nitely in deficit. A chronic deficit in the U.S. balance of payments, particularly if it were accompanied by price inflation, would be one of the very critical conditions that could undermine the role of the dollar as a reserve currency and as the pragmatic standard for stable exchange rates. That is why the world monetary environment depends so much on the success of the United States in maintaining a strong balance of payments and stable prices and costs.

The United States is aware of the importance of eliminating its payments deficit. In this, it made remarkable progress between 1959 and 1964. This adjustment was halted by the tremendous increase in domestic expenditures resulting from the Vietnam war and the investment boom. It is unfortunate that because of inflated home demand, the U.S. surplus on goods and services fell from $8.5 billion in 1964 to $7.0 billion in 1965 and has been running at an annual rate of about $6.3 billion in the first half of 1966. But while the U.S. surplus on goods and services declined drastically, U.S. private capital outflow was very much reduced from $6.5 billion in 1964 to $3.7 billion in 1965 through a tight credit policy and through guidelines on bank lending and private investment. There is no doubt that if effective measures were taken to eliminate the excess demand and to halt the rise in prices, the U.S. trade position would be quickly restored and with it the U.S. balance of payments.

Despite the large and prolonged deficit, the U.S. balance of payments is not as bad as is generally assumed. Unfortunately, the usual method of presenting the U.S. balance of payments grossly exaggerates the deficit. The liquidity definition of the U.S. deficit includes as part of the settlement items the increase in foreign private holdings of dollars without offsetting them by the increase in U.S. banking claims against foreign governments, foreign banks and foreign companies. By this definition, the deficit of the United States averaged $2.3 billion a year from 1963 to 1965. The alternative definition, which means the deficit by official reserve transactions (the change in gold and foreign exchange assets, dollar liabilities to foreign central banks, and net position in the IMF) shows an average of $1.6 billion a year during the past three years. The reserve transactions definition of the deficit recognizes that foreign private holdings of dollars are necessary for the business of the world economy, just as U.S. banking