less employment in the deficit country and/or income-and-price inflation in the surplus country. Since excessive expansion of demand in the deficit country has often contributed to the emergence or persistence of the payments deficit, stopping the inflation is, in such instances, the first and most urgent recommendation. But merely disinflationary policies cannot accomplish full adjustment when the surplus countries likewise desist from inflating aggregate demand. Only if these countries allowed their income and price levels to rise would the prevention of income-and-price inflation in the deficit country initiate a process of real adjustment, leading gradually to restoration of external balance as the "demand pull" in foreign countries washed their surpluses away.

While halting or containing the inflation in the deficit country is not yet a sufficient condition for real adjustment, it is a necessary condition for preventing the deficit from getting bigger. Thus, fiscal and monetary restraint – higher taxes, reduced expenditures, tighter credit – are imperative, simply to keep the imbalance of payments from getting worse. Yet, to prescribe the same orthodox medicine in doses large enough to induce full adjustment would mean to expose the country to great risks. Stopping an inflation is one thing; forcing a deflation is another. In the absence of inflation abroad, real adjustment of the existing imbalance would require net deflation in the deficit country, at a probably exorbitant social and economic cost, which no government is willing to impose on the country.

The third approach to real adjustment – exchange-rate adjustment – is also resisted by governments. The United States regards it as practically impossible, partly because of some past promises and commitments, partly because of the role of its currency in international affairs. The trading partners of the United States regard this kind of adjustment as undesirable, and perhaps intolerable, chiefly because it would weaken the competitive position of their industries. Exchange-rate adjustment may, nevertheless, prove to be the only practicable way out. However, it can become practicable only by courses of action not yet sufficiently examined. Some of them will be considered here, but only after an analysis of the problem of confidence.