agencies, branches, or subsidiaries of foreign banks and their head offices or parent organizations and/or branches overseas are considered liquid, although they may be directly connected to nonliquid (and even long-term) lending by the foreign affiliate. All deposits are liquid, even those that are held as compensating balances against nonliquid borrowings.

GROSS LIQUIDITY BALANCE. Changes in liquid claims on foreigners are included in the gross liquidity balance with above-the-line items, leaving changes in liquid liabilities to private foreigners as the only settlement items aside from official reserve transactions. As Table IV shows, liquid liabilities to private foreigners means, simply, short-term bank-reported liabilities to private foreigners and all private long-term foreign holdings of United States Treasury securities. The asymmetry in treatment of liquid claims as opposed to liabilities has been justified on the ground that the balance measures additions to the potential drain on the United States monetary reserves. United States residents' liquid claims on foreigners, it has been argued, could not necessarily be mobilized for this purpose, while the liabilities did represent a potential "call" on our official reserves. In recent years, however, the total stock of liquid liabilities to foreigners has so much exceeded the stock of our reserves that this idea has lost all possible relevance. Therefore, the symmetric treatment of the net liquidity balance has generally been preferred by users of the liquidity concept.

The liquidity balance definitions above have been designed specifically for analyzing United States payments and are not used in other countries. A somewhat similar measure which does have wide international usage is the balance of monetary movements. In this balance, all bank-reported short-term capital movements[6] are treated as financing items along with official reserve transactions, and all other flows are placed above the line. The assumption underlying this treatment is that, in some countries at least, central banks through various regulations exert a major influence on the net short-term international position of commercial banks. Table II includes a computation of this balance for the United States in the last four years.

OFFICIAL RESERVE TRANSACTIONS BALANCE. The most comprehensive of the standard balances is the balance of official settlements. Here, all international transactions except for changes in the net official reserve position of the United States are above the line. This measure is intended to reflect the amounts of foreign exchange which monetary authorities have supplied to the markets to balance private supply and demand at current exchange rates. All private and nonreserve Government transactions are

[6] Bank-reported capital, it should be noted, includes some assets and liabilities which are not part of the banks' own balance sheets: for example, items held for the account of the banks' customers and securities issued by the United States Treasury or United States Government agencies.

Table III

NONLIQUID VERSUS LIQUID UNITED STATES SHORT-TERM CLAIMS ON PRIVATE FOREIGNERS

Claims	Nonliquid	Liquid
Reported by United States banks:		
Payable in dollars	Loans (including overdrafts); collections; acceptances	"Other" dollar claims, including deposits, money market paper, and all claims (except acceptances) of United States banks on their own foreign branches and of United States agencies and branches of foreign banks on their own head offices and/or foreign branches
Payable in foreign currencies	"Other" foreign currency claims	Deposits; foreign government obligations; commercial and finance paper.
Reported by United States nonbanking concerns	Credits to finance exports or other transactions; claims of United States brokers on foreigners, mainly to finance securities transactions	Deposits held abroad; negotiable and transferable foreign obligations; loans repayable on demand

Table IV

NONLIQUID VERSUS LIQUID UNITED STATES SHORT-TERM LIABILITIES TO PRIVATE FOREIGNERS*

Liabilities	Nonliquid	Liquid
Reported by United States banks	None	All short-term bank-reported liabilities
Reported by United States nonbanking concerns	All short-term liabilities	None

* In addition to these short-term liabilities, liquid liabilities to private foreigners also include net purchases by the latter of long-term United States Treasury securities reported by both banks and nonbanking concerns.

thus interpreted in this balance as autonomous phenomena, which are accommodated by official reserve transactions.

Most foreign countries measure their official settlements balances simply as the net change in external assets and liabilities of the monetary authorities. In the United States, the matter is more complicated because foreign countries hold United States dollars as an international reserve asset. Recognizing this international reserve currency role of the dollar, the United States includes, in its official reserves measurement, information which it collects from private United States residents about their liabilities to official foreigners. In recent years, changes in these liabilities—primarily foreign official holdings with United States commercial banks and bank-reported official holdings of United States Treasury securities—have accounted for most of the movements in the official settlements balance, since reserve assets (primarily gold) held by the United States monetary authorities have been relatively stable.

In the last year and a half, United States liabilities to the monetary authorities of OPEC have undergone a very large increase, as OPEC countries have invested part of their huge reserve accumulations in various types of assets in the United States. All of these are counted as deficit items in the United States official reserve transactions balance, which has deteriorated as a result. Some analysts believe that these investments should be regarded as largely autonomous rather than as accommodating flows, and the reasons for this are discussed in some detail in the next main section. It has therefore been suggested that official reserve transactions *vis-à-vis* OPEC and those *vis-à-vis* non-OPEC countries should be looked at separately, with only the latter being taken as a measure of exchange market disequilibrium in the traditional sense. Published balance-of-payments statistics do not allow a precise separation of OPEC reserve transactions from the others; however, the last item in Table II roughly approximates this adjustment by using published data on liabilities to residents of these countries. As the reader can see, constructing the balance in this way transforms into approximate balance what appears by the usual definition as a very large official deficit for 1974. In contrast to the impression that might be created by casual interpretation of the 1974 official settlements deficit, this adjustment shows that the dollar was not artificially supported by massive net official intervention over the year as a whole.

Some foreign countries, for which changes in official (i.e., monetary authorities') liabilities are relatively insignificant, use gross changes in reserve assets alone as their measure of official settlements. Because of the fact that foreign monetary authorities accept dollar liabilities of the United States as a means of settlement, this has not usually been considered a useful balance-of-payments measure for the United States. However, in the United States as in all countries, these assets do comprise a source of the domestic monetary base. As a result, their changes play an important role in monetary theories of balance-of-payments adjustment, which is discussed in the next section.

PROBLEMS IN INTERPRETING THE BALANCE-OF-PAYMENTS MEASURES

One of the principal uses of balance-of-payments measures is to evaluate changes in underlying conditions which may alter the equilibrium value of a country's exchange rate. In the Bretton Woods system of fixed but adjustable par values, this meant an attempt to identify cases of "fundamenal disequilibrium". Under International Monetary Fund (IMF) rules, the existence of such a disequilibrium, depending on its source and other circumstances, could lead to the changing of the value of the national currency relative to gold or foreign currencies, or to other adjustment measures. In the present exchange rate regime of managed floating, balance-of-payments measures are still used to identify disequilibria which may occur when official intervention is large enough to influence

market exchange rates. However, a more important current concern is to anticipate sources of future exchange rate change and the potential impact of international developments on domestic economies. Some of the balance-of-payments concepts that were previously used to identify fundamental disequilibria are now applied in assessing underlying trends that may help in making such predictions.

When analyzing trends evidenced by the balance of payments over a fairly lengthy period—i.e., a few years or more—economists have generally focused on comprehensive measures such as the *official reserve transactions balance*. Its treatment of all transactions by persons other than official reserve agencies as autonomous phenomena, while regarding all official reserve transactions as accommodating,[7] means that developments in all types of private financial relationships are considered to play a role in determining the equilibrium value of national currencies. This recognition of all private financial flows as ultimately market determined is particularly important in the case of the United States, which as a world financial center provides such a wide variety of banking services to foreign residents. It would be a mistake to exclude any of these services when considering trends that affect the value of the dollar over the long run.

The treatment of all official reserve transactions as below-the-line, or accommodating, items is subject to important exceptions. The assumption behind the official settlements concept is that central banks gain or lose reserves only through direct exchange market intervention undertaken to defend established parities. However, even under the fixed exchange rate system the decision of monetary authorities to intervene in exchange markets (as opposed to changing the national parity) could be influenced by an official desire to accumulate or decumulate reserves, rather than being only a passive accommodation of market conditions. This qualification is all the more important now, when the major countries are no longer committed to defending specific, established parities. Hence, the differentiation between private and official foreign holders of dollars is not always an adequate basis for measuring disequilibrium, because central banks are motivated by some of the same considerations as, and handle their exchange portfolios similarly to, private participants in the market.

Part of the problem with the official settlements concept is that official reserve positions are also affected by other transactions besides intervention. For instance, monetary authorities may borrow foreign exchange from private holders or lend it to them, and this will add to or reduce their reserve holdings. Another important measurement problem arises from the fact that foreign central banks place some of their dollar exchange holdings with commercial banks outside the United States—usually with banks in their own countries (Japan being a well-known instance of this) or in Euro-dollar centers elsewhere. In such cases, a part of the dollar balances that are owned by foreign monetary authorities is reported as liquid liabilities to private foreigners in the United States balance-of-payments statistics. As a result, while in principle the official settlements of each country with all other countries should be symmetric and the official settlements of all countries when added together should total zero,[8] there are in fact very large discrepancies between the official balance that is recorded for the United States in any recent period and the total reported official settlements of all other countries.

The acquisition of large amounts of new reserves by oil-exporting countries is currently providing a spectacular example of all of these problems. On the one hand, OPEC governments have placed many of their dollar reserves with Euro-banks, and the principal reflection in the United States balance-of-payments statistics of this part of the OPEC reserve accumulations is likely to be increased liquid liabilities to private foreigners, primarily to foreign banks or the foreign branches of United States banks that are located in Euro-dollar centers. At the same time, it may be incorrect to regard all of OPEC's direct claims on the United States as deficit items, since many such placements are investments motivated in part by ordinary economic considerations rather than being simply a passive accommodation to outflows from the United States. In other words, these increased United States liabilities to official foreigners reflect a conscious portfolio choice by those officials to hold a certain portion of their large reserve gains in a variety of dollar-denominated instruments. This is the reason why some analysts currently prefer to look at a narrower official settlements measure, like the one in Table II which excludes changes in liabilities to OPEC, for an indication of the

[7] For the history of these concepts of autonomous and accommodating transactions, and their use in identifying fundamental disequilibrium, see particularly Meade [9], Gardner [2], and Machlup, "Three Concepts of the Balance of Payments" in [8].

[8] More precisely, they should total zero aside from any net changes in total world reserves, such as increases in monetary gold, in SDR allocations, or in other liabilities of the IMF.

amount of official intervention that has been affecting the dollar's value in any given period.

The *liquidity balance* is an alternative overall balance-of-payments measure which has been used for a long time in the United States. This balance recognizes that official reserve movements are sometimes motivated by market considerations and thus are similar to private capital flows. Moreover, it separates out changes in private holdings of liquid claims on the United States as a potentially disequilibrating phenomenon that may eventually be translated into market pressure on currency rates and reserve movements. Proponents of the liquidity measures argue that the latter show the ability of the United States to defend the dollar, and the possibility of needing to do so in the future, whereas the official settlements balance concentrates on the amount of intervention required in the past.

The artificialities in the official-private distinction have been recognized by most users of the official settlements measure, which admittedly can be seriously distorted, particularly in the short run. However, very few economists have been able to accept the alternative distinction between liquid and nonliquid capital as a useful basis for balance-of-payments analysis. First, the notion that liquid claims portray a "potentially disequilibrating" situation cannot be applied indiscriminately to all such claims by residents of one country on those of another, but only to those amounts over and above the monetary balances needed for transactions purposes. No theoretically sound method has been advanced for making this separation in the balance-of-payments statistics. Second, many assets which are classified as nonliquid are in fact readily convertible into liquid form. Thus, the exchange market implications of growth in these other claims are not necessarily different, in any clear and simple way, from those of a growth in foreign-held bank deposits. These are the principal reasons why the liquidity balance has fallen increasingly into disuse by economists in the United States.[9]

As described above, *monetary movements* is commonly used in other countries as an overall measure much like the liquidity balance of the United States. The difference is that balance of monetary movements includes as settlement items all bank-reported short-term capital transactions, but not liquid nonbank flows. Drawing the line at short-term bank capital has the advantage of being conceptually simpler than the liquidity distinction, but for analytic purposes it is almost as arbitrary, at least for a country with highly developed financial markets like the United States. Because the monetary movements balance is used by other countries, it is sometimes useful to compute it for the United States also. However, this is a concept that is asymmetric in definition. Consequently, it cannot be added up for different countries to total zero. For example, a transaction which is short-term bank capital on the United States side frequently involves a nonbank resident on the foreign side, and vice versa.

Under fixed exchange rates, and so long as United States dollars held by foreign monetary authorities were effectively convertible into gold, changes in United States *official reserve assets* alone provided one type of measure of overall balance-of-payments disequilibrium for the United States, as foreign official dollar acquisitions could then reasonably be viewed as voluntary. Without convertibility there is no sense in which the disequilibrium measures for the United States can be realistically confined to reserve assets, and most official intervention to support the dollar's value in exchange markets has in fact reflected itself in increased United States liabilities to foreign monetary authorities rather than in reduced assets.

In all countries, *primary international reserve assets* constitute part of the domestic monetary base, and therefore changes in these assets have an influence on money supply. As a source of change in the domestic monetary base, changes in primary reserve assets play a central role in monetary models of the balance of payments. These models treat the international balance as part of the mechanism that equilibrates portfolio choices of both residents and nonresidents—including, in particular, their choices to hold money denominated in various currencies. When a balance-of-payments surplus results in an increase in international reserve assets of a country, this adds to the domestic monetary base. So long as this increase is not offset by actions of the domestic monetary authorities, it will affect the domestic money supply, and thereby national income and the price level. In the case of a balance-of-payments deficit resulting in a reserve loss, the opposite sequence occurs. So long as payments imbalances are in fact reflected in changes in reserve assets, this constitutes an adjustment mechanism by which external disequilibria tend to be eliminated automatically. This monetary mechanism of balance-of-payments adjustment was first outlined by David Hume in the eighteenth century, and the theory is now being further developed in

[9] This brief discussion does not pretend to do justice to the questions raised, since they have been extensively argued over the years in many other places. The reader is referred particularly to Lederer [7] and to the Bernstein Report [10]. Some additional references are given following this paper, and more can be found in Kindleberger [5] and in Stern [11], particularly Chapter I, "Balance of Payments Concepts and Measures".

contemporary literature.[10]

This monetary adjustment mechanism does not necessarily work the same way for a reserve-currency country like the United States, because deficits in United States external payments are not usually reflected in changes in United States reserve assets but rather in liabilities. Changes in United States liabilities to official foreigners do not normally affect the monetary base of the United States except when they lead to a change in the level of foreign deposits with the Federal Reserve Banks. The great bulk of foreign central banks' dollar holdings is invested in nonmonetary assets (such as United States Treasury securities) which are purchased from private domestic holders, and in this case there is no net impact on the monetary base in this country.[11] This causes an asymmetry in the international adjustment mechanism described by the monetary models because, when the monetary authorities in a foreign surplus country acquire dollars through exchange market intervention, these dollars are included in the international reserve assets of that country and thus add to its monetary base. However, the increase in United States liabilities causes no corresponding reduction in the monetary base here, so that the inflationary impact in the foreign country is not matched by any automatic deflationary tendency in the United States. Even in foreign countries, the practical usefulness of this primary reserve assets measure of balance-of-payments disequilibrium can be exaggerated. The automatic nature of the international adjustment is in any case limited by the fact that domestic monetary impacts of external disturbances are frequently swamped by actions of the domestic monetary authorities. Monetary authorities in all countries consider domestic as well as international factors in making policy, and by open market operations or other actions they may—whether intentionally or not—cancel the effect which official reserve changes might otherwise have had on the monetary base, at least for a time. Thus, so long as the monetary authorities in each country exercise independent control over their own money supplies, the price-specie-flow mechanism described by Hume does not work.

The overall balances, such as those discussed above, may be considered an accurate guide to payments trends that continue for a fairly long period. However, the inclusion of some capital flows which can vary widely in the short run, even though their movements tend to cancel out over a long period, makes these balances unreliable for analyzing changes over only a few months or quarters. Additional balance-of-payments measures are therefore needed for current analysis. This is the motivation for computing a *basic balance,* which attempts to isolate stable, underlying patterns and separate them from movements of volatile, short-term capital. The latter are taken to respond much more quickly to changes in relative interest rates and/or exchange rate expectations, which means that they are also more amenable to the influence of short-run changes in monetary policy. Another way of regarding basic transactions, therefore, is that they are those transactions which can, in principle, be considered as exogenous influences in short-run models used to formulate monetary policy.[12] In practical terms, this means that an imbalance in overall payments over a short period—as measured, for example, by official settlements—is more likely to be taken as indicating fundamental disequilibrium if the imbalance is due to basic transactions than if it is due to short-term capital movements. Moreover, trends in basic payments may sometimes signal an emerging disequilibrium situation before it materializes in official reserve movements or exchange rate changes.

While the theoretical distinction underlying the basic balance is one on which there is wide agreement, it is perhaps the most difficult balance of all to translate into measurement. The conceptual distinction outlined above simply cannot be identified with the categories found in the available statistics. For this reason as much as any other, balance-of-payments analysts often focus particular attention on changes in *merchandise trade,* and perhaps on trade in services. These flows are seen as depending on relatively stable and well-understood relationships among those classified as basic transactions. As a result, economists feel somewhat more confident about trying to predict trade developments in the short run than they do about predicting capital flows, even so-called long-term capital flows.

All of the international payments balances discussed so far are intended to indicate fundamental patterns in United States external payments, in part to evaluate ex-

[10] For a brief introduction to the monetary approach to the balance of payments and references to the important literature, see Kemp [3, 4].

[11] For details, see Auerbach [1].

[12] This view of the problem is not new. In particular, the analysis by Hal B. Lary in 1963 [6] employed essentially this approach to the issue.

change rate developments. Aside from this concern, however, economic policy makers, in the United States as well as in other countries, sometimes display preferences as to the current-versus-capital-account structure of the balance of payments. For this, they look at the overall *balance on current account,* which includes trade and service transactions as well as unilateral transfers to foreigners by the United States Government and private residents and which appears in the national income accounts as "net foreign investment".[13] Since the current-account balance measures the extent to which the United States is a net borrower from, or net lender to, foreign countries, it may sometimes be a target of national economic policy even aside from the question of maintaining a specific exchange rate. (Another way of looking at the same number, of course, is as net saving or borrowing by the foreign sector in the national flow-of-funds accounts.) The slightly narrower *balance of goods and services* carries significance also, within a Keynesian framework of domestic employment analysis, as a component of the GNP accounts which measures the contribution of foreigners to aggregate demand for United States output. The goods and services and current-account balances are both internationally symmetrical in definition. These balances for the United States can thus be usefully compared with the corresponding statistics for foreign countries, and the balances for all countries taken together must in principle total zero.

The current regime of fluctuating exchange rates has led to some changes in the way economists use the balance-of-payments statistics. Rather than asking whether and how existing parities can be defended, analysts are now trying to interpret the movements that occur simultaneously in exchange rates and payments flows. Assessing the permanence of short-run changes in exchange rates and predicting changes that may be indicated beforehand are activities in which balance-of-payments information will always be used. Of course, one should remember that the resident-versus-nonresident distinction made by balance-of-payments statistics may not accurately reflect all the exchange market pressures for an international currency like the United States dollar. Therefore, any such analysis, while it may begin with balance-of-payments numbers, cannot stop there.

[13] For the years in which new SDR allocations have been made (1970 through 1972) "net foreign investment" corresponds to the current-account balance plus the United States portion of these SDR allocations.

The official settlements balance would presumably be insignificant in size if the monetary authorities did not intervene in the exchange markets and did not take other measures to influence national currency rates and reserve positions, such as official Euro-currency borrowings or deposits of foreign exchange with commercial banks. In reality, however, we have a mixed situation, in which national authorities undertake some intervention in the exchange markets to influence currency values, even though they may not be committed to defending a fixed set of parities. Thus, the official settlements balance is still very much a fact of life, and it still measures market disequilibrium at current exchange rates. The main difference is that simultaneous changes occur both in the official settlements balance and in the exchange rate, and the two must be interpreted as mutually determined.

In attempting to assess the permanence of changes in exchange rates (and/or official settlements balances), the same characteristics—short-run sensitivity to interest rates and exchange rate expectations—are as important in the case of floating exchange rates as in the Bretton Woods framework. It is still desirable to separate payments according to how stable or volatile they are, and how responsive to short-run changes in monetary policy, in much the same way as the basic transactions concept was used under fixed rates to analyze short-run fluctuations in the overall payments balance alone. In theory, therefore, the basic balance, as well as other variants of this concept, is just as natural a basis for analysis in the world of floating exchange rates as it was under fixed exchange rates. At the same time, however, the shift to more flexible exchange rates has done nothing to mitigate the problems of measuring these balances.

SUMMARY OF CONCLUSIONS

The United States balance-of-payments accounts contain a great deal of useful information about transactions between residents of this country and foreigners. But it is misleading to focus attention on any one balance of part of these transactions and attempt to conclude from that balance whether the external sector of the economy has become better or worse in a given period. A surplus or deficit on any of the balances is not necessarily a sign of what is good or bad for the United States economy. And there is no single balance of payments that can always be taken as a measure of the pressure on dollar exchange rates. Therefore, the most important conclusion to be drawn is that we should not expect too much from payments balances as a guide to policy.

The official reserves transactions balance is still a useful

statistic, but only if used with great care. Its contribution is to give some indication of the extent to which exchange rate movements, in any period, are influenced by direct central bank intervention. Without such a measure of short-run market disequilibrium, it is almost impossible to evaluate the significance of observed exchange rate changes. Supplementary information which central banks publish about their intervention and/or nonmarket foreign exchange transactions will sometimes be helpful in this evaluation. In using the official balance, we must also consider factors that might lead to changes in foreign official demand for dollar reserves and look at shifts among official holders who are thought to have sharply different preferences. For example, because the potential distortion due to investment in the United States of official oil earnings is now so large, it is useful to supplement the overall official settlements balance with bilateral information indicating how much of this balance is with the OPEC members and how much is with others.

The goods and services and current-account balances continue to be relevant to domestic and international policy questions. The value of both these balances is enhanced by the fact that they are internationally symmetrical in definition and correspond to the usage followed by other countries.

In applications whose object is to separate "stable" from "volatile" payments, or to distinguish flows that are exogenous to short-run policy decisions from those that are not, the basic balance concept still represents the ideal that is sought. The available statistics are so flawed by measurement problems, however, that none of the usual approximations of this balance can be recommended with any enthusiasm. Perhaps all that should be attempted is to add the current-account and United States Government capital items together, since they are the only measured flow categories that can be regarded as largely interest insensitive. The information gained from examining this balance by itself will be slight, though. Some estimate (or guess) about underlying trends in private direct investment must certainly be added by the user in order to interpret the basic payments situation. The empirical basis for such an estimate must be a careful examination of past and current trends in a number of the gross private capital flows, and probably of other information as well. The search in our present statistics for a reliable net basic balance that will consistently illuminate the underlying balance-of-payments situation of the United States is doomed to disappointment.

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