

They all invite substitution, evasion, and circumvention; they discriminate against some sectors and in favor of others, distort the structure of prices, and induce misallocation of productive resources. Usually, they are also incapable of effecting their purpose. For, while they improve particular items in the balance of payments, they worsen others, partly because of the substitution of purchases for which the dollar is not devalued, partly because of foreign and domestic repercussions from the reduction of purchases for which the value of the dollar is reduced.

If the disguised devaluations of the dollar were uniform — for example, by means of proportional taxes on all imports and subsidies on all exports of goods, services, and securities — they might work indiscriminately; but the administrative difficulties would be serious. While theoretically taxes and subsidies could be used in lieu of a uniform alteration of exchange rates, in practice they would amount to a system of multiple exchange rates with plenty of bureaucratic bungling and high rewards for cheating and bribing.

I conclude that selective measures to remove the deficit, whether they are real correctives (designed to affect the flow of goods and services) or financial correctives (operating on the flow of capital funds) are not likely to achieve sustainable balance. Only real adjustment is likely to accomplish that.

Restoring Balance: Real Adjustment

In the process of real adjustment relative prices and incomes are changed in such a way that the allocation of real resources and the international flows of goods and services are altered sufficiently to improve the current account so as to make it match the balance on capital account and unilateral payments. I distinguish three approaches: aggregate-demand adjustment, cost-and-price adjustment, and exchange-rate adjustment. The first two are practically inseparable, because demand adjustment works largely through changes in costs and prices, and cost-and-price adjustments cannot, as a rule, be achieved without demand adjustment.

Aggregate-demand adjustment implies income deflation and