world monetary stability. In the plan for an International Clearing Union, Lord Keynes proposed that the responsibility for adjusting a persistent imbalance in international payments should be shared by surplus and deficit countries. He believed that the existing system involved a deflationary bias. That was because deficit countries were impelled, by the depletion of their reserves, to take corrective action by restrictive measures, while surplus countries could neutralize the expansionary effects of their balance of payments. This analysis reflected the philosophy of the great depression and it was a generalization based on the large U.S. payments surplus of the 1930's. In fact, the asymmetry of the adjustment process is not one between surplus and deficit countries, but between larger countries and smaller countries, and particularly between the United States and other countries.

The attitude of the United States on adjustment was that a surplus country could not be asked to accept an obligation to restore a balanced pattern of international payments by expanding its own economy without regard to the conditions that led to deficits. If the imbalance were caused by persistent inflation in the deficit countries, the surplus countries could not be expected to induce an equal degree of inflation merely to restore the payments of the deficit countries. Such a principle would mean that the price level throughout the world would be determined by the countries with the most inflation. It would give international sanction to a steady and uninterrupted inflation throughout the world.

To reject the principle that a surplus country must expand its economy until a balanced pattern of international payments has been restored is not the same as saying that surplus countries have no responsibility for adjustment. But if they maintain a high level of employment, if they do not impose restrictions on imports, and if they encourage the outflow of capital, they have done all that can be reasonably expected of them. The responsibility thereafter is on the deficit countries to restore their balance of payments by appropriate means. If the deficit is caused by inflated demand, then the elimination of the excess demand may be sufficient to restore the balance of payments. And if its competitive position has been permanently impaired by an inflated level of prices and costs, then the deficit country may have to devalue its currency in order to absorb the inflation of the past, and it must protect its competitive position by avoiding inflation in the future. That is the principle adopted at Bretton Woods and it is the only principle consistent with international monetary stability.

The industrial countries have for some years been studying how the adjustment process can be improved. Working Party No. 3 of the OECD has just issued a very useful report on its deliberations. The Report points out that the most important step in improving the adjustment process is early detection of an emerging balance of payments problem. A country that acts promptly to eliminate a payments deficit, before its competitive position has become impaired, may find that it can quickly improve its trade position. This has been the experience in a number of countries with a payments deficit—Italy, Japan, and more recently Germany. In the United States, the surplus on goods and services was increased from $150 million in 1959 to $8.5 billion in 1964, simply by holding down prices and costs while the economy continued to grow at a very rapid rate.

Where the payments deficit is due to an enormous outflow of capital for long-term investment, the adjustment is very difficult. Some forms of foreign investment, particularly direct investment, may not be readily responsive to credit restraints. Although more direct measures may be necessary to limit such capital outflow, an appropriate credit policy would be helpful in holding down capital outflow. The United States, which has this problem in acute form, would have a considerable payments surplus if it could combine its 1964 goods and services account with its 1965 capital account. Allowing for the special problem of the United States with capital outflow, it is not unreasonable to say that the adjustment process is actually working reasonably well.

It would be useful to have general rules to guide surplus and deficit countries on their responsibilities. In fact, however, because each surplus country and each deficit country will have domestic problems of its own, they may find difficulty in applying general rules to their own case. Nevertheless, international cooperation can be helpful in getting that combination of fiscal, credit and exchange rate policies that would permit adjustment of the pattern of international payments without imposing serious deflation on the deficit country and without generating inflation in the world economy.