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INTERNATIONAL PAYMENTS IMBALANCES AND NEED FOR STRENGTHENING INTERNATIONAL FINANCIAL ARRANGEMENTS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

MAY 16, JUNE 19, 20, AND 21, 1961

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
71496 WASHINGTON : 1961

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington 25, D.C. - Price $1.00

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INTERNATIONAL PAYMENTS IMBALANCES AND NEED FOR STRENGTHENING INTERNATIONAL FINANCIAL ARRANGEMENTS

TUESDAY, MAY 16, 1961

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND
PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met at 4 p.m., pursuant to notice, in the Old Supreme Court Chamber, the Capitol, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss, Senators Douglas, Pell, Bush, and Javits.

Also present: Wm. Summers Johnson, executive director; John W. Lehman, deputy executive director and clerk; and Emile Despres and William Salant, consultants.

Representative REUSS. I will now call the meeting of the Subcommittee on International Exchange and Payments of the Joint Economic Committee of the U.S. Congress to order. This is the first of a series of hearings scheduled by the subcommittee. The remainder will be held during the week of June 19. Today we are exceedingly fortunate to have before us Dr. Reinhard Kamitz, president of the Austrian National Bank. He is accompanied by Mr. Edgar Plan of the Austrian Embassy.

I had the pleasure, as a member of the House Banking and Currency Committee, to visit in Vienna with Dr. Kamitz in December 1960. We had a very fruitful exchange of views which has helped me and has helped the Joint Economic Committee in clarifying our thinking on many issues involving the international balance of payments. Knowing that Dr. Kamitz was to be in this country, we invited him to be present with us this afternoon.

The subcommittee is now in executive session. The transcript of the hearing will be presented to Dr. Kamitz. After Dr. Kamitz has corrected the transcript and returned it to us, it is my understanding that he has no objection to its contents being made public or to its insertion in the formal records of the committee.

We are deeply grateful to you, Dr. Kamitz, for your presence here today. I understand that you have an introductory statement. We would be delighted to have you give us that statement, after which we may ask you to elaborate on some of the points.

STATEMENT OF HON. REINHARD KAMITZ, OESTERREICHISCHE NATIONALBONK, ACCOMPANIED BY EDGAR PLAN, FINANCIAL COUNSELLOR, EMBASSY OF AUSTRIA

Dr. KAMITZ. Thank you.

Mr. Chairman and members of the subcommittee, I consider it a great honor to appear before this committee and to exchange with its distinguished members views on international finance and payments in a framework which is most likely to insure a sound expansion of world trade. Looking back over the period of 16 years which has elapsed since the end of World War II, I think there is no doubt that we can note a significant improvement in the pattern of world payments. After the end of World War II, the European countries which had been devastated by the ravages of the war had practically no gold and foreign exchange reserves, and only through the generous aid supplied by the Marshall plan were they able to obtain the means of subsistence for their starved populations and the capital and raw material necessary for the reconstruction of their economies. The United States of America then urged the European countries to combine their efforts and to create what was to become a large preferential area of 17 European countries, which comprised the Organization of European Economic Cooperation (OEEC).

Trade discrimination against the United States and other oversea countries stemmed from the fact that the OEEC members, in the years from 1950 onward, gradually dismantled quantitative import and payments restrictions in their relations with each other, but not with the outside world. The establishment of EPU facilitated multilateral payments in the area it comprised, but necessarily entailed some discrimination for outsiders. In view of the large balance-of-payments deficits Europe had in those years, a situation which was then often described as Europe's structural or chronic dollar gap, the United States acquiesced in this discrimination and even made itself its advocate.

Because of the facts well known to this audience, and which I may just briefly summarize as reduction of the previous substantial surplus in the U.S. trade balance, continued large outflows of U.S. Government money for defense support and economic aid abroad, as well as large outflows of private capital for foreign investment plus the large shifts of short-term capital in the recent past, the U.S. overall balance of payments during the past 3 years has shown deficits of the order of almost $4 billion per year, whereas, in the preceding years the deficit had averaged only about $1 billion per annum. This has led to a strengthening of the reserve position of most of the European countries and it is, therefore, understandable that in the present situation the United States of America no longer condones any measures which would discriminate against its exports.

Over the past several years all OEEC members have extended their liberalization of imports to the dollar countries, and in most cases there is now little or no discrimination left, as far as the issuance of import and payments licenses is concerned. With most of Europe's trade freed from quantitative controls, customs tariffs have again gained in importance, and it is a characteristic feature of the new European integration plans that their main emphasis in reducing barriers to trade is placed on customs tariffs, not unlike the free trade movements of the 19th century, a period when quantitative restrictions and exchange control were virtually unknown and when customs duties were the only weapon of commercial policy.

In December 1958 most European countries declared the convertibility of their currencies for nonresidents, which removed any logical reasons for trade discrimination toward the United States. Indeed, when holdings of deutsche mark, pounds sterling, guilders, or Austrian schillings can be converted automatically into dollars, the country which imposes discriminatory restrictions would obviously deprive itself of the benefits which arises from buying at the cheapest source, and this would thus mean a loss of total welfare, which would not be compensated by any saving in a foreign currency considered to be scarce.

With the assumption of the regime of article VIII of the statutes of the IMP by nine European countries, plus Peru in February of this year, a further important step was made toward achieving a free international payments system. Given the high degree of liberalization prevalent at this time, this measure had a very limited additional effect on the reduction of restrictions, but a technical factor which is important with respect to the U.S. payments positions is the possibility that drawings made from the Fund in any currency can now be repaid in any convertible currency; that is, in the currency of any of the 21 countries which is under the regime of article VIII.

As I pointed out before, the U.S. balance-of-payments deficits during the past decade had, as a corollary effect, the strengthening of reserves of most of the other industrialized countries of the Western World, whereas the balance-of-payments position of the underdeveloped countries has improved very little, if at all, partly because of the depressed level of raw material prices over the last several years, partly in view of the huge demand for imports (machinery, equipment, but also vital consumers goods) which arises in connection with these countries' investment and industrialization programs. Over the past decade the reserves of the continental European countries which are members of the OEEC more than tripled, rising from $6.4 billion at the end of 1950 to about $21 billion at the end of 1960.

On the other hand, the United Kingdom's gold and foreign exchange holdings, as well as those of the whole sterling area, are now no larger than 10 years ago. Over the same period the gold holdings of the United States declined by $5 billion to $17.8 billion. The dollar assets of other countries, or in other words the short-term liabilities of the United States, rose by about $11 billion.

The new distribution of foreign exchange reserves which developed in the past decade was one of the prerequisite conditions for the return to convertibility and thus for the improvement of the international payments system.

I think it is important that, from an overall point of view, the world payments situation is now better than at almost any other time since the end of the last war. This does not mean that I want to belittle the difficulties and problems which are posed by the appearance of substantial U.S. payments deficits during the last 3 years. But I think one need not feel pessimistic about the present or future strength of the dollar if the U.S. administration continues to adhere to the economic and financial policies which have been eloquently defined by the former and the present President.

With gold holdings of about 17.5 billion, the United States as the world's principal banker is still in a very strong position. It is true that short-term liabilities to foreign countries which can theoretically be converted into gold are of about equal size. But, as no individual person would withdraw his deposits from his bank as long as he continues to have confidence in its management, there is no reason for governments and central banks to withdraw their short-term assets in the United States as long as there is certainty that the U.S. Government pursues economic and financial policies which will guarantee the maintenance of the value of these assets. No gold and foreign exchange reserves are high enough for a country which pursues reckless financial policies leading to inflation and consequential external deficits.

If a country pursues the right kind of economic and financial policy and maintains monetary stability, its currency will be valued by other countries. I think it is very important that perhaps for the first time it is realized that, in pursuing domestic economic aims, the United States also has to pay heed to the external-payments situation.

I would now like to make a brief comment on equilibrium and disequilibrium in international payments. In the setting of multilateral world payments which has evolved, there must obviously be surpluses and deficits.

I pointed out before that the deficits of the United States which made it possible for other countries to accumulate foreign exchange reserves have laid the basis for the return to the free trade and payment system. Before the last war the balancing of the foreign accounts of the principal countries came about through the working of relatively flexible rates of exchange. This quasi-automatic adjustment is now no longer possible since the articles of agreement of the International Monetary Fund expressly provide for fixed rates of exchange, and changes exceeding a certain limit can only be made in the case of a fundamental disequilibrium. Therefore, the balancing of external accounts must come about through adjustments in the internal price and income levels. In other words, countries with excessive payments surpluses must pursue expansionary domestic economic policies and those with excessive balance-of-payments deficits should pursue restrictive monetary policies.

In view of the repercussions which certain kinds of domestic policies have on the external accounts and thus also on the other countries, it is now more important than ever to coordinate economic and finnacial policies between all countries of the free world. The OEEC, the Bank for International Settlements and the International Monetary Fund have been important milestones in this field.

The new Organization for Economic Cooperation and Development (OECD) can, in my opinion, play a most useful role in extending and enlarging this cooperation between the member countries. But, in view of its worldwide aspects, the International Monetary Fund should be the essential clearinghouse for this purpose and its role should be further strengthened and increased.

I do not think that at the moment there is a worldwide shortage of international liquidity. But, nevertheless, it is important to devise plans and schemes for the future which can help to avoid the resurgence of illiquidity of the world's main trading countries. The Triffin, Bernstein, Stamp plans all point in this direction and I think we are fortunate in having such a wealth of ideas and suggestions from which we can distill the best and most practical parts.

I would like to stress one thing: No international payment system can function properly if the world's main currencies, the dollar and the pound sterling, are not sound. There are no expedients and gimmicks which can replace confidence which has been lost.

I would like to end my brief introductory statement by expressing my satisfaction with the economic program outlined by President Kennedy in his foreign economic message. I think it is very gratifying to see that the U.S. Government is trying to solve the temporary exchange problems in a liberal way and not by resorting to controls and restrictions. The emphasis he placed on the avoidance of an inflationary development has greatly increased the confidence in the dollar which depends at least as much on the U.S. fiscal and monetary policies as on the amount of gold in your banks.

Thank you, sir.

Representative REUSS. Thank you very much, Dr. Kamitz.

I would like to introduce Senator Jacob Javits of New York.

I would like to pursue, Dr. Kamitz, a point you made just a moment ago when you congratulated this country on sticking to a basically liberal trade policy despite some temptations and some advice to the contrary.

Would you care to comment on the effects of the Common Market and the European Free Trade Association on the future of trade liberalization?

Mr. KAMITZ. Well, you certainly know that many European countries are very much concerned about the existence of two trading blocs in western Europe, and certainly means and ways have to be found to form a bridge between these two blocs. But, on the other hand, let me state that between the two world wars the whole world, including the United States, followed a policy of protectionism and restrictions. The United States had a high-tariff policy and Europe a policy of trade barriers, quantitative restrictions of all kinds, quotas, exchange controls, or whatever it was. The spirit behind this was that countries tried to counteract the increasing economic difficulties by resorting to a policy of autarchy, self-sufficiency, and protectionism.

I think that the development showed that such policies were wrong. They did not help to overcome the depression. They increased the forces of capital destruction and the depression was only overcome when the rearmament programs were started in the big world trading countries, in 1937 and 1938.

Now we can be happy that after the Second World War there is a new spirit behind an effort to build up the world. It is the liberal approach by which countries tried to form a new world. The abolishment of trade restrictions in Europe, mainly due to the working of the OEEC which I mentioned before, was successful by a concerted effort of all European countries.

I think that even the two blocs, the Common Market as well as the European Free Trade Area, are results of this new liberal approach to solve economic difficulties.

Now, what is left to be done is, as I told you, the bridging of these two blocs which we really think is very urgently needed. I cannot tell you precisely in which way this could be done, but I would like to refer to a proposal I made, namely that the Common Market as a group should join the European Free Trade Association.

Representative REUSS. So that it would join it as a unit?

Dr. KAMITZ. Yes; discussion about ways to bridge the gap between the two blocs could be carried out within the framework of this new OECD, which will come into existence as the successor of OEEC. But I feel we have to pursue the economic integration of all European countries.

Senator JAVITS. Would you mind a question at this point?

Representative REUSS. May I first introduce to Dr. Kamitz, and his associate, Mr. Plan of the Austrian Embassy, Senator Bush of Connecticut and Senator Pell of Rhode Island.

Senator JAVITS. It is just on this point, Dr. Kamitz, that I would like to ask this question. Assuming that you can find the bridge, that you can find the formula which will take care of the British Commonwealth and will take care of the different concepts of a free-trade area and an economic community, what happens to the United States and the other free-world traders with these two groups?

I ask this question very advisedly because we are facing an enormous struggle in this country next year. Your preoccupation with your struggle, with which I am, as you know, very familiar because I served in this area myself, may lead people in Europe to forget the fact that this could all be undone in an afternoon right here and all your conversations over there could be just academic because the trading power of this country is so great just as the trading power of this bloc is so great.

I would hope, therefore, that you could tell us, and that perhaps at an early oppportunity it could be communicated to the United States, generally, as to what the concept must be; that it must not only be a bridge between the two blocs; it must also be where we fit. If it is not, we are going to have tremendous trouble here next year with the renewal of our reciprocal trade agreements.

Thank you very much.

Representative REUSS. I think Senator Javits has put his finger on a point that is worrying us all. You are thoroughly familiar with it and you see it at firsthand. One of Austria's troubles, I am informed, is that a large portion of your export trade is with West Germany, which now has fairly low tariffs. The result of the Common Market, of course, will be through the Common Market external tariff to raise the tariffs of one of your best customers, perhaps your best customer. To a degree, the United States is faced with a similar problem.

This country has a large trade with West Germany and with Benelux, the low tariff countries.

The effect of the external tariff is actually to raise tariffs against us at the very time when we need and think we have a right to lower tariffs.

This is a great problem, and I want to second what Senator Javits has said.

We in this country who want to keep our policy liberal are genuinely concerned about it, and we would welcome any light you can shed on the problem.

Dr. KAMITZ. I would say that the promoters of integration in Europe have always felt that what is done in the way of forming an integrated European economy should certainly be not the final aim; there should also be a bridge toward Canada and the United States.

What the promoters of integration really want to see fulfilled within a couple of years is not only a European integration, but an extension of integration to the United States and Canada. But I must tell you that the difficulties of integration are so enormous that I feel if today both topics are linked together, we will never be successful.

The first step is difficult enough, but I think, if an integrated European economic area is formed, then we can integrate this unit with the United States and Canada, but I think if you would now try to do both things at the same time and say, "Well, we have to integrate Europe and at the same time we have to integrate Canada and the United States," I think this would increase the practical difficulties in Europe and might delay integration for a couple of years.

What I am telling you is my personal conviction because I have followed these discussions for quite a long time, and I know what is going on. It is extremely difficult to get these people within Europe itself together even within EFTA, which is not such an intense form of integration as the Common Market. Even in the Common Market, if you read the newspaper comments of what countries are doing to escape the consequences of integration by raising additional turnover taxes and all kinds of things, you see, how difficult it is to follow the new liberal approach though we have got very able leadership by many outstanding personalities.

Senator BUSH. When did the Common Market actually start to function as such?

Dr. KAMITZ. The treaty was concluded about 4 years ago but I would say that the implementation of it is not yet very far advanced. As I told you, some nations tried to escape the consequences of integration.

Senator BUSH. Mr. Chairman, may I continue to inquire?

Representative REUSS. Yes, please.

Senator BUSH. Is it felt that progress has been made in these past 2 years?

Dr. KAMITZ. Yes; it has been made, and gentlemen, I must add another thing. It is not only a progress which is made within the framework of the organization in the Common Market or EFTA countries, but the general feeling that we are going the way of integration leads to the release of additional dynamic forces within the economies.

I have an example of entrepreneurs in our country who opposed integration and said, "We are unable to meet all this competition," but finally decided to make so many improvements by new methods of production that they now say, "Go on with integration. You told us we will have integration and now we have investments made for integration, but we have no bigger market."

A certain development out of the economy itself is therefore taking place in view of this coming integration additional pressure.

Representative REUSS. I think Senator Javits' point had to do to a very large extent with timing. You see, we have a crucial decision on commercial policy which we must make a year from now. If a year from now, when the Congress is considering the matter of renewing the Reciprocal Trade Agreements Act, this country is confronted with heightened tariff walls against our goods, the task of renewal will be made just that much more difficult.

I would therefore ask this question: Is it not possible for both the Common Market and the EFTA countries, in view of their surplus payments position, the deficit position of this country, and the need to maintain confidence in the dollar as an international reserve currency, to make tariff concessions both in the Common Market external tariff and in the individual tariffs of the EFTA countries on a most-favored-nation basis? This would be in accordance with the principle of GATT, and it would insure the continued expansion of worldwide trade.

Dr. KAMITZ. In the case that the bridge cannot be worked out I think this will be the only way of continuing the liberal effort. You will get the support of the EFTA countries in Europe because the EFTA countries in Europe would not like to stand aside and wait until something happens in the future. You may have five or six, or seven or eight countries forming a political nucleus, but for these eight, or seven, or six countries to make free trading arrangements with the rest of Europe which cannot fit into this community because they have the status of neutrality like we, Switzerland, or Sweden. Therefore, I would say, if you would suggest such a policy and begin with preferential arrangements for the whole area we would like to have the same.

Representative REUSS. Would the EFTA countries, so far as you are able to determine, be willing to make tariff concessions of a multilateral nature as part of a program to promote widescale multilateral trade liberalization.

Dr. KAMITZ. I think the most important partner in that respect is Great Britain, and there is some indication that Great Britain is willing to make some concessions with respect to their Commonwealth situation, in paying for the advantages of a positive solution.

Representative REUSS. Dr. Kamitz, I would like to introduce Senator Douglas of Illinois.

In addition to listening to a very interesting opening statement by Dr. Kamitz, Senator Douglas, we have in the last few minutes been discussing the impact of the Common Market with its internal trade preference upon free world trade generally, on Austria's trade and on U.S. trade. Does Senator Pell, Senator Bush, Senator Douglas, or Senator Javits have further questions on this topic?

Senator JAVITS. I think this trade topic is the most important. I would like to ask you this question. Assuming that these negotiations which we know about may or may not be going on, or part of them, to which you have already alluded, how do you think that the OECD, in which both Austria and the other so-called neutrals as well as the NATO powers will be engaged, could help us in this connection within the next year?

Dr. KAMITZ. Well, this is a problem to which you have just alluded now. The OEEC had tremendous merits in abolishing trade restrictions in Europe, the quantitative restrictions, and I think that OECD can provide devices for freer trade with all countries which are members of OECD notwithstanding the fact that some of the countries have a special organization in the form of a Common Market and others have a special organization in the form of EFTA. Why should it not be possible to lower general tariffs, to facilitate the movement of capital and labor in Europe by this new organization, the OECD, which are like the OEEC in respect to trade restrictions? It was exactly the same situation. I feel that, notwithstanding the fact that you have two organizations which cannot be bridged, why do we not try within a bigger organization to do away with the main trade obstacles which are still existing in Europe? I think it would be possible and we would welcome it.

Representative REUSS. When you speak of "Europe," Dr. Kamitz, do you include this country and Canada, in view of our membership in OECD?

Dr. KAMITZ. Yes.

Representative REUSS. In this same connection, let us look at the history of world trade in the last 25 years. In the midthirties this country adopted a policy of liberal trade and thus made a historic break with the policy of the preceding period. I think most Americans and most members of the free world community would say this was a good thing, and that we are all better off as a result of moving in this direction. While this program was officially designated a reciprocal trade agreement program, in actual practice and application we have not exacted true reciprocity. In the late forties, while Western Europe was recovering from the destruction of World War II, this country continued to lower its tariffs but agreed to permit our friends and trading partners temporarily to keep their quotas and exchange restrictions. Therefore, without wishing to seem too pro-American, I should like to remind you that the United States, over a considerable period, contributed somewhat more than it took. This was perfectly proper because of the large imbalance in payments in favor of the United States during most of this period.

I suggest to you that perhaps, in view of the total responsibilities of this country in the free world complex for trade, for aid to underdeveloped areas, for military defense, and so on, this country can, in justice and in fairness be entitled to something more than reciprocity.

I would like your comment on that. I think I read into what you have already said a recognition of this principle. The initiative of the Common Market and the EFTA countries in the direction of tariff reductions would be a good example of "turnabout is fair play" in international trade.

Dr. KAMITZ. Congressman, I would say that I think you are right. The late forties were the time of the dollar gap and therefore the United States agreed to be discriminated against to some extent in order to allow these European countries to overcome the afterwar difficulties.

The astonishing effect was the building up of such a booming Europe with balance-of-payments surpluses to the surprise not only of the United States, but even of Europe.

But it is a fact that the free world has to stick together, you see, and I really feel that, in pursuing common aims, such as the ones described by you, whether it is help to underdeveloped countries or the general establishment of economic strength or stability, all countries have to work together, and in that respect an argument like yours might have an influence on the discussion.

Senator DOUGLAS. Forgive me if I say that generally the argument that we must all stick together means that the United States must make the exclusive sacrifices.

Dr. KAMITZ. You are perfectly right. If I state it like that, it is not to the address the United States. It is addressed to Europe.

Senator BUSH. May I ask a question? You have the OECD now. You have the Common Market. You have the Outer Seven. That is what you call EFTA.

Dr. KAMITZ. That is right.

Senator BUSH. Then we have the GATT organization. These are all operating in the same field, at least in part; namely, the field of international trade.

Now, how do these things correlate their efforts as you see it? Are they working at cross purposes?

Dr. KAMITZ. No.

Senator BUSH. Do you think that we are benefited by having all of these various organizations working in the same field in trade liberalization? Do you feel that?

Dr. KAMITZ. Well, I would like to say that we certainly have a little too much of this kind of organization but there is a difference between the GATT, the General Agreement on Tariffs and Trade, and the organizations which have more stringent connections. The Comon Market is a supernational institution which includes common economic policy and all kinds of things, and is therefore much more than an agreement on tariffs and trade.

Senator BUSH. That is right.

Dr. KAMITZ. EFTA is not so far reaching as the Common Market but it is more than the General Agreement on Tariffs and Trade.

Senator BUSH. It is aiming in the same direction.

Dr. KAMITZ. It is aiming in the same direction but the GATT, of course, comprises more countries than EFTA and Common Market.

Senator BUSH. Although all of these countries in the Common Market and EFTA are also in GATT?

Dr. KAMITZ. They are also in GATT.

Senator JAVITS. If Dr. Kamitz would allow me, I would like to make one other distinction which is important to us all. Both the EEC Economic Community and EFTA are ruled by treaty. The treaty obliges members to make certain reductions or readjustments, in one case both internal and external and in the other case internal alone, whereas GATT is a strictly negotiating operation and there is no commitment except the commitment to bargain.

Senator BUSH. They come to an agreement which has force and effect.

Senator JAVITS. But they are not obligated to make certain adjustments at stated times as are the others.

Dr. KAMITZ. Their purpose is to make agreements.

Senator JAVITS. They serve the same ultimate purpose.

Dr. KAMITZ. Yes.

Representative REUSS. Are there further questions on the commercial policy matter that we have been discussing?

Senator JAVITS. I would like to ask Dr. Kamitz another question, if I may.

What are the chances in Europe to reduce its imposts on South American commodities like coffee and other commodities which can contribute enormously to help us with a tremendous problem and where Europe is now prosperous enough to loosen up a little bit?

Dr. KAMITZ. Well, you see, this question has been discussed in OECD and has been discussed in the Common Market. Many countries have fiscal duties on these products and to get the Ministers of Finance to say "No, we ought to rule them out," is not so easy, though I must confess that, to have fiscal duty on a product which is a main world-traded product is certainly not the right thing to do. This is agreed on by many countries. I think it needs a further push to get them to get rid of it. There is no definite inclination to deny this proposal.

Senator BUSH. Who can supply the push for that purpose?

Dr. KAMITZ. In that case I would say this would be up to you.

Senator BUSH. You see, some of us have been talking about the idea of trying to get Europe to join into the Latin American alliance for progress and that is one of the big reasons why we have been interested in that because Europe takes about 35 percent of Latin America's exports. We only take 9 percent more, 44 percent. They have almost as big a stake as we and they can influence the situation almost as much as we.

Senator DOUGLAS. Mr. Chairman, I apologize to you and to our guest for being late. If it is not inappropriate, I would like to ask one question of fact which may have been covered and another question of policy.

Representative REUSS. May I tell Senator Douglas that before he came in Dr. Kamitz very kindly agreed to the following: This meeting is in executive session. However, Dr. Kamitz has promised to read the transcript of the testimony, after which it will be made public and become a valuable part of the record.

Senator DOUGLAS. The question of fact is this: When I was in Europe a few years ago studying the Common Market, I thought that the uniform tariff which could be imposed on outside countries was to be a weighted average of the tariffs of various countries. Now Congressman Reuss informs me that, in his opinion, the tariff that has been arrived at is a simple average.

That is correct, is it not?

Representative REUSS. That was my information.

Mr. PLAN. An arithmetic average.

Senator DOUGLAS. And that therefore this operates adversely against American goods in that countries which import very little from the United States are given the same importance as countries which have imported a great deal so that the result is in effect an increase in tariffs to American goods within the Common Market instead of merely an average tariff, which is the same as it was before.

Dr. KAMITZ. Yes, I think you are right, but this is the result of the whole external tariff of the Common Market not only against the United States but against other European countries. We are suffering from the same result.

Senator DOUGLAS. So that, it is not quite accurate to say that the Common Market does not raise tariffs on goods from countries outside.

Dr. KAMITZ. No, this would be incorrect.

Representative REUSS. It is a fact, is it not, that many of Austria's future worries about the Common Market arise from the fact that your best customer, West Germany, had low tariffs but now they are going up?

Dr. KAMITZ. We would have been affected already if the Germans would not have revalued but, by this revaluation, there was a certain compensation for the rise in external tariffs.

Senator DOUGLAS. The second question may well have been covered prior to this time. It is a point that Congressman Reuss has stressed a good deal. That is the imposition of quotas by European countries. In the past, these quotas have been much greater impediments to trade and to our exports than is commonly stated and, while I know that the British have removed a great many of the quotas, is it not true that a large number of the quotas on very important commodities still remain (*a*) in West Germany, (*b*) in France, and (*c*) to some degree and to a lesser degree, in England?

Dr. KAMITZ. Yes. That is true and in other European countries, yes. The liberalization toward American is not too perfect.

Representative REUSS. If I may, I would like to switch the focus of the discussion to another very important subject which you touched on in your introductory remarks, Dr. Kamitz; namely, the general question of international liquidity. You recall that last December when I had the pleasure of visiting with you in Vienna there was some concern throughout the free world about the gold loss of this country. That concern is now at least temporarily abated and our present position looks much better. Nevertheless, we still have with us the problem that with a greater number of convertible currencies it is possible for short-term bonds to be shifted rapidly from country to country. If this occurs and central banks then demand gold, this can present a problem.

Dr. KAMITZ. That is right.

Representative REUSS. We would be extremely grateful for any suggestions you may have for ways and means the free world can take to diminish the seriousness of this problem.

Dr. KAMITZ. Well, this is a very long story and has many implications. To make a long story short, I want to state first that, as I pointed out in my introductory remarks, of course the foreign liabilities are now of roughly the same size as the gold reserves of the United States. But the foreign countries will not draw on the United States and convert all their short-term assets into gold. Why should they? Of course they could do so and this might bring an imminent danger, but I must tell you that, after the revaluation of the German mark, for the first time since a long time the governors of the Central Bank of Europe got together and said, "We are going to make an agreement in order to reduce the possible impact on the world currencies which might be the consequence of the German revaluation." You know that the week after the German revaluation $350 million were converted in Switzerland against Swiss francs and about 100 million pounds sterling in Switzerland and Germany. This was a terrible shock for the international exchange market. But, through the collaboration of the main central banks, repercussions on the concerned could be avoided, because they agreed not to convert these currencies into currencies or into gold but to hold them on special accounts. By that and by the willingness to demonstrate the concerted effort to avoid speculation, a crisis could be avoided. Through constructive collaboration with a definite aim to solve this worldwide problem of short-term capital movements, we can be successful.

But there is another thing. You know of the plans of Bernstein to enlarge standby credits of the monetary fund and to come to new standby credits, and there are other ways and means in the same direction. But I think what is really necessary is not only the techniques which settle a present situation of disequilibrium, of high deficits and high surpluses, through short-term movements but to avoid those movements. Let us say you must find or you should find a way of producing preconditions which exclude these enormous deficits and surpluses. Well, how can you do it? There are two possibilities. The one is you return to flexible exchange rates. I would not propose to do so.

Senator DOUGLAS. You would not?

Dr. KAMITZ. No; I would not. I think the international capital movements of today have shifted from private movements to a great extent to movements of public funds, and I think it is very difficult, under those circumstances, to reestablish a system of flexible exchange rates if public funds are concerned in such a huge amount. But this has to be thought over. I would not say that this is a definite statement but, under the prevailing circumstances, I think it would be at least difficult to go back to the flexible exchange rates. If you would have flexible exchange rates, it would mean that a disequilibrium of the balance of payments is going to be adjusted immediately by the mechanism of exchange-rate variations. If the balance of payments of a certain country is in deficit so that you have an outflow of gold or foreign exchange and you have a stimulus of exports and a reduction of imports and a new flow back of capital, you soon get a new equilibrium; but, in the case of fixed exchange rates, you have no other chance than to eliminate these preconditions which produced the surpluses and deficits.

This can only be done by a coordination and cooperation in the basic financial and monetary policies. That is to say that basic financial and monetary policies—that is, whether a financial policy should be expansive, restrictive, or neutral—should be agreed on in a greater extent than it is done now. If it is not possible to reestablish a certain automatism of adjustment, we must provide preconditions which exclude those difficulties at least to the greatest possible extent. What is left, of course, we would not be able to exclude entirely, but what is left can be managed by those technical measures which, in the long run, leave time to adapt yourself.

Senator DOUGLAS. Doctor, do you mean, however, that instead of having a uniform policy as between different countries, in one set of countries you would raise interest rates and restrict production and in another set of countries lower interest rates, so that there would be variable treatment?

Dr. KAMITZ. That is right.

Senator DOUGLAS. As between countries?

Dr. KAMITZ. That is right.

Senator DOUGLAS. Neither universally expansive nor universally contractive?

Dr. KAMITZ. That is right.

Senator DOUGLAS. Do you think really you could get the countries to do that, to hold back some countries and push forward other countries?

Dr. KAMITZ. I know how difficult it is but I must tell you that we have monthly meetings of the governors of the central banks of Europe which are fortunately now attended by a representative of the United States, and I must tell you that the simple exchange of ideas about the situation is a very worthwhile result of those meetings, although the governors of the central banks alone are, of course, unable to really adjust all financial policies, since they are limited to the field of monetary policy. If you would add to those meetings the ministers of finance discussing the shape of financial and economic policy for the coming year, you would enlarge the possibilities of cooperation.

Representative REUSS. Would you suggest that the newly formed OECD might be a very useful device for making these representations?

Dr. KAMITZ. That is what I feel.

Representative REUSS. And is it not a fact that its predecessor, the OEEC, had quite remarkable success in persuading its members to adjust essentially internal economic policies?

Dr. KAMITZ. I agree with you but the main merits of OEEC were the abolishment of quantitative restrictions.

In the other field, the recommendations were very worthwhile, but, for the achievement of aims like those which we were discussing now, it is not strong enough, you see. It should be enlarged in a way of more comprehensive discussion of those special problems, of financial problems.

Representative REUSS. In this country, we are, like people in any other sovereign state, concerned to confine the ultimate responsibility of making decisions affecting the country to our own Government.

Would it not, in your opinion, be possible to work out a method of recommendations in the financial and monetary and fiscal fields by the OECD which would leave each member free to follow or not to follow the recommendations that were made? In other words, do you envisage that much could be accomplished along the lines you suggest without impairing the sovereignty of each of the 20 countries?

Dr. KAMITZ. I must tell you that I have never thought of impairing the sovereignty of the countries, you see. What I felt should be a very liberal agreement on saying, "Are we going to collaborate and coordinate, yes or no? If we do so, it is our own will in doing so and nothing has to be impaired."

I think your suggestion to go the evolutionary way and say we are going to work out recommendations is worthwhile trying.

Senator BUSH. Sir, I think a recommendation from the OECD, even though it was not unanimous, would have some impact on this situation. I should think it would be regarded with considerable interest here in the Unted States.

That leads me to ask you whether you have any observations you would like to make? Maybe you made them in your prepared statement. I did not hear that. But have you any observations that you would like to make concerning our own problem of balance of payment at the present time? Have you any advice that you would like to give us?

Dr. KAMITZ. Well, I stated in the introductory remarks in the way that I said that at the present moment I think nobody is unduly concerned about your balance of payments.

Senator BUSH. That is your present estimate of the situation. That is in Europe.

Dr. KAMITZ. It is perfectly all right. But beginning next year you have two problems to consider. The one is the upcoming recovery of the United States, which will lead to an increase of imports and may be to a new deficit in the balance of payments on current account or at least to a diminution of its present surplus, and the second is the uncertainty of the attitude of the new administration concerning spending and the maintenance of an approximate budgetary balance. Of course, if there would be an excess of spending, you would have all the problems of balance of payments deficits in the coming years. My personal opinion is that the basic situation of U.S. balance of payments is not unsound, because, according to statistics which have been elaborated by the International Monetary Fund, it shows that the deficit between 1950 and 1960, over a period of 10 years, is about the same as the increase in foreign investment assets.

Senator BUSH. In this country?

Dr. KAMITZ. By this country. So that, you may be looking with great hope to the future because the investments will produce dividends and repayments. So I would say basically your balance of payments situation is absolutely all right and justifies an optimistic judgment for the future.

Senator BUSH. I am afraid I did not quite understand that, Mr. Chairman.

The deficit over the 10-year period in balance of payments is measured quite closely by your investment overseas.

Dr. KAMITZ. That is right.

Mr. DESPRES. American investment abroad?

Mr. PLAN. The U.S. investment abroad was about $31 billion in 1949, and it is $65 billion in 1959, an increase of about $34 billion.

Now, over the same period, the foreign investments in the United States rose from $17 billion to $41 billion, so that the net increase in U.S. foreign investments was about $10 billion, which figure is not far from the total of U.S. gold losses plus increase in current liabilities to foreign governments and central banks. So you exchanged your short term assets against long term assets.

Dr. KAMITZ. You may have a problem of liquidity but not a problem of unsoundness.

Mr. PLAN. You are rich, but your money is not always readily available.

Dr. KAMITZ. It is like a most powerful bank which may have good investments but in a way that the liquidity is not granted.

Senator BUSH. There has been quite a rash of American investment in Europe during that decade, I believe. Has that been welcomed over there, would you say?

Dr. KAMITZ. I would say so, yes.

Senator BUSH. And a continuation of it would be welcome?

Dr. KAMITZ. Yes; certainly, from our point of view. I do not know whether that is true from the American point of view.

Senator BUSH. I meant from your point of view, yes. It has begun to be a little bit of a controversial point here.

Dr. KAMITZ. I know that.

Senator BUSH. Well, I would not say it is the greatest controversy, but it has been discussed a lot in the last year. I think there would be a reluctance to block it.

Dr. KAMITZ. That is right.

Senator BUSH. Have you any further comment on the general balance-of-payments problem as we face it? Have you any further guidance you would like to give us?

Dr. KAMITZ. Well, I said if a policy of excessive spending goes on, of course this might raise problems. Why? Because it leads to price and wage increases. But there is one point I would perhaps make clear from the European point of view, whatever happens we would not like to see America go back to restrictive practices. Europe is certainly ready, as shown by the cooperation of the banks during the time after the reevaluation of the deutsche mark to cooperate in all kinds of ways; but please do not go back to restrictive practices.

Senator DOUGLAS. Let me tell you that you have imposed quotas on American goods, and unless they are largely removed, I think we are going to have great difficulty in renewing the Reciprocal Trade Act next year.

Representative REUSS. So Senator Javits said before you came in, Senator.

Senator DOUGLAS. I speak as one who has defended reciprocal trade.

Dr. KAMITZ. I understand this program and I agree with you. I think it is a little different whether you still continue those quotas and restrictions and you hesitate to get rid of them or you start again, having followed a liberal policy for quite a number of years. This would mean a reversal of the American policy and would awaken all forces of restrictionism.

Senator DOUGLAS. I expect to support reciprocal trade even though Europe does not change its policies next year, but I think we will be in a minority unless restrictions are removed and I do not think the Europeans have sufficiently realized the gravity of the situation that we face here. We are in a recession. We have had in these last 2 years an unfavorable balance of payments. We need to build up our exports. We find our exports discriminated against, so that we may move to the restriction of imports; and, very frankly, there will be a good deal of ethical justification for it because you cannot expect one country to bear the burden indefinitely.

Dr. KAMITZ. I agree with you.

Senator BUSH. I would like to observe for the record that I agree in general with what Senator Douglas said but I would not go so far as to say that I think that, in the event that Europe did not loosen up for us, we would not pass that Trade Agreements Act. I think it would result in other actions which would be more restrictive here, but I cannot conceive of us giving up the Trade Agreements Act. Can you?

Senator DOUGLAS. Or we could avoid it by putting on quotas ourselves.

Senator BUSH. This is what it would lead us to.

Senator DOUGLAS. Well, in effect.

Representative REUSS. However, from the standpoint of liberal world trade, Senator Bush, I think you would agree that that would be worse perhaps than not continuing to lower tariffs.

Senator BUSH. I do not think either is attractive. I do not know which is worse, but I would say it would be worse to lose the Trade Agreements Act. I just cannot conceive of going back to the dark ages on that program and having this Congress setting trade restrictions on every item. I just cannot conceive of it.

Senator DOUGLAS. I think we will have a whole series of quotas.

Senator BUSH. I think I agree on that point that it will likely result in more restrictive action here, but I would not go so far as to say that it would pull us out of GATT altogether.

Dr. KAMITZ. It is not up to me to ask questions, but may I ask a question?

Representative REUSS. Please do.

Dr. KAMITZ. Concerning this point that we were just discussing, I understand your principal point of view but did you ever investigate the magnitude of the exports of the United States to Europe and the probable impact of our restrictions on your exports to Europe? You will see that these exports to Europe are increasing from year to year so that probably the influence of the remaining European restrictions—with which I do not agree myself personally and I hope we can get rid of them—is not so important as to justify for the United States to go back to restrictive trade practices.

Senator BUSH. We are increasing from year to year.

Dr. KAMITZ. You are increasing. Your deficit in the balance of payments is not due to that kind of discrimination. It is due to your tremendous foreign investments, and the outflow of capital.

Senator DOUGLAS. They tell me that somewhere between $½ billion a year and $1 billion a year is involved if the quotas are driven out. My State of Illinois has been a big coal State. We could lay down coal in Germany at an appreciably lower price than German coal is selling for but Germany has a very restrictive quota on coal. I do not suppose there is much chance that they will eliminate it since the coal and steel people are the big financial backers of Adenauer and the Christian Democrats. But the fact that our export market on coal is shut off is in turn causing the coal industry to demand more quotas on residual oil from Venezuela and we are being pushed to restrict imports of oil from Venezuela, which, in my judgment, will have a very disastrous effect on our relationships with Venezuela which is a touch and go situation anyway. So that these things ramify and I do not want you to think that I am adopting what we call a 100 percent American attitude but I do not think that Europe has always realized the seriousness of the situation and the fact that we have borne a very heavy burden for a great many years without too much complaint and it is simply human nature for the coil to spring after a time.

Representative REUSS. Senator Pell, you had a question.

Senator PELL. One question which has bothered me is the difference in concept as to what a duty or tariff is. We use it primarily as a device for the protection of our own industry. In Europe it seems to me that you use it more as a revenue-raising device or as a means of preventing the flight of currency out of your country. To be specific, in your own country, Austria, there is no automobile plant whatsoever. Yet the duty on automobiles is as stiff in your country as it would be in Sweden or Germany or France where they manufacture them. What would be the reason behind that?

Dr. KAMITZ. I must tell you that in Germany all European countries use customs and tariffs only out of reasons of trade or for trade policy. The example which I raise now of the customs on automobiles in our country has a very real history. We had an automotive industry before 1938, you see, and these high duties were incorporated in our customs tariff. This customs tariff was never canceled. During the Nazi occupation it was eliminated but, after the Nazi occupation, all these laws which existed before came into power again, you see. Now we have the queer situation that we have no more production of motor cars but we have this high tariff, you see, and I myself reduced this tariff by 50 percent and I caused a terrible rumor within the workers in trade unions because they said, "There is a silly man. He is going to give a sort of donation to the rich instead of collecting this customs and providing the money for-I-don't-know—pension schemes" or whatever it is.

Senator PELL. This is the point I am driving at. In essence they think of the tariff as a means of revenue and not as a protective device.

Dr. KAMITZ. This is a special case of the views and attitudes of trade unions and Chamber of Workers.

Senator PELL. But, pursuing that thought one step further, would you not be inclined to agree with the view that tariffs are more used for revenue production in Europe than they are here?

Dr. KAMITZ. Perhaps more than here because we have those fiscal duties like coffee and other things, you see; probably more than in the United States.

Senator PELL. Then it would always be hard to get the two systems in balance unless we have the same ultimate objective as to what a tariff is designed to accomplish.

Dr. KAMITZ. That is absolutely right but it is one objective of international discussions and agreements that you should get rid of all customs duties, which are only raised out of financial and revenue purposes. This is an agreement. People are quite aware that you cannot continue on that line.

Representative REUSS. A moment ago, Dr. Kamitz, you were discussing what the next year or two might bring to the United States balance of payments. You pointed out that a stronger economy here would produce a higher national income and thus larger purchases by America of imports from abroad which would, to some extent, contribute to the balance of payments problem.

You also said that an inflation in this country would also hurt our balance of payments. I assume you mean that inflation would price our exports out of the market and thus further add to our difficulties?

Dr. KAMITZ. That is right.

Representative REUSS. I call your attention to the fact that, although none of us is rejoicing about it, there will be a deficit in our budget next year and that expenditures on current account will be greater than income. Do you regard a budgetary deficit unwise for the United States in its present domestic and balance-of-payments situations?

Dr. KAMITZ. I would say not at the present situation in which you still have unemployment but I think you should be careful when this so-called level of full employment is reached and to avoid a wage push or cost push which provokes a spiral which is always continuing. We have little chance to avoid it.

Representative REUSS. I am glad that you draw a distinction between conditions of full employment and those which prevail in the United States today.

I should like to ask whether I understood you on another point. I gathered from what you said about the recent reevaluation of the deutschemark that, as a central banker, you see certain disadvantages and indeed dangers in either devaluation or revaluation of currency rates.

Dr. KAMITZ. This is exactly my opinion.

Representative REUSS. Would you tell us why you think this is a less desirable way of going about adjusting payments balances than by other methods?

Dr. KAMITZ. Well, because I feel that this is nothing else but to cure the symptoms and how far can you really go to cure symptoms in such a way? If you remember the development of the thirties, when all currencies were devalued the final effect was zero. It is, I think, absolutely clear that, in adjusting the exchange rate to give new conditions without doing anything else just makes a little stop to a given development which continues immediately after the new exchange rate is fixed in the same way as it initiated before and lead to the change of the exchange rate. What you have to do is to eliminate the reasons for the discrepancy but not the discrepancy itself.

Representative REUSS. Do you think that a shift in an exchange rate may accentuate the kind of speculative activity which may have induced the change? That is to say, if a country revalues its currency by 5 percent, does it occur to speculators that they might have a go at another 5 percent and thus precipitate additional capital movements?

Dr. KAMITZ. That is indeed advisable. There are unforeseen consequences and I think the consequences of the German revaluation had one good result that it is agreed, I think, among all European and central bankers that such a step, whether in one or the other direction should not be taken. It is so funny that even in Germany the reaction of the people was just the reverse. I know it from German bankers. People came to the bankers and said, "Did we deserve that, that they are going to speculate with our safe money? Shall we take it out?" So that it was just the contrary of what was intended. They intended to strengthen the mark.

People said, "If they go to change exchange rates, now what are they going to do next week and can we rely on our savings?" This was the reaction. There is nothing more sensitive than the exchange rate of a currency.

As long as you have flexible exchange rates we will adjust ourselves to flexibility.

Senator DOUGLAS. That is just the point. If we have exchange rates determined by the market impersonally, governments are not held responsible, for there is then an automatic adjustment more or less of exports and imports and balances. Have you not discarded the idea of flexible exchange rates too quickly?

Dr. KAMITZ. No. I think if you have flexible exchange rates it is up to all the people concerned to look at the development and to take into account that for a country having a severe balance-of-payments deficit, it would take a long time to cure this situation by the adverse development of its exchange rates, but people know that there is flexibility, and they cannot escape losses if, for example, they try to sell and buy foreign exchange at a certain date. But there is no such chance at fixed exchange rates, and it is a different thing to judge whether a government is going to change an exchange rate today or tomorrow. Who tells the people what the Government is going to do? What are the reasons for such an action? You see? The uncertainty that the new situation is provoked by the decision of somebody is what shocks people and if such a step is taken, of course they say, "Well, when will the next step be taken?"

Senator DOUGLAS. If you will forgive me, I think everything you have said now is an argument for flexible exchange rates so that the decisions will not be made by the governments.

Dr. KAMITZ. I think I did not make myself clear.

If the exchange rate is up to a decision by the Government, so people look at it as a decision of the Government, they have no influence and they cannot help themselves.

Senator DOUGLAS. I see.

Dr. KAMITZ. But this is different with a flexible exchange system, when the Government has no decision on the exchange rate, because it is self-determinating. If there is a big demand the exchange rate goes up. If there is a big offer it goes down. Everybody knows he has to adjust to the situation, but there is no government interference; but, if there is no such adjustment and there is a government interference, you cannot judge when. That is the idea.

Senator DOUGLAS. But, my good friend, I do not want to prolong the point but I think when you read the statement over in cold print you will see that you have made a very eloquent argument for flexible exchange rates so that people will not go by the Government but by the fluctuations in rates.

Dr. KAMITZ. I think the flexible exchange rate is a very good thing but at the present moment, under the reasons which I pointed out before, I cannot imagine that we have a chance to come to flexible exchange rates.

Representative REUSS. Senator Bush?

Senator BUSH. I have no questions.

Representative REUSS. Senator Pell?

Senator PELL. I have no questions.

Representative REUSS. Senator Douglas?

Senator DOUGLAS. No, thank you.

Representative REUSS. We are extremely grateful to you, Dr. Kamitz, for giving us an hour and a half of your time. We wish you were staying longer in this country so that the committee might have lunch or dinner with you and a chance to continue our interesting discussion.

We are going to send the transcript of this hearing to Mr. Plan at the Embassy tomorrow. We would hope that, either before you go or as soon as possible, you will be able to send it back to us with such corrections as you have.

I know that this has been a most useful discussion. It will help us in our deliberations and we all look forward to seeing you again.

Dr. KAMITZ. Thank you.

Representative REUSS. Thank you so much.

(Whereupon, at 5:30 p.m., the subcommittee recessed, subject to the call of the Chair.)

INTERNATIONAL PAYMENTS IMBALANCES AND NEED FOR STRENGTHENING INTERNATIONAL FINANCIAL ARRANGEMENTS

MONDAY, JUNE 19, 1961

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND
PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The joint committee met, pursuant to notice, at 10 a.m., in the Old Supreme Court Chamber, room P–63, U.S. Capitol, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss; Senators Douglas, Pell, and Bush.

Also present: John W. Lehman, deputy executive director and clerk; and Emile Despres, William Salant, and Lorie Tarshis, consultants.

Representative REUSS. Good morning.

The Subcommittee on International Exchange and Payments of the Joint Economic Committee will come to order.

These hearings are being conducted as part of the subcommittee's comprehensive study of imbalances in international payments, measures to correct them, proposals for safeguarding the dollar, and for improving present international monetary mechanisms.

We are honored to have with us as the first witness the Honorable Douglas Dillon, Secretary of the Treasury.

Welcome, Mr. Secretary.

Please proceed in your own way.

STATEMENT OF DOUGLAS DILLON, SECRETARY OF THE TREASURY

Secretary DILLON. Mr. Chairman, I appreciate this opportunity to appear before you this morning to discuss recent developments in the international payments structure. The committee's review of these developments and its study of possible ways to improve present international monetary mechanisms is both timely and welcome.

The problems stemming from persistent imbalances in the international economy are, of course, not new—they have been with us in one form or another throughout much of the postwar period. While the so-called dollar shortage of earlier years was recognized as a source of international instability, and policies were adopted by the United States specifically to deal with this problem, its effects were felt more directly by the rest of the world than they were by us. What is new is that the constraints imposed by our own recent balance-of-payments deficits—most conspicuously evidenced in the decline of the U.S. gold stock—have become a matter of direct public concern in this country.

Problems in the world's financial markets cannot be divorced from the underlying economic conditions and trade patterns of the world's major countries. Therefore, although the committee has indicated its desire to focus on the financial side of the international payments structure during the current hearings, I should like to begin by highlighting recent developments in this country's balance of payments with the rest of the world, relating these developments to the pressures that have arisen in the exchange markets. Against this background, I should then like to comment on the exchange market pressures themselves and some of the specific steps that have been taken to deal with them.

THE U.S. BALANCE OF PAYMENTS 1960–61

The problems which gave rise to the rapid gold outflow during the second half of 1960 had their roots in the unprecedentedly large balance-of-payments deficits incurred by the United States in both 1958 and 1959. In analyzing these deficits, we need to distinguish between what may be called the basic components of our payments accounts, and the short-term capital flows which, as we have seen, can have such an important impact on our overall position at any given time. It was partly to point up this distinction that I made arrangements several months ago to set up a special interdepartmental Committee on Balance of Payments Information to study possible ways of rearranging our international accounts to make them analytically more useful. I thought that your committee might be interested in one form of presentation that we have adapted for our use in the Treasury, on the basis of the interdepartmental committee's work thus far.

If you will look at line 15 of table I, you will see that our basic deficit was very large in 1958, and increased still further in 1959. Last year, however, there was substantial improvement in the basic balance as exports picked up sharply and imports actually declined somewhat. In the first quarter of this year, moreover, exports remained at high levels while imports continued to fall slightly, with the result that we actually achieved a small surplus on these basic items.

While there are some indications that the recent improvement in our merchandise accounts reflects a strengthened U.S. competitive position—for example, in the displacement of foreign automobile imports by domestically produced compact models—we cannot overlook the fact that much of the change was due to the conjunction of high levels of economic activity in other advanced countries with a recession in the United States. Therefore, since the progress of recovery in the United States will undoubtedly bring some increase in our imports, we must expect somewhat less favorable results during the second half of the year. Furthermore, even if we should achieve a basic balance this year, there is no assurance that this balance can be maintained in 1962. Certainly we cannot afford to depend on the recent combination of circumstances—boom conditions in Europe and Japan side by side with recession in the United States—which make for the widest possible trade surplus. It is essential, therefore, that we push forward with the President's balance-of-payments program in order to assure our ability to maintain balance in our international accounts over the long run.

We must, of course, be concerned not only with policies that will strengthen our basic balance, but, also, with the development of measures to cope with international short-term capital flows. While we must expect some transfers of funds between countries in response to differing commercial incentives, there is no economic justification for—and potentially much harm from—movements that begin to feed on themselves for speculative reasons. As you know, the considerable improvement in our basic balance during 1960 was offset almost completely by outflows of short-term funds. Line 16 of the first table shows the rise of more than a billion dollars in this outflow last year. An additional strain was placed on our overall balance by the shift in unrecorded transactions (line 17) from a substantial inflow in 1959 to an outflow of more than half a billion dollars in 1960. These unrecorded transactions represent largely private transactions and much of last year's shift is clearly associated with the speculative atmosphere that developed last fall.

While short-term capital movements are more difficult to analyze than changes in the basic components of our international accounts, it seems likely that much of the outflow, initially at least, was attributable to widening differentials in interest rates and credit availabilities between this country and other financial centers. Not only was there a substantial incentive to transfer funds to foreign money market instruments such as Treasury bills and bankers' acceptances, but the differential in bank lending rates also caused business borrowers to shift their source of financing from other countries to U.S. banks. At the same time, the unfavorable short-run prospects for capital appreciation in this country caused foreigners to contract their investments in the stock market, and enhanced the attractiveness to U.S. firms of direct investments abroad.

As the summer months progressed, and the earlier improvement in the trade balance was increasingly offset by these capital outflows, rumors began to appear in the exchange markets that even the dollar itself could not withstand continued deficits of the magnitude that had been experienced in the 3 preceding years. As a result, there was some liquidation of dollar holdings to avoid any risk from devaluation, with the result that speculative withdrawals of funds were added to the outflows already taking place in response to business incentives.

The wide differentials in money market rates which helped to activate the sizable movements of short-term funds in 1960 have, for the most part, been considerably narrowed this year. Even more important, the President's unequivocal statements of our determination to maintain the present gold value of the dollar, together with his program for dealing with balance-of-payments deficits, have fully restored confidence in the dollar, and thus eliminated a source of heavy pressure on our reserves. This changed atmosphere was reflected in the sharp swing in unrecorded transactions from a large negative figure in the latter part of last year to a small plus figure during the first quarter. On the other hand, foreign business firms, particularly in Japan and Germany, continued to borrow heavily from U.S. banks with the result that recorded outflows of short-term capital continued at roughly the same rate as the second half of last year during the first 3 months of 1961, that is, close to $2 billion a year on a seasonally adjusted basis. Therefore, even though there has been a significant improvement from the latter part of 1960, we must still keep an eye on short-term rates in this country so as not to encourage a resumption of sizable money market investments abroad.

Before going on to discuss some of the steps that have been taken to deal both with the basic balance-of-payments problem and the unsettling effects of short-term capital movements, I think it would be useful to summarize the geographical distribution of gold and dollar gains during the past 3 years. In a very rough way, these gains reflect, and, indeed, are the counterpart of, U.S. deficits. Table II at the back of my statement emphasizes the well-known fact that by far the largest part of excess U.S. expenditures abroad has ended up—directly or indirectly—in the gold and dollar holdings of continental Western European countries. Japan, too, has accumulated sizable balances during this period, though the increase in official reserves seems to have come to a halt recently. The large increase in the gold and dollar holdings of the sterling area during 1960 was more than accounted for by short-term capital inflows into the United Kingdom, and there has been some reverse flow in the last few months.

The point I wish to emphasize is that international imbalances are two sided. The obligation to take effective action to bring about equilibrium in international accounts falls as heavily on surplus countries as it does on those incurring a deficit. The United States recognized this obligation and acted decisively during the earlier postwar perod to alleviate the dollar shortage. Now that circumstances have changed, others must follow this example.

At the same time, we ourselves have embarked on a broad program aimed at achieving a sustainable balance in our international payments within the next 2 years. The general outline of the proposed measures was described in the President's message to Congress of February 6, and I do not believe it is necessary to reexamine the whole program in detail at this time. I would, however, like to offer a few general observations.

First of all, these measures have been designed to avoid damage to our national security and to be consistent with our international obligations. For this reason, we have not proposed curtailment of our overall military or economic assistance programs. We have, however, carefully reviewed these programs and taken action to reduce their foreign exchange costs as much as possible. Both our military and our economic assistance programs are now being administered so as to place primary emphasis on procurement of U.S. goods and services. In fact, we estimate that more than $2 billion of U.S. Government economic grants and credits were spent internally even in 1960.

The administration's balance-of-payments measures were also designed to conform to this country's liberal commercial policy. We have ruled out the imposition of either trade or foreign exchange controls because such controls would, of course, be self-defeating, particularly for a country of our relative importance in international transactions. We have advocated the removal of special tax incentives to direct investment in developed countries overseas. It would clearly be to our own long-run disadvantage, as well as contrary to our principles, to impose general restraints on foreign investment. Similarly, in the area of trade, our efforts have been aimed at inducing other countries and trading groups to eliminate discriminatory quotas and reduce tariffs on dollar exports, rather than imposing restrictions ourselves.

While the United States will continue to seek a solution to its balance-of-payments problem along lines that are consistent with its international obligations and policies, I cannot emphasize too strongly that the task will be exceedingly difficult without the fullest cooperation of the surplus countries. A continued accumulation of reserves, year after year, cannot avoid straining the international financial system. Industrialized countries must work together closely to eliminate the basic imbalances that have developed during the past few years.

At the same time, it is also important that we continue our efforts to strengthen the international financial framework itself so that the danger from speculative capital movements generated by these imbalances may be minimized. I should like to turn now to some of the steps that have already been taken, both unilaterally and in cooperation with authorities abroad, to this end.

STRENGTHENING THE INTERNATIONAL FINANCIAL SYSTEM

The problems that arose from the outflow of short-term funds during the second half of 1960, not only for the United States but also for the recipients of these funds, grew out of the conditions that have developed since the return to convertibility by most of the world's important currencies at the end of 1958. It quickly became clear that these new problems required new measures to deal with them.

One of the most widely discussed experiments undertaken in this country involved the attempt to influence the structure of domestic interest rates through new techniques in the implementation of monetary and debt management policies. For several months now, the authorities have sought to achieve the seemingly contradictory goals of holding up short-term rates while enlarging the flow of funds into all forms of domestic investment in order to spur domestic recovery. On the whole, this venture has been gratifyingly successful thus far, both in limiting the interest incentive to transfer short-term funds abroad and in maintaining credit ease and encouraging monetary expansion at home.

In part, this has been made possible by the cooperation of other countries in an effort to reduce the volatility of short-term flows. This was most clearly seen in the measures taken by various European monetary authorities to reduce the attractiveness of their money market instruments to foreigners. In both Germany and Switzerland, for example, the authorities took administrative action to discourage foreign investments in their respective money markets by barring the payment of interest on such investments, and in certain cases even imposing a penalty on foreign balances. Similarly, in Germany short-term interest rates were reduced specifically with a view to the foreign effect. As a result, the differential between short-term rates here and abroad—particularly after allowing for forward exchange cover—has narrowed, and thus reduced considerably the interest advantage of shifting funds abroad.

Although these measures were most helpful in alleviating the immediate problem posed by interest differentials, it was generally agreed that there was a need for continuing contact and discussion of international financial problems in order that steps might be taken before a potentially unstable situation got out of hand. The Federal Reserve, both on its own behalf and as fiscal agent of the Treasury, has been keeping in closer touch with monetary authorities in Europe. At the same time, the U.S. Government has taken the initiative in developing a framework for close consultation with European authorities through the Organization for European Economic Cooperation-Organization for Economic Cooperation and Development.

A new working party on monetary and fiscal policies has been established as a subcommittee of the Economic Policy Committee of OEEC. It is meeting at 4- to 6-week intervals in Paris, where a small group of responsible officials can discuss questions of mutual interest and concern, and gain a practical grasp of the flexibility which exists in national policies to help discourage excessive or disequilibrating movements of liquid funds. These officials well realize that international financial considerations are only one of many objectives that must be taken into account in the overall financial policy of a nation. Yet it is through the lessons learned last year and through consultations of this kind that progress has been made toward a better coordinated and more stable pattern of international interest rate relationships than was the case last year. These OECD meetings also afford an opportunity to keep the basic balance of payments situation under scrutiny, and the confrontation serves to keep both the surplus and deficit countries aware of their responsibilities to correct their positions. At the same time, the International Monetary Fund is beginning regular consultations with convertible-currency countries, thus broadening the scope of these useful periodic reviews which previously had been largely confined to countries maintaining exchange restrictions.

The need to strengthen the international financial system and improve international financial cooperation was again dramatized recently by the speculative movements of capital that developed following the revaluations of the German mark and the Dutch guilder in early March. The methods employed on that occasion to contain these movements and prevent them from forcing either an undesirable and unnecessary change in exchange rates, or a reversion to the controls removed only after such painstaking struggle through the postwar years, were impressive. Even though no question concerning the standing of the dollar was directly involved in this latest speculative flurry, the techniques developed, and the lessons learned through the close day-by-day contact which we have maintained with various European monetary authorities during this period, will have lasting value to the United States.

I believe you will have an opportunity to explore this subject further tomorrow with the representatives of the Federal Reserve Bank of New York, whose operational contacts have been utilized on behalf of the Treasury as our fiscal agent as these new procedures were being developed. The particular techniques used are not as important, however, as the fact that ways were found to offset speculative capital flows of very large magnitude. What stands out, against the background of uneasiness prevailing last autumn, is that the speculative flows which began in March at the time of the revaluations of the mark and guilder did not precipitate any resumption of gold purchases by foreigners. Our Treasury gold stock has actually increased by more than $100 million since the revaluations.

We have, meanwhile, initiated a number of measures designed to diminish the likelihood that speculation against the dollar might recur. Our decision to undertake limited operations in forward exchange markets represents one step in this direction.

The impact of the currency speculation during March did not confine itself to the markets for spot exchange. In the case of the German mark, for example, the premium on the forward mark rose to very high levels immediately following the revaluation. Had this premium been allowed to rise unchecked, it might well have aggravated the speculative conditions prevailing in the market. However, arrangements were worked out between the United States and Germany whereby a stabilizing influence could be exerted on the market. It is our intention to conduct similar operations in other major currencies whenever such action appears appropriate and useful. I might point out that, although the recent official operations in the forward exchange market have been directed primarily at suppressing potential speculation on currency revaluations, essentially the same techniques can be used to exert an influence, upward or downward, on the covered interest incentive to move short-term investment funds from one market to another.

Aside from these operations in the forward market, the Treasury, through the facilities of the Federal Reserve System, and in cooperation with authorities abroad, has begun to acquire modest holdings of foreign exchange which could be sold in the spot market should the dollar again come under pressure. You will recall, for example, that we requested Germany to make some marks available to us temporarily at the time they agreed to prepay $587 million of their official debt to the United States. The Treasury has also taken advantage of opportunities to acquire certain other convertible currencies in relatively small amounts during recent months. Whereas other countries have long been in a position to even out short-term influences on their currencies through sales or purchases of dollars, the United States, because it held no convertible currencies, had no similar option. Our decision to acquire small balances of foreign currencies is designed to eliminate or reduce this disparity. Henceforth, in order to indicate clearly the increased strength and flexibility of our position, we expect to include holdings of convertible foreign exchange as well as gold in the reports of our monetary assets.

While it is too soon to judge the possibilities for lasting effectiveness of these actions in dealing with disturbances in the exchange markets, we have been highly pleased with the results of our operations thus far. Another implication of the experiences in Europe during March is that inter-central-bank credits can play an important role in offsetting the destabilizing effects of speculative capital flows. I believe the various participants would agree, however, that inter-central-bank credits must supplement rather than replace the facilities provided by the International Monetary Fund. In fact, there would seem to be considerable logic in an arrangement whereby central-bank credits might in some part be repaid or refinanced through drawings on the fund whenever the capital flows that had initially given rise to the interbank credits did not reverse themselves quickly enough to permit repayment by this means.

I should point out, however, that the Fund at the moment holds only moderate amounts of continental European and Japanese currencies, so that drawings of these currencies by the United States, should such action ever seem desirable, would in practice be restricted. For this reason among others, the United States is participating in exploratory discussions which we hope will lead to an agreement among the industrial countries to provide standby credits to supplement the Fund's resources of needed currencies. Many technical questions remain to be explored in this approach, but there seems to be increasing agreement on the need for standby facilities of this sort to deal with short-term capital flows.

I believe it would be premature at this time to go into detail on the technical aspects of any change that might be made in the operations or resources of the International Monetary Fund. However, I think it is fair to say that our efforts at the moment are directed toward strenghtening the existing international framework, and improving the institutional arrangements for making more effective use of present world reserves.

There has been considerable public discussion, as you know, of proposals for fundamental changes in the international finance system. These proposals arise out of concern that over the longer run, injections of international reserves may be needed to finance a growing volume of trade and financial transactions. Whether there in fact is likely to be a shortage of aggregate world liquidity some time in the future, and specifically whether any such shortage will need to be corrected by creating an international currency to replace dollars (and sterling) as official reserves, are controversial questions on which there is as yet no agreement among economists. Therefore, although these questions need to be included in our continuing study and consideration of long-range monetary problems, they seem very unlikely to be matters of practical policy at the present time. Today our problem is the correction of imbalances, and the handling of excessive shifts of liquid funds, rather than a shortage of overall liquidity. Indeed, in several countries the problem is to direct some of the excess liquidity into longer term finance through long-term capital exports. New reserves injected into the present payments situation would simply move to the centers which already have excess reserves.

In the final analysis, there is no substitute for balance-of-payments discipline in this, or any, economy—a discipline that reaches through our productivity performance, our price and wage performance, our governmental budgetary position, and our monetary and credit policies. Neither the force nor the form of this discipline is materially different for a reserve-currency country than for any other. But because of its position as the principal key-currency country, the United States does have a special position of prominence. The way in which it acts to maintain the conditions for balance-of-payments equilibrium sets the pace for many other countries of the Western alliance, all of whom use our currency in carrying on their trade, and in supporting their own monetary reserves. In that sense, the present role of New York, and thus of the United States, as the financial center for the world, carries great responsibilities and great opportunities. The further shaping of that role will clearly benefit from periodic review of the kind that Congress is initiating with the meetings beginning here today.

(Tables I and II referred to are, as follows:)

TABLE I.—*U.S. balance of payments, 1958–60*

[Billions of dollars]

	1958	1959 [1]	1960	1st quarter 1961 (seasonally adjusted)
BASIC COMPONENTS				
1. U.S. payments, total	27.4	29.7	30.1	7.2
2. Merchandise imports	13.0	15.3	14.7	3.4
3. Nonmilitary services	4.7	5.1	5.6	1.4
4. Military expenditures abroad	3.4	3.1	3.0	.8
5. U.S. direct and portfolio investment abroad	2.5	2.3	2.5	.5
6. U.S. Government grants and credits (gross)	3.1	3.0	3.4	1.0
7. Pensions and remittances	.7	.8	.8	.2
8. U.S. receipts, total	23.9	25.3	28.2	7.3
9. Merchandise exports	16.3	16.3	19.4	5.0
Nonmilitary services:				
10. Income on investments	2.9	3.0	3.2	.9
11. Other	3.8	4.1	4.4	1.1
12. Military sales	.3	.3	.3	.1
13. Foreign direct and portfolio investment in United States	(2)	.6	.3	.1
14. Repayments to U.S. Government	.5	1.1	.6	.1
15. Basic balance, deficit (−)	−3.6	−4.3	−1.9	+.2
OTHER COMPONENTS				
16. U.S. private short-term assets abroad increase (−)	−.3	−.1	−1.3	−.5
17. Unrecorded inflow (+) or outflow (−)	+.4	+.5	−.6	+.1
18. Overall balance, deficit (−)	−3.5	−3.9	−3.8	−.3

[1] Excludes U.S. subscription of $1,400,000,000 to IMF.
[2] Less than $50,000,000.

NOTE.—Excludes military grant transactions. Details may not add to totals due to rounding.

TABLE II.—*Net changes in gold and dollar holdings*

[Official and private; millions of dollars]

	1958	1959	1960
Total, foreign countries	+3,927	+3,112	+3,120
Latin America	−268	−228	−335
Canada	+207	+208	+99
United Kingdom and sterling area	+878	+2	+939
Continental Western Europe	+2,876	+2,352	+1,908
Other foreign countries	+234	+778	+509
Japan	(+379)	(+471)	(+602)
Others	(−145)	(+307)	(−93)
International institutions [1]	+451	+2,854	+1,053

[1] Beginning with 1959, includes changes in dollar holdings of international shipping companies operating under the flags of Liberia, Panama, Honduras, and the Bahamas.

Secretary DILLON. Thank you, Mr. Chairman.

Representative REUSS. Thank you, Mr. Secretary.

There was a story in the New York Times of Saturday, June 17, about the annual report of the Board of Management of the European Monetary Agreement, a subsidiary of the OEEC, which stated that our U.S. international basic payments deficit last year was only $860 million. This figure is substantially lower than the estimates previously made of the 1960 basic deficit. I wonder if you would care to comment on that report.

Secretary DILLON. Yes, Mr. Chairman; I would be glad to comment on that report.

The figure in that report is erroneous. Unfortunately, the report was made without checking with the United States and without checking the figures that went to make it up. There are a number of minor errors scattered throughout the report.

But there is one major error, and there is one difference of approach. While in our figures we have included the Ford transaction last year, which amounted to just under $400 million, $370 million, as part of our basic balance, being a direct investment abroad, that was left out of account in the EMA report because they apparently figured that this was a one-term affair that would not repeat itself.

We do not necessarily feel that that is true, and we feel it is proper to include it.

If you add the $370 million to their figure, you get a total of $1,230 million.

Then for some reason, in transcribing the figures for this EMA report, they apparently either excluded from the total U.S. payments on account of pensions and remittances—these average about three-quarters of a billion dollars a year, and last year were in our account for $800 million—or they lumped these, along with an estimate of unrecorded receipts, into the category of "services."

If the above items had been handled as we are handling them, the EMA figures would total $1.7 billion as compared with the basic deficit figure of $1.9 billion in table I. The discrepancy between these two figures is made up of a number of minor differences, some of which were caused by the fact they used earlier figures which have since been revised by ourselves.

Representative REUSS. Turning now to what you have told us about measures currently being taken to handle more effectively excessive shifts of liquid funds, I would like to ask you a number of questions.

You say, for example:

> The United States is participating in exploratory discussions which we hope will lead to an agreement among the industrial countries to provide standby credits to supplement the Fund's resources of needed currencies.

I am delighted to hear that. Is it your objective, through some institutional arrangement, to alleviate pressures on the dollar, such as those which resulted from excessive hot money movements last autumn, and thereby to eliminate the risk of similar situations in the future?

That is what you are after, is it not?

Secretary DILLON. That is correct, although, as I pointed out, I think, in my statement, holdings of the International Monetary Fund are pretty adequate in dollars to meet the needs particularly of less-developed countries which seem to have been making a greater use of the Fund recently. However, the holdings of dollars and sterling might not be—certainly dollars might not be—as effective in the case of a United Kingdom need as they would be for the less-developed countries because of the fact that the United Kingdom might have a much larger need, and if the dollar at that same time was under pressure, as was the case last fall, well, it would not be very useful to increase that pressure by utilizing dollars.

So, therefore, we have to look also at the resources of the Fund in other currencies.

The same would apply if the United States, as you pointed out, needed to make a drawing on its own account.

Now, the resources of the Fund in the currencies of other Western European countries and Japan, which are presently the large surplus countries of the world, creating surpluses every year, only amount to a total of about $2.5 billion. And we do not feel that this is adequate, and it is generally not felt that it is adequate.

Therefore, we are attempting to work out some method whereby those countries who are continually running surpluses would be asked, if the need should arise, to lend some of their own currencies to the Monetary Fund, and the Monetary Fund could then transfer them to the countries that required them as a result of temporary deficits, which would have been the case if the United States had required something last fall, or if the British should require a drawing this year.

Representative REUSS. When you say, Mr. Secretary, that the surplus countries should be required to lend their currencies to the Fund, for temporary use by deficit countries, you are saying, are you not, that an arrangement should be worked out whereby surplus countries will refrain from demanding as much gold as they theoretically have a right to do, the right to demand 100 percent gold?

Secretary DILLON. Well, it would have that effect. It would also have the effect of mitigating or easing their building up of foreign exchange resources, because as they were building up the surplus, they would offset the effects of this surplus by lending their own currencies back to the Fund.

I think we ought to be careful about the use of the word "require." I do not think there ought to be a strict requirement here, except in the case in which the rules have been very carefully worked out, so that no country would feel that they were required to make an advance or loan to the Fund when they were not in surplus, or when the situation had changed.

It might even be necessary to have such advances made in consultation with the country who will make the advance. That is one of the details that is the subject of study now in the Monetary Fund.

This basic idea was first suggested in rather practical form, concrete form, by the Director, the head of the International Monetary Fund, Mr. Jacobsson, last winter. And since that time the various members of the Fund have been studying it and working on it.

Representative REUSS. I would like your comments, later, on the considerations on which any new institution must be based. But I would like to yield now to Senator Bush.

Senator Bush?

Senator BUSH. Mr. Secretary, our own budget here in this country ought to have some important bearing on this whole problem of the balance of payments, and especially a psychological effect upon it.

Would you tell us what your most recent estimate is respecting the budget deficit for 1962?

Secretary DILLON. Our most recent estimate for a budget deficit for fiscal year 1962 is $3,700 million.

Senator BUSH. $3,700 million?

Secretary DILLON. That is right.

Senator BUSH. And that does not include the trust fund; that is the Administrative budget?

Secretary DILLON. That is the Administrative budget.

Senator BUSH. Have you any idea about what the trust fund budget might add to that?

Secretary DILLON. It is possible that there will be a moderate deficit in the trust fund next year.

Senator BUSH. I have no further questions at the present time, Mr. Chairman.

Representative REUSS. Senator Douglas?

Senator DOUGLAS. Mr. Secretary, I have been trying unsuccessfully to get a list of the quotas imposed by the Western European countries and Great Britain on the American imports.

I wondered if you would be willing to tell us about the quantitative restriction of American imports practiced by Great Britain, France, West Germany and Italy.

Secretary DILLON. I think, Senator, that probably Mr. Ball from the State Department would have a more up-to-date list than I have.

But, generally, as of now, quantitative restrictions on practically everything except agricultural products have ceased to exist in all these countries.

Senator DOUGLAS. In all those countries?

Secretary DILLON. In all those four. The last country to move in that direction is Italy. I do not know whether their action has actually been taken as of this date, but we have been informed of it. It is a matter of public knowledge, and it will take place this year.

Senator DOUGLAS. And has West Germany abandoned its quota upon the importation of coal?

Secretary DILLON. I should have added coal to agricultural exports. Coal is a specific commodity which the countries of Europe have in excess, and they have felt that for protection to themselves they had to put on some restrictions.

As you know, we have been continually negotiating with them to achieve maximum import quotas for continued imports of U.S. coal into Europe, and we have been only moderately successful in that, although the quotas are larger than they would have been without our efforts.

Senator DOUGLAS. I would like to stress the importance of this restriction by West Germany, if I may.

I am informed by coal operators in Illinois that we can lay coal down at the German steel mills, at a price appreciably below the German price, and they believe that something like 40 million tons of American coal could be sold in this manner.

Now, with this market denied, the American coal industry is demanding the imposition of quotas upon the importation of residual fuel oil from Venezuela, which, if it goes into effect, I think, will have very unfortunate consequences upon our relationship with Latin America and our relationship with Venezuela in particular.

Yet, this demand will continue and will be very strong, and may well be voted by the Congress next year. And I think our German friends should realize that their policy is creating tremendous difficulties for the United States, the free world, and for the program of free trade which, presumably, they say they believe in.

Secretary DILLON. Yes; they do. We have been making this very clear to them.

I think it is a very real and difficult problem for them. Fortunately, with the healthy state of their economy, they have been able to make considerable progress. They have recently closed down a number of their more inefficient coal mines, and that led to unemployment in the coal mines. But it has been possible for them to absorb this unemployment in other activities.

And they have a program over the next few years to close a substantial number of inefficient mines, thereby reducing their own coal production.

This is a very delicate internal political problem for the Germans which runs directly in conflict with their basic foreign trade policy. It is somewhat similar to the problems of agriculture, which had similar difficulties on a worldwide basis.

Senator DOUGLAS. Is it true that there is a private agreement between Great Britain and the Hong Kong industrialists that the export of Hong Kong textile and clothing products to Great Britain is severely limited?

Secretary DILLON. That is true. Whether the adjective "severely" is appropriate or not, I don't know, because the limitation was set above the level of previous trade.

But there has been a limitation there for some 3 years, and we have been unable to get any limitation ourselves, which we have felt is unfair.

We have made substantial efforts in that direction. And I think there is a good chance that this is about to be, at long last, crowned with some success.

Mr. Ball has been conducting these negotiations himself, traveling to Europe, and there are going to be some meetings held here later this month on textile problems which will include this subject. And I think he has a sort of general oral agreement that the Hong Kong Government will, or the Hong Kong industry and government working together will try to work out some sort of limitation on their exports to the United States. But I am sure he can tell you about that in detail.

Senator DOUGLAS. I notice criticism in the British press as to the possibility of the United States imposing a quota on the importation of goods from Hong Kong. Does not this criticism seem somewhat inconsistent from your point of view when they have a quota system themselves, even though private in nature?

Secretary DILLON. I have not seen those particular comments, but it would certainly be entirely inconsistent with their own situation.

Senator DOUGLAS. One final question.

You mentioned the alteration of tax policy. As you know, there is a 14 percent reduction in the corporate tax on American corporations doing business in the Western Hemisphere. Do you think the removal of this 14-percent tax benefit on American companies doing business in Canada would be wise? The Canadians believe that too much American capital has been flowing into Canada. Would not this be a chance of increasing our revenues and promoting international good will by removing the differential advantages which American companies now have if they invest in Canada rather than at home?

Secretary DILLON. I agree that there is no reason to promote investment in Canada at this point, because you are quite right, there has been a general sort of feeling in Canada that the flow of investment is excessive.

The only disagreement in Canada is the intensity with which those feelings are held by some and by others.

Senator DOUGLAS. This is a good chance to save money and promote international good will; is that not correct?

Secretary DILLON. The Canadian Government itself has also taken some actions to restrict the inflow.

Senator DOUGLAS. Is this in your tax program, Mr. Secretary?

Secretary DILLON. That particular item is not in the present program.

Senator DOUGLAS. I suggest it might well be included.

Secretary DILLON. I see your point. We do have the question of the tax deferral; Canada is included with the other developed countries to which our proposed elimination of tax deferral on foreign subsidies will apply, so we do have the Canadian situation covered there.

Senator DOUGLAS. Thank you.

Representative REUSS. I would like to return to the problem of West German import quotas, raised by Senator Douglas.

You state that Germany now imposes quotas on imports of American coal. It is also true, is it not, that Germany has a considerable apparatus of quotas on American agricultural products, particularly grains, which we would like to sell there?

Secretary DILLON. Yes.

I specifically mentioned agricultural products as the one area where there are controls still pretty generally all over Europe.

Now, the most important areas in volume and dollar volume for us in this field are, of course, various kinds of grain, but particularly wheat.

And we and the Canadians are working vary hard with members of the Common Market at Geneva to try and obtain a better break on this than we have had in the past.

Again, I would think that probably Secretary Ball would be more up to date on the details of those negotiations than I would.

Representative REUSS. I wanted to restate these facts concerning German commercial trade policy before going on to a corollary development, also hurtful to our efforts.

It is true, is it not, that the imposition of the Common Market external tariff means in practical effect that German tariffs on a great range of our industrial products are, in effect, being increased?

Secretary DILLON. That will be the case as the common tariff comes into effect, because, as you know, that is based on an arithmetical average between the tariffs of the various member countries.

Now, they are shooting at a reduction from the arithmetical average of 20 percent. Since Germany was on the low side, her tariffs will be increased even taking into account the 20 percent reduction from the arithmetical average, because, as a practical matter, Germany had reduced her tariffs unilaterally 25 percent below the level at which they existed at the time the Common Market tariff was negotiated.

Representative REUSS. It is unhappily true, is it not, that the 1957 German tariff reduction of 25 percent will, in effect, be wiped out with the imposition of the Common Market external tariff?

Secretary DILLON. I would say that is one of the few unfortunate things regarding the Common Market common tariff, because that reduction was a temporary and unilateral reduction and not built into the German tariff rates; therefore, it was not taken into account in figuring out the common tariff, and so it has been, as you say, lost.

Representative REUSS. I would like now to return to questions more particularly in your domain. West Germany, as you well know, revalued its currency upward by 5 percent in March of this year.

Would it not have been vastly better for this country had West Germany chosen to adjust to her surplus position by increasing coal import quotas so that more American coal could come in, increasing agricultural import quotas so that more American feed grains and other farm products could come in, and revamping the external tariff of the Common Market so that the net incidence of the new German tariffs on American goods was less? Would not that approach have had two important advantages over the German revaluation:

First, would it not have minimized exchange speculation;

Secondly, would not a trade liberalism approach to the German surplus situation, rather than a currency revaluation approach, be much more in accord with the principles of expanded, liberalized world trade.

Secretary DILLON. Certainly, if it were looked at quite straight, solely from the U.S. point of view, everything you say, Mr. Chairman, is correct. However, I would not wish by that to imply any criticism of the German Government's action, because any government has to be governed in its actions by political realities, domestic political realities, as well as by general worldwide economic policy.

Certainly, what you are suggesting—that type of policy—while it would have been most helpful for the United States and Canada, because Canada is also a great grain exporter, would have involved a very substantial domestic dislocation in the farming communities in Germany, and also in her mining situation. So it is really a question of the extent to which Germany can move in that direction.

At the present time the Common Market itself is engaged in what appear to be very difficult negotiations to reach agreement on a common agricultural policy. And the difficulty of this lies largely again in the fact that German agriculture, in general, is based on a lot of small farms which are not competitive with the larger farms in France, Italy, and various other places.

So German agriculture has historically been more restrictive, at the same time that Germany has believed in free trade in manufactured and industrial products.

Great pressure has been brought on Germany to have some relaxation and change in its policy. I think it would have been for the good of Germany and the good of the world in the long run, but it is a difficult thing that cannot be done rapidly or easily.

Now, as to this 25 percent being taken into account in the Common Market, that also is something that was not in Germany's hands.

I think Germany, if they had the ability to do so, would have liked to have seen such a revision come about. But that could only be by agreement of their partners in the Common Market.

And I think it is largely because of this situation that agreement was reached about a year ago and announced by the Common Market countries that they would be prepared to move toward a common tariff that was 20 percent lower than the actual tariff figured out, provided that they could get reasonable reciprocity from others. And the understanding was that they would be willing unilaterally to reduce this 20 percent for part of the distance, and the reciprocity would only have to be for the rest.

And there was also general understanding that full reciprocity would not be required from the United States, which had done more than its share in tariff reduction in the years following the war. It was primarily directed at countries of the rival trade group, the EFTA, particularly, at the United Kingdom, which has a very high industrial tariff.

Representative REUSS. Are you satisfied with the international institutions and machinery that are currently available to us in which we might argue for trade liberalization as an alternative to currency revaluation as a means of reducing persistent payments surpluses?

To put the question more specifically, if OECD, an organization in which I put great store, as I know you do, too, were in place and functioning fully, would it not be our task in such an organization to make quite specific remonstrances to industrial nations with surplus positions to take the best steps to reduce payments surpluses?

Secretary DILLON. I do not think, since the OECD is not fully in effect, we are in as good a position as we will be when it is in effect, and when there is a trade committee, and when we are full members. This will take place, I think, on schedule.

The OECD will probably come into being by the end of September of this year, and then we will be in a better position to exert our influence and raise our voice toward greater trade liberalization in areas where it is particularly important to us.

We will also have to receive certain remonstrances from some of our partners because there are some who think that our trade position in certain agricultural products is a little too restrictive ourselves.

Representative REUSS. Senator Douglas?

Senator DOUGLAS. I am very glad you added that point, because I am not criticizing European countries for imposing agricultural restrictions, because we do the same thing. But I do think that these other commodities are a proper subject for concern, because Germany now has an ample supply of dollars, and France has, too.

I notice there is criticism abroad on the restrictions which the administration wishes to impose on the amount of duty-free goods which American tourists can bring back, which are to be reduced from $500 to $100.

I believe in consistency in these matters. I wonder, from your previous service as Under Secretary, if you have any knowledge of the restrictions imposed by European countries on the amount of duty-free goods which their nationals can bring back?

Secretary DILLON. I do not think any of them, Senator, permit as much as $100, which is the figure that we talk about reducing our figure to.

Senator DOUGLAS. That is my impression.

Do you not think that Americans have frequently been too polite when European countries subject us to this criticism, when we are only doing things which they are doing to a greater degree?

Secretary DILLON. I think that may be so. I think one reason for that, probably, is that there was a period during the dollar shortage when we did all sorts of things; we got into the habit then—which was correct for that time—of allowing and not protesting various activities in the trade field that were detrimental to the United States directly, but which we permitted because they were necessary to overcome a dollar shortage and rebuild the European economies after they had been shattered by the war.

After the situation had changed abruptly, it probably is a little difficult for some people, who have been used to thinking this other way, to readjust to the present situation, which is quite different.

Senator DOUGLAS. It is very hard for them to readjust.

Secretary DILLON. It is hard for the Europeans.

Senator DOUGLAS. Would not it be well if we gave a seminar for correspondents for foreign newspapers on this matter, foreign financial writers, and expose them to the comparative facts of life both on quotas, tourist balances, and so forth; would not that be a contribution to international good will?

Secretary DILLON. I think it is always useful to get the facts fully spread before the people, because then I think problems generally are easier to handle.

Senator DOUGLAS. If we would arrange such a seminar, would you see that some of your experts testify?

Secretary DILLON. I certainly would.

Senator DOUGLAS. I think that is a very constructive suggestion. I suggest that we have such a seminar for foreign financial writers and correspondents.

Representative REUSS. Mr. Secretary, back to the subject of what we should do about institutional arrangements to prevent shifts of liquid capital funds from causing exchange crises and other international embarrassments. Do you agree that these arrangements should as a first objective provide for the marshaling of funds sufficient to offset the foreseeable shifts of short-term capital? In order to be adequate, would you not agree that such arrangements must be for large amounts, in the order of magnitude of $1, $2, $3 billion, for example?

Secretary DILLON. Yes; it depends on what one means by the word "large." And it is obvious these things are relative. I think as far as the United States is concerned, you have to decide what is large in relation to our overall payments abroad, in relation to our quota in the Monetary Fund, and so forth.

And on that basis I would not call $1 to $2 billion large, and certainly the Monetary Fund should be prepared to meet flows of that order when the United States is concerned. I emphasize this meaning of the word "large" because it is important, because there are limitations in the articles of agreement of the Monetary Fund. The Monetary Fund is not supposed to be used for the covering of capital transactions that are large or sustained; that is in article VI of the Monetary Fund articles. The Executive Board is presently discussing this, and I think the general view is, the view which we share, that as far as the United States is concerned a flow of that size would not be classified as large, although, of course, it is large in comparison with ordinary operations of the Fund.

Representative REUSS. When we agree, as apparently we do, that any institutional arrangement must be equipped to handle large outflows of liquid funds and their byproduct effects, this means, I should think, that some new institutional arrangement has to be made.

The Fund, as presently constituted, is not fully equipped to do this job; the OECD, as presently constituted, is not equipped to do the job; and we cannot rely on meetings of central bankers at Basle, nor on the BIS, to fully achieve our objectives.

Therefore, there has to be a new thing under the sun here; does there not?

Secretary DILLON. I do think some method has to be achieved to increase the availability of other currencies of countries that are presently in a very strong surplus position.

When the Monetary Fund was originally formed, none of these countries was in a very strong position and, therefore, the quotas that they have reflect to some extent the situation at that time.

They certainly do not reflect the economic strength of these countries at the moment. So something has to be done to make their currencies, which are, of course, a part of overall international liquidity, more available, and certainly available for any need that may arise.

And that is what the present negotiations are directed toward.

Representative REUSS. I have asked you whether the provision of adequate funds is not an essential objective in any new international monetary arrangements.

Is it not equally important that any new institution also be in a position to make broad recommendations to its members on matters affecting international payments imbalances—commercial policy, fiscal and monetary policies, foreign aid policy, and so on? Does not the OECD fulfill this requirement?

Secretary DILLON. I think that we do approach that in what we presently have in the OECD and the International Monetary Fund. The International Monetary Fund in its examinations of the financial situation of its member countries does take into account all these various things.

Under the articles of the Monetary Fund these examinations have in the past only taken place where countries were making use of the Fund's resources or had certain exchange restrictions in effect. The Fund recently adopted a new policy which was that they would encourage voluntary consultations with the Fund by member governments that were under article VIII where exchange restrictions were no longer permitted without Fund approval.

And these consultations will be more informal in nature, and they will not result in findings or decisions by the Monetary Fund, as is the case in the other kind of consultation, but they will nevertheless be very useful, and the results of them will be available to the various members of the Board.

This procedure has now been started, and it is a totally new procedure, and should be very helpful. When we complement that with what will be available as the OECD develops for the important industrialized and trading countries of the world, I think we will have a reasonably effective manner to the problem which you pose, which certainly does need an answer.

Representative REUSS. You believe, then, that between the International Monetary Fund and the OECD, there could be an institutional arrangement in which the free world industrialized countries are not making payments decisions in a vacuum, but are making them in conjunction with considerations of commercial, monetary, fiscal, and other policies?

Secretary DILLON. That is correct; yes, sir.

Representative REUSS. Let me turn now to the broader question to which you addressed yourself on the last 2 pages of your testimony, the question of the long-term sufficiency of world monetary reserves, the sort of question with which men like Professor Triffin have concerned themselves recently.

I gather that while you believe the Treasury should continue to study this question, you do not see any immediate danger arising from a shortage of reserves?

Secretary DILLON. Well, I would put it this way. I think that the basic problem is at the moment to utilize the reserves that are available in the world to their maximum extent.

In other words, there is a problem today of imbalance in the total of world reserves. I think there is general agreement among economists that there are adequate reserves in total in the world as of now.

The argument centers around the future. But even as of now, these reserves are not well balanced; there are too many of them frozen in Germany. For instance, recently Western Germany repaid the United States $500 million, by giving us back dollars. This theoretically reduced, by $500 million, the amount of reserves that were available to the world.

However, it did no harm, because they were merely sterilized in Germany, and it was just as good to give them back to the United States.

Now, the type of thing we have in mind, which is quite similar to some of the proposals of Mr. Bernstein, would, in effect, make sure that the system we now have would operate more effectively.

World liquidity depends—liquidity anywhere depends not only on a total amount of funds that are measured, but also on the velocity with which they are used and their availability.

And so we can increase and better the use of world liquidity by the various things we have under study now, and we think it perfectly clear that what we should do first of all—and that is what we have to address ourselves to—is make the present system, the present structure, work better by any modifications that may be desirable. And I would consider that the general type of thing, as I said, that Mr. Bernstein has in mind, falls in that category.

Now, in the totally different category is the proposal of Triffin; he agrees that we do have adequate reserves, adequate world liquidity, today.

But he looks ahead and he says that these will not be adequate in the future, and that therefore we need a totally new system which will substitute some sort of international reserve for the present national reserves.

This is something that certainly may one day come about. It should be kept under continuing study, which is what we recommend and what we are doing.

However, there are serious questions as to whether the particular detailed plan which he has put forth will work. He himself has proposed various modifications of it as various criticisms have come along, and in that way it will probably evolve and be improved.

However, I think the other point is that there is not an immediately foreseeable need for such a sharp and complete change in the world's monetary structure. When it becomes desirable, if it does, which might be a number of years hence—it certainly would not be sooner—that would be the time to take it up in detail.

It would require a complete renegotiation of the International Monetary Fund, and, based on views we have exchanged with other member countries, none of the other larger countries which would have the larger reserves at the moment seems to favor this type of an approach; in fact, many of them are quite strongly opposed to it.

So, whether it will eventually be needed or not, we do not think it is practical at the moment as a subject of negotiation, and, therefore, we feel we should put it in a somewhat separate category from the type of thing which we think is practical and should be negotiated right now.

Representative REUSS. I certainly agree with that order of priority.

However, do you not think that Mr. Triffin is right, at least with respect to additions we may expect in monetary reserves from gold?

Since increases in monetary gold are not likely to prove adequate, additional reserves will have to be found from some other source—that is, key currency reserves, International Monetary Fund drawings, or some as yet untried device?

Secretary DILLON. Well, I certainly would agree that it is perfectly clear, I think everyone will have to agree, that there does not seem to be a prospect that international gold reserves will increase, that new gold will be mined and found and put into reserves at the same rate at which world trade seems to be increasing.

But the question of whether this will lead to an inadequacy depends both on whether the present level of gold reserves is the perfect level and whether anything less than this is inadequate; maybe we can do with somewhat less gold.

Now, this would depend on how we utilize our machinery. Certainly the gold reserves have been supplemented in the past decade, of course, by substantial additions to U.S. dollar liabilities. Sterling balances have stayed about level over the last decade. Probably this substantial increase in U.S. balances has come to an end, and, although there may be some further increases a few years hence, I do not think we can foresee immediate increases of the type that took place in the last 10 years.

We cannot afford them at the present time.

So I think now, therefore, we have to turn to a better use of our resources to make them more flexible, more readily available. And it is this which will determine their velocity and their adequacy.

When we begin to see that there is no further progress that can be made there, then at that time it will be clear that we will have to find some way of increasing the overall total, and at that time Mr. Triffin's idea—or some modification of it—might well be the solution we would have to take.

Representative REUSS. On the subject of the free world's gold reserves and the necessity for using the free world's reserve resources prudently, I notice that you have on your table, Mr. Secretary, the admirable recent report of the Commission on Money and Credit, which was just published over the weekend.

That document contains a recommendation, among others, that since the United States outlaws the private holding of gold by Americans both here and abroad, it would be a good idea to persuade our free world trading partners to similarly outlaw the private holding of gold.

While I am not at all confident that an outright prohibition would be possible or effective, say, in France, I wonder whether it might not be a good idea to urge the leading reserve countries to agree to sell gold only to central banks and governments? As it is now, the governments and central banks of most countries, other than the United States, can and do sell to private persons. Would it not be wise to stop this drain on international liquidity by asking other countries to do what we have done?

Secretary DILLON. Certainly, Mr. Chairman, from the economic point of view it would be an advantage if the private hoarding of gold would cease, because then all gold that was newly mined would become available for international reserves to finance international trade.

The problem you point out is that this is an age-old practical problem, and many people feel that they have a right to own gold, and whether they would be responsive to laws is questionable.

But certainly, to the extent that private hoarding could be stopped, because it serves no useful purpose at all, it would be a very useful objective of our policy.

Representative REUSS. Senator Pell?

Senator PELL. I would like to apologize for being late and not having the pleasure of enjoying your testimony, Mr. Secretary.

I have one question. It probably is an elementary question, but it has always puzzled me. In view of the fact that gold is primarily produced in areas of the world that are uncertain or hostile, such as areas of the Soviet Union, do you see a present danger in dependence upon such sources of supply and have you visualized facing up to this problem.

Secretary DILLON. Certainly the problem of the adequacy of international reserves would be precipitated much more rapidly if there were no accretions to the world gold supply, if the South African supply, which amounts to about three-quarters of a billion dollars a year, ceased to be available as an addition to international liquidity.

If that should happen, we would have to look much more rapidly at other methods of handling the situation.

However, I do not think that the mere fact that there are difficulties and problems there at the moment, is sufficient cause for the whole world to change its basic age-old reliance on gold as a means of value.

Senator PELL. Thank you.

Senator DOUGLAS. Congressman Reuss' testimony touched off a question in my mind which I am sure you have been thinking about: namely, since private holding of gold is now illegal, what is the real advantage of 25 percent of reserve for Federal Reserve banks?

Secretary DILLON. Personally, I do not think there is any advantage. I think that the advantage is all with removing that restriction, so that it is clear that all our reserves are available for the only purpose to which they are pledged, which is the international gold exchange standard.

However, there are those who believe that the fact that this 25-percent figure applies to an issue of currency and to the Federal Reserve deposits is in some way a limitation on the ability of the Executive to follow inflationary policies. I do not think that this is very effective, because, as you know, we do have about $6 billion of excess gold available now.

At a 25-percent ratio, that would cover some $24 billion of reserve deposits in the Federal Reserve, and that, in turn, would serve as the basis of something near $150 billion of bank deposits. Therefore, the period before this reserve would have any effect on inflation is so far in the future that it is not there at all.

The only way it would have an effect is if we should begin to lose gold, and our gold should come down to this figure of reserve.

Senator DOUGLAS. If we acquire more dollars of free gold to combat the possible foreign raids; is that correct?

Secretary DILLON. That is correct.

Senator DOUGLAS. In times past I have had an amusing interchange with the Secretary of Treasury and the Chairmen of the Federal Reserve Board on the question of the redeemability of Federal Reserve notes.

One of my good friends was Randolph Burgess, who, as you know, was a New York banker, and who, as a New York banker, used to write me to urgently request that we return to the gold standard.

And when he came to be the Under Secretary of the Treasury, I presented to him, and later to William McChesney Martin, Federal Reserve notes and asked that they be redeemed. I hold in my hand now one of the $20 reserve notes which says it is "legal tender for all debts, public and private, and is redeemable in lawful money at the U.S. Treasury or any Federal Reserve bank."

I now present to you, as Secretary of the Treasury, this $20 note and ask that it be redeemed in lawful money.

Secretary DILLON. That is very easy. I can give you five $20 bills that say the same thing.

Senator DOUGLAS. I want it redeemed, sir.

Secretary DILLON. I do not know what that means.

Senator DOUGLAS. I can tell you what Mr. William McChesney Martin did to me. He gave me back other Federal Reserve notes.

Secretary DILLON. That is right, five $20 notes.

Senator DOUGLAS. Drawn on other banks.

I notice the representative of the Federal Reserve bank here. I would like to call him forward.

Would you come forward, please.

Since the Secretary of the Treasury has refused to redeem this, I ask that you redeem it.

Mr. SHAY. I do not think I have one just like that.

Senator DOUGLAS. I think we should have a visual demonstration of just what this lawful money is. I would like it in gold, if you please.

Senator BUSH. Gold is unlawful money.

Senator DOUGLAS. You just exchange one note for another?

Mr. SHAY. Yes, that would be in lawful money.

Senator DOUGLAS. Just what does this 25-percent reserve amount to?

Mr. SHAY. Senator, I do not think I am here to testify this morning.

Senator DOUGLAS. That is a rhetorical question.

Mr. SHAY. But the $20 bill I just gave you in exchange of yours is lawful money and therefore meets the redemption requirement.

Senator DOUGLAS. I think you demonstrate the point of what value this 25-percent gold reserve is, and if I did receive it, I would be jailed for receiving it, and you would be jailed for giving it to me.

Financial writers take notice, and the New York press especially.

Representative REUSS. Has everybody got his ante back?

Just one final question, Mr. Secretary. In your statement, you say:

"In the final analysis, there is no substitute for balance-of-payments discipline in this, or any, economy * * *."

I want to ask you to clarify that last paragraph a little bit for me. You had immediately prior to that ruled out the immediate necessity of expanding international reserves.

However, you had indicated that you are now proceeding to take steps to remove the harmful effects of excessive shifts of liquid funds.

I am wondering therefore if your statement about the discipline of the balance of payments may not be a little more absolute than you would like to have it. I am sure, for example, that you do not mean that we should repeal the International Monetary Fund, and otherwise force our domestic economy to make quick and drastic payments adjustments. I am sure that you recognize our primary obligation under the Employment Act of 1946 to achieve and to maintain maximum production, employment, and purchasing power.

Am I, therefore, right in thinking that your final paragraph needs to be read in context with what we have discussed here this morning, namely, the necessity of rather promptly evolving new and improved international mechanisms for protecting this country as a reserve country against the consequences of our involvement in the international scene? While we must strive for a sound dollar and see to it that we do not have inflation, our immediate need is for more adequate international institutions and arrangements to shield this country in a world of strong convertible currencies from the byproduct effects of the very convertibility which we have been striving to achieve.

Secretary DILLON. I would say, Mr. Chairman, that certainly that particular paragraph, as well as all of the other paragraphs of the statement, should be read in connection and in context with each other. What I was merely trying to point out there is the converse, maybe, of what you have just stated: that while we certainly do need to strengthen our present institutions to take care of this new development in the world of convertibility, of rapid and large short-term flows, that we cannot hope and should not hope by creating any particular institution or changing any institution to completely remove ourselves from the world as far as balance-of-payments disciplines are concerned.

And by that I refer to what you just mentioned: The need to keep a stable currency and to avoid inflation; and, in particular, I also mean the need to keep our costs competitive in the world at large, because this is what is needed to maintain a balance in our basic accounts, irrespective of short-term flows.

And unless we do reach a point where we have a relative balance in the basic accounts, I think that new institutions, while they may ameliorate the situation will only postpone the difficult day.

So I return to what was in the earlier part of my statement—that we do need to push along the lines of the President's balance-of-payments message for a basic balance in our international accounts, and that one of the most imortant things there is the costs of our products here in the United States.

Representative REUSS. But you do not think—and I gain this impression from what you said—that this country need depart from the goals of maximum employment and production in order to live in the world in which we find ourselves today?

Secretary DILLON. No, I would say that we could best achieve reasonable costs in a society where we are utilizing everything we have, our equipment at maximum efficiency and effectiveness.

And that means at reasonably full employment, and at reasonably full capacity.

Representative REUSS. Thank you very much, Mr. Secretary, for your very frank and helpful statement this morning. You have contributed to our studies.

We will now stand adjourned until 2 o'clock this afternoon, at which time we will hear from Dr. Walter Heller.

(Whereupon, at 11:45 a.m., the hearing was adjourned, to reconvene at 2 p.m., on the same day.)

AFTERNOON SESSION

Representative REUSS (presiding). The committee will come to order.

This afternoon we will hear Dr. Walter W. Heller, chairman of the President's Council of Economic Advisers. He is accompanied by his associate, James Tobin, also a member of the Council of Economic Advisers.

Dr. Heller, please proceed in your own way.

STATEMENT OF WALTER W. HELLER, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS; ACCOMPANIED BY JAMES TOBIN, MEMBER

Mr. HELLER. Mr. Chairman, if it is appropriate, I should like to read this statement. And I am glad that you took judicial notice of the presence of my colleague, Mr. Tobin, who in the division of labor in the present Council of Economic Advisers, carries the major responsibility for our work in the international monetary and financial field, including, I might say, the analysis underlying the statement that I shall present today.

I shall be turning to Mr. Tobin for a good many of the answers to the questions that the committee may raise.

All of us in the executive branch who are concerned with economic policy welcome the comprehensive study of international imbalance and international financial arrangements which you are undertaking. We look forward to the discussions of these problems which you will be having with the distinguished witnesses scheduled for these hearings, and to the report which you will prepare with the help of your staff and the authorities on these subjects who are assisting you as consultants.

The time is ripe for a fundamental examination and appraisal of our present international monetary mechanism and for a far-reaching and open-minded consideration of possibilities and proposals for improving it. We come to learn rather than to teach, but I am happy to contribute some observations on the subject of your inquiry from the point of view of one whose principal concern is the health of the U.S. domestic economy.

I would like to deal first with the problem of employment policy and the balance of payments.

The Council of Economic Advisers was created by the Employment Act of 1946 with the responsibility to recommend policies to the President designed to "promote maximum employment, production, and purchasing power," goals of economic policy to which the act committed the Federal Government. The Council analyzes current trends and developments in the economy and appraises existing or proposed programs of the Federal Government insofar as they relate to the goals of the act.

Through this responsibility the Council has been led to a concern with the international balance of payments of the United States and with the adequacy of international arrangements for achieving balance and for financing temporary imbalances in payments between countries. In comparison with most other countries, it is true, our direct dependence on foreign trade is small.

Exports of goods and services amount to only about 5 percent of our gross national product, and exports net of imports are a small component of gross national product, usually less than 1 percent. Nevertheless, the trade balance can be of great importance. The decline of gross national product from the second quarter of 1960 to the first quarter of 1961 would have been one-third greater except for the improvement that occurred in the net foreign balance. Furthermore, policies aiming at achieving domestic goals of income and employment are related to our trade balance, our international financial position, and our world leadership in ways that have recently grown to compelling importance.

The need to be concerned with the interrelations between balance of payments and domestic policies is a novelty to the United States. Net exports of goods and services have seldom varied enough to create major difficulties for employment or the price level. Furthermore, during the 1930's the United States acquired such an enormous portion of the world's monetary gold that we could ignore problems of maintaining adequate international reserves. This situation continued into the postwar period when reconstruction and recovery in Europe guaranteed the United States as large a net export surplus as the European countries were able to finance from their own resources and our aid. Thus, until the last few years, problems of international balance and international liquidity have not constrained our domestic economic policy.

This is not to say that the United States has ignored the international consequences of its policies. During the 1930's our own depressed level of economic activity and import demand was a major drag on recovery of world trade from its shrunken levels and on clearing of the jungle of national restrictions on trade and payments. An important byproduct of high employment policy as embodied in the Employment Act of 1946 is to provide strong and steady markets for our trading partners. Our European allies regarded this commitment as a key step in the restoration of world trade. The United States played a central role in designing the International Monetary Fund to help restore and maintain international payments equilibrium and to increase the potential supply of dollars or other strong currencies.

For the immediate purposes of postwar recovery and reconstruction, the United States granted an early loan to the United Kingdom, and other credits to European countries through the International Bank for Reconstruction and Development and the Export-Import Bank.

Later we made available some $23.5 billion in aid and loans to Western Europe (besides $11.7 billion in military grants) over the years 1947–55. This flow facilitated first the rebuilding of production facilities in Western Europe and later the accumulation of enough reserves in gold and dollars to allow the steady relaxation of controls over international trade and payments. These movements culminated in external convertibility for the major European currencies at the end of 1958, inaugurating an era of greater freedom of international payments than had been known at any time in the preceding three decades.

Paradoxically, it is this very success in the recovery of Europe and in the freeing of international payments that has placed new constraints on the U.S. domestic economic policy. The United States ran a cumulative deficit of $17.7 billion in its international payments during the decade of the 1950's. In the earlier years this deficit filled the useful function of supplying needed reserves to the other industrial countries. But by the years 1958–60, the cumulative size of this deficit, plus the effect of convertibility on the freedom of international capital movements and other payments, came to impose significant restrictions on our domestic policy and to demand corrective action.

Yet, correction of the U.S. deficit can hardly be undertaken without other policy changes as well, for U.S. deficits still are a major source of the liquid international reserves of other countries. Without this source, it is doubtful that international liquidity, however adequate it may be today, can remain adequate over the foreseeable future unless we develop some new way of providing it.

The balance-of-payments deficits of the last few years and the gold outflow of 1960 have limited our freedom of action in domestic stabilization policy in general, especially monetary policy. One limitation is the result of the increased freedom with which capital moves internationally in response to interest rate differentials. Low interest rates to stimulate recovery in the United States can now give rise to outflows of capital. A second constraint on domestic policy lies in the threat of international speculative movements of capital, independent of interest rates and in fear or hope of a change in exchange rates. A third and basic constraint lies in the effect of increases in the domestic price level on the competitiveness of U.S. exports abroad and foreign imports in our own markets.

Now, with respect to interest differentials, capital movements, and monetary policy.

With short-term interest rates in Frankfurt, London, and many other money markets above our own last year, short-term capital left New York. Although rate differentials are much smaller now, there is still danger that too substantial a lowering of the Treasury bill rate would move interest-sensitive, short-term capital away from our shores.

For this reason the Federal Reserve has not permitted the bill rate to fall to the levels (below 1 percent) reached in earlier recessions. Instead, it has kept the bill rate above 2 percent and has been buying longer term Government bonds in an attempt to provide bank reserves and to induce low, long-term rates without an excessive decline of short rates.

Although it is too early to judge the success of this policy, it illustrates how economic policy can be adapted to new constraints. But even in respect to the long-term rate, the autonomy of the United States or of any single nation has been declining. The establishment of currency convertibility in 1958, among a group of individual countries more nearly symmetrical in economic and political risks than at any time since 1914, is making capital increasingly mobile across national borders.

Interest rate differentials are not the sole source of international capital movements. Some long-term capital movements occur in response to profit opportunities in equities or in direct investments. Domestic recovery in the United States will help improve the balance of payments to the extent that it makes real investment here more profitable and attractive and reduces the incentive for U.S. capital to go abroad in search of profits.

Now, second, with respect to speculative capital movements.

A large volume of speculative, short-term funds moves internationally in response to rumors, fears, and hopes of changes in currency parities. In 1960 the dollar was the victim of a flight into other currencies and gold. Some gold went into private hoards abroad. Some went into foreign official reserves when central banks—sometimes merely following customary precedures and sometimes reflecting their own fears of dollar devaluation—cashed into gold the dollars sold to them.

Confidence in the gold parity of the dollar has been restored. But further speculative movements of short-term funds occurred in the wake of the German and Dutch revaluations of March 1961, so long as further upward revaluations of these or other currencies were expected.

The danger of speculative movements against currencies—the need to maintain confidence—places a diffuse and indeterminate constraint upon numerous aspects of domestic economic policy. Here, the judgments, opinions, and prejudices prevalent among the people who control internationally mobile funds are decisive. These are inevitably much less calculable and predictable than, for example, the incentives to move funds provided by interest rate differentials and forward exchange discounts.

To a large extent, no doubt, speculative funds move in response to objective information and analysis that quite reasonably cast doubt on the viability of some exchange rate. But they also move in response to judgments of the international banking and financial community regarding the "soundness" of economic policies in various countries. These judgments have some powers of self-fulfillment which compel them to be considered in framing domestic policy, whether or not the domestic policymakers themselves regard them as reasonable. For example, real or imagined opinions of bankers, businessmen, and investors here and abroad could be a limit on the freedom of the United States to run an appropriate budget deficit in the interest of domestic recovery.

Third, the competitive position of U.S. industry.

A constraint on domestic economic policy that acts more slowly than the preceding two but is even more basic concerns the tolerable pace of price and wage increases. This problem is particularly acute interest of domestic recovery.

I should perhaps interpolate here to say that I do not mean to suggest that we face a major problem of inflation dead ahead. All I am saying is that if we encounter the problem of the upward price creep later on in the recovery, the consequences would be a good deal more serious than just judged by domestic policy alone because of the impact on our international position.

Even at present price levels here and abroad, our imports will rise as national income rises. And they will rise even more if there is an upward creep in American prices relative to the rest of the world. Moreover, any tendency for American goods to rise in price faster than the prices of our competitors would handicap our exports to Europe and to third markets. Our European competitiors are at a different phase of the cycle; their boom may be tapering off as our upswing begins. The recovery will thus tend to bring a deterioration of our trade balance even without a relative increase of American prices. With such an increase, worsening of the balance of trade and the balance of payments becomes even more likely.

Since 1953, export prices for manufacturers have risen more rapidly in the United States than in Japan or the major trading countries of Europe, with the obvious consequences for our share of the export market. While in percentage terms hourly earnings in manufacturing have risen at about the same pace here as elsewhere, output per man-hour has risen less rapidly in the United States. The result has been an increase in unit labor costs in American manufacturing relative to France, Germany, Italy, and Japan, as shown in table 1, where you will note in the right-hand column that the unit cost, with 1953 as 100, was 114 by 1959.

There were several other countries that were above 1953. Canada was at 115; Germany was at 110; and the United Kingdom was at 121; but all the rest had a unit labor cost in 1959 below that cost in 1953.

(Table 1 is as follows:)

TABLE 1.—*Selected indexes for manufacturing industries, 1959* [1]

[1953=100]

Country	Export prices [2]	Hourly earnings	Output per man-hour	Unit labor cost
United States	116	133	117	114
Belgium	95	[3] 123	125	98
Canada	109	[3] 126	110	115
France	[4] 91	[4] 129	156	[4] 83
Germany, Federal Republic	102	[3] 148	134	110
Italy	98	137	[5] 150	[5] 91
Japan	96	132	142	93
United Kingdom	110	142	117	121

[1] The countries listed account for about 80 percent of world exports of manufactures.
[2] Export unit values for manufacture.
[3] Excluding relative growth of noncash supplementary benefits.
[4] Adjusted for changes in exchange rates.
[5] Production workers only.

Sources: Council of Economic Advisers estimates based on data from Department of Labor, Department of Commerce, and United Nations.

Senator DOUGLAS. May I ask a question?

Representative REUSS. Yes.

Senator DOUGLAS. Dr. Heller, the situation so far as unit labor cost is concerned was primarily caused, was it not, by failure of output per man-hour to go up, rather than a tremendous increase in hourly earnings?

I notice the increase in hourly earnings was 32 percent in Japan, 37 percent in Italy, 42 percent in the United Kingdom, 48 percent in Germany.

The only countries that were appreciably less were Belgium, Canada, and France. But the real weakness came in the failure of output per man-hour to rise proportionately, is that not true?

Mr. HELLER. That is true.

And that is the point we tried to stress in our statement: Namely, that it is the failure of our increase in productivity to keep pace with the increase in productivity in the other countries that is the major occasion for our falling behind.

Senator BUSH. I do not quite understand that column, "Output per man-hour." What does 117 relate to?

Mr. HELLER. That relates, Senator, to the base of 1953; in effect, it says that output per man-hour in 1959 in the United States was 17 percent greater than in 1953.

Senator BUSH. All those columns relate to 100 for 1953 base, all those columns?

Mr. HELLER. Yes, sir.

Senator BUSH. Does this mean that the French have increased their output per man-hour by 156 percent?

Mr. HELLER. They have increased it by 56 percent; that is an index.

Senator BUSH. In that short time?

Mr. HELLER. Fifty-six percent in those 6 years; and Japan, 42 percent; Italy, 50 percent.

These newly found constraints of our international balance on domestic policy are not essentially different from those long familiar to countries that depend on foreign trade more than we do. But they are accentuated by the status of the dollar as a reserve currency that is convertible for both foreign and domestic holders. During the 1950's many countries built up their stocks of liquid international means of payment in the form of dollars, and many firms doing business internationally built up dollar balances as working capital. These balances are demand or short-term liabilities and can be readily converted into other assets, gold or other currencies. Thus the first two constraints on domestic policy listed above are particularly severe for a reserve currency country. This is because of the extremely large amount of domestic and foreign funds that can move into other convertible currencies in response to interest differentials, or into other currencies and gold in anticipation of changes in exchange parties.

There is another important element in the situation apart from the U.S. position as a reserve currency country; namely, the high propensity of some European countries, principally Germany, to accumulate reserves by running surpluses. Though there is a question whether the mechanisms for creating international reserves (gold and national currencies) are sufficiently responsive to the long-term growth of world income and trade, the short-term situation is heavily influenced by the reserve accumulations of these countries. These countries should, and no doubt will, devote more of their foreign receipts to imports and to foreign aid and lending.

Second, reconciling internal and external objectives of economic policy.

There are several ways in which we might move toward relaxing the international constraints on domestic policy that have arisen in the last few years.

One possibility is to use monetary policy solely to achieve balance in international payments. Interest rates can deal exclusively with combating capital movements that disturb the balance of payments, while fiscal policy and other instruments take on the whole job of achieving full employment and other domestic objectives. But there are too many other objectives, and too many constraints on the use of instruments of economic policy, to release monetary policy entirely from domestic tasks.

For one thing, it is difficult or inefficient to adjust fiscal policy frequently, and it takes time to enact and put into effect changes in taxes and expenditures. It would be uneconomic to raise Government expenditures above levels consonant with social priorities. Permanent tax reduction to encourage consumption conflicts with the widely held objective of growth, which suggests the desirability of a high-investment economy. Given all the constraints and conflicting objectives, flexible monetary policy is a necessary part of the mixture of domestic economic policies in the United States at the present time.

If monetary policy cannot be entirely released from its domestic tasks, what are the possibilities of its serving two masters—domestic and international objectives—at once? One possibility for the monetary authorities is to affect the structure as well as the level of interest rates. As was mentioned above, U.S. monetary policy has recently attempted to lower long-term interest rates relative to short-term rates. The theory of this attempt is that long-term rates are, relative to short-term rates, more important for domestic economic activity than for international capital movements. The feasibility of altering the structure of rates depends on the existence of some frictions in the process of switching between short-term assets and long-term assets, both by borrowers and by lenders, and both in foreign and in domestic assets.

A second way of using monetary policies for both domestic and international objectives is to pay different rates of interest to foreign and domestic holders of bank deposits, Government securities, and other liquid assets. The President's message of February 6 on the balance of payments proposed such an interest differential in favor of foreign banks or governments holding official reserves in the form of dollar liabilities. This differential may help to prevent conversions into gold at times when domestic objectives dictate low interest rates. Some have suggested that such interest differentials be given to private as well as to official foreign holders of a currency. Differentials of this kind depend on market imperfections and institutional rigidities which will tend to vanish under the strain of high or sustained opportunities for arbitrage profits. A differential in favor of foreign official holdings alone is easier to enforce.

Another possibility is official intervention in the forward exchange markets. Lending in another currency entails an exchange risk which lending in one's own currency does not. If the lender contemplating purchase of foreign short-term securities wishes to avoid any risk of exchange fluctuations, he must go into the forward exchange market to make a future sale of the foreign currency these securities will yield. A low forward price of foreign currency tends to offset the profit due to higher foreign interest rates. To the extent that the interest advantage of lending abroad is offset by forward discount, the United States is more at liberty to lower short-term rates for domestic purposes. Thus monetary authorities can within limits discourage short-term international capital movements by selling foreign exchange forward and driving down its price (that is, raising the forward discount or reducing the forward premium). The Treasury has begun certain operations in forward markets, through the trading facilities of the Federal Reserve as its fiscal agent.

Policies to reduce the international constraints on domestic economic policies will have more prospect of success if they are adopted in cooperation with other countries. Such cooperation can make the sort of policies described above much easier to put into effect. It can also help in the more fundamental matter of distributing equitably between surplus and deficit countries the adjustments necessary to achieve equilibrium in international payments. There is good prospect that the new Organization for Economic Cooperation and Development can be a useful vehicle for international cooperation in economic policy.

Already the Organization for European Economic Cooperation, which the OECD is to replace, has established machinery through its Economic Policy Committee for frequent and frank mutual consultation among the members of their monetary and fiscal policies as these affect international payments.

Now, third, with respect to international liquidity and domestic economic objectives: Serious imbalances in a country's international payments can be corrected in two basic ways. One is by "external" adjustments that affect the flows of international payments directly, such as a change in the exchange parity of the country's currency. The other is by "internal" changes that affect the flows of payments indirectly through actions on the domestic economy. The most fundamental internal changes affect the level and structure of a country's output, employment, or prices and through them the international flows of goods, services, and capital.

The President's message of February 6 on the balance of payments set forth a coordinated program of external and internal adjustments, which Secretary Dillon discussed in detail in his testimony this morning. For example, one of the external changes proposed is to lower the tourist's exemption from customs duties. An example of an internal adjustment is the recommendation that steps be taken to speed the growth of productivity in American industries and thus to improve their international competitive position.

The governments of most countries, including the United States, now directly influence or regulate a large portion of international payments. Hence, there are many sorts of correctives, particularly external ones, that governments can apply just by varying their own policies. However, there are limits to this type of correction. It would be disastrous for the United States to reduce its foreign economic and military aid to achieve balance in international payments at the sacrifice of the growth and security of the free world. Most countries, if they face a significant imbalance of international payments, must ultimately consider more basic internal or external changes. And these are often not easy for modern industrial countries to make in ways consistent with their domestic objectives and international commitments.

Domestic objectives of full employment are now well established; they cannot be and should not be sacrificed to balance-of-payments considerations. General price levels have become relatively rigid downward, so that serious deflationary efforts merely produce unemployment. On the other hand, most countries are seriously concerned about avoiding inflation, and few are willing to permit large or rapid increases of the price level to eliminate balance-of-payments surpluses. These objectives severely limit the degree to which domestic policies can serve the goal of maintaining continuous balance-of-payments equilibrium.

If the business cycle affected all countries with the same timing and to the same degree, the problems created by the inflexibility of national economic policies might be relatively small. But, contrary to much of our historical experience, national business fluctuations have recently been getting out of phase, with the United States having a recession in 1960–61, while European economies were booming. This means another source of international imbalance for the major nations of the world. They have to deal not only with long-term disequilibria resting in the basic factors of comparative advantage, but also with disequilibria whenever they are at or near turning points of their business cycles.

What external measures will achieve adjustment of the balance of payments? The United States is fortunate in now being able to improve its balance of payments by adjusting policies and practices which deliberately encouraged the flow of dollars abroad. Although appropriate in the days of "dollar shortage," many of these measures are outmoded now that other industrial countries have strong convertible currencies. An example is the proposed change in the taxation of foreign susidiaries of U.S. firms, which is designed to remove an artificial inducement for U.S. capital to go abroad. Most countries will not find themselves with such convenient external correctives to choose.

Variable tariff rates, quantitative restrictions, and exchange controls are external adjustments which are so obnoxious in their effects on trade that they have been rightly ruled out under most conditions by agreements among the nations of the free world. As for changes of exchange rates, members of the International Monetary Fund are committed to maintaining their exchange parities except to correct situations of "fundamental disequilibrium." Actually it is very difficult to operate a system of fixed exchange rates without confidence in the permanence of the rates. Occasional changes of exchange parities may do more harm in keeping alive destabilizing and disruptive capital movements than good in correcting trade imbalances.

The coming of convertibility has done a great deal to promote the growth of international trade, the most economic allocation of capital investment, and the development of the economic strength of the free world. As such, it is one of the greatest milestones of recovery from the Second World War, an achievement that stands in happy contrast to the breakdown of the world monetary system following the First World War. Paradoxically, however, convertibility has not rendered any easier the task of attaining equilibrium in nations' international payments.

First of all, it has given much greater freedom to international capital movements. This is already apparent in the large international movements of short-term capital that have occurred in the period 1958–60, and under foreseeable conditions the mobility of capital between countries will probably continue to increase. In many ways this mobility is desirable, but it has two troublesome consequences. One is increasing the amount of capital that can take flight from what is felt to be a weak currency, thereby making it weaker still. The other is the constraint placed on domestic monetary policy seeking to promote income and price stability, as was discussed above.

A second major consequence of convertibility concerns the stability of the gold exchange standard, the system by which nations keep their international financial reserves in convertible currencies of major nations as well as in gold. The American dollar and the British pound now serve this role for many of the other countries of the free world.

This role has both advantages and disadvantages for the reserve currency countries, the United States and United Kingdom. The principal advantage is the possibility of unrequited imports or foreign investments, for which other countries are willing to be paid in short-term I O U's. But these liabilities held for foreigners can be converted quickly into other national currencies or gold or both. The reserve-currency countries must avoid any action that would induce a flight from their currency by foreign or domestic holders. The fact, therefore, is a difficult dilemma in regulating their balance of payments.

By running deficits, they supply the reserves other countries need to support growing volumes of international transactions, but in the same process worsen their own net debtor positions at some risk to confidence in their currencies. On the other hand, by running surpluses they increase the confidence in their currencies but at the same time contract the volume of world reserves and tend to pinch the liquidity of their trading partners.

We are entering a world with potential for rapid and efficient expansion of international commerce, yet a world in which prompt correction of disequilibrium is not easy and, if anything, grows more and more difficult. This situation points to the great importance of reserves or other financing arrangements which allow nations temporarily to run imbalances, and of the mechanism whereby reserves are created and transferred from country to country. International liquidity is no substitute for correction of basic imbalances. These cannot be financed indefinitely, and it is uneconomic to evade adjustments to permanent shifts in the structure of comparative advantage and productivity of capital.

But in our world, adequate finance must be available for temporary imbalance and for transition periods in long-run adjustments.

Many approaches to this problem have been suggested. Some of these would increase the supply of reserves, the reliability of the supply, or the responsiveness of the supply to changes in requirements.

Some would increase the efficiency of use of reserves by providing additional facilities for official compensatory finance.

Some would attack the problem by reducing the need for liquidity.

Many of these proposals have in common the essential feature of providing for the surplus countries to lend their surplus reserves automatically or semiautomatically to deficit countries. To this extent they accomplish the same result as putting pressure on surplus countries to adjust their policies unilaterally to stop their accumulation of reserves. However, securing a better distribution of reserves is by no means the whole of the problem. The more international reserves there are to go round, the less are the problems of deflation and trade restriction created by the desires of particular countries to hold on to large amounts. However, if international liquidity is overabundant there will be worldwide inflationary pressures.

The United States has a vital stake in a viable international monetary system, with satisfactory arrangements for providing reserves and distributing them among the nations of the free world. Partly this is because of our status as a reserve currency country, which must maintain international confidence in its currency as a medium in which foreign governments and private parties can hold liquid reserves. Partly it is for the purpose of reducing the constraints on domestic economic policies. But most important of all is our interest in strengthening the free world.

Only if the industrial countries arrange successfully the economic relations that connect them can they play their historic role in aiding the development of the rest of the world. Only through cooperation in securing international economic balance together with full exploitation of the opportunities for economic growth can the nations of the free world achieve the strength and unity essential to their survival.

Representative REUSS. Thank you, Dr. Heller.

I gather from the whole of your report that you are of the opinion that the likelihood of a shortage of reserves is so great that steps ought to be taken now to guard against an insufficiency of reserves.

Mr. HELLER. Mr. Chairman, the possibility of such a shortage or inadequacy of reserves is sufficiently great to make it desirable to study the means of coping with the problem should it arise. I don't believe we have the information required to say with absolute certainty that there will be such a shortage of liquidity. But there is enough of a possibility so we ought to have our powder dry by studying the alternative ways of meeting such an eventuality.

Representative REUSS. And by having our powder dry, exactly what do you mean? Do you mean that an international institution should be in being with a charter and bylaws before there is trouble, or that we ought merely to be thinking about it so that after the trouble starts we can proceed fairly fast to do something about it?

Mr. HELLER. I don't come here prepared with a formula to lay out a revised set of international monetary institutions. I think, as the Secretary of the Treasury pointed out this morning, there is a short-term problem of imbalance which requires one set of remedies and there is the possibility of a longer-term problem of a shortage of liquidity that represents a somewhat different kind of problem.

What I am saying here is that the kind of study that the committee is making could be extremely useful in preparing for the possible insufficiency of liquidity in the long run.

Representative REUSS. You have discussed at some length in your paper the problem of domestic monetary policy, and you have mentioned that there are certain constraints upon it resulting from increased convertibility of currencies and the ability of short-term capital to move around rather fast. Is it your opinion that we ought by all means not inconsistent with other objectives to see to it that domestic monetary policy be as free as possible on the one hand, to achieve full employment, and on the other, to prevent inflation. Is that a fair statement?

Mr. HELLER. Yes, I do agree.

Representative REUSS. You mentioned as one of the current means of adjusting monetary policy to constraints imposed on it by international developments, the purchase by the Federal Reserve, of somewhat more long-term securities and somewhat less of the short term, so that short-term interest rates have been prevented from falling while some downward pressure has been placed on long-term rates.

Mr. HELLER. This is certainly a direct response to the dual problem of domestic expansion on the one hand, and the problem of international capital flow on the other.

Representative REUSS. Is there not another possible way to achieve the dual objectives? The Council of Economic Advisers told us, in its report of April 1961, that by and large it believes in more emphasis on fiscal policy and somewhat less on monetary policy as a means of fighting inflation. Is that not a fair recap of what you told us over a month ago?

Mr. HELLER. Yes. In effect, in determining the policy mix as between reliance on fiscal measures and monetary measures, we were suggesting that if fiscal policy is relied on to a greater extent for expansionary economic policy, one can rely somewhat less on monetary expansion.

Representative REUSS. Not only for an expansionary policy, but where the situation is relevant for a restrictive policy?

Mr. HELLER. Yes. You did say inflation, I was referring——

Representative REUSS. But it works both ways?

Mr. HELLER. That is right, it works both ways. In other words, if you have a larger budget surplus, a more restrictive fiscal policy, then you can operate under an easier or less restrictive monetary policy, and vice versa.

Representative REUSS. Let me come to my question: If this is good advice for us, is it not also good advice for our allies of the free world industrial community? Shouldn't we persuade some of our trading partners to rely more on fiscal restrictions and less on monetary measures? If country X is in the midst of an industrial boom, with high interest rates which are inducing the outflow of capital from this country, and if country X has shown a reluctance to tax more and spend less, would it not be in our national economic interest to urge that country to rely more on fiscal methods and less on high interest rates to fight inflation?

Mr. HELLER. Yes, indeed. Your question virtually answers itself. That is, if they rely too heavily on monetary tightness, the tendency will be to draw short-term capital, indeed even some long-term capital, away from us, and complicate our balance of payments position.

Now, these interrelationships among the interest rate policies and fiscal policies of various countries are being recognized in the structure of operations of the new OECD. There is a working party of the Economic Policy Committee, of which Mr. Tobin is a member that concerns itself precisely with the interrelationships of domestic policies as they bear on the balance of payments consideration.

Representative REUSS. I am very glad to hear that. I am well aware of the delicacy involved in one country's recommending to another country that it raise its taxes. Tax increases are always politically unpopular, but it does seem to me that no more interference with domestic and economic sovereignty is involved here than is involved in many another aspect of our OECD operation.

Mr. HELLER. I think Mr. Tobin may want to comment on that.

Mr. TOBIN. I just want to comment that if the reverse question is asked, namely, "Why doesn't the United States use expansionary fiscal policy and let its interest rate go up high enough so that there is no temptation for our money to go to Germany and other European countries?" It is a question that the Germans might want to ask us, "Why don't you shift the emphasis of your policy to expansionary fiscal policy and let your interest rates be high enough to keep the money home in New York?"

Representative REUSS. I suppose one answer for us is that we wish to encourage more private, and less Government, investment and expenditure—an answer with which the Germans would be extremely sympathetic.

Mr. TOBIN. The point I was going to make is that we have perhaps other reasons for wishing the particular mixture of fiscal and monetary policy that would place emphasis for low, relatively low interest rates and a tight budget if we are interested in the allocation of resources or full employment between investment for growth and Government investment and Government policies for growth and consumption. So that if we have interest in having a relatively low interest and high, tight budget policy for growth purposes, we can't follow the opposite prescription, the opposite mixture for regulating the balance of payments. And this is to underline the necessity for the countries to have some buffers between them so that they can pursue whatever mixtures of fiscal and monetary policies are appropriate to their own objectives and their own situation in the business cycle.

Representative REUSS. And by buffers between them you mean, I take it, some form of international arrangements so that temporary deficits and surpluses are not translated into crises?

Mr. TOBIN. Right.

Representative REUSS. Senator Bush.

Senator BUSH. I will pass for a while, Mr. Chairman.

Representative REUSS. Senator Douglas.

Senator DOUGLAS. Dr. Heller, in your statement I was struck with the reaffirmation of what you stated to be the official Government policy of raising the short-term interest rate, and lowering the long-term interest rate. Do you think that this has worked out entirely successfully?

Mr. HELLER. Well, Senator, the short-term interest rate has been maintained.

Senator DOUGLAS. Let's take that point. It has been maintained, but it has not been raised. The average for bills in January, according to the Economic Indicators which are furnished us, was 2.302, and for the week ending last Saturday, 2.295. So there has been no increase. It has been maintained, but it has not been raised.

Mr. HELLER. As I recall the stated objective, it was not to increase the short-term rate, but to keep it from falling to levels which would stimulate outflow.

Senator DOUGLAS. What about the reduction in the long-term rate, has that been achieved?

Mr. HELLER. Well, temporarily it was achieved, and since then the rates have returned to or have gone, indeed, above the point of departure at the time the policy was instituted. And then of course——

Senator DOUGLAS. May I quote the figures on that?

Mr. HELLER. Yes, please.

Senator DOUGLAS. The average for January was 3.89 on taxable long-term Government bonds. For the week ending June 10 it was 3.86. I see no real decrease there. It is true that the 3.86 was an actual increase from the 3.70 which prevailed 5 weeks before, but, as compared to January, a slight decrease.

Do you think the policy will really work?

Mr. HELLER. First of all, we are thankful for small favors, there is this to be said——

Senator DOUGLAS. I say, you are thankful for nonexistent occurrences.

Mr. HELLER. But this is like so many experiments in economics and economic policy; it is difficult to determine what would have happened in the absence of policy. Long-term interest rates are probably below what they otherwise would have been.

Senator DOUGLAS. Has any real effort been made to lower the long-term interest rate, for instance?

Mr. HELLER. Yes, I think in our postwar period.

Senator DOUGLAS. I mean in these last 5 months.

Mr. HELLER. Oh, in the attempt to feed reserves into the market through the purchase of intermediate and long-term securities.

Senator DOUGLAS. You mean by the Reserve Board?

Mr. HELLER. By the Reserve Board and the Treasury.

Senator DOUGLAS. May I quote from page 27 of your Economic Indicators, which shows that member banks' reserves for January were $18,570 million, and for May were $18,370 million, or a decrease in member bank reserves of $200 million.

Would you say that the Reserve Board has been heroic in its effort to pump more reserves into the market when you have $200 million less member bank reserves in the Federal Reserve banks than before?

Mr. HELLER. Senator, may I abstain from answering that?

Senator DOUGLAS. I don't want you to get into a contest; I just want to find out the facts. And unless there is something wrong here, it looks as though the Federal Reserve, instead of expanding the loanable capacity of banks, is actually diminishing the loanable capacity of banks.

Mr. HELLER. I believe it is fair to say that the emphasis of the Federal Reserve has been on the net free reserves, and it has been maintaining something in the neighborhood of about a half a billion dollars——

Senator DOUGLAS. You mean they wanted to increase free reserves?

Mr. HELLER. Not necessarily.

Senator DOUGLAS. Again may I point out that in January the free reserves were $745 million, and in May $540 million, so they have diminished the free reserves by $200 million at the same time they have diminished the member bank reserves by $200 million. So you are not protecting the Federal Reserve on this matter very effectively.

What is the explanation for this? You are a chivalrous man.

Senator BUSH. Tell him loans have gone up.

Senator DOUGLAS. Loans have gone up from 114.2 to 117.6 billion, or by about 3 percent. But business loans have gone up by only $300 million. I am mystified. It is hard for me to follow all these rationalizations.

Mr. HELLER. Let me just say that the maintenance of a net free reserve position is, according to the definition of some, a means of maintaining relatively easy monetary conditions. There are, of course, other indicators one might use to evaluate monetary policy.

Senator DOUGLAS. There are fewer free reserves now than there were in January.

Mr. HELLER. That is true.

Senator DOUGLAS. How can you say there is a great monetary——

Mr. HELLER. Of course, they do fluctuate very considerably from day to day and week to week. But all I am saying is that the current policy of the Federal Reserve Board seems to be to maintain about half a billion dollars of net free reserves as a means of maintaining the conditions of relative monetary ease.

Senator DOUGLAS. Is there any tangible evidence to indicate that the Federal Reserve Board made any real effort to lower the longtime interest rate? Is there any evidence that it has done anything in this direction?

Mr. HELLER. The only evidence we can adduce there, not going into questions of intent, is that there was a shift in the buying policy in February in which they moved out into the longer ranges of securities, buying 1 to 5 and 5 to 10, and even a bit over 10 years, and likewise the Treasury Department purchased securities in the long market. Whether the volume of such purchases has been sufficient is a separate question.

Senator DOUGLAS. Now, at the same time that this policy was said to have been adopted, the Federal Reserve also declared that it had given up its bills only policy, and was beginning to buy long-term Government securities.

Now, do you have any record as to what the volume of long-term purchases by the Federal Reserve Board has been since the 20th of January?

Mr. HELLER. I think Mr. Tobin can give you some approximations of those figures.

Mr. TOBIN. I don't have the exact figure, Senator. They purchased over a billion dollars.

Senator DOUGLAS. They purchased a billion?

Mr. TOBIN. Of securities of maturity over 1 year.

Senator DOUGLAS. How many with maturity over 5 years?

Mr. TOBIN. Well, I am afraid I couldn't give a breakdown from memory of that. But they have made considerable purchases in both the 1-to-5 and 5-to-10 category since the change of policy on February 20.

Senator DOUGLAS. You mean they have sold short-term bills at the same time?

Mr. TOBIN. They have sold some short to accomplish the change of reserves.

Senator DOUGLAS. Do you mean that but for this action the interest rate on long-term bonds would have risen, and the interest rate on short-term bills would have fallen?

Mr. TOBIN. The interest rate on short-term probably would have fallen; yes. There is some seasonal significance to the figures which you are quoting there, and I think the general position of the market is no tighter than it was in January.

Senator DOUGLAS. As I say, these subtleties are really beyond me. But I see no evidence, so far as I am concerned, that there has been any strong effort by the Federal Reserve Board to carry this policy through. If there is such evidence I should like to see it.

Senator BUSH. I would just like to ask, apropos of Senator Douglas' last question, if it isn't appropriate for excess reserves to go down at a time when loans are going up. You are seeing quite an increase in loans, as the Senator pointed out, some 3 percent, he said. And I don't have his June figures.

Senator DOUGLAS. 2.5 percent.

Senator BUSH. Whatever it is, 2.5 percent. But wouldn't it be appropriate for excess reserves to go down during the period when loans are going up month by month? It seems to me that you can't expect otherwise. You don't keep on creating excess reserves at the time loans are going up, do you?

Mr. TOBIN. If you want to continue to give the economy a stimulus you do.

Senator BUSH. You do?

Mr. TOBIN. And the policy under which you keep aiming at a target of free reserves implies that you keep on providing for it.

Senator BUSH. Of course, the economy has been improving during this time, the Federal Reserve Board index have gone up from 100 to 108, I believe, at the last publication last week. Do you think in the face of that kind of recovery that the Federal Reserve should have done more in the way of creating reserves than they have done?

Mr. Tobin. Well, your question originally was whether they should——

Senator Bush. This is my question now, I remember the question I asked originally, I am asking this one now. Do you think they should have done more?

Mr. Tobin. I don't think I should comment on whether the Federal Reserve should have done more or less in the past. I think it is appropriate for them to continue to provide free reserves to the banks to finance an expansion of bank loans. I might add that loan expansion over recent months has been less than we would expect seasonally.

Senator Bush. They obviously have not created reserves in excess of what they had in January, but they are less. So I must take it that you don't feel that they have created reserves even in the face of this recovery we have had.

Mr. Tobin. My feeling is that as long as we have unemployment and excess capacity throughout the economy, it is still appropriate for the Federal Reserve to provide bank reserves to finance an expansion of bank loans, so that the banks don't have to finance that expansion by the selling off of their secondary reserves in Federal securities, which is what I believe the Federal policy is today.

Senator Bush. I commend for your consideration Senator Proxmire's comments in the last report issued by this committee on the question of the use of monetary policy in connection with economic growth. And I think there is quite a conflict in your view and that expressed by him in that, I thought, a very excellent memorandum, in which I concur.

Senator Douglas. It is always pleasant to have the Republicans quote the Democrats as authorities.

Senator Bush. It is always good to have one Republican around here, I will say that.

Representative Reuss. Senator Pell.

Senator Pell. Dr. Heller, in your statement you mention the various measures we might adopt to adjust the balance of payments, and among them you mentioned the proposed change in taxation of foreign subsidiaries.

I was wondering in that connection if you had any ideas as to what increase, what you are actually paying, what estimated change in procedure would result if you applied that to all foreign subsidiaries, or just those subsidiaries in underdeveloped countries.

Mr. Heller. If I understand your question, the change here is to apply only to the subsidiaries in the developed countries. The tax advantage should be retained by the subsidiaries in underdeveloped countries.

Senator Pell. That, as I understand it, is the administration's thinking.

Mr. Heller. That is correct.

Senator Pell. What would be that change? What would it result in, roughly?

Mr. Heller. You mean in terms of balance of payments?

Senator Pell. Yes.

Mr. Heller. I don't believe we have any estimates. I doubt that this is something that can be reduced to a specific quantative estimate as to the flow of capital.

Senator PELL. Thank you.

Representative REUSS. Let me pursue a bit the point that was discussed by Senators Douglas and Bush on free reserves.

As you say, free reserves are now about a half billion dollars. While there may be some questions on whether the half billion is well enough distributed throughout the banking system to provide sufficient reserves for business and industry, such a total of free reserves has usually been taken as an indication of relative monetary ease.

Now, in the past two recession periods, in the 1954 recession, and in the 1958 recession, after unemployment had improved about a percentage point, the Federal Reserve, which in each case had, during the recession, provided in excess of a half a billion of free reserves, proceeded to tighten credit and to bring the banking system from a net free reserves position toward an ultimate net borrowed position of around one-half billion dollars. Certainly the drastic and speedy tightening in 1958 produced effects on the economy which, speaking for myself, I found unfortunate.

Is it your——

Senator BUSH. What period is that?

Representative REUSS. I am referring to the 1954 and 1958 recessions.

Senator BUSH. That is not reflected in this report.

Representative REUSS. It was shown in a chart which I introduced at the last hearing of the full committee. Senator Bush is referring to page 27 of the May 1961 Economic Indicators. That table does not indicate free reserves directly——

Senator BUSH. Here they are over here, excess reserves——

Representative REUSS. In the year 1959 the table on page 27 shows excess reserves of 482, and borrowings of 906, so that by subtraction you find the banks were in a net borrowed position of about a half billion.

My question was this: Would you share my hope that when unemployment improves by 1 percent, that is, gets down from around 7 percent to around 6 percent, the Federal Reserve does not repeat its policy of the 1954 recession and the 1958 recession and deprive the system of adequate net free reserves at that high a rate of unemployment?

Mr. HELLER. May I at the outset cite the statement that the President made in his second state of the Union message in which he indicated that some further downward adjustments in interest rate would be desirable, and to raise interest rates might choke off recovery.

Representative REUSS. Yes. But at the hearing shortly after that, Chairman Martin of the Federal Reserve Board said in effect that there wasn't much the Federal Reserve System could do to implement the President's goal.

Mr. HELLER. But you asked me what would be desirable.

Representative REUSS. Yes.

Mr. HELLER. Not what the action of the Federal Reserve Board would be.

Representative REUSS. Yes, what do you think would be desirable?

Mr. HELLER. And this basic policy that the President has laid down is indeed the policy which we would strongly urge be followed, namely, that in the stages of recovery that now lie immediately ahead of us, with substantial unemployment, it would be unfortunate to permit rising interest rates to choke off the pace of recovery.

Now, the precise turning point at which in the balance between unemployment and the eventual threat of price level increases, the precise turning point at which you might want to tighten, is difficult to predict at the present time. Much depends, too, upon the fiscal policy that we follow. Given a sufficient increase in revenues, relative to expenditures as the recovery proceeds, the case for maintaining monetary ease is stronger than if we have large deficits. But within the limitation of your question, I agree entirely that as long as there are substantially large amounts of slack in the economy, it is important not to throttle expansion through restrictive interest rate policy.

Representative REUSS. Now, in your report to the Joint Economic Committee in May of this year, I believe you listed 4 percent as the level of unemployment which you regarded as the highest tolerable level. There was some discourse on this. Some of us thought that 3 percent would be a better target, but 4 percent, as I recall, was your target.

Mr. HELLER. We characterized it, if I may interrupt, as an intermediate goal which we hope to exceed in the course of time by a combination of both expansionary measures and retraining, and so on.

Representative REUSS. Taking your 4 percent of unemployment as your intermediate goal, would you agree that the national economic interest would be best served by keeping bank reserves at something around the present level, that is, net free reserves of about half a billion, until such time as the 4 percent intermediate unemployment target was reached?

Mr. HELLER. There is no question in my mind that we need to maintain relative monetary ease, not only today but until the recovery is well along. When inflation threatens, we can and should be ready to reverse the direction of policy. And we cannot ignore the fact that many of the effects of any given change or any given condition of monetary ease or tightness tend to be delayed for a time after the action is taken. Therefore it is very difficult to say that you should wait until a particular target has actually been reached before taking the monetary action that would have a particular effect, because there is some lag in the impact of that policy. One has to deal with the general direction of policy, and then be very sensitive to economic developments, and be prepared to reverse the policy when conditions change.

An important factor in the current situation, as we pointed out, Mr. Chairman, in our testimony on March 6, is that we are starting from a much higher a plateau of interest rates this time than in the preceding two recessions. We presented figures indicating, that for example, on 3 months' Treasury bills the rates dropped from 2.4 percent at the high of the 1953–54 recession to 0.6 percent at the low. In 1957–58 they dropped from 3.7 to 0.6 percent. This time they dropped much less: from a high of 4.7 to 2.1 percent. And you find the same situation in the U.S. Government long-term bonds; in the 1954 recession their interest rate dropped to 2.45 percent interest, and in 1957–58, 3.07 percent. But this time they touched bottom at about 3.70 percent. So that we do have a problem of coming out of this recession with a considerably higher level of interest rates, which certainly affects the desired interest rate policy for the future.

Representative REUSS. Now let me talk about interest rates for a moment. Going back to some of the questions that Senator Douglas was asking you concerning the limits of the present Federal Reserve policy of selling short-term securities and buying longer term securities, isn't there still considerable elbow room for further reductions in long-term rates without decreasing short-term rates? Doesn't the present spread of 2 percentage points between the short- and long-term rates give a considerable amount of elbow room?

Mr. HELLER. Well, this is one of those very iffy questions, Mr. Chairman, which makes it difficult to give a certain answer.

The short-term rate now is about 2.3 percent, as Senator Douglas pointed out.

The long-term rate is about 3.9 percent as of about a week ago. This is, of course, heavily dependent on expectations with respect to the course of the business cycle. This can be influenced by the Federal Reserve with its actions as to open-market purchase of securities and maintenance of free reserves, but it depends also on expectations in the private money markets and on developments in the private economy.

Senator BUSH. Mr. Chairman, going back to page 27 of the Economic Indicator, I want to go back to this question of excess reserves and there we see in the last 5 months' recorded there, beginning in December where the excess was $769 million that the borrowing was only $87 million as against the excess, and the most recent month I have in the record is April showing excess reserves of $623 million and borrowings of only $56 million, so the excess reserves are substantially in excess of $500 million during all of this period right up to date, I believe.

Now, those excess reserves are there, of course, to respond to a request for credit from the banks.

Do I understand correctly that you are saying that despite this excess and despite the small amount of borrowing against excess, that you still think that there should be more excess reserves credited by the Federal Reserve; is that your position?

Mr. HELLER. Well, I am saying this: if the Federal Reserve were to find that in spite of creating excess reserves to the extent of $500 million; in spite of the fact that the borrowings at the banks are not so heavy at the moment; in spite of these factors the flow of securities into the markets now seeking long-term funds was forcing interest rates up, one of the ways the Federal Reserve could use to try to hold interest rates down would be to increase the quantity of net free reserves; in other words, to increase the ease of the banking system.

Mr. TOBIN. Senator, may I comment?

Senator BUSH. Yes, I would be glad to have you do so.

Mr. TOBIN. The overall figure for excess reserves minus borrowings which is what is referred to as net free reserves, sometimes conceals a great many changes in the distribution of those free reserves between types of banks and between types of reserves.

As you know, last year the Federal Reserve allowed the banks to begin to count vault cash to get their reserve requirements and it is apparent that vault cash does not get into the market for excess reserves, so-called Federal funds in the same degree that ordinary reserve balances in the Federal Reserve banks do.

Senator BUSH. It is available.

Mr. TOBIN. It appears to have a figure of net free reserves that corresponds to the situation before this change in the law in regard to reserves, and you have to correct the present figure upward anywhere up to $200 million, according to some people's estimate.

Now there is a real measure in the market of the availability or nonavailability of net free reserves, and that is the rate at which they are lent and borrowed by banks to each other in the Federal funds market, so-called. During a great part of the time that you were just speaking about that rate was at its maximum. Its maximum would be at the Federal Reserve discount rate, currently 3 percent, where you can borrow as cheaply from the Federal Reserve banks themselves as you can from other commercial banks. At this rate I think you would have to say that the reserve position of banks is not particularly easy.

Now, more recently, those rates have been much lower. They have been down below 1 percent this last week, and that, it seems to me, is a good indicator that the banks were fairly well provided with reserves.

I think you have to look at that as well as total free reserves.

Senator BUSH. I don't have that available here. I mean to say it should be in here.

Do you have it?

Mr. TOBIN. I don't have a series with me now, but during the past week the Federal funds rate was below 1 percent for a good part of the time.

Senator BUSH. I appreciate what you say, but I don't think it affects what I have said particularly that which is due to the small amount of borrowings against these excess reserves and it doesn't suggest that the Federal Reserve should be increasing more excess reserves.

Mr. TOBIN. I was suggesting that the measure of whether the Federal Reserce has given the banks sufficient reserves so that they feel free to go ahead and lend them is not merely the total quantity of excess reserves relative to borrowings, because the distribution of reserves may be very peculiar as between country banks and money center banks, and as between vault cash and regular reserve balances. To get a pretty good measure of the availability of reserves for financing expansion by banks you should also look at the rate at which excess reserves are lent, that is, the Federal funds rate.

Senator BUSH. Again, I would suggest that these figures don't reffect any lack of desire on the part of the banks to lend because the loans have gone up this year, as Senator Douglas has pointed out, and the total loans went from $114.2 to $117.6, that is from April until May. That is a substantial increase. Despite that, the borrowings have not gone up. They stayed down.

I don't think you make a very good case, if I may say so. I don't think I have convinced you but I think your case that the Federal Reserve has been laggard in creating reserves, your figures just don't support it.

Senator DOUGLAS (presiding). Senator Pell.

Senator PELL. In connection with this morning's question of Senator Douglas to the Secretary of the Treasury, I was wondering what you would think could be the effect on the domestic economy if the gold reserve classes are repealed.

Mr. HELLER. There would be no immediate impact at all. That is to say, we don't rely on the 25-percent gold cover in any meaningful way at the present time. It is more of a symbol than a reality in our domestic economic situation.

Senator PELL. Thank you.

Senator DOUGLAS. Thank you very much, gentlemen. We appreciate your testimony here today.

Our next witness is George W. Ball, Under Secretary of State for Economic Affairs.

STATEMENT OF HON. GEORGE W. BALL, UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. BALL. Mr. Chairman, I have a brief statement I would like to read, if I may.

Mr. Chairman and members of the committee, let me say first that the Department of State welcomes your initiative in undertaking this inquiry into international exchange and payments. The problem of improving the mechanism of international payments is as intricate as it is important. I think it wise, therefore, that you are planning to hear witnesses from the financial and academic communities as well as from Government agencies.

Secretary Dillon and Mr. Heller have dealt with the international financial, and the domestic economic, aspects of this subject in considerable detail. I shall discuss certain of its foreign policy aspects.

The first—and in fact the principal point I wish to make—is that the position of the United States, as the leading power in the free world, makes it imperative that we have an international financial mechanism that contributes to ever-increasing economic strength and political unity in the free world. Dependable international monetary and credit managements are indispensable to the expanding international trade and investment that are needed if we are to strengthen the free world and outdistance the Communists.

I was glad to note in your letter to me that your committee is concerned with "the general problem created by recurrent international imbalances and their amplification through movements of 'hot money,'" rather than just our present balance-of-payments situation. The methods of dealing with balance-of-payments deficits are well known. Indeed, we have been lecturing our friends around the world for many years on how to put themselves in international equilibrium. And I am sure that we can take our own advice. But at the same time we must not yield to the temptation to make our balance-of-payments adjustments in ways which thwart our other objectives—of expanding trade opportunities and encouraging international investment for economic development.

I hope, therefore, that your committee will explore thoroughly and patiently every possible facet of the major problem you have so perceptively isolated for attention. I do not see this as a rush job. The Secretary of the Treasury has provided us with details about the current trends and consultative arrangements. These are encouraging. But the problem on which your committee is concentrating may well arise again in a world of convertible currencies and we must be prepared to meet it.

This problem is a broad one. This afternoon I shall concentrate my remarks primarily on three aspects. The first has to do with the activities of the Organization for Economic Cooperation and Development—OECD; the second, with the special requirements of the less developed countries; and the third with commercial policy, with particular reference to Western Europe.

THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD)

Pursuant to the advice and consent of the Senate, the President in April ratified the Convention on the Organization for Economic Cooperation and Development. Since then several other countries have ratified it, and we expect that the Convention will come into force sometime prior to October 1. The OECD will have 20 members, including all of the industrialized countries of North America and Western Europe. The members, in formulating the Convention, have recognized "the increasing interdependence of their economies" and have stated their determination—

> by consultation and cooperation to use more effectively their capacities and potentialities so as to promote the highest sustainable growth of their economies and improve the economic and social well-being of their peoples.

The members have agreed that—

> they will, both individually and jointly * * * pursue policies designed to achieve economic growth and internal and external financial stability and to avoid developments which might endanger their economies or those of other countries * * *.

With this membership and these aims and commitments, the OECD is a forum well adapted to the development of policies designed to minimize international economic imbalance and to restore international equilibrium when imbalances arise.

In April of this year the United States sent a special delegation to the meeting of the Economic Policy Committee of the Organization for European Economic Cooperation—which will continue to function until the OECD actually comes into being. The delegation included the Chairman of the Council of Economic Advisers, the Chairman of the Board of Governors of the Federal Reserve System, the Under Secretary of the Treasury for Monetary Affairs, and the Assistant Secretary of State for Economic Affairs. At this meeting it was agreed to establish two high-level working parties, one on economic growth and one on international payments.

The working party on payments, which includes senior treasury and central bank officials from nine countries, has a broad mission: to analyze the effects on international payments of monetary, fiscal, and other measures and to consult on policy measures, national and international, as they relate to international payments equilibrium. The group is starting out by discussing current and prospective developments in the field of international payments and the policies now being pursued by member countries that significantly affect international payments equilibrium. These discussions, which began a month ago and will be resumed shortly, will probably cover the whole range of subjects important to the payments positions of members, such as fiscal policies, interest rates, cyclical developments, operations in exchange markets, commercial policies, and capital movements.

The improved understanding that will come out of these discussions should, by itself, promote a greater degree of harmony in the policies of national governments.

In addition, we expect that this group will find ways and means of averting or minimizing imbalances that can prove disturbing for both surplus and deficit countries and ascertain how intergovernmental action or accommodations can make it easier to deal with problems of external imbalance without undue constraints on internal policy. As such ways and means are devised, the problems of maintaining international economic balance and liquidity will be eased, not only for the members of OECD, but for the free world as a whole.

When the OECD comes into being the Development Assistance Group (DAG) will become one of its major committees—the Development Assistance Committee. The role of the DAG, as you know, is to enlarge and make more effective the individual and joint efforts of the capital-supplying countries—the United States, Canada, Japan, and the countries of Western Europe—in assisting the economic development of the less-developed countries. Although the DAG is not directly concerned with international payments questions, the results of its work should help the less-developed countries deal with their problems of international imbalance.

LESS DEVELOPED COUNTRIES

Although the industrial countries have a very large share of world trade, and an even larger share of international financial resources, the numerous less-developed countries of the world have a very great stake in the international payments mechanism and the methods by which it is kept functioning.

In terms of fundamentals, the international payments problems of the less-developed countries may be viewed in the same light as those of the developed countries. Any country, regardless of its state of economic development, needs working balances to finance its day-to-day international transactions, and it needs monetary reserves or available credits to meet the fluctuations in its payments position that arise from time to time in response to international and external developments. Moreover, it needs the institutional arrangements, administrative skills, and policies to restore equilibrium when its payments position goes awry.

I would understate the needs of the less-developed countries, however, if I implied that they are as well equipped to cope with these problems as the more advanced countries. Let me mention some of the special disabilities of the less developed countries.

First, they are, in nearly all cases, driven by powerful political and social forces to grow and to grow rapidly. Monetary reserves represent investment, but an investment that looks relatively unprotective to people who have smelt the yeasty air of economic expansion. It is easy to understand why these countries are strongly tempted to use their reserves for more machinery, more steel, or more fertilizer.

Second, the export earnings of many less-developed countries are highly volatile. The usual pattern is for the export earnings of a less-developed country to come from a few foods, raw materials, or minerals. Both quantities and prices show wide fluctuations. Moreover, marketability overseas may be threatened by technological change or inhibited by quotas, preferences, or fiscal devices.

Third, less-developed countries are generally short of trained administrators, civil servants, and financial technicians. These countries tend to lack the constituents of skilled and effective policy formulation and execution, even as they face all kinds of difficult governmental problems, particularly in the financial field, where the public pressures to discard fiscal and monetary discipline are relentless.

Fourth, their economies lack flexibility. Economic shocks are not easily absorbed, and economic adjustments are difficult and slow. If the quantities or prices of their principal export items decline, they have few, if any, ready alternatives.

Considering these factors, it could be argued that less developed countries need more reserves, relative to their trade, than more developed countries. But usually they must get along on less. Some try to restrain imbalance by fluctuating exchange rates or multiple-rate practices; others, by maintaining trade restrictions and bilateral trade agreements. In some instances, these devices have been successful in repressing imbalance, although they may be costly in terms of their effects on growth and the allocation of resources. All too frequently, however, less-developed countries slide into financial crises which disrupt their development efforts and create new political instabilities.

The United States, other industrial countries, and international institutions are providing a growing volume of financial and technical help to the less-developed nations. Directly and indirectly, this help will eventually make their problems more manageable. What else can and should be done?

One form of progress would stand out above all others: greater stability and growth in the export earnings of the less-developed countries. The United States is placing a new emphasis on the problems of instability in international trade in agricultural and mineral products. We recognize that these commodity problems vitally affect the economic development of large areas of the world. As President Kennedy said in his "Alliance for Progress" speech of March 13:

> The United States is ready to cooperate in serious case-by-case examinations of commodity market problems.

It is essential that the less-developed countries obtain enlarged markets in the industrial countries for their traditional exports. This means lowering existing trade barriers and resisting pressures for new ones. Moreover, the industrial countries must find constructive solutions to the problems that have arisen, and will inevitably grow more pressing, as a result of the economic advances of the less-developed countries. The fruits of economic development will appear, in part, as new exportable products, increasingly in the field of manufacturers. These products represent hard-won economic gains, to which our taxpayers have contributed their money and our Nation its influence. If markets cannot be found for them, much of the common effort will go to waste. And beyond that, the hopes, enthusiasm, and political stability that should accompany economic growth will be turned into disillusion.

One final word on the financial side. The International Monetary Fund has been of great help to the less-developed nations in providing technical assistance, in furnishing needed financial resources, and in providing moral support to governments determined to save their economies from the disruption of financial disorder. We think that the Fund will be able to do even more for the less-developed countries within its sphere of competence. These countries were reminded recently by the group of experts appointed by the United Nations to study commodity problems that "member countries have not tested fully the Fund's willingness to provide resources to meet difficulties arising from commodity fluctuations and should be encouraged to do so." The experts also noted that "an enhancement of the compensatory role of the Fund is desirable." It would appear that the Fund is in substantial agreement with these observations.

Helpful though such compensatory financing can be, it cannot provide a satisfactory answer to the problems of fluctuations in employment and production which stem from unstable exports and export revenues.

Senator BUSH. Mr. Chairman, may I ask a question?

What does that mean, compensatory financing?

Mr. BALL. It means financing to provide resources during periods of cyclical fluctuation.

Senator BUSH. I don't quite understand that. You say "enhancement of the compensatory role of the Fund is desirable."

Mr. BALL. Simply that there is a mechanism through the Fund which could be utilized by these countries during periods when there are short-term cyclical swings in export earnings because they are dependent on single commodities that could compensate for the loss of income that they are suffering from until the swing starts back up the other way.

Senator BUSH. Thank you. I was confusing the word with another interpretation. It hasn't anything to do with that. It means to compensate for a deficit.

Mr. BALL. That is what it amounts to.

Representative REUSS (presiding). As long as we are on this compensatory financing, far from being anything new, it is precisely what the Fund was set up to do.

Mr. BALL. That is right. The only point I am making is that the undeveloped countries, particularly some of the primary commodity producing countries, have not utilized the Fund to any extent to which we think it might be used for this purpose.

I turn now to the commercial policy aspects of this problem of international economic imbalance and international liquidity. It seems to me that it is always healthy to tell one's self, if not other people, that international monetary and financial arrangements have as their fundamental purpose to facilitate trade in goods and services. They have no purpose in and of themselves. On the other hand, it is clear that steady growth of trade greatly eases the international payments problem. Yet even the achievement of a perfectly adjusted trade pattern could not, by itself, stop large and rapid short-term capital movements, such as we have had in the last 2 years, with their potentially disruptive influence on travel.

To state the matter positively, we need an international payments mechanism that will make it possible for the United States and other countries to pursue the commercial policy objective of freer, multilateral, nondiscriminatory trade. It is with reference to this fundamental objective that I wish to discuss commercial policies of our European trading partners, a subject to which you have particularly asked me to address myself. As you know, the United States has lent its support to the European Economic Community since its inception. The Community involves a radical reorientation of the economic fabric of Western Europe, and has important political consequences. It holds great promise for the future prosperity, peace, and stability of the area. The political stability and steady economic growth of Western Europe is of overwhelming significance to the whole free world.

In giving our support to the Community, we have recognized that certain trade adjustments will be necessary and that our own trading interests may be affected, at least temporarily. We are convinced that, in the long run, the greatly expanded market which is being created will materially increase the demand for our exports, just as the economic expansion of the United States has greatly enlarged Europe's trading opportunities over many decades.

Our experience with the European Economic Community to date has been too short to enable us to reach any definitive conclusion as to trade effects. In 1960, when the Community had made internal tariff reductions of 20 percent, our exports to the six countries reached $3.4 billion, exceeding the previous record year of 1957 by nearly a quarter of a billion dollars. However, a good part of these tariff reductions were generalized to outside countries, including the United States. The best indication of future effects we now have is that even a very slight increase in the rate of economic growth of the six countries would be sufficient to produce a demand for foreign goods high enough to offset completely the trade diversionary effects of the customs union. If the Community growth rate should increase significantly, it would follow that our trade with the area should increase substantially during the coming decade.

We can take advantage of this expanded market in Europe, however, only if the Community continues to maintain an outward-looking, liberal commercial policy and adopts the lowest possible common external tariff. The round of GATT tariff negotiations which is presently proceeding in Geneva is a start in this direction. The leaders of Western Europe are well aware of the importance of a liberal trade policy. I am confident that they recognize in this context both their new responsibilities stemming from membership in the Economic Community and their current status as creditor nations on international account. They have, in fact, seized from us the leadership in liberal trade policy by their concrete offer of an across-the-board 20-percent reduction of the common external tariff in the industrial area.

The problem of trade barriers in the agricultural field is more difficult for the Community, owing to the necessity of its developing a common agricultural policy. But in our current negotiations we are pressing vigorously for more liberal treatment of U.S. agricultural exports.

Some of the questions with respect to international liquidity in connection with the Community also arise in connection with the European Free Trade Association, the seven members of which are likewise in the process of removing trade barriers among themselves. However, the implications of the EFTA in this respect are of a somewhat different character, owing to the fact that the EFTA, as a free-trade area, does not provide for a common external tariff, has no institutions designed to deal with monetary problems, and generally does not contemplate integration as far reaching as that of the European Community.

In concluding my statement, Mr. Chairman, I should like to say again that the central problem before your committee is an intricate and many-sided one. Some things can be done reasonably soon—for example, the provision of standby credits to supplement the International Monetary Fund's resources—while other things may take much longer, such as the development of measures to reduce the instability of international commodity markets.

I commend you and your committee, Mr. Chairman, for taking the initiative in investigating this very important problem of international economic imbalance, with particular reference to the international movements of short-term capital.

The Department of State will be working on the problem and if we can be of assistance to your committee, I hope you will call on us.

Representative REUSS. Thank you, Mr. Ball.

You can be particularly helpful to us because of your long background both in the Common Market and more recently in OECD.

I would like to ask about the GATT tariff negotiations referred to on the last page of your statement. I am particularly concerned, as you know, that the Common Market does not produce dire economic side effects either for this country or for the rest of the free world not inside the Common Market.

I had the impression that the GATT negotiations at Geneva which are now in progress were to be in three phases. The first phase pursuant to article 24 of the Geneva Agreement on Tariffs and Trade was to make sure that the customs union set up by the Common Market did not have a higher or more restrictive effect in its general incidence than the duties and regulations which were in effect before the establishment of the Common Market. The second phase of the negotiation, as I understood it, was with respect to compensatory adjustments for changes on rates previously bound by negotiations, and the third phase was to be the traditional reciprocal trading of tariff reductions.

Mr. BALL. We have them, Mr. Reuss, primarily in two phases, that is the first two phases you mention as a single phase.

Representative REUSS. Fine.

I overanalyzed it perhaps. Phase 1 then is for making the adjustments required by article 24 and phase 2 is for reciprocal tariff cutting.

Mr. BALL. That is right.

Representative REUSS. Now I have the impression, and I wish you would straighten me out if I am mistaken, that phase 2 has been embarked upon without phase 1 really having been accomplished.

Mr. BALL. What has happened, Mr. Chairman, is that with respect to phase 1, as far as the tariffs on industrial goods are concerned, there has been satisfactory agreement reached as to its compliance with article 24–6. There are some agricultural items which are still under discussion, particularly between the six conutries and the United States.

Most of the countries—I think all but the United States, or all, possibly, but the United States and one other—have come to an agreement with regard to the compliance of the proposals with article 24–6.

Now the difficulty that is faced here is that under the terms of the Treaty of Rome which created the Common Market, the countries are called upon to create a common agricultural policy.

You know, of course, the difficulty of creating an agricultural policy, even for a single country, that is on a satisfactory basis. But when you come to merging the agricultural policies of six countries which have grown up quite separately with separate traditions, separate relations between agriculture in the States, different standards of living on the farms, different methods of agricultural production, different methods of State support or State subsidy, or whatever the case may be, this is an extremely formidable and difficult problem. It has caused a great deal of pain and anguish to the members of the Common Market in trying to arrive at a policy.

In order to enable them to arrive at a policy, they have worked out a program of employing variable levies for a period of time until there can be adjustments made between the high support levels of some countries and the low support levels of others. This is a matter for discussion currently between the U.S. Government and the countries of the Common Market. It is now down to a few items, and I hope this can be concluded within a very short time.

Meantime, there has been a general agreement to go forward with the reciprocal negotiations—the second phase—while we are still engaged in trying to work out definitive and satisfactory arrangements with respect to a few of these items.

Senator BUSH. Mr. Ball, can you explain here, parenthetically, the relationship that you visualize between the GATT organization on the one hand and the Inner Six on the other? These Inner Six are all members of GATT, aren't they?

Mr. BALL. That is right.

Senator BUSH. And now, I am puzzled as to how that is going to work because you are going to make agreements on tariffs and trade in the GATT Conferences from year to year which will affect these Inner Six and yet, they are likewise engaged in making agreements of their own and the United States according to you, and I am very much puzzled as to how this is going to work.

Tell me, do you foresee that conflict there?

Mr. BALL. No, the way it will work is this, Senator Bush.

At the moment, the problem under the first phase of the article 24–6 negotiations has been to accept the proposals made by these six countries acting as six countries with regard to their common agricultural policy and measures that they are taking under that policy.

Under the terms of the Treaty of Rome it is provided that the six countries will, after the transitional period, have a common commercial policy with regard to the rest of the world. In other words, they will have, within the area of the six countries, complete free movement of goods, labor, services, and capital.

With regard to the rest of the world they will have not only a common external tariff but a common commercial policy. This means that they will be, in effect, a single member of GATT, bargaining with all the other members of the GATT as though they were a single country. This is what is contemplated so that I can see no possibilities of dispute or concern.

The Common Market will make its proposals as an entity just as the United States makes its proposals as an entity for bargaining.

Senator BUSH. And such proposals made as an entity would affect all of those six countries in relation with all the other GATT members.

Mr. BALL. Those proposals would affect the common, external tariff of the six countries, and they would be made with respect to changes in that common external tariff just as a single country makes it.

Senator BUSH. Thank you, Mr. Chairman. This is a good explanation.

Representative REUSS. When was the agreement signed which accepted the industrial tariff schedule of the Common Market external tariff?

Mr. BALL. A general understanding was reached on industrial items within the last few weeks. I wouldn't say it was a signed agreement. The way these things are worked out, there is a series of proposals which are accepted or rejected and finally bargaining reduces one after another until there is an effective agreement. This has not actually been formalized yet.

Representative REUSS. Can you furnish this committee with a copy of that agreement?

Mr. BALL. Well, it hasn't been formalized yet but we can give you a statement with regard to it, Mr. Chairman.

Representative REUSS. I mean if it hasn't been formalized by being signed, give us a copy of the statement.

Mr. BALL. I think what we will do is this. I am advised by one of my colleagues, Mr. Vine, who has just come up here, that there has been no specific acceptance by the United States of any of the offers and that there will be no acceptance of the offers until everything has been agreed upon. This is a very long, complicated schedule. These are not made public at the time and we would have to give them to the committee in confidence.

Representative REUSS. We would appreciate seeing them on whatever terms you wish and, of course, if they aren't public we would receive them in complete confidence for our own internal use. I would like to make that request at this time.

Mr. BALL. We will provide you with such information as we can get and with a full explanation of it, sir.

(The information to be supplied is as follows:)

The negotiations held with the EEC during the first phase of the Tariff Conference, which was convened in Geneva in September 1960, have been concerned with establishing a schedule of tariff rates for the EEC to replace the national tariffs of the member states in accordance with the provisions of article XXIV of the GATT. In the course of these negotiations the EEC has made offers of bindings and reductions in the common external tariff covering a large segment of U.S. exports to the EEC area. The overall incidence of the offered rates, particularly in the industrial sector, compares favorably with the incidence of the national rates which they replace. In the agricultural field negotiations have been complicated by the fact that the European Economic Community is still in the process of developing a common agricultural policy and has not been able to determine definitive levels of protection for some of the commodities involved. Items in this field are therefore subject to further negotiation. Pending the conclusion of these negotiations the United States has not finally accepted the offers made by the EEC. Under accepted rules of procedure in these tariff negotiations the Department of State is not in a position to indicate specific results of the negotiations until the EEC offers have been confirmed by the EEC and accepted by the United States.

Representative REUSS. Then is my understanding correct, that while phase 1 has not been completed as far as the United States is concerned, we are going on to phase 2 even though the phase 2 exercise is a provisional one and depends upon ultimate agreement on phase 1.

Mr. BALL. There can be no final agreement on phase 2 until phase 1 has been completely agreed upon.

Representative REUSS. Would you not agree with me, Mr. Ball, that our agreement on phase 1; namely, whether the Common Market external tariff is of such a nature as to qualify as a customs union exception to the General Agreement on Tariffs and Trade, is dependent on the whole package presented to us? It would profit us nothing, for example, to have a liberal, industrial tariff schedule if the agricultural tariff and quota provisions are not liberal but grotesque.

Mr. BALL. Well, it is not grotesque. It is now narrowed down to a narrow range of issues. We have every intention of concluding it before any final agreements are reached with regard to phase 2.

Representative REUSS. Let me ask you a further question with respect to this phase 1, article 24 of the General Agreement on Tariffs and Trade negotiations.

It is my understanding that in 1957 both Germany and Italy reduced their tariffs 25 percent.

When the Common Market external tariff came to be set up some time later, this 25-percent reduction was withdrawn and not included in the base on which the Common Market external tariff was calculated. This is a fact, is it not?

Mr. BALL. The common external tariff is based on the tariff rates in effect on January 1, 1957, except that a temporary 10-percent reduction in certain Italian rates was not taken into account. German reductions of 25 percent were made in the summer of 1957. These were of a temporary nature and were designed to correct cyclical changes in the German economy. They were made subsequent to the base date of the Rome Treaty.

Representative REUSS. Article 24, to rephrase it in lay language as I read it, says that the Common Market external tariff cannot be higher or more restrictive in its incidence than was the case before the external tariff went into effect.

Doesn't the withdrawal of the German-Italian "on-again, off-again," "now-you-see-it, now-you-don't," tariff reductions conflict with this requirement of GATT? Should we not insist that our German and Italian friends who are in a position of abundant surplus should start from the actual situation before the external tariff went into effect?

Mr. BALL. My understanding is that the effective date of the treaty was January 1, 1957, for the purposes of the base period, and that this is the way in which article 24–6 has been interpreted as applying to the situation which existed on January 1, 1957. Thus, this is not an element in the consideration.

I would certainly agree with you that we should do everything possible to persuade the members of the Common Market to reduce their common external tariff.

I may say that I think this is something where we are going to be quite gratified in our hopes. They have offered the 20-percent, across-the-board cut on industrial tariffs. The indications are that, in discussing the question of reciprocity, they will take into account the need for them to move toward a great liberalism in relation to the outside world.

Representative REUSS. They have indicated that they view reciprocity with favor.

Mr. BALL. In this case, they want to move toward liberalism and they will take a very flexible view with regard to reciprocity in this case.

Representative REUSS. Has this country formally accepted the interpretation of the Common Market countries that it was acceptable under GATT to determine upon a base date for the Treaty of Rome, which, in effect, wipes out the earlier German and Italian tariff reductions?

Mr. BALL. It is my understanding that the terms of the treaty were such that, because the effective date was January 1, 1957, it had that effect only with respect to a 10-percent Italian reduction. The German reductions were made later in 1957 in order to deal with a problem existing at that time.

Representative REUSS. We weren't, of course, a signatory of the Treaty of Rome, and interpretations which the countries concerned seek to make of its compliance with GATT provisions are not binding on us.

Mr. BALL. There is one other point, Mr. Chairman, which I should mention and that is the Italian and German reductions that you had reference to were reductions that were not made on the basis of reciprocity. They were made gratuitously and were not bound under the GATT. Therefore, they are not regarded as being subject to the same provisions of article 24–6 as if they had been reductions granted as a result of reciprocal bargaining.

Representative REUSS. Yes; although article 24–6 doesn't say that. It refers to duties and regulations in effect before the Customs Union becomes effective.

I would like to leave this subject by saying that I think, as a matter of national policy, we should hang on to every right given us by treaties and other agreements that we have signed.

Mr. BALL. I am wholly in accord with that principle, sir.

Representative REUSS. Senator Pell?

Senator PELL. Mr. Ball, you have had a hard day, ever since this morning when I saw you in another hearing.

Mr. BALL. Yes, Senator.

Senator PELL. I was wondering, in view of your recent trips abroad, what your general reaction was to the formidableness of the tariffs in industrialized countries abroad as compared to our own. Do you feel they are heavier abroad or lighter?

Mr. BALL. I should say with regard to industrial products that we are on the edge of losing our leadership toward liberalism. Ever since 1932, we think the United States has been in the forefront of seeking a world where goods can move freely.

At the moment, because of the new dynamism of the Common Market, the fact their growth rates are proceeding at an extraordinarily high rate, the fact that they are feeling a measure of self-confidence in the whole world trade market, they are moving toward liberalism and I think to some extent may be taking the leadership from us.

Now it is a little hard to compare rates because they vary so much as between countries. I have been interested myself for a long time, for example, in trying to get an objective examination of the statement very often heard that in this whole process of reciprocal bargaining under the Trade Agreements Act, we have tended to give more concessions than we have gotten.

I have had some people look at this. I have never seen any satisfactory answer to the question. To some extent it may be true and to some extent it may not.

I would hope we can get some very serious studies on this. If you compare rate for rate, then I would say the U.S. tariffs are higher than some and lower than others. But I think the important thing right now is the direction of movement, the degree of the drive for liberalization, where it is coming from, and where it is likely to go. This is the impression that I got in Europe: that with the self-confidence that they gain from a dynamic market they have created, they are much more inclined than we are to go forward with liberalization, at least in industrial sectors.

Senator PELL. And along that same line, do you have any reaction with regard to the Eastern European or Soviet bloc nations? Are they also attempting to reduce the tariffs in any way?

Mr. BALL. The problem there is that the restraints on trade with the Soviet bloc are restraints we ourselves have imposed, and also the Western nations.

Senator PELL. Are there any other nations which impose restraints on trading with the Soviets beside ourselves?

Mr. BALL. We have the strategic list, the so-called strategic list, but with regard to the Soviet bloc where you have most trading through state channels, whether there are tariffs or not is quite an academic question, because when you have a state trading system you have a total control of the situation.

The problem that we are encountering now with the Soviet bloc nations concerns the whole question of the encroachment of Soviet goods on the Western market, particularly in the case of oil where we are giving very serious thought and study to the problem of the increasing oil shipments to the West.

I think we can expect this to become a very much larger problem as the Soviet Union and the bloc countries develop export surpluses, which I think they almost inevitably will do; and this is going to be a matter of increasing scrutiny and increasing concern not only for us but our Western trading partners as well.

We are watching this and studying it and it presents some very disturbing problems.

Senator PELL. Thank you very much. That is all I have.

Representative REUSS. Back on the question of the Common Market, in your statement you say that even a very slight increase in the rate of economic growth of the six countries will be sufficient to produce a demand for foreign goods high enough to offset completely the trade diversionary effects of the Customs Union.

Now, I have a couple of questions on that. I hope that this increase in the rate of economic growth of the Common Market countries does come about, but it would be only realistic, would it not, to concede that the rate of growth of those countries has been very high in recent years, and that it is quite possible that the rate of growth would slow down.

Mr. BALL. It is possible. There are a number of elements involved. There may be some structural changes in the Common Market itself.

Representative REUSS. Your two predecessors at these hearings, Secretary Dillon and Chairman Walter Heller of the CEA, they thought that there was a very real possibility of some slowdown.

Mr. BALL. They are concerned, particularly Secretary Dillon, of course, with the problem of the balance-of-payments situation of the United States, and they could foresee a slowdown in the rate of growth of the Economic Community as creating further problems for our exports and this is certainly the case.

Now, I think the sustained periods over which the countries of the Community have been able to maintain their growth rates is quite notable, quite remarkable. I think that they sustained them longer than most of us thought they would. Whether they will continue to do so, I don't know.

I think that you are right in noting that the growth rates are already high, and perhaps it would be overoptimistic to think that there is going to be an increase then.

I merely made this statement to note that the leverage was very considerable in the sense that a relatively slight fluctuation could have a very considerable effect on trade and that the degree of trade diversion which might have an adverse effect on our own exports was a marginal amount which could be wiped out very easily by even a relatively small increase.

Representative REUSS. Well, I would agree that it might be wiped out by an increase in the rate of economic growth of the Six, but if there is not an increase in the rate of economic growth of the Six or if there is a decrease then the diversionary effects of the Common Market external tariff would hurt our exports and add to our balance-of-payments difficulties; would they not?

Mr. BALL. There is no doubt that, at least on the short term, there are trade diversionary effects which have an adverse effect on our exports.

Now we faced this quite consciously, and as a matter of Government policy we regarded the political factors involved in the greater cohesion given Europe by the creation of the Community as an overriding consideration which is more than compensation for what we would think of as a relatively temporary effect, if any, that the trade diversion might have for us.

Representative REUSS. Even if there is an increase in the already high rate of economic growth of the Six, is it not likely that most of the fruits of that increase might well go, say, to Western Germany within the Six?

Mr. BALL. Our exports have been able to hold their own very well up to this point.

Representative REUSS. As you pointed out in the sentence just prior to the one I read, one of the reasons our exports have been able to hold up so well is because the initial tariff reductions were generalized to us.

Mr. BALL. I hope they continue to be generalized.

Representative REUSS. So do I, and I am delighted to hear you articulate that as a goal because I think and many members of this committee think, it is terribly important that the advantages of the Common Market not be dissipated by its becoming a discriminatory trade diversionary end play. The only way to avoid that is to generalize its benefits, not just to the Outer Seven, not to this country alone, but to the whole free-trading world.

Mr. BALL. Of course, Mr. Chairman, if we expect the Common Market countries to do this we must also be prepared ourselves to bargain with some reciprocal concessions because you can scarcely ask them, with their ultimate objective at the end of the transitional period, which is to come down to zero tariffs, to be an oasis of free trade in a world in which the rest of the industrial countries are imposing tariff restrictions.

Representative REUSS. However, I want to record a partial disagreement with you on that, Mr. Ball. I think it would be a mistake for us to proceed solely on the basis of the reciprocity vis-a-vis the Common Market for two reasons. One, the Common Market, which came into being with our consent, represents a very substantial concession that the other GATT signatories are giving to the Six; namely, the right to discriminate against outsiders. It does not bother my sense of justice a bit to ask that they, who have thus received more than reciprocity, in return be asked to give more than reciprocity.

Moreover, the fact is that the Common Market happens to include countries which are currently enjoying almost an embarrassing and persistent surplus in payments, notably West Germany and Italy.

Quite apart from any questions of tit for tat, it seems to me that under these circumstances, more reciprocity should be expected of the Common Market, and if we don't ask for it we surely aren't going to get it.

Mr. BALL. I would agree with everything up to the last sentence, because I think we are going to get it without asking for it, and I think this is the mood of the Common Market countries and the Common Market Commission.

When they talk of a 20-percent across-the-board reduction, in industrial tariffs that is, I think they are thinking of going a long way down this route without asking for reciprocity to the fullest extent.

Representative REUSS. Let's turn a moment to the things you said about meeting the payment difficulties of the industrialized countries of the free world.

Quite recently, at the time of the German and Dutch revaluations, the central banks of the major nations made some quite successful ad hoc arrangements for dealing with the side effects of those revaluations.

Do you see any advantages or disadvantages in having these arrangements made on a continuing basis rather than on an improvised basis each time, and what seems to you a good organizational and institutional framework for conducting those arrangements of marshaling aid for payments difficulties?

Mr. BALL. Well, as far as the central banks are concerned, obviously there are great advantages in the close working relationships between them and the attitudes which they have adopted of showing restraint or taking policy measures which will be useful in easing some of the difficulties that countries may get themselves into.

I would think that the OECD offers a very useful mechanism, the Economic Policy Committee, for working out some of these problems and for providing a forum in which there can be a kind of consultation on these questions, and I am hopeful that it is going to develop along this line.

Certainly, the meetings that have been had so far have been very promising in this respect.

Representative REUSS. I am glad to hear you say that. The three major areas of concern to the OECD are now the monetary and fiscal policies of its members, their commercial policies, and the development of new policies on foreign aid. Is that right?

Mr. BALL. That is right, sir.

Representative REUSS. Don't you think it would be useful if a fourth goal were added to OECD's functions at the proper time—and the proper time may not be far off—to work out institutional arrangements for meeting problems caused by payment surpluses and deficits.

Mr. BALL. I should refer to the working party on payments which has been set up under the Economic Policy Committee. A good deal of this can be accomplished under this nine-member group that has been created here.

I would think, Mr. Chairman, that we are in an area where we ought to proceed with a good deal of pragmatism, a kind of empirical spirit because we are moving toward a new plane of cooperation with our European friends. We are moving into a kind of much more intimate discussion and agreement on our domestic policies and on our monetary policies than has been the case before. Just how we institutionalize this, if we do, is something I think should come later rather than now.

In other words, I think the first thing is to establish the atmosphere and the general forum where these things can be worked out and I think this is being done.

Representative REUSS. You agree there is a need right now for evolving pragmatically some institutional arrangement which can deal with payments crises such as we had last September.

Mr. BALL. I think that the working party on payments can be most helpful in that regard and that includes not only the senior Treasury officials but the central bank officials so that this is an area in which there can be this kind of a converging policy.

Representative REUSS. The working party can be most helpful in proposing a set of arrangements which can handle the problem. You aren't suggesting that the working party in and of itself is such a body.

Mr. BALL. It is becoming a body, I think, where it serves as a mechanism for the consultation on policy. What kind of offspring it may have itself or propose to the OECD I think is a matter which we should proceed on with a good deal of care. We should give a good deal of thought to it.

Representative REUSS. Some have suggested that payment arrangements between the advanced industrial nations would be best handled through some institutional organization other than the International Monetary Fund on the ground that the use of International Monetary Fund resources by the advanced countries will diminish the Fund's value for the developing countries.

In your paper you have some very good points about the special needs of the undeveloped countries.

Would you care to comment on the thesis I have just advanced?

Mr. BALL. There has been a good deal of discussion of this question, and I recognize it. I think it would be a little premature for us to express a view on exactly how this should be done. We are giving it very careful thought.

I know that not only in the Department but also in the Treasury and in the Council of Economic Advisers we are considering the whole set of relationships here and where the emphasis of effort should be. But I think it would be rather a premature thing for me to express my views now.

Representative REUSS. You have also commented on the need for providing better markets for primary producing countries, one commodity countries and so on.

In that connection, let me ask you this. Is there not some hazard that the Common Market, with whatever auxiliary arrangement it may make for the former colonial countries of Africa, might leave Latin America out in the cold and should we be recognizing this and doing what we can to mitigate it?

The only thing we can do to mitigate it as you have said, is to see that the Common Market is as liberal as we can make it.

Mr. BALL. We are trying to do something more than that. We have had a series of discussions with both the British and the French Governments with regard to this problem, and we are setting up a working party at the technical level to consider what can be done about it in which the British Government, the French Government, and the European Economic Commission should all participate.

I think one of the approaches to this that may be the most beneficial is not to look at these two great preferential systems—the Commonwealth system on one hand, and the system of preferences which results from the relations between the Common Market and the associated oversea territories on the other—as things which have to be frontally approached, but rather to make a commodity-by-commodity examination of what can be done to provide for a nondiscriminatory free entry of certain tropical products into the Northern Hemisphere countries on a basis where all the producers will have the same free access.

This is a question which, as I say, I have undertaken to discuss with both the French and the British Governments. We have had some long talks about it. I don't know just what is going to come out of it, but we are actively pursuing the possibilities. It is complicated. It has to be tied in, in many instances, with some proposals for bringing new flexibility into market arrangements for individual commodities. But I can assure you, sir, we are giving this a great deal of thought and study, and there is some discussion going on with our friends in Europe with regard to this problem.

Representative REUSS. It sounds like an extremely sensible approach. As you carve out these important primary commodities from the area of discrimination, you certainly take the sting out of such arrangements.

Another thing that I read that you are doing which I certainly want to commend you on, is an attempt to secure entry for the light manufactured products of certain developing countries, like India, for example, to areas in Western Europe where they are now pretty well excluded.

Mr. BALL. This is something which we must do progressively because I think the problem is going to get far more serious before it gets better.

Representatives REUSS. Senator Pell?

Senator PELL. I have no questions.

Representative REUSS. Thank you very much, Mr. Ball. We appreciate your help.

We stand adjourned until 10 o'clock tomorrow morning at which time we shall hear in this room officials of the Federal Reserve Bank of New York.

(Whereupon, at 4:30 p.m., the committee adjourned, to reconvene at 10 a.m. on Tuesday, June 20, 1961.)

INTERNATIONAL PAYMENTS IMBALANCES AND NEED FOR STRENGTHENING INTERNATIONAL FINANCIAL ARRANGEMENTS

TUESDAY, JUNE 20, 1961

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND
PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The joint subcommittee met, pursuant to recess, at 10 a.m., in the Old Supreme Court Chamber, room P-63, the Capitol, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss, Senator Douglas, Senator Proxmire, Senator Pell, and Senator Javits.

Also present: John Lehman, deputy executive director and clerk; and Emile Despres, Lorie Tarshis, and William Salant, staff consultants.

Representative REUSS. Good morning.

The subcommittee will come to order for a continuation of the hearings on international payments and exchange.

This morning we are privileged to hear from representatives of the Federal Reserve Bank of New York. We had invited Mr. Alfred Hayes, the president, as well as his associates, Mr. Coombs, Mr. Sanford, vice presidents, and Mr. Trued, manager of the foreign department. But Mr. Hayes, unfortunately, has a virus infection and asked that he be excused.

We are very happy, however, to have his statement, and to have present here the other gentlemen. And I think we will proceed in the usual way.

You have a prepared statement from Mr. Hayes?

Mr. COOMBS. Yes; I do, Mr. Chairman.

Representative REUSS. We would like to admit that to the record. And I would ask you to proceed briefly, either to read it or to summarize it as you see fit.

STATEMENT OF ALFRED HAYES, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK, AS PRESENTED BY CHARLES A. COOMBS, VICE PRESIDENT; ACCOMPANIED BY HORACE L. SANFORD, VICE PRESIDENT, AND MERLYN N. TRUED, MANAGER, FOREIGN DEPARTMENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. COOMBS. All right, sir.

I want, first of all, to thank you for the privilege of appearing before the committee. Mr. Hayes asked me to express his great regrets that he was unable to appear personally. And, if you don't mind, I will read through the statement.

Mr. Chairman and members of the subcommittee, I consider it a privilege to have the opportunity to file this statement with the Subcommittee on International Exchange and Payments of the Joint Economic Committee of the Congress. My associates who will appear at the hearing this morning are Charles A. Coombs and Horace L. Sanford, vice presidents, and Merlyn N. Trued, manager, foreign department, Federal Reserve Bank of New York.

In creating the Subcommittee on International Exchange and Payments, the Joint Economic Committee has recognized the need for periodic review of United States international financial policy and, more generally, of the performance of the international financial system. Certainly the experience of the last few years has impressed upon all of us the necessity of continuing intensive study of the very complex problems we face in this area.

For many years after World War II the U.S. economy was alone equipped to supply the goods and services so urgently required by a war devastated world, and the resultant dollar shortage forced many foreign governments to impose severe controls over trade and capital transactions with this country.

Today, the economies of Europe and Japan—assisted by generous U.S. aid—have not only fully recovered but have moved on into a new phase of dynamic expansion. Their resurgent economic strength has permitted the restoration of currency convertibility and the dismantling of most discriminatory exchange controls against the dollar. They have made major progress, as we have so often urged, toward a closer relationship of their commodity and financial markets with our own. But our very success in thus stimulating the recovery of Europe and Japan, and the liberalization of trade and payments among the nations of the free world has brought in its train a whole series of new problems.

From the experience of the past year, it has become abundantly clear that national economic and financial policies can no longer be based solely upon domestic considerations; they must also take into account potential repercussions in the exchange markets and the balance of payments. As the major foreign currencies have regained their strength and prestige, and facilities for capital transfers have become more readily available we have now to face the problem of dealing with large-scale and potentially disruptive, flows of short-term funds and other payments from one financial center to another. Further, the United States and, more recently, other developed countries, have undertaken to support massive programs of economic development in those vast areas of the world where an intolerably low standard of living still prevails. But unless the financial burden of this development effort is equitably shared among all countries capable of supplying capital and other assistance, the dollar, and indeed the entire international financial structure, could be subjected to excessive strain.

We thus face a wide range of new and perplexing problems to which there are no easy answers. The defense of the dollar is a job for all of us, since it depends, basically, on the maintenance of a sound and growing American economy. In the area of monetary policy, the Federal Reserve system must continue to seek to promote maximum sustainable economic growth. For the period immediately ahead, the System must continue to encourage the forces of recovery while at the same time guarding against the reemergence of inflationary forces as the recovery progresses. Proper fiscal and debt management policies are highly important; there is a danger that too great a burden will again be placed on monetary policy if budget deficits that were appropriate during a period of recession are allowed to persist during a phase of the business cycle in which such deficits would be inappropriate. Defense of the dollar equally requires the most serious efforts by both labor and management, and a growing awareness by the public generally that the American economy is not isolated from the rest of the world. The sellers' market of the early postwar period has become a part of history, and the vigorous competition of today serves as an additional warning that costs must be kept down and productivity increased if the United States is to retain its role as a leading exporter in world markets. These competitive forces have not been without a healthy influence on our domestic price structure, and there is hope—provided we keep our own house in order—that a period of sustained growth with reasonable price stability lies ahead for us and for the other leading countries of the world.

To some students of international finance the challenge appears so formidable as to require sweeping reforms in the international financial system itself. I do not agree. In my view, there is no reason to fear this new era of international competition and currency convertibility, nor to shrink from the challenge posed by the development needs of Latin America, Africa, and Asia. For me, the key to all these problems lies primarily in the formulation of appropriate policies and in their coordination through international consultations, rather than by radically transforming existing institutional arrangements. This is hardly intended to suggest that the present international financial system does not suffer from certain weaknesses and I shall mention later some modifications which I think are needed.

The present international financial system is, of course, the result of gradual evolution over many years. The cornerstone of the whole structure is the link between gold and the U.S. dollar, with the dollar firmly anchored by its interconvertibility with gold at a fixed price of $35 per fine ounce. Most other governments in the Western World have established with the International Monetary Fund par values for their currencies in terms of either gold or the dollar, and monetary authorities generally are committed to maintaining these par values by buying or selling dollars in their exchange markets to maintain the rates for their currencies within a relatively narrow range.

This network of fixed exchange rates has greatly facilitated the growth of international trade and capital movements, and has thereby contributed to the increasingly close integration of world trade and payments.

In this international system the United States plays the dual role of the most powerful trading nation and the foremost banker for the rest of the world.

The role of the United States as the world's leading trader is based upon many factors—the massive raw material requirements of our factories, the high consumption demands of our people, the competitive strength of many export industries, an abundant flow of private savings into investments abroad, and sizable governmental programs of foreign economic aid. The growth of our foreign trade has been further strongly stimulated by U.S. Government policy which has consistently sought to minimize artificial barriers to trade and payments between our domestic market and the rest of the world. Last year our total payments and receipts came to some $57 billion, with receipts falling short of the payments by $3.8 billion or, roughly, 13 percent.

I am sure that many competent witnesses have already provided you with an exhaustive analysis of our balance-of-payments experience during recent years, and I shall try to highlight only a few points which, to me, seem particularly important.

As you know, the deficit position of 1960 was not something new. Indeed, such deficits have been a characteristic feature, except in 1957, of our balance of payments for more than a decade. Prior to 1958, however, these deficits generally ran in the magnitude of $1 to $2 billion and served the highly useful purpose of reconstituting foreign dollar balances and securing a more appropriate distribution of gold stocks. Such deficits, in fact, were instrumental in helping to bring about the rapid expansion of international trade and investment, the dismantling of discriminatory controls abroad, and the retoration of currency convertibility by the leading Western European countries at the end of 1958. While some might be tempted to criticize what seemed a delayed awakening by the United States to its growing balance-of-payments problem, full recognition must be given to the changing nature of the problem during these transitional years.

By late 1959 it was reasonably clear that convertibility was a solid success and that most of the leading trading nations had so reconstituted their international reserves that they had little need to build them up further. Moreover, there had been a very sizable increase in the dollar working balances in the hands of private foreign interests, and, with the restoration of confidence in European currencies, there was an increasing tendency for funds to flow to foreign financial centers where interest rates were most attractive. In this new context, and particularly with declining interest rates in the United States in 1960, the continuing balance-of-payments deficits of the United States took on a more ominous aspect. The storm signals had been raised.

I do not believe it is necessary to review with this group, in any detail, the various measures that were undertaken to defend the dollar. While I would reject the tying of U.S. foreign aid to the American market as a basic long-run principle of our aid program, I believe that the moves which have been taken in that direction since late 1959 are entirely appropriate under the circumstances.

Subsequent measures and proposals designed to secure a more equitable sharing with our allies of economic and defense aid outlays, to stimulate exports, to economize on military expenditures abroad, to prohibit private U.S. ownership of gold abroad, and to reduce the duty-free allowances for returning tourists were all highly desirable. In addition, various official statements, especially President Kennedy's message on balance of payments and gold to the Congress in February of this year, had a highly beneficial effect, providing impressive reassurance to the world of our determination to defend the dollar.

I have been particularly gratified that recourse to restrictive trade and other controls has had no part to play in this program. Continued efforts are still necessary to eliminate restrictions against U.S.

exports and to encourage a number of countries to make their capital markets more freely accessible to foreign borrowers.

We would only hurt ourselves by turning our backs on the principles of liberal trade and unrestricted international payments for which we have stood. Much still needs to be done to create a sufficient awareness of the need to expand our exports. It is encouraging, however, that there are indications of a more vigorous pursuit of foreign markets. I have full confidence in the ability of American labor and management to rise to the challenge, with benefits to all concerned.

I should now like to turn to the role of the United States as banker for the rest of the free world. As a central banker, I am, of course, particularly concerned with this banking function of the United States and with the role of the dollar as an international reserve currency. The Federal Reserve Bank of New York now maintains accounts for 97 central banks and monetary authorities throughout the world, and this brings us into close day-by-day contact with the many complex problems facing the dollar as a reserve currency.

As of the end of 1948, foreign official holdings of gold and dollar reserves amounted to $8.8 billion and $2.8 billion, respectively. Since then, there has been an impressive rise in both types of reserve assets, with foreign official holdings of gold amounting, as of the end of March 1961, to nearly $21 billion, while official dollar reserves had risen to somewhat more than $11 billion as of the same date. We hold earmarked in our vaults in New York $9.5 billion, or nearly one-half of total foreign official gold holdings, and also hold for foreign official account roughly $6.5 billion of dollar balances and other liquid dollar assets. In addition to these official dollar holdings, foreign private and international holdings now amount to about $12 billion.

It is important to note that the $11 billion in official short-term balances is convertible into gold on demand. Balances held by foreign private interests, as well as those of domestic holders, acquire the convertibility privilege if they are shifted into foreign official accounts. Since the United States stands ready to convert at a fixed price, foreign official dollar balances into gold on demand, these dollar balances are regarded by foreign countries as equivalent to gold itself and hence have been included in their official reserves. By thus serving as the banker for such a gold-exchange or dollar-exchange system, as it is sometimes called, the United States has made possible a massive reinforcement of international liquidity upon which the free flow of world trade so heavily depends.

There are many reasons why the dollar has acquired this status as a reserve or key currency and, of these, I would mention particularly its stability, its interconvertibility with gold, its widespread use in financing world trade, and the availability, in New York, of financial markets of unparalleled size and efficiency which permit dollar holdings to be readily put to work.

These factors were instrumental in establishing the dollar equally with gold as the reference point for setting par values for other currencies with the International Monetary Fund. The emergence of the dollar as a key currency has been mainly a postwar phenomenon, although it had its beginnings in the prewar period when there was a massive inflow of capital from abroad in search of a safe haven.

It may be noted that the conditions which have made the dollar a reserve currency were not fostered solely, or even largely, for that purpose. Rather they are an integral part of our market economy and the result of our efforts to achieve much broader goals. The reserve currency status of the dollar thus ultimately flows from and depends upon the preeminent role of the United States in international trade and finance, a role which can be fulfilled only by continuing adherence to sound economic and financial policy. Any undermining of confidence in our ability to keep our financial house in order—any slackening of resolve in the pursuit of monetary stability or any weakening of fiscal responsibility—could result in a severe blow to the dollar as a reserve currency and, in fact, to the entire international financial system.

This would be a development that would prejudice our economic well-being in the broadest sense by undermining the base on which so large a share of world trade and payments now depends. We, therefore, have a responsibility—and one not without advantages—which we have met, and should continue to meet, with a resolution equally as firm as that required for leadership in the security and economic progress of the free world.

Since 1959 the United States has faced a new problem of insuring, in an increasingly competitive world market, a sufficient volume of exports and other earnings abroad to finance our import requirements, our military expenditures abroad, our foreign aid programs, and our foreign investment activities. Simultaneously, we have had to guard against the very real risk that the volume of our short-term dollar liabilities, in our role of banker for the rest of the world, might grow so rapidly in relation to our gold stock as to create doubts as to our ability or willingness to pay out gold on demand.

This dual problem, which has involved striking an appropriate balance in our economic and financial policy decisions between domestic and international considerations, has been a matter of concern to the Federal Reserve System for some time past.

As the U.S. economy moved into recession in 1960, the problems of reconciling the domestic and international objectives of monetary policy became a very real and immediate issue. While domestic business conditions clearly required an easy money policy, the ever-present threat of sizable outflows of funds to foreign financial centers made it essential that short-term interest rates should not be permitted to decline to the low levels that had prevailed during comparable phases of the business cycle in 1958 and 1954. Here was a clear-cut example of the possibility of conflict in policy objectives that can emerge in the competitive and convertible world of the 1960's.

The domestic situation called for supplying the commercial banks of the country with additional reserves not only to meet their seasonal needs cutomarily arising in the second half of the year but also to improve their liquidity and encourage them to make more loans. Vast purchases of U.S. Treasury bills by the System would have unduly raised the price and depressed the yield of such securities, and thereby would undoubtedly have stimulated a further outflow of funds from the United States.

Accordingly, the Federal Reserve furnished the banks with a large amount of reserves in other ways than by Federal Reserve purchases of short-term Government securities. In several steps timed to meet seasonal needs, the commercial banks were authorized to count currency and coin held by them as part of their reserves, and the reserve requirements for banks in central reserve cities were reduced to make them the same as the requirements for banks in Reserve cities, thus bringing about in 1960 a uniformity required by law not later than in 1962.

In addition, beginning in October, open market operations were undertaken in short-term Government securities other than bills. Then, in February of this year, the System broadened the maturity range of its operations to include purchases of intermediate and longer term securities. Such securities were purchased by the System to supply reserves on balance as well as to offset the loss of reserves that otherwise would have resulted from the sale of short-term Government securities designed to counteract downward pressures on short-term rates. Of course, they were intended also to facilitate the flow of longer term funds into productive investments.

While many other factors were also involved, I feel certain that these System actions were important in preventing further declines in the rate on the key 3-month Treasury bill. Over the last 9 months the 3-month Treasury bill rate has been within a range of 2⅛ to 2⅝ percent; during most of the time the range was 2¼ to 2½ percent. This compares with the five-eighths percent rate reached in both 1954 and 1958.

The mere fact that it was widely recognized, both at home and abroad, that the Federal Reserve was actively concerned with the problem of relative interest rates was a reassuring factor in the exchange and money markets. To sum up Federal Reserve experience, I feel that in 1960–61 we were able to reconcile the apparently conflicting demands of the domestic and international situations through a flexible adaptation of our existing techniques. Future conflicts may prove more intractable, however, and we must be ever alert in the search for policies and techniques that will best serve the Nation's overall interests.

The letter inviting me to appear before this committee raised a question as to the significance of the international currency movements of the past year as the result of speculation and of differences in money rates. I believe I have already indicated that the role of the dollar as a reserve currency means that the United States must constantly face the possibility of pressures arising from short-term capital movements and other abrupt changes in the flow of payments, and of resulting demands on our gold stock.

It was such movements of funds, superimposed upon basic balance-of-payments deficits, that created serious problems in the fall of 1960 for the United States and, more recently, for certain European countries. In a reverse sense, such flows have caused difficulties for recipient nations, including particularly Switzerland and Germany. International capital flows will continue to take place as part and parcel of the free world economy we have ben striving so hard to build; the price of eliminating them would be to slide back into pervasive and rigid controls. Over the years I feel sure that the United States will have to face not only problems arising from undesirably large outflows of short-term capital but also those arising from massive inflows.

In my view, there are two major problems associated with short-term capital movements. The first problem involves the possibility that such movements will feed upon themselves and encourage speculative forces which could imperil a currency and, by causing disorderly exchange markets, disrupt trade and other financial transactions. The second is the possibility that such movements might threaten a reduction in the liquidity required by a particular country to sustain other trade and financial transactions. I believe there are means available to meet successfully these twin threats to currency stability and liquidity—and within the framework of the present international financial structure.

The importance of confidence in the underlying soundness of international currency relationships cannot be stressed too often. We must make sure that the rest of the world can have no doubt about the soundness of the dollar. If there is any basis for suspicion that we have relaxed our guard, techniques designed to insure international currency stability and liquidity can give only temporary relief. Techniques alone cannot solve problems for us, although proper techniques are essential for such solutions.

The first line of attack, therefore, involves clear and frank recognition on the part of all countries of the importance of international factors in the shaping of domestic monetary and fiscal policies. As mentioned earlier, for the United States this is a relatively new consideration, but it has been a real fact of life to most countries for many years. Over the past few months, to cite a limited period, foreign monetary authorities have taken a number of important measures with international considerations in mind. I would note, for example, that since last fall the Bank of England has twice reduced the bank rate, while the Deutsche Bundesbank has made three such reductions, together with substantial releases of additional reserves to the German banking system. This relaxation of credit restraint in the United Kingdom and Germany, while the U.S. Treasury bill rate has held firm around the 2¼-percent level, has resulted in a significant narrowing of international interest rate differentials.

In all probability, however, coordination of national monetary policies cannot in many instances prevent interest rate spreads from reaching a magnitude sufficient to induce short-term capital flows from one financial center to another. Furthermore, we face the ever-present possibility of speculative pressures arising not only from fact but also from mere rumor, which can readily induce massive shifts of "hot money" in search of a safer haven. During recent months we have gained a great deal of useful and encouraging experience in the potential effectiveness of central bank cooperation to cushion and reverse such speculative capital movements.

During the early months of this year there was a further growth of speculation in the exchange markets on the possibility of revaluation of one or more European currencies. As a result, funds initially attracted to certain European markets by considerations of higher interest earnings or capital appreciation were strongly augmented by a wave of speculative transfers across the exchanges. These speculative anticipations were partially confirmed by the revaluations of the German mark and the Dutch guilder on March 6 and March 7, respectively. Far from inducing profit taking and a return flow of such speculative funds, however, the short-run effect of the revaluations was to excite still further speculative anticipations of further readjustments in European currency parities. To meet this threat to orderly and stable exchange markets, a group of central bankers at their monthly meeting in Basle, Switzerland, issued on March 12 a declaration of mutual support and cooperation. Such cooperative action has involved not only financial support to the currencies under attack but also a variety of coordinated operations on the foreign exchanges. Recently, as you know, the United States has undertaken certain exchange operations, notably in the forward market for German marks. These operations appear to have served a most useful purpose in sustaining stable and orderly exchange markets.

Representative REUSS. At that point, these operations in the forward market involved the sale of marks?

Mr. COOMBS. These involved the sale of marks; yes, sir.

I might add in this connection that yesterday we also began operations in spot marks.

This cooperation has helped not only to temper speculation but has also provided a means of promptly reinforcing international liquidity in the required amounts. It would be my hope that close study of this heartening experience will suggest additional important steps which could be taken to broaden and regularize a system of intercentral bank cooperation. The United States will need to cooperate in the exploration of such steps and to consider the extent to which its participation in them would be required to assure their success.

It would be a mistake, however, to think of any system of central bank cooperation in the form of reciprocal credits as a substitute for the credit facilities now available from the International Monetary Fund. Intercentral bank credits are essentially of a short-term nature and the reversal of certain types of speculative capital flows may well require a somewhat longer period of time and possibly greater resources. In such circumstances, I would hope that access to the medium-term credit facilities of the International Monetary Fund would not be impeded by possible inadequacy of Fund supplies of certain currencies or by an unduly narrow interpretation of the eligible uses of the Fund's credit facilities.

In this connection, I have been encouraged by the consideration that is now being given to certain reinforcements of the Fund's resources and to a clarification of uncertainties as to the availability of Fund resources for meeting reserve drains generated by short-term capital movements. On the matter of expanding the Fund's resources, various proposals have been made. In my mind, the most promising approach is that recently suggested by Mr. Per Jacobsson, the Managing Director of the International Monetary Fund, for the establishment of a system of dependable but limited standby credits to the Fund by the major industrialized countries likely to be subject to major flows of capital among their financial markets.

In conclusion, I should like to venture some comments on the question of the longer term problem of insuring an adequate growth of international liquidity over the years. It is sometimes contended that if we succeed, as we must, in restoring balance-of-payments equilibrium, our very success will operate to the disadvantage of the rest of the world by limiting the amount of liquidity that will be added to the international financial system.

I question seriously any such conclusion. Certainly there is at present a fully ample stock of world liquidity in the form of gold and foreign exchange balances and other forms of credit. While the rate of new gold production over the years may slip somewhat behind the growth of world trade, there is no particular reason to assume that world liquidity needs will rise automatically and proportionately with trade and investment. Just as we have developed within our economy increasingly efficient uses of money and credit, so also similar possibilities are available internationally through cooperative arrangements which will not impair the individual responsibilities of each country. Moreover, while the United States must keep its balance of payments under firm control, this does not preclude moderate flows of dollars abroad when such movements would serve a constructive purpose.

Furthermore, to the extent that the United States may find it desirable to accumulate foreign exchange balances, new sources of liquidity would be opened up.

In this connection, it is important to recognize that liquidity should not be defined narrowly with reference solely to existing stocks of gold and foreign exchange but should also be taken to include private and governmental credits, the intercentral bank credit facilities I have discussed, and the resources of the Monetary Fund.

If, therefore, domestic policies are appropriate and fashioned with due regard to international realities, and if means to deal with short-term capital flows are available and adequate, there is no reason, in my judgment, why the international financial system cannot work satisfactorily for at least the foreseeable future. I would thus conclude that there is no present need for far-reaching reforms which would basically alter the present financial structure, practices, and institutions of the world.

Representative REUSS. Thank you, Mr. Coombs.

For the benefit of those in the hearing room who may have come in late, Mr. Alfred Hayes, due to illness, was unable to be here this morning, and his statement was read by Mr. Charles A. Coombs, vice president of the Federal Reserve Bank of New York, who is here to testify along with another vice president, Mr. Horace L. Sanford, and Mr. Merlyn M. Trued, manager of the foreign department of the New York Federal Reserve Bank.

In accordance with our previous discussion, Mr. Coombs, it probably will be necessary presently that we ask a number of questions concerning current operations of the Federal Reserve Bank of New York which, for obvious reasons, will be asked in executive session.

However, before getting to that, there are one or two questions which we would like to put to you in open session.

I would like to refer to your statement where you recount the measures taken last fall to create a higher interest rate on U.S. securities, and thus narrow the interest disparity between short-term rates here and abroad and lessen the danger of a flight of short-term capital.

You list as a step taken in that direction your implementation in the autumn of 1960 of the law of Congress permitting the reduction of the reserve requirements for banks in the central reserve cities, New York and Chicago.

Now, in fact, did that move accomplish what you apparently hoped to accomplish by it? I should think that the lowering of the reserve requirements of the big banks in New York and Chicago at a time of recession such as was the case last fall did not enable them markedly to increase their loans but instead led them immediately to buy 90-day bills and other short-term U.S. securities, with consequent direct downward pressures on short-term yields. What about that?

Mr. COOMBS. I wish I could give you a direct and detailed answer on that, Mr. Chairman. The unfortunate fact is that most of my time is devoted to foreign operations. I do not follow the domestic side of it, obviously, nearly as closely as do Mr. Rouse, Mr. Treiber, and Mr. Hayes.

It is my understanding from what they have said that it was effective.

But I am sorry I can't give you the details at this time to prove that it was effective.

Representative REUSS. I am not being fair to you in going into what was a domestic operation when you are in foreign operations.

However, you might convey to my friends in New York my skepticism as to this particular move. I think it may have gone 180° in the wrong direction, and they may want to set me straight if they stick to their guns and disagree with me.

Mr. COOMBS. I will convey your interest and comments.

Representative REUSS. Senator Douglas?

Senator DOUGLAS. There is just one question I would like to ask. What is your estimate of the current annual increase in the gold supply excluding possible increases in the Soviet Union?

Mr. COOMBS. About 2 percent a year. I think it is $1.1 or $1.2 billion.

Senator DOUGLAS. And this is a 2-percent increase?

Mr. COOMBS. Roughly.

Senator DOUGLAS. At what rate is the real gross national product of the free world increasing?

Mr. COOMBS. There are a good many countries, of course, for which adequate statistics are not available. Growth rates in the countries for which there are reasonably good figures seem to range anywhere from 2, 3, 4, up to 5 or 6 percent.

Senator DOUGLAS. Well, excluding Asia and Latin America and Africa, taking Western Europe and the United States, wouldn't the average increase be somewhere around 3½ to 4 percent?

Mr. COOMBS. I would think that would be a pretty fair guess.

Senator DOUGLAS. It is lower than 3½, around 2½ in the United States and Great Britain, and over 4 on the Continent of Western Europe; isn't that correct?

Mr. COOMBS. I think it varies from time to time. In certain years, of course——

Senator DOUGLAS. In the last 5 years.

Mr. COOMBS. I don't have the average at the moment.

Senator DOUGLAS. Isn't that approximately correct?

Mr. COOMBS. Certainly the rate of growth in Germany, France, Italy, and Japan has been very rapid indeed during the past 10 years.

Senator DOUGLAS. And West Germany?

Mr. COOMBS. I am sorry, I thought I had mentioned Germany.

Senator DOUGLAS. West Germany, France, Italy, and Japan.

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Now, if this is so, we will have to have restrictions on the use of gold or the creation of additional monetary purchasing power to offset the slower rate of growth in the gold supply than in the real gross national product; isn't that true?

Mr. COOMBS. Yes, I think that we can count upon a 2-percent annual increase in gold. In this connection, it might make quite a bit of difference depending upon where the gold flows. If the United States needs no more newly mined gold, the flow to the rest of the world might mean not 2 percent but closer to 4 percent in relationship to their existing gold holdings. There is, I think, a possibility of further gradual growth, at our discretion, of dollar balances. There is also a possibility of further growth in the availability of credit facilities.

Those three sources of liquidity in conjunction would seem to me to provide reasonable hope of taking care of whatever may be the increase in liquidity requirements of the free world resulting from the growth in trade and payments.

Senator DOUGLAS. Do you have any information on the production of gold in the Soviet Union?

Mr. COOMBS. The guess is that it is currently running at about $300 million a year. But that is guesswork.

Senator DOUGLAS. Does any of that get into the Western World and not entered on your books?

Mr. COOMBS. We haven't taken in any here. Most of it is sold in Western Europe, in amounts ranging over the past 4 or 5 years between $200 and $300 million.

Senator DOUGLAS. $200 and $300 million a year?

Mr. COOMBS. That is right.

Senator DOUGLAS. Which they use to buy commodities from Western Europe?

Mr. COOMBS. Yes—anywhere in the world. The rate of sale during recent months seems to have been somewhat heavier.

Senator DOUGLAS. Is that included in your figure of $1.1 billion total increase?

Mr. COOMBS. That is not part of the increase.

Senator DOUGLAS. So that if it is included that would make an increase of about 2½ percent?

Mr. COOMBS. Approaching 2½; yes, sir.

Senator DOUGLAS. I take it by your response you feel that it is not necessary to develop new methods for settling international balances, that the increase in gold plus the accumulation of dollar reserves will be adequate.

Mr. COOMBS. Plus central bank credit facilities, and, I think most important of all, expansion in the resources of the International Monetary Fund.

Senator DOUGLAS. How would those be obtained?

Mr. COOMBS. As indicated in the statement, we believe that the most effective approach would be for the Fund to negotiate with the major industrial countries of the world a series of standby credits which would enable the Fund, in times of shortages of individual currencies, such as marks and so on, to obtain additional supplies of those currencies.

The quotas of some European countries, notably Germany, and also Japan, are probably on the low side in relation to their role in international trade and payments at the moment.

Senator DOUGLAS. Do you advocate our contributing more to the more to the Monetary Fund?

Mr. COOMBS. I have a hunch that it would have to be a joint operation in which we would have to do our part. I would assume, however, that in view of the very sizable U.S. quota, the chances might be less that a standby given by the United States would be drawn upon than it might be in the case of some of the other countries.

Senator DOUGLAS. Do you think Great Britain should contribute more to the Monetary Fund?

Mr. COOMBS. Yes, I think that the United Kingdom might well find it advantageous to do so in return for the greater credit facilities it would enjoy, if the other countries went along with a series of standby credits. It is a quid pro quo argument.

Senator DOUGLAS. The statement is sometimes made that the one way to get great international liquidity is for governments to run deficits. Do you agree with that?

Mr. COOMBS. You mean balance-of-payments deficits?

Senator DOUGLAS. Yes.

Mr. COOMBS. No; I rather have the feeling that it is the surest way of destroying international liquidity. If the United States were to continue to run massive balance-of-payments deficits and made no efforts to correct them, we would bring down in time our own financial structure and induce a flight into gold of all the dollar resources capable of so moving.

Senator DOUGLAS. It has also often been said that the way to create national liquidity is for governments to run budget deficits. Would you agree with that?

Mr. COOMBS. No; I don't see the connection—unduly large budgetary deficits could clearly create speculation on the exchanges, and conceivably, through inducing conversions into gold, create the same tendencies toward a contraction of liquidity.

I don't quite see the connection.

Senator DOUGLAS. I have never been able to see the connection myself.

You have studied the so-called Bernstein plan and the Triffin plan?

Mr. COOMBS. Yes; we have. The Triffin plan has many variances, I have found. There have been many additions made to it. I am never quite sure what the latest version is. We have certain objections to the Triffin plan. Possibly in the executive session I might be able to speak more fully on that one.

I think that we would favor the general principle of the Bernstein plan. Whether the mechanical arrangements involved in the Bernstein plan of issues of debentures by the Fund and a reserve settlement account, which is in a sense distinct from the Fund, whether this is preferable to simple standby agreements which would add to the resources of the Fund and in a sense be commingled with the other resources of the Fund, and would also be subjected to the same standards as the Fund applies to the average run of drawings; of these two I think we should be inclined to favor the standby arrangement, but we should like to give it much further study.

Senator DOUGLAS. In other words, the power to draw upon balances held by the several banking authorities in the various countries, but not formally turned these funds over to the IMF?

Mr. COOMBS. I am not sure that I fully understand your question, Senator.

Senator DOUGLAS. Who would hold title to those funds in the interim under the standby agreement? Would it be the central banking authorities of the various countries?

Mr. COOMBS. The central banks, or the treasuries, or the monetary authorities—I presume what would be meant by standbys—they would undertake to stand ready to supply additional credit to the Fund if they were called upon to do so.

Senator DOUGLAS. In the meantime, these funds, if invested, would be drawing interest——

Mr. COOMBS. They would not be available, in my understanding.

Senator DOUGLAS. What?

Mr. COOMBS. My understanding is that the funds would not be available; they would be a standby.

Senator DOUGLAS. They would be sterilized?

Mr. COOMBS. They simply wouldn't be paid into the Fund.

Senator DOUGLAS. I understand.

What would happen in the meantime?

Mr. COOMBS. There would be a contingent claim upon the foreign central bank or treasury. It would undertake, if necessary, to provide money if called upon by the Fund to do so.

Senator DOUGLAS. They would not be invested?

Mr. COOMBS. No.

Senator DOUGLAS. In other words, they would be sterilized?

Mr. COOMBS. It would be, in effect, a contract to supply the funds when required. The funds would not exist, in effect, until they were called upon to provide them.

I must confess that I have not participated in the discussions on the subject, and am not familiar with the details of it. And the opinions which I am expressing are in terms of principle rather than in terms of the detailed mechanics of any of these plans.

Representative REUSS. At this point, I think we will go into executive session, because we do have some questions on very current matters.

The afternoon session will be held in this room at 2 o'clock. Mr. E. M. Bernstein, of Washington, will be the first witness, followed by Mr. David Rockefeller, president of the Chase Manhattan Bank, and these other sessions are, of course, all open sessions.

(By mutual agreement the discussion in the executive session is made a part of the record, as follows:)

Representative REUSS. We will go into executive session.

There are present Senator Douglas and myself, Mr. Shay, the representative of the Federal Reserve System, the three gentlemen from the Federal Bank of New York, members of the staff of the subcommittee, representatives of Senator Javits and Senator Pell, and the court reporter. The record of this executive session will, for the present, be kept confidential.

The understanding is that the Federal Reserve Bank of New York will promptly review the transcript that we submit to them, and hope-

fully all or a large part of the testimony will shortly become eligible for full publication.

Mr. COOMBS. May I ask you what your publication schedule is? That could be a factor, too. This could be highly confidential a day or a week from now and much less so 2 months from now.

Representative REUSS. We would like to publish the transcript of these proceedings as soon as it can be edited. Today's transcript will be sent to you shortly, and I suggest that you tell us what is ready for immediate publication. If there are other things that have to wait awhile, you tell us, and we will wait awhile.

Mr. COOMBS. Thank you very much.

Representative REUSS. I would like to pursue the questions that Senator Douglas was asking.

You have said, Mr. Coombs, that the increase in the free world gold supply is not likely to equal the increase in the growth rates of the gross national products of the industrialized countries, nor is it likely to equal the growth in the world trade. However, you don't think that there will be a shortage of international liquidity. You also said that you don't believe that running further payments deficits is a good way of insuring adequate international reserves. I think your feeling there is——

Mr. COOMBS. We could possibly run moderate deficits, very moderate.

Representative REUSS. Your feeling there is that drastic deficits create many other problems, that this is a bad way of creating reserves?

Mr. COOMBS. It can destroy them.

Representative REUSS. However, in your proposed solution to the problem of future world liquidity, as I understand it, you rule out any method which would create additional reserves over and beyond those otherwise anticipated, and instead would attempt to meet the problem by more efficient use of the reserves which we in fact have, and the mild accretions thereto that you expect. Is that a fair statement?

Mr. COOMBS. Yes, it is.

Representative REUSS. What makes you think, that the more efficient use of reserves will bridge the gap and furnish the necessary total volume of reserves?

Mr. COOMBS. I would say, Mr. Chairman, that the main problem we face in terms of international liquidity is that of dealing with abrupt flows of funds from one country to another.

In part, this could be in response to difficulties on the trade side, deficits of a wasting nature of reflecting trade factors.

I have a feeling, however, that for some time to come, perhaps for the foreseeable future, that far more important problem of liquidity will be that resulting from capital movements.

Now, part of the efficient utilization of the stock of reserves throughout the world will involve the extension of credits by countries receiving these mass inflows to the countries losing them. This is one means.

We have already seen an experience since March in Europe of an extensive use of that technique.

The second means is by ready recourse to the International Monetary Fund.

So the countries in time have the assurance that if they do suffer losses of reserves, that they will be able to call upon others, other central banks, or the Fund to back them up.

Representative REUSS. I would like to ask the members of the staff to propose any questions that they may have.

Mr. DESPRES. I would like to ask a question, first of all, to clear up a bit the record on a question that you answered during the public session.

I think you said that the annual increase in free world monetary gold supplies was about $1.2 billion, apart from the Soviet bloc.

Mr. COOMBS. Right.

Mr. DESPRES. That figure, I thought, was about the figure for free world gold production, and in order to estimate the increase in free world monetary reserves, one has to deduct some $500 million for the absorption of gold into nonmonetary uses, which would bring the net increment down well below a billion. I think this was just a misunderstanding.

Mr. COOMBS. No, I was unconsciously netting out that demand upon gold output from free world sources against Russian production, which suppplies $250 to $300 million a year. There should be close to a billion available for official resources, I would say, if the countries of the free world so conduct their affairs as not to generate speculative private demand for gold.

If we are thinking in terms of years ahead, in making assumptions as to how much could be available from gold output, I would be inclined to set the figure close to a billion.

Mr. DEPRES. So that the net addition to free world monetary gold reserves from domestic production net of normal private absorption would be close to a billion dollars worth?

Mr. COOMBS. Yes. And, furthermore, there seems to me to be a distinct possibility that if things settled down—and I think there is some hope that that could be the case—through the coordination of policies, and stability in most of the countries of the world, that you might well find sizable dishoarding of gold, so there would be an additional supply there.

Senator DOUGLAS. The volume of International Financial Statistics as of June 1961 on page 19 lists the world total of gold production in 1960 as $1,175 million, at the U.S. rate of $35 per fine ounce. Now, I missed your statement as to what the nonmonetary uses of gold came to, how much is that a year?

Mr. COOMBS. It has varied widely. In 1960, it absorbed the great bulk of total output, mainly, I think, owing to the difficulties we ran into. We ran into estimated private use in 1960 of more than $1 billion.

Senator DOUGLAS. More than $1 billion?

Mr. COOMBS. Yes.

Senator DOUGLAS. Then I am unable to—I am quite unable to see how the world gold reserves for monetary purposes increased during this time by $1 billion. I would think that $1,175 million minus $1 billion would be $175 million.

Mr. COOMBS. It depends upon—are we speaking about the actual experience in 1960? As I understand your question, you are asking what is the likely availability of gold over the years to come? I think we can anticipate a certain growth in this gold.

Senator DOUGLAS. Well, let me ask you about 1959, what was the nonmonetary consumption of gold in 1959?

Mr. COOMBS. Total output in 1959 came to $1.125 billion, exclusive of Russian output. Additions to official reserves were $680, estimated private use about $700.

(Mr. Coombs subsequently supplied the following table for the record:)

Free world gold: Sources and uses, 1950–60

[In millions of dollars]

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960
Sources of new gold supplies:											
(1) Free world gold production	845	826	850	848	897	940	978	1,017	1,048	1,125	1,175
(2) Estimated Soviet gold sales [1]	------	------	------	140	35	70	150	260	210	255	[2] 210
Disposition of new gold supplies:											
(3) Increase in official gold holdings (including international organizations)	300	220	240	475	650	680	495	705	670	695	340
(4) Apparent "disappearance" of gold into use in industry and the arts and into private hoards. [(4)=(1)+(2)−(3)]	545	606	425	513	282	330	633	572	588	685	1,045
(5) Total official gold and foreign exchange holdings (including international organizations)	56,045	56,485	57,490	60,020	61,685	62,390	63,920	64,935	66,105	[3] 70,610	74,140
Of which, gold	35,355	35,575	35,815	36,290	36,940	37,620	38,115	38,820	39,490	40,185	40,525
(6) Annual percentage increase in official holdings of gold	.9	.6	.7	1.3	1.8	1.8	1.3	1.8	1.7	1.8	.8
(7) Proportion of total official reserves held in gold	63.1	63.0	62.3	60.5	59.9	60.3	59.6	59.8	59.7	[3] 56.9	54.7

[1] It is estimated that a small amount of gold was sold by the Russians in 1952, but no reliable estimates of the precise amount exist. There were apparently no Russian sales during 1950 and 1951.

[2] While sales through the London gold market fell to only $105 million, it is estimated that there were very substantial direct sales to the Continent.

[3] The large change in these figures reflects in good part the $3.8 billion increase in member-country currency subscriptions to the International Monetary Fund.

Sources: International Monetary Fund, International Financial Statistics, Balance of Payments Yearbook, and Annual Report; and Samuel Montagu, Annual Bullion Report. Estimated figures are also largely based on these sources.

Compiled by Federal Reserve Bank of New York

Senator DOUGLAS. So that the increase in the reserves of gold and foreign exchange was really only one-half of 1 percent or a net addition of about $400 million. This puts an entirely different complexion on it.

And even if you bring in the Soviet Union gold, the Soviet Union gold that finds its way into the free world through Switzerland and other sources, you will have an increase of only around three-quarters of 1 percent, and in the face of an annual increase in production in the Western World of not far from 4 percent or more, it seems to me that the problem is graver than I had inferred from your testimony in open session.

Mr. COOMBS. I don't think so at all, if you will excuse me, Senator, because as I understood the question it was, What sort of a comparison can we make for years to come?

Senator DOUGLAS. Years to come?

Mr. COOMBS. Years to come, not what has happened in these——

Senator DOUGLAS. There is no way to judge the future except by the past. And we are not going into the question of what is going to happen in the future.

Let me ask you this: Do the facts indicate that during these last years the increase in the monetary stocks of gold has been at a rate of less than 1 percent a year?

Mr. COOMBS. That, I think, in recent years would be roughly the case. But I would not agree that this is necessarily the case for the next 10 or 15 years, if the major countries of the free world manage their affairs successfully.

Senator DOUGLAS. Then you are basing this on hope rather than on what has happened.

Now, I do not object to that, but I thought your testimony was based on current happenings, or recent happenings.

Excuse me, Mr. Despres, I just wanted to pick this up, pick the line of thought up which you started. You go ahead.

Mr. DESPRES. The statement by Mr. Hayes mentions that during recent months a great deal of useful and encouraging experience has been gained relating to the effectiveness of central bank cooperation to deal with the hot money problem. Before we discuss all these matters, I think it would be useful for you to describe in as much detail as you can the arrangements and operations which it has been possible to work out through central bank cooperation during recent months. I take it this is in connection with the flights of funds and the movements of funds both preceding the mark and guilder revaluations and more particularly following these revaluations, and before we discuss the significance of these it might be well to get the facts as fully as you can describe them.

Mr. COOMBS. As you know, the speculation that had focused on the dollar in 1960 shifted during the early months of 1961 to the possibility that there might be currency readjustments within Europe. The most popular candidate for a currency readjustment was the German mark. It was widely known in the exchange markets that there were differences of view on this within the German Government. And this contributed to a buildup of speculative anticipations, and a sizable, continuing flow of funds into Germany.

The markets were nevertheless quite unprepared for the revaluations of the German mark which actually took place on March 6, and for the revaluation of the guilder which occurred on the following day. This left the markets virtually shellshocked, you might say and there was an enormous flow of funds across the exchanges in the matter of a week or two.

At the Basel meeting on March 12 of the Bank for International Settlements, at which most of the governors of the European central banks were present, the problem was discussed. They issued a statement, a public statement of mutual support and cooperation in the exchange markets; I think this was perhaps the first time they have ever done this. And they backed up this declaration with money. There were credits of various types extended by the European countries gaining funds to the countries losing funds. Those credits had a very useful stabilizing effect; and I might add that the cooperation shown by these European central banks in extending credits, the recipients of funds extending credits to the countries losing funds, had very important implications for the United States.

We were quickly given assurances by the European central banks with which we were in contact that they had no intention of following the revaluations of the mark and guilder, and that their intentions were to use the dollars taken in, in part at least, to supply credits to the countries losing funds. It was a truly remarkable display of cooperation, of protecting the international financial system, with direct benefits not only to the countries in Europe losing funds, but also to the United States.

Mr. DESPRES. The Secretary of the Treasury yesterday in his testimony referred to the recent forward operations in the deutsch mark as one of the operations designed to contribute to meeting this general problem. Could you explain that?

Mr. COOMBS. Yes, I can tell you something about that.

I go to these Basel meetings every month. I have been six times in the past 7 months, the trips being roughly 10 days each. And we have many discussions during these trips with my opposite numbers, the heads of the foreign departments, and discuss what we might do under a variety of contingencies.

We had discussed with the people of the Deutsche Bundes Bank various possibilities. When the crisis broke, the deutsche mark moved to a very sizable premium against the dollar. This, in itself, became a speculative factor in the market.

There were telephone conversations shortly thereafter between the Bundes bank and ourselves in New York.

I might add that in all stages of our operations the Treasury was fully informed, we telephoned back and forth constantly—when I say "we" I mean the Treasury, too.

And it was agreed that we would undertake sales of forward marks in order to bring down the premium on the forward mark, or reduce, that is, the discount on the forward dollar.

We feel that the operations had a decidedly tranquilizing effect upon the market in showing the readiness of the two central banks of the Governments concerned to back up, to give concrete proof of their faith in the maintenance of existing parities. It had the further important result of providing an alternative to German borrowing in New York, or the Euro-dollar market, in order to hedge against future dollar receipts.

Representative REUSS. I would like to ask a question at this point, if I may.

What notice did you and the Fed of New York or the Treasury have of the German revaluation before it occurred, what opportunity to protest that its consequences might have a bad effect on international payments was afforded to you, and what remonstrances or protests were made?

Mr. COOMBS. We had no advance knowledge.

Representative REUSS. No notice: you read about it?

Mr. COOMBS. The action was taken and approved by the Fund, as I said, on March 6. It was a Saturday.

Representative REUSS. And this being a revaluation of 5 percent, it was within the area which under IMF rules can be done unilaterally without notice or consultation?

Mr. COOMBS. Precisely.

Representative REUSS. Am I right, if it is 10 percent you have got to consult and justify it?

Mr. COOMBS. I believe that is the case, more than 10 percent.

Representative REUSS. I would just comment in passing at this point that the man from Mars, in my opinion, would wonder what in the world is going on where you get such wonderful international cooperation after the harm is done, yet there is no effort to get the benefits of the advice of one's trading partners beforehand. I think this is something that should concern all of us.

Mr. DESPRES. There is a further point I would like to ask you about in connection with these credit arrangements. Those were entirely ad hoc arrangements to cover a particular emergency situation. The question I would like to ask is, is anything institutionalized here which would permit this kind of arrangement to develop and grow in the future, to meet future speculative crises in the foreign exchange market?

Mr. COOMBS. There is nothing institutionalized as yet.

There is involved in central bank credits, of course, not simply the question as to whether central bank X will stand ready under certain circumstances, not any and all circumstances but under certain circumstances, to supply credit to another central bank, but also the question of, if these capital flows which central bank credits are designed to cushion are not reversed within a relatively short period of time, and central bank credits are essentially of a short-term nature, what is the takeout, what is the source of medium term credit which is available to, in effect, replace those central bank credits?

And here we get into this discussion which is now going on with respect to the role of the Fund, you see.

And so a central bank is involved in one part of the problem, and the other part of the problem involves governments and their policies with respect to the Fund.

So this takes a lot of exploring, and it is still in a tentative stage.

Mr. DESPRES. I gather from what you say that the central bank credit arrangement cannot by itself provide an adequate compensatory mechanism for dealing with these hot money movements, and that, although this might be a line of first defense, it does not obviate the need for further resources of the IMF variety.

Mr. COOMBS. That is precisely what I had in mind.

Mr. DESPRES. So that if the market movements don't promptly reverse themselves, the International Monetary Fund would be performing a rediscounting or bailing out role, as it were, for the central banks?

Mr. COOMBS. I think that if there had to be requests to the Fund, it would suggest that the problems of the country losing money required basic action, basic corrective action, which might take a year or two.

The need goes beyond the immediate short-term area, it goes into medium term.

Mr. DESPRES. I would like to ask you a few questions of a more general sort, referring particularly to the last few pages of Mr. Hayes' statement.

Mr. COOMBS. Yes, I would be delighted.

Mr. DESPRES. The testimony points out on the one hand that monetary policy can no longer be used exclusively with the objective of domestic economic considerations in mind, that there is a real conflict, or there can be a real and sharp conflict between domestic and international considerations here.

You take the position, on the other hand, as I take it, that nothing really very drastic needs to be done to improve the international liquidity situation, that fairly modest measures would suffice.

Does this mean that you would be prepared to surrender the domestic stability and growth objective, wherever this seemed necessary for purposes of international balance, that we must be prepared to forego something in the way of domestic stability and growth?

Mr. COOMBS. I don't see that it is necessary to forego anything in the way of domestic stability and growth. It seems to me that it is entirely possible to reconcile these two. It is basically a question of policies, of devising the most appropriate policies to bring about this result. The key to the whole thing is productivity, and keeping wages and prices in line.

I see no reason why, with the full range of technical resources that we have available, that we cannot devise compromises which wouldn't involve any major sacrifice of domestic considerations. The sacrifice which may have been involved in the most recent episode, as I see it, has been a bill rate of between 2¼, as compared with one of five-eighths in 1958, which I don't think has been a terribly important sacrifice.

Mr. TARSHIS. I am interested in pursuing the questions that the chairman and Senator Douglas raised about the adequacy of liquidity. In particular, I want to ask whether, since this was the first important revaluation after convertibility whether there isn't a very much greater danger than there has been of further speculative capital movements of this character?

Mr. COOMBS. Yes.

Mr. TARSHIS. Following that, I wondered—you were probably privy to some of the discussions in Basel, and around then—did you see any possibility of danger in the hesitancy of some of the central banks whose support is needed to provide that support perhaps because they don't feel confident in, let's say, the fiscal policies that the country that needs support is pursuing?

Mr. COOMBS. I would assume that central banks would do the same worrying about appropriate policies of countries receiving the funds, as, say, the International Monetary Fund does. Member countries don't have automatic access to the fund. They do have to show that they are pursuing policies designed to restore equilibrium. I have no idea what the discussions have been among the European central bankers. But I would assume that a bank in one country would not seek funds from another unless it could point at least to the hope that corrective measures were in prospect.

Mr. TARSHIS. But if there is an incompatibility because of world circumstances, with the pursuit of international equilibrium being at odds with the desire to maintain high prosperity and to get out of a recession at home, would there be a possibility of conflict on that scale that you can see?

Mr. COOMBS. No. I think it is always a matter of degree; there is nothing incompatible with trying to get out of a recession and maintaining foreign confidence in your currency and your prospects. It depends on how you do it. If you open up all the stops and pursue policies which abroad might be regarded as leading not only to recovery and expansion but also to inflation, then they might have worries.

But I don't know that one need necessarily push those measures to that degree; they should be designed as precisely as possible for the objective in mind.

I am hopeful that these problems can be reconciled. In fact I think they have to be reconciled; there is no other choice.

Mr. TARSHIS. Would you not, given the speed with which these very massive movements apparently develop, would you not think there is a very great deal to be said for an almost automatic commitment to provide funds?

Mr. COOMBS. An almost automatic what?

Mr. TARSHIS. An almost automatic commitment to provide funds that would be needed.

Mr. COOMBS. A certain case might be made for that. I have a feeling that the more experience we get in this, the more stability we can obtain over a period, over a long period of time, the more ready countries would be to accept automatic commitments.

Consider the Fund, for example; there has been a progressive—there has been a gradual but continuing movement toward increased automaticity in the use of the Fund facilities. And it may be that there is a scope for further progress there.

But you have to have the two things together, you have to have a discipline and you have to have credit facilities. And the problem is a continuing one of getting the appropriate blend.

I would hope that as we move along and more fully understand the problems that we will find it easier to effect such a blend.

Mr. DESPRES. In all past changes in the official gold value of currencies, devaluation or the other way, that I can think of, the speculative movement of funds that preceded the change was invariably reversed, at least to a limited extent, in the few days or week following the change. Is there any precedent for what happened that you know of, for what happened after the German and Dutch revaluations, and were the authorities in fact taken completely by surprise with respect to the direction of the speculation after the revaluation?

Mr. COOMBS. Of course, there had been some speculative anticipations that the Germans would revalue. When the 5 percent was chosen, the immediate reaction of the exchange markets was that there might be a possibility of more.

And I think this is one of the main reasons why the flow did not reverse itself.

One of the advances we have made in the past 3 months, I would say, has been a growing acceptance on the part of the exchange market that were will not be a further revaluation.

Mr. DESPRES. Your earlier remarks suggested that there has been no substantial reversal as yet——

Mr. COOMBS. No reversal, there has been a tapering off. After the first 3 weeks or so, after the revaluation, the inflow of funds into Switzerland tapered off, and in fact the dollar has been stronger against the Swiss franc in recent months. In the last few weeks there have been signs that the inflow into Germany has also tapered off.

Mr. DESPRES. The statement says a good deal about the need for confidence in the stability of currencies.

The existing system is not really a system of permanently fixed gold parities, but one of quasi-fixed gold parities. In the light of the speculative tendencies that you have observed in the foreign exchange market, the alertness with which people try to guess which currency is going to undergo a change in gold values next, do your observations about stability mean that you think we ought to, that the world ought to, move toward a system in which it does not rely upon revaluations or devaluations of currencies to correct the balance-of-payments situation, or do you think that the present situation of fixed parities with occasional unannounced changes in one currency or another is a workable one?

Mr. COOMBS. I think that under the present system it is essential to keep the parities of the major currencies fixed.

Mr. DESPRES. No revaluations, you mean, in the future?

Mr. COOMBS. That is right. It is conceivable, of course, that a certain foreign country, even a major foreign country, will, for one reason or another, perhaps partly because of its own fault or somebody else's fault, get into serious trouble, and conceivably there can be no alternative. But it should be absolutely a last resort.

And I would very much hope that, with the increasing skill which foreign countries as well as this country will acquire in managing their economic affairs, the contingency of having to resort to an exchange adjustment will become increasingly remote.

Mr. DESPRES. In order to achieve this very desirable goal and to establish growing confidence in the stability of existing gold parities, isn't it necessary in the present-day world that individual countries should have a fair amount of leeway for financing temporary deficits in their balances of payments?

If the discipline of the balance of payments is too tight, is it not likely that in fact something is bound to break, either in the form of reimposition of exchange controls, or in the form of devaluations?

Mr. COOMBS. I quite agree. If we think that the target should be one of shooting for a virtually even balance every year by all the major countries, I think that is impossible. There will be swings. One year a certain country will tend to run a surplus and a deficit in another year. But the important thing is that over a period of time they should balance out. You shouldn't have a continuing string of deficits for 3, 4, 5, or 6 years, and, more particularly, sizable deficits.

I don't know, in the case of the United States, to what extent it will be possible for us to run moderate deficits at our discretion. But this is the important thing: We should have them under control, and should be able to correct them. If we were able to do so, it would provide an additional means of gradually injecting additional liquidity into the international financial system.

Mr. DESPRES. Is it not necessary, also, that the known size of the supporting financing facilities will be large enough so that no country's hand is forced by speculative movements alone, isn't this a necessary precondition to curbing speculation?

Mr. COOMBS. I would agree entirely, Mr. Despres, that this is a highly important consideration that relates at this point to confidence in parities. If the exchange markets know that the central banks are cooperating and that the fund stands ready with massive resources to move in to support a currency under attack, this can have an immensely stabilizing effect.

Mr. DESPRES. And so far as the basic deficits and surpluses are concerned, the underlying balance of payments, is it not true that for psychological reasons alone, one major country being in a prosperity phase, the other in a recession, or something of that sort, that you may get quite wide swings in the underlying balance of payments, and that these may last 2 or 3 years, in fact, and that the basic arrangements should be such that swings of this magnitude can be accommodated within the framework of stable exchange rates?

Representative REUSS. Would you withhold your answer, for just a minute, Mr. Coombs, until I welcome the presence of Senator Javits, a member of this subcommittee, who has been delayed because of other duties on the Labor Committee.

Senator JAVITS. I just dashed over to say hello to Al Hayes, Mr. Coombs.

Mr. COOMBS. I am sorry he is not here.

Senator JAVITS. I hope you gentlemen will give him my best. I have been marking up the National Defense Education Act in my committee. I will read over your testimony.

And give Al Hayes my best.

Mr. COOMBS. I will. Thank you.

Representative REUSS. Do you recall the question?

Mr. COOMBS. Yes, I think I recall the question.

I would say that the international credit facilities should be adequate to take care of these swings from, say, basic deficits to basic surpluses of moderate magnitude. And in so doing, and in taking care of them, and by the market knowing that these facilities were available to take care of them, this would have the extremely useful result of preventing those basic deficits from being magnified by purely speculative movements.

Representative REUSS. Mr. Tarshis?

Mr. TARSHIS. I have just one question to ask.

This has to do with the possibility of controlling or limiting speculative movements in the future. You mentioned the existence of a two-way street. And I wonder if it wouldn't impose some discipline on speculative activities if this street were somewhat extended by a widening of the amplitude within which exchange rates could fluctuate without calling for support.

Mr. COOMBS. I remember being asked in school examination questions on this very point. And there are theoretical questions on both sides.

If I could cite one consideration which I think is of a more practical and immediate nature, which I think is shared by most of the people in the central banks in Europe on operating the exchanges, it is that with wider spreads, there might well be, probably would be, a tendency for the speculators to assume that if the rate settled at one extreme, this was a prelude to the establishment of a new parity at that level; or possibly a further broadening of the spread; that the very fact that one had begun to monkey with the arrangement, would raise the possibility that there would be further steps.

In actual fact, most of the European central banks have not taken full advantage of the existing spreads. In the case of the Swiss franc, for example, I think that legally they have a spread which could be as much as 3½ percent. In actual fact, they have probably kept it within the range of 1 percent. In the case of sterling, it is rarely allowed to go to extremes.

Now, these fellows might be wrong. But I have a hunch that their assessment of speculative thinking in the market is probably correct, and that they have minimized speculative reactions by not letting the rate jump suddenly to the limits.

Quite aside from this speculative question is, of course, the further very important consideration that the wider the swings in exchange rates, the greater the risk in international trade transactions. You could have some seriously disturbing effects upon the flow of international trade.

Representative REUSS. Thank you very much, Mr. Coombs.

Are there any further questions?

(No response.)

Representative REUSS. I want to thank all of you gentlemen from the New York Federal Reserve for your helpfulness this morning. And please present our compliments to Mr. Hayes and wishes for his speedy recovery.

And the session is now adjourned. We will meet in open session at 2 o'clock this afternoon to hear E. M. Bernstein.

(Whereupon, at 12:10 p.m., the committee recessed, to reconvene in open session at 2 p.m. the same day.)

AFTERNOON SESSION

Representative REUSS. The Subcommittee on International Exchange and Payments will be in order.

We are privileged to have with us as the first witness for this afternoon's hearing Mr. Edward M. Bernstein. Mr. Bernstein was formerly assistant to the Secretary of the Treasury. He was for many years director of research for the International Monetary Fund, and is today a consultant on international monetary questions.

If you have a statement, Mr. Bernstein, we will admit that statement in its entirety to the record, and then you may proceed in your own way.

STATEMENT OF EDWARD M. BERNSTEIN, E. M. BERNSTEIN, LTD., WASHINGTON, D.C.

Mr. BERNSTEIN. Thank you, Congressman.

(The prepared statement of Mr. Bernstein follows:)

THE PROBLEM OF INTERNATIONAL MONETARY RESERVES

The large balance-of-payments deficits of the United States from 1958 to 1960 and the payments difficulties now being experienced by the United Kingdom have again brought to the fore the problem of international monetary reserves. This complex problem can be divided into three questions:

(1) Is the present level of international monetary reserves adequate for world trade and payments?

(2) Is the present system of providing international monetary reserves satisfactory for a world economy with expanding trade and investment?

(3) Is it possible to make provision for the extraordinary monetary reserves that may be needed to finance massive capital movements?

Every aspect of the problem of monetary reserves has been debated almost constantly over the past 3 years. In the course of these debates, a wide measure of agreement has been reached on some of these questions. The differences of opinion that still persist are largely concerned with the changes in institutional arrangements that are desirable, particularly those concerning the role of the International Monetary Fund. The views that I express on these questions are my personal opinions. I believe that many governments hold similar views. Some economists, perhaps even a considerable number, may differ with me.

ADEQUACY OF PRESENT RESERVES

The concept of what constitutes international monetary reserves is not a simple one. Clearly, monetary reserves include the gold holdings of official institutions—treasuries, central banks, and exchange stabilization funds. They also include official holdings of U.S. dollars, sterling, and other convertible currencies—that this, claims on reserve centers. Holdings of foreign exchange by commercial banks are not regarded as part of official reserves, although it is possible for the monetary authorities to acquire such balances in time of need. In addition to their own reserves, the members of the International Monetary Fund have access to the large resources of that institution, contributed by its members and intended for use by its members.

Some countries hold their reserves exclusively in gold. Other countries hold reserves of foreign exchange as well as gold. Still others hold their reserves almost exclusively in the form of foreign exchange, notably U.S. dollars and sterling. Not all forms of international monetary reserves contribute equally to the liquidity of the world economy and it is important to take into account their composition in considering the adequacy of reserves. For example, holdings of U.S. dollars and sterling, as well as other convertible currencies, can be used by any country in its international payments; and reserve centers must count on such use of their currencies in determining their own need for reserves. Massive withdrawal of reserve currencies to make payments to countries holding their reserves exclusively or largely in gold, or the conversion of such currency balances into gold, may put serious pressure on the reserve centers.

The resources of the International Monetary Fund cannot under present conditions be regarded by its members as part of their reserves. These resources now amount to nearly $3.3 billion in gold and $6.4 billion in convertible currencies. A member has virtually complete assurance that it can draw its net contribution to the Fund (i.e., the gold tranche). Thereafter, a country has decreasing assurance that it will be able to use its quota for each successive credit drawing of 25 percent. The right of members to draw on their quotas seems to be conditioned on their presenting an approved program for restoring equilibrium in their balance of payments. Under these conditions, the resources of the Fund represent another source of credit that may be available in time of need. They are by no means the same as reserves.

At the end of 1960, the total gold and foreign exchange reserves of all countries outside the Soviet bloc, and excluding holdings of international institutions, amounted to $59.6 billion. Between the beginning of 1950 and the end of 1960, the gross reserves of these countries increased by nearly $18 billion, quite apart from the substantially large resources of gold and convertible currencies held by the International Monetary Fund. It is true that the United Kingdom and a few other high income countries have inadequate reserves at this time. And it is also true that the underdeveloped countries generally hold far less in reserves than would be required to finance fluctuations in their trade and payments. The deficiency in the reserves of the high income countries is the consequence of their inability to strengthen their balance of payments. The deficiency in the reserves of the underdeveloped countries reflects the continuing shortage of real resources for their development, not an inadequacy of aggregate international monetary reserves.

The large surpluses in the payments of the great trading countries of Continental Europe and Japan are not an indication of a shortage of their reserves. If these countries could have found a satisfactory way of avoiding the large surplus in their balance of payments in recent years they would have done so precisely because they do not want a further increase in reserves. It may be expected that the continued rise in wages, the reduction in interest rates, and the greater responsibility for aid and defense assumed by the surplus countries will contribute to a better pattern of world payments. It will be helped by the recent revaluation of the German mark and the Netherlands guilder. If the United States and the United Kingdom succeed in holding down their costs, there is a good prospect for establishing a better pattern of world payments.

It should be emphasized that no amount of reserves, even the very considerable reserves of the United States, can enable a country to meet large balance-of-payments deficits indefinitely. The test of the adequancy of international monetary reserves is whether they are sufficient to meet cyclical and fortuitous fluctuations in international payments without undesirable restrictions on world trade or deflation in the great industrial countries. The purpose of reserves is to give countries time to restore their balance of payments, not to avoid the necessity of doing so. By this test, the present level of reserves seems adequate for world trade and payments under reasonably well-balanced conditions. There is no evident shortage of international monetary reserves, certainly not if allowance is made for the availability of the resources of the International Monetary Fund.

PROVISION FOR FUTURE RESERVES

While international monetary reserves are adequate at this time, it is unlikely that the growth of reserves in the future will match the greater needs of the world economy. Excluding the United States and the United Kingdom, all countries outside the Soviet bloc held official gold and foreign exchange reserves of $38.6 billion at the end of 1960. Of these reserves, about $17.6 billion consisted of gold and about $21 billion consisted for foreign exchange holdings. Thus, on an average, all countries outside the Soviet bloc, except the United States and the United Kingdom, held 55 percent of their official reserves in foreign exchange, principally in dollars and sterling. These large reserves of foreign exchange were created in the past 20 years—sterling in the 1940's and dollars in the 1950's. Other countries, as a group, have not increased their sterling balances since 1950; and it is unlikely that they will increase their dollar balances indefinitely. In its own interest, the United States must match any further increase in foreign holdings of dollar balances with an equal increase in U.S. gold reserves.

Without further increases in dollar and sterling balances, the sole source of addiitonal monetary reserves would be newly mined gold not going into industrial use or private hoards, sales of gold by the Soviet Union, and the accumulation of foreign exchange balances of other currencies. Over the past 5 years, the increase in holdings of monetary gold by all countries and international institutions, but excluding the Soviet Union, was $2.9 billion. This is an average annual increase of about 1 percent of the gross official monetary reserves of all countries, excluding the Soviet bloc. Such an increment of gold reserves is clearly inadequate for the future needs of the world economy. It is possible that new reserve centers will emerge whose currencies will be held as reserves with the same assurance as dollars and sterling; but this is a contingency that cannot be counted on.

The best means of meeting future needs for reserves is through the International Monetary Fund. It is not enough, however, to give countries quotas in the Fund which they have no assurance of being able to use. The characteristic of reserves is that they are available when needed. The Fund has been hesitantly seeking means of giving its members assurance that they can count on its resources with confidence. It has done this definitely on the gold tranche (i.e., the net contribution of a member to the resources of the Fund). It has developed the use of standby agreements under which a member is entitled to draw an agreed amount from the Fund during a stated period. All this is helpful; but it does not meet the basic problem.

For the resources of the International Monetary Fund to be equivalent to reserves, it is necessary to integrate the quotas of members with their working reserves. A member of the Fund should have an unqualified right, unless declared ineligible, to draw up to 25 percent of its quota in each 12-month period until the Fund's holdings of its currency reach the prescribed maximum. Countries drawing on their quotas would be expected to use their own reserves in equal amount, as already called for by the repurchase provisions, and they would be expected to restore their position in the Fund as soon as their reserves increase, in any case within a period of 3 to 5 years. Larger drawings than 25 percent of the quota and drawings in excess of the prescribed maximum would require a waiver and would be made on terms and conditions agreed by the Fund and the member.

There is no reason for believing that members would abuse the right to draw on their quotas in the International Monetary Fund. In the 15 years of its operations, members have been scrupulous in meeting their financial obligations to the Fund. Quotas are not large relative to reserves; they average about one-fourth of the reserves of members. The integration of Fund quotas with their working reserves would, however, make a significant difference in the reserve position of all countries, including the United States. It is worth noting that the quotas of all underdeveloped countries amount to only $2.6 billion. The best means of getting these countries to hold reserves to meet their recurrent payments needs is through the use of Fund quotas, with the obligation of restoring their position within the prescribed period. The influence of the Fund on the financial policies of its members would be much greater, in my opinion, if they had assurance that their quotas could be used as part of their own reserves.

As a corollary to this policy, it would be necessary for members to recognize that drawings on quotas constitute an ordinary use of reserves and not extraordinary credits to be called on only in time of crisis. The leadership in establishing this practice should be taken by the United States. This country has never drawn on the Fund, although it has had ample justification for doing so in the past 3 years. The policy of aloofness from the exchange market that the U.S. Treasury followed from 1946 until recently is unsuitable to the present world. It is encouraging, therefore, that by arrangement with Germany, the U.S. Treasury has been supplying marks to strengthen the exchange market. As part of this new policy, the United States may find it convenient to draw on its quota in the Fund from time to time.

CAPITAL MOVEMENTS AND THE RESERVE CENTERS

When the International Monetary Fund was established, there was no intention of having it finance capital movements. The expectation was that if other countries permitted the free transfer of capital, the flow of funds to the United States would be enormous. For this reason, article VI of the Fund agreement stated that "a member may not make net use of the Fund's resources to meet a large or sustained outflow of capital." [1] In 1947, in response to a request by the U.S. Executive Director for an interpretation, as required by the Bretton Woods Agreements Act, the Fund declared that its resources could not be used for this purpose.

While the Bretton Woods Conference was aware that certain capital transactions could not be separated from current transactions, there was an underlying assumption that large capital movements could be distinguished from other payments and that measures could be taken to prevent them. As a practical matter, in countries with convertible currencies in which international payments are made through the exchange market, it is difficult to determine at the time such payments are made whether they are for current or capital transactions. A country may forbid its own residents to transfer capital; it cannot prevent the transfer of nonresident funds without abandoning convertibility of its currency. In a system of convertible currencies, capital movements are an inevitable, and not necessarily undesirable, part of the general problem of international payments.

With the rapid economic growth of the countries of continental Europe, the strength of their balance of payments and the convertibility of their currencies, economic forces have induced a large capital flow to Europe in recent years. Much of this capital flow consists of short-term funds transferred from the United States to other financial centers whenever interest differentials permit covered interest arbitrage or the conjuncture of a boom in Europe and a recession in this country offers the prospect of profitable speculation in securities or exchange. In 1960, the outflow of short-term U.S. funds is estimated to have been about $2.6 billion, over two-thirds of the U.S. payments deficit of that year. With U.S. short-term banking liabilities to foreign governments, banks, and others amounting to $17.2 billion, there is the additional risk of large and sudden conversion of dollars into gold.

Obviously, the United Kingdom is open to much the same danger with oversea sterling liabilities at the end of 1960 amounting to $10.9 billion, of which nearly $4 billion was held outside the sterling area. The financial centers of Europe are also vulnerable to large capital movements, although foreign holdings of their currencies are considerably less than similar holdings of dollars and sterling. Economic difficulties or a political crisis could set off a very considerable outflow of capital from Europe to the United States. In a world of convertible

[1] The Fund can finance capital movements linked with trade and other current payments and ordinary banking transactions involving credit or the repayment of credit for such purposes. The Fund can also finance the drawing down of sterling or dollar balances by other countries to meet their own payments deficits. The Fund cannot finance the conversion of currency balances into gold or capital movements for interest arbitrage, exchange speculation or forward exchange transactions.

currencies, in which a large part of reserves is held in the form of foreign exchange, it is essential to avoid the disruption that could result from the necessity of financing large movements of capital or the conversion of currency balances into gold.

Some provision must be made to finance capital movements. The International Monetary Fund does not have the resources necessary for this purpose. Professor Zolotas, the governor of the Bank of Greece, has suggested that the Fund could acquire additional resources by entering into standby agreements with the leading creditor countries, using for this the borrowing authority under article VII, the scarce currency provision of the Fund agreement. This is an ingenious proposal, although it is not the best way to meet the problem. It is doubtful whether any member of the Fund, including the United States, would be willing to have such financing linked with the scarce currency provision. For the implication is clear that if a country is not prepared to give unlimited credit to finance an inflow of foreign capital (and what country could accept such an obligation), the Fund would have the right to declare its currency scarce. This would open a country to the penalty of having other countries discriminate against it in their trade and other payments.

All doubts about the Fund's power to finance capital movements and the right to invoke article VII to acquire resources for this purpose could be overcome by establishing a subsidiary institution, say a Reserve Settlement Account, to be operated by the International Monetary Fund. A supplementary agreement to establish a Reserve Settlement Account would not require amendment of the Fund agreement, but it would enable the subsidiary to undertake transactions in connection with capital movements and the large-scale conversion of reserve currencies. The agreement would simply provide that:

1. Members of the Fund are to become members of the Reserve Settlement Account by accepting the supplementary agreement.
2. The Reserve Settlement Account is authorized to lend currencies for capital or current transactions on terms and conditions to be agreed with the borrowers.
3. The Reserve Settlement Account is authorized to enter into prior agreements with its members to borrow their currencies to be used in its operations.

When the large financial centers secure approval of membership in the subsidiary institution, their parliaments could, at the same time, authorize their central banks or treasuries to purchase notes or debentures of the Reserve Settlement Account up to a stated amount. If the United States, the United Kingdom, France, Germany, Italy, the Netherlands, Belgium, Canada, and Japan would undertake to subscribe to the notes of the Reserve Settlement Account, it would have sufficient resources to meet any contingencies that could arise.

When the Reserve Settlement Account borrows from a member, it would do so through interest-bearing notes of specified maturity, denominated in the currency of the lending countries, with the same gold guarantee that now applies to transactions of the Fund. The Reserve Settlement Account would call on a country to take up all or part of its agreed subscription only when it is increasing its reserves and other members need that currency to meet a major outflow of reserves. The lending country would be able to use the notes prior to maturity to purchase any currencies it needs to meet a balance-of-payments deficit. Thus, a subscriber would be assured that its own payments and reserve position could not be impaired by lending to the Reserve Settlement Account.

Suppose there were a capital outflow of $3 billion from the United States to the United Kingdom, Germany, and the Netherlands. The Reserve Settlement Account would borrow an equivalent amount in sterling, marks, and guilders. The currencies would be lent to the United States which would either sell them in the exchange market or use them for converting dollar balances. Suppose that after a year or two, there were an outflow of funds from the United Kingdom to the United States and the Netherlands. The United Kingdom would redeem the notes it holds, taking payment in dollars and guilders. If its need exceeds the notes it holds, it would borrow the rest from the Reserve Settlement Account. The establishment of a Reserve Settlement Account would not, of course, eliminate the need for a strong balance of payments. It would, however, give countries time to deal with large capital movements and currency conversions that might otherwise be disruptive.

APPENDIX

SOME COMMENTS ON THE TRIFFIN PLAN

Professor Triffin has proposed a far-reaching plan for transforming the International Monetary Fund into a world central bank. Under the Triffin plan, members would be required to keep as deposits with the Fund a stated proportion of their gold and foreign exchange reserves. The dollars and sterling deposited initially in the Fund would be converted into long-term debts, and additional dollars or sterling acquired by the Fund from its members would be converted into gold. The United States and the United Kingdom would cease to be reserve centers.

Under the Triffin plan, the present system of quotas would be abolished and the Fund would become a credit-creating and deposit-holding international central bank. The present net creditor position of some members would be used to meet the required reserve deposits in the Fund and the present obligation of other members would be repaid within the next 2 or 3 years. Countries would draw on their reserve deposits at the Fund to supplement the use of their own reserves. For the future, reserve needs would be met by credits extended by the Fund to its members or through the Fund's open market operations.

Theoretically, a fund organized along the lines of the Triffin plan would have enormous power to create additional reserves. As a practical matter, it might create far too much or far too little. The task of passing upon innumerable requests for credit, of maintaining a steady turnover in a rising aggregate amount of loans, is not an easy one for an international institution. As the growth of world reserves is ordinarily expected to be linked to credits granted to members, it is conceivable that in a period of balanced expansion in world trade and payments, there might be too little demand for credit from the Fund. A latent deficiency in reserves would be gradually built up that would appear suddenly whenever a few large countries decided to accumulate reserves by generating a surplus in their balance of payments or whenever international payments became unbalanced for any other reason.

To avoid a latent deficiency in reserves, Triffin would have the Fund enter into open market operations—i.e., it would buy Treasury bills or other gilt-edge securities of the United States, the United Kingdom, or other countries. Presumably, the increase in reserves (and of liabilities to the Fund) thus thrust on the financial centers would lead them to increase their foreign lending and bring about a gradual seepage of reserves from them to other countries. The open market operations would make the Fund the determinant of the balance-of-payments policies of some of its members. Perhaps methods could be worked out by which such open market operations could be undertaken without disrupting the money and capital markets in the financial centers. It would still be true, however, that unless the financial centers were prepared to increase their foreign lending in response to the open market operations of the Fund, a latent deficiency in reserves would emerge.

Many of the countries of continental Europe fear that the power to extend credit through the Fund would lead to an excessive increase of reserves and encourage inflation in the deficit countries. There is this risk. It is equally important to recognize that there is the risk that the Fund will extend much less credit than is needed for the growth of reserves. There is an inherent conflict between the interests of the surplus and deficit countries. This is not merely because the surplus countries wish to limit the real resources they put at the disposal of the deficit countries through the Fund, but even more because under certain cyclical conditions the surplus countries are confronted with pressure on their aggregate resources. To avoid the danger of inflation in the surplus countries, they will want the Fund to be extra cautious in extending credit.

The fact is that the greater the power given to the Fund to extend reserve credit, the greater its responsibility will be to judge the desiribility of extending any credit at all and in particular to provide credit for countries whose financial policies do not meet the specifications of the Fund. Professor Triffin has said: "The Fund should retain the right it now has or asserts to subordinate its lending assistance to full agreement on the borrowing country's policies." This is more power than the Fund has or than any international institution is wise enough to use. In a world in which national financial policies must differ from country to country, it would be a mistake to entrust to an international institution the power to deny ordinary reserve needs to a country when its financial policies do not meet an average standard more or less suitable to a diverse world or an ideal standard set by an international institution.

It is much more sensible, even if more commonplace, to have the Fund committed to provide to each country reserves equal to its quota to be drawn at an annual rate not exceeding 25 percent of the quota. This is large enough to give members the increment of working reserves they need for all ordinary purposes. It is moderate enough to avoid surrounding the quotas with supposed safeguards that would hamper a country in meeting its payments problems through policies suited to its economy. There is time enough for the Fund to impose rigid policy requirements when countries seek a waiver of the quota limits in their use of Fund resources. Naturally, this need not inhibit the Fund from making known to any member at any time its views on their financial policies.

It is difficult to understand the enthusiasm for converting the Fund into an international central bank. The world economy is not a single unit, expanding and contracting economic activity at the same time. Forces for expansion or contraction have their origin independently, at least to some extent, in the economic conditions of the great industrial countries. Financial policies must be suited to the needs of each national economy. In particular, it would be a serious mistake to attempt to secure through the Fund, or by agreement outside the Fund, a pattern of relative interest rates in the great financial centers primarily designed to minimize the international flow of short-term funds. Interest rates in each country should be suited to its own conditions: In the short run, to the cyclical forces operating on its level of economic activity; and in the long run, to its relative international economic position and its relative capacity to supply savings for investment at home and abroad. Some average interest rate for short-term or long-term credit, common or nearly common to all the great financial centers, would be a rate suited to none. If interest rates appropriate to the needs of each country induct large capital movements, the way to deal with them is through supplementary reserves provided by a reserve settlement account.

I see nothing of value to be gained from converting the Fund into an international central bank. The supposed advantages of the Triffin plan in providing credit that members would use only in payments to the surplus countries are largely illusory. The additional powers given to the Fund under the Triffin plan would have to be offset by additional safeguards to protect some countries from being compelled to provide unlimited credit. The commonsense approach is to adapt to new needs the institution we already have. The present Fund has evolved out of 15 years of reasonably satisfactory experience in actual operation. In this period, the Fund has engaged in exchange transactions amounting to over $4 billion; it has in increased quotas very considerably; and it has liberalized, although not enough, the right of members to use these quotas. If the members of the Fund are foresighted enough to deal in good time with new problems as they emerge—such as that of large movements of short-term capital—there is every reason to expect that the institution will grow in usefulness and influence. The conversion of the Fund into a central bank will create more problems, and more difficult ones, than it can solve.

Mr. Bernstein. The large balance-of-payments deficits of the United States from 1958 to 1960 and the payments difficulties now being experienced by the United Kingdom have again brought to the fore the problem of international monetary reserves. This complex problem can be divided into three questions:

(1) Is the present level of international monetary reserves adequate for world trade and payments?

(2) Is the present system of providing international monetary reserves satisfactory for a world economy with expanding trade and investment?

(3) Is it possible to make provision for the extraordinary monetary reserves that may be needed to finance massive capital movements?

Some countries hold their reserves exclusively in gold. Other countries hold reserves of foreign exchange as well as gold. Still others hold their reserves almost exclusively in the form of foreign exchange, notably U.S. dollars and sterling. Not all forms of international monetary reserves contribute equally to the liquidity of the world economy and it is important to take into account their composition in considering the adequacy of reserves. For example, holdings of U.S. dollars, and sterling, as well as other convertible currencies, can be used by any country in its international payments; and reserve centers must count on such use of their currencies in determining their own need for reserves.

The resources of the International Monetary Fund cannot, under present conditions, be regarded by its members as part of their reserves. These resources now amount to nearly $3.3 billion in gold and $6.4 billion in convertible currencies. A member has virtually complete assurance that it can draw its net contribution to the Fund. Thereafter, a country has decreasing assurance that it will be able to use its quota for each successive credit drawing of 25 percent. Under these conditions, the resources of the Fund represent another source of credit that may be available in time of need. They are by no means the same as reserves.

At the end of 1960, the total gold and foreign exchange reserves of all countries outside the Soviet bloc, and excluding holdings of international institutions, amounted to $59.6 billion. It is true that the United Kingdom and a few other high income countries have inadequate reserves at this time. And it is also true that the underdeveloped countries generally hold far less in reserves than would be required to finance fluctuations in their trade and payments. The deficiency in the reserves of the high income countries is the consequence of the inability to strengthen their balance of payments. The deficiency in the reserves of the underdeveloped countries reflects the continuing shortage of real resources for their development. Prima facie, it would seem that reserves are adequate for world trade and payments under reasonably well balanced conditions.

While international monetary reserves are adequate at this time, it is unlikely that the growth of reserves in the future will match the greater needs of the world economy. On an average, all countries except the United States and the United Kingdom hold about 55 percent of their official reserves in foreign exchange, principally in dollars and sterling. These large reserves of foreign exchange were created in the past 20 years—sterling in the 1940's and dollars in the 1950's. The accumulation of dollar balances by other countries is still going on. Other countries, as a group, have not increased their sterling balances since 1950; and it is unlikely that they will increase their dollar balances indefinitely. In its own interest, the United States must match any further increase in foreign holdings of dollar balances with an equal increase in U.S. gold reserves.

The best means of meeting future needs for reserves is through the International Monetary Fund. It is not enough, however, to give countries quotas in the Fund which they have no assurance of being able to use. The characteristic of reserves is that they are available when needed. The Fund has been hesitantly seeking means of giving its members assurance that they can count on its resources with confidence. It has done this definitely on the gold tranche, that is, the net contribution of a member to the resources of the Fund. It has developed the use of standby agreements under which a member is entitled to draw an agreed amount from the Fund during a stated period. All this is helpful; but it does not meet the basic problem.

For the resources of the International Monetary Fund to be equivalent to reserves, it is necessary to integrate the quotas of members with their working reserves. A member of the Fund should have an unqualified right, unless declared ineligible, to draw up to 25 percent of its quota in each 12-month period until the Fund's holdings of its currency reach the prescribed maximum. Countries drawing on their quotas would be expected to use their own reserves in equal amount and they would be expected to restore their position in the Fund as soon as their reserves increase. Larger drawings than 25 percent of the quota and drawings in excess of the prescribed maximum would require a waiver and would be made on terms and conditions agreed by the Fund and the member.

There is no reason for believing that members would abuse their right to draw on their quotas in the International Monetary Fund. In the 15 years of its operations, members have been scrupulous in meeting their financial obligations to the Fund. Nearly 80 percent of the quotas are accounted for by high-income countries that have no reason to use reserves for increasing home investments. The underdeveloped countries would be able to use their quotas only for reserve purposes because of the relatively short repayment period. The influence of the Fund on the financial policies of all its members would be much greater, in my opinion, if they had assurance that their quotas could be used as part of their own reserves.

When the International Monetary Fund was established, there was no intention of having it finance capital movements. The expectation was that if other countries permitted the free transfer of capital, the flow of funds to the United States would be enormous. For this reason, article VI of the Fund Agreement stated that "a member may not make net use of the Fund's resources to meet a large or sustained outflow of capital." In 1947, in response to a request by the U.S. Executive Director for an interpretation, as required by the Bretton Woods Agreements Act, the Fund declared that its resources could not be used for this purpose.

With the rapid economic growth of the countries of Continental Europe, the strength of their balance of payments and the convertibility of their currencies, economic forces induce a capital flow to Europe. Large sums move from the United States to other financial centers whenever interest differentials permit covered interest arbitrage or the conjuncture of a boom in Europe and a recession in this country offers the prospect of profitable speculation in securities or exchange. In 1960, the outflow of short-term U.S. funds is estimated to have been about $2.5 billion, over two-thirds of the U.S. payments deficit of that year. With U.S. short-term banking liabilities to foreign governments, banks and others amounting to $17.2 billion, there is the additional risk of large and sudden conversion of dollars into gold.

Obviously, the United Kingdom is open to much the same danger with oversea sterling liabilities at the end of 1960 amounting to $10.9 billion, of which nearly $4 billion was held outside the sterling area. The financial centers of Europe are also vulnerable to large capital movements, although foreign holdings of their currencies are considerably less than similar holdings of dollars and sterling. Economic difficulties or a political crisis could set off a very considerable outflow of capital from Europe to the United States. In a world of convertible currencies, in which a large part of reserves is held in the form of foreign exchange, it is essential to avoid the disruption that could be created by large movements of capital or the conversion of currency balances into gold.

These difficulties could be met by establishing a subsidiary institution, say a Reserve Settlement Account, to be operated by the International Monetary Fund. A supplementary agreement to establish a Reserve Settlement Account would not require amendment of the Fund Agreement, but it would enable the subsidiary to undertake transactions in connection with capital movements and the large-scale conversion of reserve currencies. The supplementary agreement would simply provide that:

(1) Members of the Fund are to become members of the Reserve Settlement Account by accepting the supplementary agreement.

(2) The Reserve Settlement Account is authorized to lend currencies for capital or current transactions on terms and conditions to be agreed with the borrowers.

(3) The Reserve Settlement Account is authorized to enter into prior agreements with its members to borrow their currencies to be used in its operations.

When the large financial centers secure approval of membership in the subsidiary institution, their parliaments would authorize their central banks or treasuries to purchase notes or debentures of the Reserve Settlement Account up to a stated amount. If the United States, the United Kingdom, France, Germany, Italy, the Netherlands, Belgium, Canada, and Japan would undertake to subscribe to the notes of the Reserve Settlement Account, it would have sufficient resources to meet any contingencies that could arise.

When the Reserve Settlement Account borrows from a member, it would do so through interest-bearing notes of specified maturity, denominated in the currency of the lending countries, with the same gold guarantee that now applies to transactions of the fund. The Reserve Settlement Account would call on a country to take up all or part of its agreed subscription only when it is increasing its reserves and other members need that currency to meet a major outflow of reserves. The lending country would be able to use the notes prior to maturity to purchase any currencies it needs to meet a balance-of-payments deficit. Thus, a subscriber would be assured that its own payments and reserve position could not be impaired by lending to the Reserve Settlement Account.

Suppose there were an outflow of $2 billion from the United States to the United Kingdom, Germany, and the Netherlands, which is about what happened in the second half of 1960. The Reserve Settlement Account would borrow an equivalent amount in sterling, marks, and guilders. The currencies would be lent to the United States which would either sell them in the exchange market or use them for converting dollar balances.

Suppose that later there was an outflow of funds from the United Kingdom to the United States, Germany, and the Netherlands. This is, of course, exactly what is happening now. The United Kingdom would reedem the notes it holds, and it would take from the Reserve Settlement Account either dollars, marks, or guilders. If its needs exceed the notes it holds, it would borrow the rest from the Reserve Settlement Account.

I do not want to leave the impression that the establishment of the Reserve Settlement Account would solve all the balance-of-payment problems. It cannot do that. Countries would still have to deal with their balance-of-payments problems, including capital outflow. If the capital outflow is not reversed in 2 or 3 years, countries would then either have to strengthen their balance of payments or draw on their reserves. But the facilities of the Reserve Settlement Account would give them time to take the measures necessary to deal with large capital movements and currency conversions that might otherwise be disruptive.

Representative REUSS. May I interrupt at this point, to ask a question about the very vivid example you have given us?

Suppose that in this model you have set up a terrible thing happened, the deficit country continued to incur deficits, and that in the end it was forced to devalue its currency. How in such circumstances would the United Kingdom, Germany, the Netherlands, and the Reserve Settlement Account, respectively, make out?

Mr. BERNSTEIN. They would have no loss. This problem has occurred several times in the International Monetary Fund. For example, the United Kingdom devalued sterling in 1949. At that time the United Kingdom was indebted to the International Monetary Fund; the Fund held $300 million worth of sterling in excess of the original subscription. Under the articles of agreement of the Fund, the United Kingdom owed the International Monetary Fund a quantity of sterling equivalent to dollars of the gold content of 1947. When sterling was devalued the United Kingdom had to give the Fund an additional quantity of sterling precisely equal to the decline in the dollar value of its holdings. Actually when the time came and the United Kingdom was ready to repay the Fund, it repaid in U.S. dollars to the full amount it borrowed.

Remember, if the United Kingdom were to borrow from the reserve settlement account, it would give the reserve settlement account a note denominated in sterling, but with a stated value in terms of gold. It would not matter whether sterling were devalued or not, if you see what I mean. The United Kingdom would still owe this much in gold dollars.

Representative REUSS. Then the deficit country, in the model here, the United States, would in event of a devaluation of, say, 20 percent, have to pay back to the reserve settlement account 20 percent more dollars?

Mr. BERNSTEIN. If it were paying in dollars, if the United States were the borrower?

Representative REUSS. Yes, sir.

Mr. BERNSTEIN. If the United States were the borrower, it would first make good the depreciation by marking up its debt in dollars to the reserve settlement account. When the United States repaid the debt, it would have to pay in gold or other foreign exchange, not dollars, but the dollar equivalent of what it pays would be that much higher because it devalued the dollar.

Representative REUSS. So the deficit country's debt to the reserve settlement account would not be altered by devaluation.

I don't think there is anything wrong with this, I was just trying to get it through my head.

Mr. BERNSTEIN. It would have to repay an amount in gold or foreign exchange equivalent to what it borrowed even if its own currency were devalued.

Representative REUSS. And how much of a grace period would it get?

Mr. BERNSTEIN. It was my expectation that if we do establish a Reserve Settlement Account, a country coming to the account to borrow would ordinarily repay within 3 years, with a maximum perhaps of 4 years.

Now, if during that period there is a reversal of the capital flow, the debt may be repaid automatically. For example, if there is a backflow of capital funds from the United Kingdom to the United States, the United Kingdom would bring back the notes which it got when it lent the money to the Reserve Settlement Account. It would take dollars which the account would get from the United States, and that would automatically, so to speak, repay what the United States borrowed.

Representative REUSS. For the deficit country, its liability to its creditors would be the same under your proposals as under the present chaotic situation, but instead of having to pay gold immediately, it would have 3 or 4 years to do it, which, of course, would be a vast difference.

Mr. BERNSTEIN. That is right.

Representative REUSS. But the liability is no different.

Mr. BERNSTEIN. The obligation to pay to a country that lends you in gold or the foreign exchange equivalent of it, would be the same. The borrowing country would have to repay through the Reserve Settlement Account the full value of what it borrowed in foreign exchange.

A devaluation wouldn't affect it. As a practical matter, this is a provision of the International Monetary Fund to which all countries have subscribed and which has actually been effective in maintaining a constant dollar value for the borrowings and the lendings of members through the International Monetary Fund.

Representative REUSS. And the United Kingdom in the 1949 devaluation situation which you just recalled, in order to repay its obligations to the International Monetary Fund, had to expend more United Kingdom resources as a result of the devaluation than it would have had to had it not devalued?

Mr. BERNSTEIN. I wouldn't use the word "resources," because it is a rather broad term. It had to use more sterling to acquire the dollars when it repaid them, that is right, sir.

Representative REUSS. Thank you.

Would you go on, please?

Mr. BERNSTEIN. I merely had one more paragraph.

You are aware that Professor Triffin has proposed that the International Monetary Fund be converted into an international central bank. I see no need for such a far-reaching step. The present Fund has evolved out of 15 years of reasonably satisfactory experience in actual operation.

In this period the Fund has lent billions of dollars. It has increased quotas very considerably, and has liberalized, although not enough, the right of members to use these quotas. If the members of the Fund are foresighted enough to deal in good time with the problems that must emerge, such as that of large movements of short-term funds, there is every reason to expect that the institution will gradually grow in importance and usefulness.

The conversion of the Fund into a central bank will create more problems than it can solve.

Representative REUSS. Thank you very much.

I note that the countries that you talk about for membership in the Reserve Settlement Account are the United States, the United Kingdom, France, Germany, Italy, the Netherlands, Belgium, Canada, and Japan. Those happen to be the principal members of OECD, with the exception of Japan, which has a relationship with OECD through its membership in the Development Assistance Group. Could not this proposal work as well or better were it under the aegis of the newly formed Organization for Economic Cooperation and Development?

Mr. BERNSTEIN. I think it would work better if it were independent of it. I had better explain why. It is true that the countries that would undertake the commitments to lend to the Reserve Settlement Account are members of the OECD, except Japan. I see no reason why other countries should not be members of the Reserve Settlement Account. To my mind, it seems more reasonable to start with the approach that the purpose of the Reserve Settlement Account is to asure holders of dollars and sterling that their holdings are as good as gold, that they can and will be freely usable and convertible when they wish. These other countries, I think, are entitled to as much protection as the big financial centers, even though there is no capital flight of dollars to them.

I see no reason why Mexico, for example, which holds almost all of its reserves in dollars, shouldn't become a member of the Reserve Settlement Account, even though it is not in a position to advance credits to be used by other countries.

This is a key point to my thinking. We are not looking for a little club of the rich countries that will lend to each other when it suits them. We do want them to provide emergency resources. But the real purpose, in fact, is to make every holder of dollars, every holder of sterling—and these include countries that are not on that list—feel assured that dollars and sterling are safe.

Representative REUSS. I want to argue this point with you just a little to test it.

Mr. BERNSTEIN. Yes.

Representative REUSS. I would have thought that the point of the proposal was to induce countries to which hot money might flee to mitigate the effects of such movement.

If that is so, then it is largely a question involving only the industrial countries, which are the points of destination of short-term capital flights.

Mr. BERNSTEIN. I would say it is one of the two parts, Congressman. The other is to induce countries that already hold dollars to keep holding them and using them in the normal course of trade and payments and not to convert their dollars into gold.

Recall, there are two parts. There are big capital movements from the United States to Europe, or there were. There are countries holding dollars who might, at the same time, decide that they prefer to get the extra security of holding gold even though it means a departure from their normal practice of holding reserves in dollars.

I want both problems to be taken care of. I am interested in having facilities for financing large capital movements. I am just as interested in seeing that other countries find it as attractive and as secure to hold dollars as they always have.

Representative REUSS. Have you made any quantitative studies of the relative volume of both dangers? I suspect that the second is a gnat compared to the elephant of the first, in that the really big flights of capital occur among strong countries like those listed.

Mr. BERNSTEIN. The second isn't a flight of capital. Actually, as between the two dangers, a flight of capital and a mass conversion of dollars into gold, the second is the bigger danger, because there are $17 billion of short-term foreign holdings of banking assets.

Representative REUSS. Indeed, a flight of capital without the danger of conversion into gold shouldn't bother anybody.

Mr. BERNSTEIN. Precisely. When there is a flight of capital, the bad feature is that often the capital comes to countries in Western Europe who hold all or most of their reserves in gold, so that an accrual of dollars to their central institutions would be converted into gold.

It is really the conversion into gold that is one of the troublesome features. We wouldn't bother with the first if it weren't for the second.

Representative REUSS. That is what you have said——

Mr. BERNSTEIN. That is right.

Representative REUSS. Since the ultimate recipients of large-scale capital movements are central banks, who unless checked by some new mechanism are likely to demand gold, isn't that nine-tenths of the problem?

Mr. BERNSTEIN. If we think in terms of capital flight exclusively, I think that would be so, that the capital flight is to those countries. It happens that those countries are also the countries that are the principal holders of gold reserves, so that countries like the Netherlands or the United Kingdom do, when they acquired dollars, convert them into gold. You might have no movements of dollar balances to Mexico, Brazil, or other countries. But these countries are always holders of large dollar balances.

I know of no reason why a Reserve Settlement Account should say to them, 'You are not rich enough to be members."

My view is they can belong to this institution, but don't have to undertake the commitment to lend.

Next, what is gained by setting up a new institution outside the framework of the fund? That is another important question. It seems to me that the separating of capital movements from current transactions, the question of whether a country starts by drawing on its quotas or comes right in and borrows from the new institution—I think these questions are all easily dealt with if the Reserve Settlement Account is operated by the International Monetary Fund, but they can become very difficult if they are separated.

To whom should the borrowing country go first? My concept is that it all really could be done fairly simply if the two institutions are together. A country that has an ordinary need of reserves within

25 percent of its quota would draw on the International Monetary Fund. If it has a larger need it could still go to the Fund and ask for a waiver. But if it is fairly clear that there are large capital movements, and it prefers to use the Reserve Settlement Account, as it should under these circumstances, it could do so.

I see no need to multiply institutions with enormous resources coming ultimately from the same source. I do not see why we want to put our international financial institutions here, there, and elsewhere instead of keeping them together.

Representative REUSS. The argument is made that the additional contributions asked of the rich countries should not be diluted by being put into a general IMF pot which would then accrue in part to the benefit of the underdeveloped countries, the poorer countries?

Mr. BERNSTEIN. Well, under my proposal, Congressman, in fact the two funds would be kept separate. They would be managed by the same institution——

Representative REUSS. But they wouldn't spill over at all.

Mr. BERNSTEIN. They wouldn't spill over one into the other, but some countries could borrow from either or both.

I understand the point made by some of our European friends. They are being called on to commit themselves to providing large sums for financing capital movements. This is not going to be a one-way flow of funds. In my opinion, the risk of a capital flow from Europe to the United States in the future is about as great as the risk of a flow in the other direction, from the United States to Europe. Once our payments position is strengthened, any economic or political disturbance in Europe could result in a large flow of capital to the United States.

Some European countries would like to have a little more sayso in the management of a Reserve Settlement Account. This is what they tell me. I can see their point of view. And it is quite possible that we could have the Reserve Settlement Account operated by the management of the Fund, but perhaps with a different Board of Directors. Definitely I would not try to separate the institutions, running one from Europe and the other from the United States.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. Mr. Bernstein, on page 2 of your statement, the very bottom, you say—

> If the United States and the United Kingdom can hold down their costs, there is a good prospect for establishing a better pattern of world payments.

You are talking about the pattern for the surplus countries, as you call them—or are you talking about the pattern involving the underdeveloped countries also?

Mr. BERNSTEIN. Well, I don't believe myself that there is much that can be done to avoid balance-of-payments pressures in the underdeveloped countries, the low-income countries.

Senator PROXMIRE. If we hold down our costs it hurts their relative position, doesn't it, in a sense?

Mr. BERNSTEIN. No, I don't believe that the holding down our costs would hurt them. If we held down our business activity it would. But they would not be hurt if the general level of dollar prices were kept down, provided the prices of export goods would also be held down.

Senator PROXMIRE. Putting it in somewhat less value terms, let's say if we hold down our costs, that it would be less incentive for us to import from any country, including countries that are underdeveloped and which may have a cost advantage on high labor control commodities.

Mr. BERNSTEIN. As I understand it——

Senator PROXMIRE. In other words, just in general terms, if they increase their cost.

Mr. BERNSTEIN. Senator, we must balance our international payments. There is no way by which the United States, even a country like the United States, can continue to incur obligations or to make payments abroad in excess of what it earns.

Senator PROXMIRE. I am not arguing with this position, I am just trying to see what the full effect of your statement is.

Mr. BERNSTEIN. If we hold our costs down, that is to say if in the United States the prices of our export goods do not rise, then of course this would mean that there would be somewhat less pressure on the prices of raw materials that are imported, though not necessarily. You know, we are by no means as important in world markets for raw materials as is generally believed. There is a fantastic exaggeration of our dominance of world markets for commodities. Europe is a much bigger importer——

Senator PROXMIRE. Would you care to give proportions?

Mr. BERNSTEIN. I will be glad to submit it for the record.. I did not bring it. This committee has a document, one I wrote, study No. 16, for the Joint Economic Committee——

Senator PROXMIRE. Will you generalize it and highlight it? It is sometimes hard to pick out a specific generalization from these documents.

Mr. BERNSTEIN. I will be glad to.

Senator PROXMIRE. Would you say that Western Europe is far more important to the United States in relation of 4 to 1——

Mr. BERNSTEIN. Not that large.

Senator PROXMIRE. Two to one?

Mr. BERNSTEIN. We would have to make a distinction between two things, as a consumer and as an importer. As an importer of raw materials it is two or three times as large as we are. As a consumer of raw materials it is probably somewhat larger, because, while our national product is nearly twice as large as the aggregate of Western Europe, manufacturing plays a much bigger role there than here. If we include in primary products foodstuffs, yes, they are rather larger consumers than we, because their population is nearly 1½ times ours.

Now, I may have some figures here on the proportion that various countries are in the consumption of basic commodities. But if you wish, I will put it in the record, it will be much easier that way.

Senator PROXMIRE. Fine.

(The following statement was submitted for the record:)

Consumption of four of the principal nonferrous metals is shown in the following table for the United States and for Europe, excluding the Soviet bloc. The data are in tons of 2,000 pounds except for tin for which the data are reported in tons of 2,240 pounds.

Consumption of 4 nonferrous metals, 1958–60

[In tons]

	United States			Europe		
	1958	1959	1960	1958	1959	1960
Metal:						
Copper	1,179,400	1,312,300	1,279,700	1,793,671	1,710,409	2,111,933
Lead	706,900	671,600	581,700	845,900	920,400	1,009,900
Zinc	868,300	956,200	861,100	1,019,100	1,108,100	1,222,600
Tin	47,998	45,833	52,230	[1] 54,004	[1] 66,772	[1] 76,139

[1] For 9 Western European countries. Excludes consumption of about 10,000 tons a year by other Europe not identified by countries.

Source: "Year Book of the American Bureau of Metal Statistics," 40th issue, pp. 12, 43, 66, and 125.

Senator PROXMIRE. Then, the first paragraph of the section under "Provision for Future Reserves" there you say this:

> While international monetary reserves are probably adequate at this time, it is unlikely that the growth of reserves in the future will match the greater needs of the world economy.

Now, on what do you base the initial clause, "International monetary reserves are probably adequate at this time?"

Mr. BERNSTEIN. Well, there are several arguments in here to prove the point. One is the great increase that has taken place in the reserves in the past 10 years. The other is the relationship of reserves to trade——

Senator PROXMIRE. How does that increase match the increase in the economic activity, trade.

Mr. BERNSTEIN. I am not sure whether my statement gives the increase of reserves in the last 10 years. Since the beginning of 1950 the increase in reserves has been on the order of about $18 billion for all countries other than the United States. All of this increase went to countries that formerly were deficient in reserves. This is a very important point. A 50-percent increase in the reserves of all countries, and a 100-percent increase in the reserves of the countries that were short, is certainly generous for the period since 1950. For countries other than the United States, the increase in reserves is greater than the increase in their trade. It should be noted that, in addition, the gold and currency resources of the International Monetary Fund have been increased considerably in the last few years. There is no shortage of reserves at this time.

I might go further than that. As a group, the countries of continental Europe are better provided with reserves today than they have been at any time since 1913, so far as I can see.

Senator PROXMIRE. Now, this increase in reserves since 1949 was the result of what forces and factors which maintained it between 1949 and 1961 but in your expectation won't in the coming years?

Mr. BERNSTEIN. Instead of forces, I would give you the forms, because it is the forms that determine it, Senator.

Senator PROXMIRE. All right.

Mr. BERNSTEIN. I would say that between 1950 and 1960, the increase in total reserves in the form of gold was $6 billion, but U.S. gold reserves decreased by nearly $7 billion. The increase in foreign holdings of short-term and liquid dollar assets in this period was $12 billion, most of it in the form of reserves held by foreign official institutions and banks. The deterioration in U.S. reserves was the principal source of the increase in the reserves of other countries.

Now, it is my view that the United States cannot permit its liabilities to foreigners in the form of dollars to continue to grow at the rate of the last 10 years unless it can increase its own gold holdings to match it. Actually our gold holdings went down. I don't see how the United States can be willing——

Senator PROXMIRE. Will you repeat that? You say that the United States cannot afford what unless we increase our gold reserves to match it? Increase what? I missed it.

Mr. BERNSTEIN. Increase our liabilities to foreigners, our dollar liabilities to foreign central institutions, to foreign banks and companies and individuals—the short-term deposits and other banking assets held by foreigners in the United States.

Senator PROXMIRE. And in your judgment, is this primarly a matter of the interest rate on the short-term obligations? Certainly we won't have this adverse capital flow, the tendency of people to disinvest in our bills and invest in short-term obligations of foreign powers if short-term interest rates relatively improve.

Mr. BERNSTEIN. Senator, these two questions are linked, but I think I can clarify them if I put it in this form. Whatever the forces that made for the big deficits of the 1950's in the U.S. balance of payments, they were met in two forms, by paying gold—that is, reducing our assets of gold—and by increasing our dollar liabilities to foreigners. Now, it is my opinion that this has been done on as big a scale as the United States can afford, on as large a scale as the United States can stand. We cannot continue it, is my point. The world reserves grew as the United States paid out gold and dollars to those countries and they added them to their holdings, you see. Now, this can't continue, because we can't afford it.

The way we will stop it is by stopping our balance-of-payments deficit.

Senator PROXMIRE. Why can't we afford it? I think we can't afford it either, but I wondered if there is a technical monetary reason why we can't afford it.

Mr. BERNSTEIN. The technical reason is that the greater our liabilities become, the greater the risk that a conversion of such liabilities into gold under adverse conditions could result in such a loss of confidence in the dollar that it might be impossible to hold the exchange rate. This is simply a question of piling up commitments to other countries that we couldn't meet under adverse circumstances.

Senator PROXMIRE. Of course in the 1950's it was a situation such as you have maintained in your argument, it was quite unique and different, and one which we can expect fundamentally to change. It is based to some extent on our massive foreign aid program. It is based on the fact that we were assisting the European economies, and we would hope and expect, and with good reason, to have them relieve us of some of this burden. It is in part because we have to expend funds for our troops overseas; is that correct?

Mr. BERNSTEIN. That is right.

Senator PROXMIRE. In great amounts. Then, too, perhaps we can expect in the future to be alleviated. These are the fundamental ways, it seems to me, we can help to solve this problem, not in a technical, monetary way.

Mr. BERNSTEIN. When this happens, Senator, then the growth of reserves in the rest of the world will be reduced to the increment of newly mined gold, gold sales of the Soviet Union, plus any increases in holdings of other currencies that may have occurred. But the big form of increasing reserves of the 1950's will then have disappeared, that is to say, the increase in gold and dollar holdings by other countries which they earned, which they were able to retain from our total trade and payments, including our governmental payments in these international transactions. That is the point. There may be enough reserves now, in fact I am confident that there is enough. I see no reason to be troubled about that side of the problem at all. But I can't see how reserves can grow in the future on the scale that they did in the 1950's unless we find some other method of doing it.

Senator PROXMIRE. You say:

The best means of meeting future needs for reserves is through the International Monetary Fund.

Mr. BERNSTEIN. Yes, Senator.

Senator PROXMIRE. I would just like to ask this: I feel very strongly, instinctively and to some extent rationally, that we shouldn't devalue the dollar. However, I must say it is hard for me to answer the questions of some very thoughtful and responsible people who told me that they thought we should, in view of the fact that the whole economy of the world is increasing as it is and the reserves are inadequate, that we should devalue the dollar, perhaps, to the extent of 50 percent of its present value. Now, you say that the better and fuller use of our International Monetary Fund is the way to solve the problem. Is this another alternative? And if it isn't an alternative, why isn't it?

Mr. BERNSTEIN. I think there is the alternative of a rise in the price of gold in terms of all currencies. I don't believe it is a desirable alternative. It seems to me very unlikely that if you raise the price of gold you could avoid the kind of changes in price originating in two places, in the countries that earn considerably more because they are producers of gold, that is, South Africa and, to a lesser extent, the Soviet Union, and those countries already having large reserves which would, as a result of a higher price for gold, have very excessive reserves. The consequence of that would be to set off a rise in prices. You see, nobody has proposed that we raise the price of gold 2 percent per annum, which might give us a steady increment of reserves that would match the needs of the world. What has been proposed is a massive, once-for-all change of 50 percent in the price of gold. That means suddenly raising the reserves of the world by $20 billion overnight—there are about $40 billion of gold reserves in the western world. I can't see how that could be done without setting off inflationary forces.

The very purpose of the Monetary Fund, Senator, was to avoid that sort of thing. The Monetary Fund was established because it was believed possible to create additional reserves as needed through an international institution in which countries, all the members, would undertake to provide the real resources necessary for such a purpose. The United States subscribed originally $2.75 billion, now a little over $4 billion to the Fund. If these resources were made available to all countries as needed they could become like reserves to them. I am proposing that the Fund now tell its members that their quotas are part of their reserves, and to go and use them in the normal way, not all at once, but drawing them in modest amount from year to year and repaying them from year to year.

Senator PROXMIRE. But if we have had an increase in economic activity which is more than doubling, over the past 20 or 25 years, and if during this period the gold reserves were roughly in balance with needs, why doesn't it seem logical that we might simply have a devaluation, which would be accomplished not unilaterally, but through international agreement everywhere, which would provide the kind of reserves we need, so that instead of this anticipation you mention of deficient reserves in the future we would have sufficient reserves, adequate reserves? Now, it may be that the step-by-step way you propose would be a wiser way to do it, a few percent a year, but it would be difficult, and it would have possibly a more inflationary trend in time than this other method.

Mr. BERNSTEIN. You can't tell people we are going to devalue all currencies in terms of gold by 2 percent a year without their knowing they would have a big premium for speculating in gold.

On the other hand, it is not possible to devalue currency in terms of gold every 20 years at the rate of 50 percent, because expectations would then be created in the same way. The truth of the matter is that we do have good ways of providing the world with reserves without doing two things which I think would be undesirable. We don't have to change the price of gold to get total reserves growing at a rate suited to a growing world economy. Second, we don't have to keep piling liabilities on the United States for short-term obligations to foreigners to give the world the reserves it needs.

We have created an institution whose purpose it is to provide the world with additional reserves. I don't see why we don't use this institution in a rational way to provide these reserves.

Senator PROXMIRE. What is the price we have to pay for greater utilization of the International Monetary Fund? Is it going to take a greater contribution by this country?

Mr. BERNSTEIN. In the proposal which I have made which you started to read: "Provision for future reserves," it takes nothing at all from the United States. It would, in fact, be very useful to the United States wthout adding any cost at all.

Let me see if I can explain what I have in mind. At present, the International Monetary Fund has about $3,200 million in gold. It has around $6,400 million, maybe a little more, in the currencies of the countries we have been talking about.

Senator PROXMIRE. What was that latter figure, 6 what?

Mr. BERNSTEIN. $6,400 million.

It has other currencies, too, Senator. These are the currencies of the big financial centers.

The rights to use the Fund are assigned by quota. The United States has a quota of $4,100 million in the International Monetary Fund. We have never drawn on that quota. If we wanted to draw on the quota we could have done it, say, in 1958 or 1959 or 1960, by getting sterling, by getting marks, by getting guilders, by getting currencies of the surplus countries of Europe. We have never used the Fund because we have a strange notion the United States is somehow above that sort of thing. I think that is a mistake. The United Kingdom has used the Fund only on two occasions, in 1947 and 1956.

Those were crisis years. The first, Senator, was the convertibility crisis following the implmentation of the Anglo-American loan agreement; the second was the Suez crisis.

Senator PROXMIRE. And what is assigned to the United Kingdom?

Mr. BERNSTEIN. $1,950 million is its quota.

Now, Senator, the United Kingdom has used the Fund on only two occasions, and then for fairly large sums. To my mind this is a mistake. Using the Fund that way creates the impression that is takes a crisis to use the Fund.

My proposal is to use the Fund as if it were an ordinary institution where you have the right to draw on your reserves, to draw from the Fund, and the obligation to put it back again.

I would like these quotas used as if they were part of the working reserves of members. There would be no difficulty in financing it. The financing has already been provided for. It merely takes two things: an understanding by the Fund that the time is ripe to do it and an attitude by members that this is a normal use of reserves. No country has actually ever defaulted on its financial obligations to the Fund; they have met them, I think, with much greater care than they have met some of their other obligations.

Senator PROXMIRE. If there should be this greater utilization of the Fund, do you feel that this $3.2 billion in gold and $6.4 billion in currency is sufficient?

Mr. BERNSTEIN. For all ordinary purposes, yes. You see, it is the nature of the Fund, Senator, that not everybody uses it at the same time, because——

Senator PROXMIRE. Supposing this Nation, which has such a very large quota, should use it in a substantial way, suppose we should continue to have this adverse balance of payments——

Mr. BERNSTEIN. We can't continue forever, Senator.

Senator PROXMIRE. I recognize that. But supposing we should continue and become more adverse than we have been in the past year or two.

Mr. BERNSTEIN. My proposal isn't that we would get more money from the present Fund when the situation is more adverse; we would get up to the amount we are entitled to under the quota. We would be able to get a billion dollars a year for 4 years. Is the question whether there are enough resources now in the Fund for that?

Senator PROXMIRE. Yes.

Mr. BERNSTEIN. The answer is "Yes." If the United States had wanted to borrow $1 billion a year from the Fund in the 3 years from 1958 to 1960, the Fund could have financed this from its present resources. The Fund has enough resources for financing ordinary balance-of-payments deficits arising from trade and other current transactions. The Fund does not have enough resources, however, to finance large capital movements of the kind we had in 1960 and which other countries may have later. To finance such capital movements, the Fund needs supplementary resources.

Senator PROXMIRE. Now, I understand that we have some expert consultants here today, and if they have any questions they would like to ask, I would be delighted to yield to them.

Mr. DESPRES. Just as a matter of clarification, Mr. Bernstein, in the proposal for the establishment of a Fund subsidiary, you suggested that the mere existence of this facility would be enough to give confidence to holders of dollars and sterling.

It is my impression that expectations of devaluations or upward revaluations of currency are the major cause of the movement for hot money. Unless this cause were removed, how could the establishment of this facility alone provide the assurance?

Mr. BERNSTEIN. Well, I have said that, although it may not be in this statement. But, in any case, I have said it elsewhere. The way I look at it is this. A good deal of the conversion of dollars into gold comes from the feeling that if you don't get in line first, you won't get the gold.

There are central banks, as you can see from the present arrangements on sterling, that are very glad to ease the pressure on other countries' gold reserves, provided they don't look like fools when they have to explain to the Minister of Finance that they didn't withdraw their money in 1929 or 1930 because it would have caused a panic in London or New York.

If you once tell them that nobody can get ahead of them in line, it will change their attitude toward whether they must have gold instead of dollars or sterling now.

This is the effect that I believe psychologically you do create with a Reserve Settlement Account. With the knowledge that there is enough for all, you don't have to be first in line. If somebody else gets ahead of you, you know you won't be deprived of access to these resources. That makes a very big difference.

But if you are asking the question, could this attitude be created for a currency in which there is no confidence, the answer is "No." If in fact countries were convinced that something was going to happen to dollars or sterling, they would not be willing to hold these currencies.

There is an awful lot of fear about letting others get ahead of you in converting currencies into gold when there is a limited amount of gold. If you can give them assurance this won't happen, many central banks would be willing to wait quite a while before they convert balances into gold.

Mr. DESPRES. Thank you very much.

You also suggested that there is a need for a growing volume of liquidity as the world economy and world trade and payments grow. How would your proposal meet this long-term growth requirement?

Mr. BERNSTEIN. Well, my proposal has two sections to it, as you know. The first one is for the integration of the quotas in the Fund with the working reserves of members. This would take place by allowing members to use these quotas, and I would say it would provide certainly for all the reserve needs for the next few years, say 5 years. For the future, you would have periodic review and increase of quotas. I don't see why that can't be done. We have already had that.

Representative REUSS. Mr. Bernstein, I have seen accounts in the press that the Director of the International Monetary Fund is supposed now to favor the so-called Bernstein plan. As I read the account, the IMF was said to be considering a plan whereby standby credits would be provided by some members of the Fund. Is this your understanding from what you read in the press, and if so, does this constitute an adoption of your proposal?

Mr. BERNSTEIN. Well, my proposal, Congressman, has gone through a lot of reformulation in the course of 3 years. In 1958, I first made this proposal in public in a speech at Harvard University. There I proposed essentially that article VII of the Fund Agreement, the scarce currency provision, be used by the Fund to get commitments from some members to buy its debentures in order to finance large capital movements. I was afraid then that such capital movements could develop on a big scale in a time of recession in the United States. Incidentally, at the annual meetings in 1957 and 1958, Governor Zolotas of the Bank of Greece proposed that the Fund enter into standby arrangements with the surplus countries.

As I have gone into this question more, I have been convinced that it is not in the interest of the United States nor of other countries to use article VII for this purpose.

It is of primary importance to find some means of financing capital movements. Nevertheless, it is not a matter of indifference to the members of the International Monetary Fund whether this is done through article VII of the Fund Agreement or through a Reserve Settlement Account as I have proposed.

The Fund Agreement states (art. I) that one of its purposes is "to assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade." The Fund Agreement further states (art. VI) "that a member may not make net use of the fund's resources to meet a large or sustained outflow of capital," although this is not deemed "to prevent the use of the resources of the fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking or other business." In 1947, the Fund transmitted to members a strict interpretation of this provision.

If the Fund uses its resources to finance capital outflow it must be for capital movements incidental to current transactions and in repayment of bank credits for such transactions. The Fund can also finance the drawing down of dollar and sterling balances by other countries for the purpose of meeting their own current payments (art. VIII, sec. 4). There are other capital movements that the Fund cannot finance—interest arbitrage, speculation in foreign securities or foreign exchange, forward exchange transactions, and the conversion of previously acquired currency balances into gold. These capital movements may be far larger than those arising from credits in connection with trade and other current transactions.

The Fund does not have the resources to finance such capital movements even if it had the authority. The suggestion has been made that it could borrow the resources from some of its members. Article VII of the Fund Agreement states that if the Fund deems such action appropriate to replenish its holdings of any member's currency, it may sell gold to a member for that currency, or it may "propose to the member that, on terms and conditions agreed between the Fund and the member, the latter lend its currency to the Fund." Under the Bretton Woods Agreements Act, the United States cannot directly or indirectly make a loan to the Fund "unless Congress by law authorizes such action."

It is difficult to understand how the Fund can say that it must borrow any member's currency under article VII while its holdings of gold are $3.3 billion. Surely, the first way to replenish its holdings of any currency is to sell gold for that currency, a procedure the Fund has followed on several occasions to acquire U.S. dollars. Of course, countries that expect to use the Fund's resources for financing their deficits on current transactions would be reluctant to see the resources that have been contributed for this purpose diverted to the financing of capital movements. In fact, the large-scale use of the present resources of the Fund for financing capital movements would inevitably create a real scarcity of the Fund's holdings of some of the leading currencies.

Neither this country nor the surplus countries of Europe can take the risks that would be entailed in permitting the Fund to finance capital movements by borrowing under the scarce currency provision of the Fund Agreement. This would imply that if a member is not prepared to provide more resources to finance an inflow of foreign capital, its currency could be declared scarce and other countries would be authorized under article VII, section 3(b) to impose discriminatory restrictions on trade and payments against it. No country can accept an unlimited obligation to finance an inward flow of capital; and no country can agree that its unwillingness to finance such a capital inflow should subject it to discrimination. This is the very danger that the United States sought to avert when it requested an interpretation of article VI on capital movements.

In a world of convertible currencies, in which international payments are made through the exchange market, capital movements are an inevitable part of the balance-of-payments problem. Although a country can forbid capital transfers by its own residents, there is no way in which it can prevent the transfer of funds by nonresidents without giving up currency convertibility. There is a need to finance capital movements, but that should be done in a way that recognizes their special character and finances them through special resources. It would be improper for the Fund to divert to this purpose the resources subscribed by its members to finance temporary payments deficits arising from current transactions. It would be improper for the Fund to ignore article VI and the formal interpretation it made in 1947.

The problem can be met by establishing a Reserve Settlement Account to be operated by the Fund. The larger countries would undertake prior commitments to make loans to the Reserve Settlement Account by buying its interest-bearing notes. The Reserve Settlement Account would be authorized to make loans to any of its members for capital or current transactions on terms and conditions agreed with the borrowers. The notes of the Reserve Settlement Account and its loans to members would carry the same gold guarantee that now covers all transactions of the Fund.

This seems to me the best way to deal with the problem of financing capital transfers. It does not strain the plain meaning of the Fund agreement. It does not divert the resources of the Fund from the basic purpose of financing payments deficits in connection with current transactions. It does not impose on countries the threat of being penalized through trade discrimination for a reluctance to provide unlimited finance for capital movements. I believe countries will recognize the advantages of dealing with the financing of capital movements in a straightforward way, through a Reserve Settlement Account.

Representative REUSS. Your plan, as you have outlined it this afternoon, envisages not only a system of loans and drawings on a Reserve Settlement Account, but a system of integrating national reserves with IMF quotas?

Mr. BERNSTEIN. That is right.

Representative REUSS. So as to get greater mileage out of your reserves.

Mr. BERNSTEIN. Yes. I would like to see the United States take the view, "We have invested $4 billion in the International Monetary Fund, we can use it as anyone else can. If we can't use it, it is simply that much commitment acting as a drain on our own reserves."

I would like to see the United Kingdom take the view—it has drawn twice—that drawings are a quite ordinary matter, that there is nothing unusual about drawing on the Fund. These resources were contributed by the United Kingdom and other countries and the United Kingdom should draw on them as needed.

Now, as I told Senator Proxmire, there is no problem of getting more resources for this—there are plenty of resources for such use of the Fund—all we need is an attitude in the U.S. Treasury that there is nothing wrong in using the Fund. Actually President Kennedy has said we would use our quota whenever the occasion arises.

Representative REUSS. And would you say that the decision to use Fund quotas for this purpose is an integral part of your plan?

Mr. BERNSTEIN. Yes, Congressman, the access to quotas as a part of the working reserves of members, the use of quotas within the quota limits, to be treated as reserves—that means countries must restore their Fund position—that is part of my plan. I think that is an essential part now of getting a proper reserve system for the Western World.

Representative REUSS. Why isn't it enough that the Reserve Settlement Account half of your plan be adopted? If you had a system of debits and credits as between members, why wouldn't that take care of the strain on short-term capital movements?

Mr. BERNSTEIN. Well, it would, Congressman. The purpose of the Reserve Settlement Account is actually to deal with capital movements.

Now, what I am thinking of is something more than that. I am thinking of the fact that while the world has $60 billion of reserves in gold, dollars, sterling, and other currencies at this time, that the increase in these reserves in the future is not likely to be more than $600 million a year from newly mined gold and the sale of gold by the Soviet Union and negligible amounts from additional dollar and sterling balances. But the world probably needs something nearer the order of $2 billion a year in reserve growth. Where is this to come from? My answer is it should come from a better use of the International Monetary Fund.

Representative REUSS. In other words, you do agree with Mr. Triffin that the trading world is perilously close to being short on adequate reserves, your method of supplying these is much simpler and different, but you do agree that the visible accretions of gold are insufficient and that we had better be thinking right now about repairing that gap?

Mr. BERNSTEIN. That is right for the future. I don't believe we are perilously close to being short of reserves, but I do believe that, in the ordinary course of events, we are not going to have the increment of reserves we need.

Representative REUSS. And so you advocate that—I would like to be perfectly clear on this—this country urge the International Monetary Fund to adopt a twofold proposal and then get it ratified by the respective legislatures?

Mr. BERNSTEIN. No, sir. We don't have to do anything for this. All we have to do is get the Fund itself to act. This doesn't change any part of the Fund agreement. All we need is for the Fund to say to Brazil, "You can draw $70 million out of your quota in 12 months. We also hope you will stop inflation in Brazil, but this is not a condition of your using the Fund."

It is my view that the Fund will have more effect on inflation in Brazil if it says, "Draw the $70 million, but remember you are going to have to restore it."

You don't need legislation for this, Congressman; all you need is for the International Monetary Fund to take the view that members can draw on their quotas within the quota limits.

Representative REUSS. But you do need a resolution by the managing director of the Fund?

Mr. BERNSTEIN. You could do it by resolution. The Fund likes to do these things by resolution, and it has had resolutions saying that if members draw the first 25 percent of the quota, that is all right, but we are going to be tough on the second 25 percent. As the Fund has done it by resolution in the past, I suppose that with a new resolution it could say a member may draw within any 12-month period 25 percent of the quota until it has reached the maximum provided by the Fund agreement. I propose the Fund should do this now.

Representative REUSS. I would like to recapitulate. You advocate the immediate adoption of two measures: one, an internal resolution by the International Monetary Fund that its quotas can now be integrated with national reserves so as to get greater mileage for each country out of its existing reserves; two—and this would require ratification by the legislatures of the constituent countries—the establishment of a Reserve Settlement Account so as to permit payments-surplus countries to come to the rescue of payments-deficit countries.

Mr. BERNSTEIN. For large capital movements, yes.

Representative REUSS. And it is your opinion that we would not solve the problem that confronts us by the adoption of just one of the two, that we need to do both?

Mr. BERNSTEIN. Well, you have two separate problems there, Congressman. And each part of the proposal can be useful in solving one problem. I wouldn't say that I would reject a solution to one because somebody is hesitant about the other. Even if the growth of reserves in the future is a little slower than I would like, I do hope that we will get international arrangements to finance large capital movements before there is another recession in the United States, or before there is a political crisis in Europe, because I think that is important.

The fact that we can't get the other part of my suggestion, that is to say, the integration of quotas with working reserves, would disturb me, but I wouldn't say it is all or none. Similarly, if we can't go ahead with the Reserve Settlement Account, I would still press hard for the integration of the quotas with working reserves and free access to quotas within the limits provided by the Fund agreement. But I believe, in fact, that those who see the need for one will see the need for the other.

Representative REUSS. And is it your impression from reading the press, as it is my impression, that the IMF is now contemplating something like the Reserve Settlement Account arrangement, but is not contemplating anything like the integration of Fund quotas and regular reserves?

Mr. BERNSTEIN. Well, I talk to people at the Fund on occasion, though I do my best not to press my own views on them. Many of these people used to be my colleagues, and I want to avoid pressing my views on them. I get the feeling that while they are not going to do much publicizing of the easier use of Fund resources, that we will gradually see within a few years an attitude which is in fact equivalent to the integration of Fund quotas with the working reserves of members. I think we will get some progress there, too.

Representative REUSS. Senator Bush.

Senator BUSH. I am sorry, Mr. Bernstein, I wasn't here to hear the first part of your presentation, and I missed the questions by the Chairman.

I was interested in one thing you said. You used Brazil as an illustration, not because it was Brazil, but just as a name, I take it.

Mr. BERNSTEIN. Yes, sir.

Senator BUSH. And I didn't quite get the import of that. If I recall what you said, it was to this effect, that if Brazil, let's say, were going to make a withdrawal of $70 million, that instead of exacting some sort of disciplinary promise from them, or placing a disciplinary condition upon the advance, that that not be done, you should simply say, "Well, here it is, come and get it." Is that right?

Mr. BERNSTEIN. Yes, Senator, that is about what I said. The Brazilians have entered into an agreement with the United States and a large number of other countries under which they have made a subscription to the International Monetary Fund. That agreement states that Brazil is permitted to withdraw $70 million a year, or within a 12-month period, until it has drawn up to a certain limit, up to a net credit of $280 million. There is a provision that it must use its own reserves when it uses the Fund, there is a provision that it must repay the Fund within an appropriate time. There is a provision that if the Fund wishes it can stop Brazil from drawing by declaring it ineligible.

Now, these provisions were all written in there, I think, with a general understanding of what they mean. Nobody has ever declared Brazil ineligible. What they do when Brazil wants to come to use the Fund is to say, "Yes and no," or "No and yes," and "Maybe," and to try to make a deal with them as to what they can get in the way of credit policy, what can they get out in the way of budget policy. The upshot of it is that, first, countries try to do this, try to give the Fund the commitment. Generally they give a commitment that is far in excess of what they can really do. And they themselves are dissatisfied with their performance, and dissatisfied with the Fund for having imposed on them the necessity of making such a commitment on a sovereign matter, say, the budget.

Now, what I am saying is a simple thing. You will get better policies from Brazil by saying to them, "This is your reserve, don't waste it, but use it. Remember, if you use it, you have to restore it."

I would say that if we did that at the Fund, the influence of the Fund on Brazilian policy would be infinitely greater than it is today.

Now, this is my experience. I was with the Fund for a good many years, and I have been through this difficulty.

No country is going to sell its monetary and fiscal policy to the International Monetary Fund for the privilege of being able to withdraw a small part of its quota and then return it. A country can be taught that its quota in the Fund is a valuable part of its reserves; that it should be used with care, as reserves should be used, and then restored as soon as possible.

A country can be taught that, because no country has in effect failed to keep its financial obligations to the Fund.

Operating in that way, it is my opinion that the Fund would have far more influence. I mean the staff of the Fund would have more influence in Brazil and in every other country if they did that. You may not know it, but there have been countries which have said to the International Monetary Fund, "Don't send your staff to us; our public would think you are trying to dictate our policy."

Now, I think this feeling comes from the notion that a country can't use the Fund unless it commits itself to a policy that the Fund regards as right.

Senator BUSH. The World Bank exercises a good deal of discipline in connection with loans which it makes, does it not?

Mr. BERNSTEIN. Yes, sir. The World Bank—they are two different institutions, Senator——

Senator BUSH. I know; one is a long-term advance in the case of the World Bank.

Mr. BERNSTEIN. I had in mind more than that; I meant they are two different institutions in the sense they are for different purposes.

In one institution, the World Bank, a borrower comes and says, "I want to build a powerplant."

The World Bank says, "Well, we would like to make sure first that you really need a powerplant, and, second, that you are going to operate it efficiently, and, third, that you are not going to waste the money through excessive costs and bad engineering, and so on."

Senator BUSH. But that is not considered an intrusion on the country.

Mr. BERNSTEIN. That is right. They have no right to these loans. And they have put no money into the International Bank, they have put in perhaps 2 percent of their quotas.

Now, when you come to the International Monetary Fund, the Brazilians put in $70 million in gold of their own. And other countries have put in large sums in gold, their own money.

Senator BUSH. So they have in the World Bank?

Mr. BERNSTEIN. No; they haven't, there is a big difference. In the World Bank, we have put in 20 percent, some of the rich countries have put in 20 percent, but most of the poor countries have only put in 2 percent in usable form. In their subscription to the capital of the

World Bank, poor countries like India have actually paid 2 percent in dollars, and that is all. The other 18 percent is in the World Bank in the form of rupees.

In the case of the International Monetary Fund, they have put up 25 percent of their capital, of their capital subscription, in gold or, in some instances, in dollars.

Senator BUSH. Well, my point—I may not see this clearly, Mr. Bernstein, but my point is, if the Fund is not to exercise some discipline in the advancing of its money, despite the fact that it does belong to the people, why go through it at all; you see what I mean? There has got to be an orderly process there, it seems to me, and it seems to me that the Fund has some responsibility to make advances on terms that would indicate that they are going to set the money back; they have that responsibility to the other members of the Fund besides Brazil, which we used as an illustration in this case.

Mr. BERNSTEIN. I think countries do have a responsibility. The point is to define it.

Let's see what these responsibilities are. First, these countries have undertaken certain responsibilities on exchange policy. They have to carry out these responsibilities whether they get any help from the Fund or not.

Second, these countries have rights in the Fund which are specified, that is to draw on their quotas up to 25 percent a year unless declared ineligible.

They have obligations in connection with their drawings. They have to use their own reserves, they have to repay, they have to pay interest charges on what they use.

There is no obligation under the Fund Agreement, so far as I know, to keep balanced budgets, or to restrict credit, or to forego programs for social reform. Of course, a country ought to follow sound policies in its own interest. It ought to maintain the exchange standards required by the Fund Agreement. Beyond that, it must make sure that it will repay the Fund. But that requirement does not justify making budget and credit policy a condition for using the resources of the Fund. No country has defaulted, no country has unduly delayed repayment to the Fund of any money previously drawn. I have never heard anyone who knows the business of the Fund suggest that there is any danger of a country's not repaying.

Senator BUSH. Is that not a fairly good endorsement of the present system?

Mr. BERNSTEIN. No, sir, it isn't, I regret to say.

Senator, the Fund also has a job of letting members know what would be good policies. This seems to me an independent obligation of the Fund, an obligation to give wise advice. But I know of no place in the Fund Agreement where it states that a country must take the advice of the Fund as a condition of using its quota in the Fund.

The staff of the Fund are just human. Very few of them are geniuses, and all of them make mistakes. When they make mistakes on what would be the proper policy for a country, it is a technical deficiency on their part, but it could be a calamity for the country to whom the advice is given.

The view, therefore, that an international institution can impose on a country like Brazil, or any other country, a certain line of policy on budget, on credit, is in my opinion a serious mistake. The attitude should be, "Look, we are glad to tell you whatever you want to know about these matters, to give you as much help in drawing up a program as you want, but we don't make the policies of the Government. Those sovereign powers rest in the Congress and the Executive. We don't make these policies a condition for your drawing on your quota."

It is my conclusion, from having watched this, that you would get better policies in the end, you would get better policies because you would get countries welcoming the Fund instead of their present attitude of doubt and aloofness.

Senator BUSH. What is the attitude of the Fund's management toward this suggestion of yours, Mr. Bernstein? Have you discussed this with them?

Mr. BERNSTEIN. Well, I can't say, Senator, that I have discussed it with them. I think many directors and many members of the staff would agree with me.

Senator BUSH. Did you advance this thought while you were employed there?

Mr. BERNSTEIN. Yes, I have advanced the thought that it is a serious mistake to tell a country it cannot use the Fund unless it will commit itself on what its budget will be. I have said, we will not get them to carry out their commitments, and they will say, "This is the wrong way to do it." And it is. The Fund has not been as effective in encouraging better financial policies as it should be. And my view is that the Fund would get a better response to its advice if it said, "These are your reserves, draw on them within the limits of the quota and within the terms of the Fund Agreement. We are also ready to help you with advice and we hope you will take it. We know it's hard to stop inflation, but in your own interest you must try." I think that would work in some cases where an insistence on a specified budget and credit policy would fail.

The underdeveloped countries need reserves. They are too poor to hold adequate independent reserves. The only way to provide them with resources that will be used as reserves—drawn down in bad times and restored in good times—is to have their quotas in the Fund serve as their reserves.

Representative REUSS. Senator Pell?

Senator PELL. Do you see in the development of this plan, if it was finally accepted, a possibilty of reducing our dependence on gold?

Mr. BERNSTEIN. Yes. The world dependence on gold has to be reduced, or the world will have a monetary system under which the pressures of deflation will be greater.

I believe the proper way of reducing our dependence on gold is through the use of the International Monetary Fund through the gradual increase in quotas, and, as I have been saying, through giving members the right to draw on their quotas as if they were part of their working reserves. Teach them the responsibility that this is the proper use of the Fund, the right use of reserves, and the Fund will get a good deal more in the way of sound policy than it gets now.

Senator PELL. Thank you.

Representative REUSS. Senator Javits?

Senator JAVITS. I have known Mr. Bernstein for a very long time, Mr. Chairman, and I am very much interested in his thesis, as I was interested in Professor Triffin's thesis, though it was quite different, of course.

I would only like to state at this time—and I hope to return to the subject at a later date, Mr. Chairman—that I think Mr. Bernstein and others who have appeared before us render us a great service in these proposals. And I agree with the basic proposition, that is, in considering the job we have to do in the world, and the extent of our productivity and resources, we are in a sense undercapitalized. And that is what they are trying to do; they are trying to show us how on the international level we can have some automatic relationship as between the necessary capitalization and the increasing productivity, and more widespread financial competence of the world.

And I hope very much, Mr. Chairman, that we will give the greatest attention, both ourselves and our staff, to those recommendations, and that we may be able to come up with some conclusion of our own.

But certainly the problem is a very profound one, and I am, as one Senator, grateful to Mr. Bernstein and others of his colleagues who have given us so much first-rate thinking on that subject.

Representative REUSS. Thank you very much, Mr. Bernstein. We appreciate the help you have given us this afternoon.

The next witness is Mr. David Rockefeller, president of the Chase Manhattan Bank, New York.

Will you come up, Mr. Rockefeller?

Mr. Rockefeller, we welcome you down here this afternoon. You have a prepared statement and if it is agreeable with you, we will admit the prepared statement into the record, and then ask you to proceed in your way either to read it or excerpt from it, or whatever you see fit.

STATEMENT OF DAVID ROCKEFELLER, PRESIDENT, THE CHASE MANHATTAN BANK, NEW YORK, N.Y.

Mr. ROCKEFELLER. Thank you, Mr. Chairman and gentlemen.

I would suggest that in the interest of time I will eliminate a few paragraphs from the prepared statement. However, I think it would be useful if I would follow the text to a considerable extent.

(The prepared statement of David Rockefeller follows:)

STATEMENT OF DAVID ROCKEFELLER, PRESIDENT OF THE CHASE MANHATTAN BANK

I propose to address my remarks this afternoon primarily to the problem of international liquidity and to the changes in the international financial structure that may be necessary to deal with this problem. In doing so, I do not in any way wish to minimize the gravity of the balance-of-payments problem our Nation faces, or the urgency of effective steps to achieve a viable balance in our international payments accounts. However, your invitation suggested that I include a discussion of the role of New York as an international reserve center. Thus, I feel I should concentrate on the problem of what may need to be done to improve the world payments mechanism, since that ties in closely to the questions you have posed.

TWO SEPARATE TASKS

At the outset, it seems to me important that we recognize that our Nation faces two separate tasks in the international financial area. We must first deal with our balance-of-payments problem, for I do not believe there are any effective devices which could long withstand large continuing deficits on the part of the world's biggest trading nation and major reserve currency center.

However, success in bringing our basic payments position into balance will not solve the problem of international liquidity. That problem can be defined this way: We seek a world financial structure which will withstand short-term pressures against key currencies and meet the longer term need for an adequate supply of assets acceptable in international payments.

The immediate problem is to improve the world payments mechanism to prevent short-term capital movements from becoming disruptive. In normal times, such movements perform a constructive function in financing international payments. However, short-term capital movements can place excessive pressure on any key currency where the country involved is experiencing temporary balance of payments deficits. Such capital movements are also highly sensitive to differentials in short-term interest rates. This fact restricts the ability of monetary authorities to ease money and credit in a recession since such action could drive down short-term interest rates and encourage an outflow of short-term capital. Consequently, we will face a problem of international liquidity even after our basic payments position has been righted.

SPREAD OF CONVERTIBILITY

This problem of short-term liquidity has arisen for two reasons. First, the spread of convertibility among industrial nations has made it possible to shift short-term funds from one market to another in response to interest rate differentials, or in response to changes in the appraisals which holders of such funds make of prospects in various money markets. In many ways, this is a healthy development. Currency convertibility has been one of our foreign policy goals because of the benefits it brings in the form of more effective competition and enlarged trade. The greater mobility of short-term capital makes it possible to handle a much larger volume of trade and investments than was the case before the spread of convertibility. However, it does pose the problem I mentioned earlier of finding ways to keep such capital shifts within proper bounds.

CHANGE IN U.S. POSITION

A second reason for concern over the problem of short-term international liquidity lies in the change in the position of the United States. In the earlier postwar period, the dollar was universally regarded as invulnerable. The dollar was the leading reserve currency since dollar holdings could earn interest and were convertible into gold at a fixed price. Thus, foreign dollar holdings were built up from $8.6 billion to $21.4 billion between 1950 and the end of 1960.

This buildup in U.S. short-term liabilities, which has supplied a massive dose of needed international liquidity, now poses problems to the United States. The dollar is no longer invulnerable to any and all circumstances, as is shown clearly by developments of the past 2 years when the dollar has been under pressure.

In a sense, the position of our Nation is somewhat like that of a commercial bank. The United States had demand liabilities at the end of last year amounting to $21.4 billion. Against these liabilities the Nation held $17.8 billions of gold, of which nearly $12 billion was earmarked to back Federal Reserve notes and deposits. U.S. long-term foreign investments are, of course, very substantial. But these long-term investments cannot be liquidated to cover short-term claims against the United States.

Thus, the United States has reached a point where it must be concerned about the pace and extent of the increase in its short-term foreign liabilities. The Nation's reserves are large in relation to our trade and our short-term liabilities. Yet they are not so large in relation to the pressures that could be placed on them by short-term capital movements as to leave room for complacency. For that reason, the United States has a genuine interest in measures to improve the world financial mechanism to deal with the problem of short-term international liquidity.

If such a mechanism can be developed, the longer-term liquidity position of the world would appear to be satisfactory for at least the near-term future. Much has been made of the fact that official gold stocks have been growing at an average annual rate of 2 percent while world trade has been expanding at a 5 percent rate. However, there is no simple and mechanical realtionship between the growth of trade and reserves. In large part because of the massive injections of dollars into foreign reserves in recent years, world liquidity is high in relation to world trade. As I shall say later, this may be a problem to watch in the years ahead. But it does not appear to be the problem to focus on at the moment.

FOUR APPROACHES

What, then, should be done about the short-term liquidity problem? Four approaches have been suggested to improve the world's financial mechanism:

(1) Increase the price of gold;

(2) Strengthen the present mechanism by internal measures and by increased cooperation among key currency nations;

(3) Expand the scope of the IMF by increasing quotas and enlarging its powers to borrow currencies in surplus;

(4) Convert the IMF into a world central bank.

While an increase in the price of gold would appear to be a simple and direct solution, it actually has significant disadvantages. The gains from a markup in the price of gold would accrue chiefly to South Africa and the Soviet Union, the two largest gold producers, and to the Western industrial nations which hold gold. Lesser developed nations would receive minor benefits since they hold little gold. Nations holding their reserves in key currencies would find that these reserves would be worth less in terms of gold. Any hint of a possible gold price change would set off a widespread and disruptive speculative move. Consequently, the case against raising the price of gold is most persuasive.

THE KEY CURRENCY APPROACH

A second approach would involve building on the present mechanism to bolster the ability of key currencies to withstand pressures. Since the dollar is a key currency, it is important to consider what might be done to strengthen the position of the United States as an international banker. There are a number of steps which could be taken unilaterally, and several others which would require international cooperation.

A first step which we could take would be to remove the requirement that gold be held against the note and deposit liabilities of the Federal Reserve banks. The Commission on Money and Credit discussed this problem at length, and I should like to quote the Commission's recommendation:

"The Commission believes that the threat of a confidence crisis would be greatly reduced if it were generally recognized, both here and abroad, that all of the U.S. gold is available to meet our international obligations. Any doubts about U.S. policy should be removed by elimination of the gold reserve requirement at the earliest convenient moment so that all of the U.S. gold stock is available for international settlements."

As a second measure I believe that continued efforts should be made to hold prices on the London gold market from rising unduly and thereby encouraging increased speculation. The speculation in the London market last fall, which drove the price of gold above $40 an ounce temporarily, was a factor that helped accelerate the outflow of short-term capital from this country. The U.S. Treasury (acting through the Federal Reserve) and perhaps other central banks as well, can cooperate with the Bank of England in efforts to prevent extreme moves in the gold price. The resulting cost may be low in comparison to the damage that can be done to confidence through wide speculative moves in the price.

DOMESTIC ECONOMIC POLICIES

U.S. domestic economic policies can also be adapted to reduce the pressure of short-term capital outflows in a period of recession. Such outflows are importantly influenced by differentials in short-term interest rates as between the United States and other industrial nations. The Federal Reserve can supply necessary reserves to the banking system by open market purchases of intermediate-term securities, thus reducing short-term rates less than would be the case if short-term securities were purchased. The Federal Reserve has been following this policy in recent months and I believe the record shows that it has been generally successful.

At the same time, greater reliance on fiscal measures could reduce the amount of monetary ease needed to facilitate business recovery. The resulting deficits could be financed with short-term securities, which would help keep short-term interest rates from declining to unusually low levels. The use of short-term financing by the Treasury is an appropriate procedure in a recession.

REGULATION Q

Regulation Q, under which the Federal Reserve sets ceilings on interest rates which commercial banks can pay on time deposits, should be revised to enable commercial banks to compete more effectively with interest rates abroad, and thus be better able to retain holdings of foreign dollars in the United State. This is particularly important in the case of large dollar holdings of foreign central banks and official institutions, some of which might otherwise be converted into gold.

Steps can also be taken to reduce the profitability and hence the volume of short-term capital flows. To avoid the foreign exchange risk, those who shift short-term funds abroad frequently cover themselves through purchases of dollars in the forward market. By operating in this market, U.S. authorities could increase the cost of purchasing forward dollars, perhaps to the point where shifting funds would not be worth while. This would increase the risks of temporary movements of funds and reduce the volume. U.S. authorities could cover their short position by borrowing from the IMF or from foreign central banks. Such operations have been carried on recently in German marks.

INTERNATIONAL COOPERATION

Several other steps could be taken by agreement among the six or eight countries which are the main holders of foreign currencies. Central banks could agree to hold other currencies for limited periods rather than convert them into gold. This would reduce the possibility of an exchange crisis arising from large shifts of short-term funds. Such cooperative arrangements among central banks have been used in part to cover the shifts in funds following the German revaluation.

It seems to me that the key currency approach is a constructive one. The experience now being accumulated through cooperative efforts could pave the way for further steps to improve the world financial structure.

IMF REVISION

However, I believe we must soon take such further steps to develop a structure that will withstand the massive movements of short-term funds which are now possible as well as to meet eventual needs for a growing volume of international reserves. I believe the most effective approach lies through strengthening the International Monetary Fund along the general lines proposed by Mr. Bernstein. You have just heard him outline his proposals, so I shall not repeat them.

It seems to me that these proposals would, if they could be adopted on the proper scale, deal with the problems we confront in the foreseeable future. It would be possible for key currency countries to rely on drawings from the Fund to finance temporary exchange deficits, since the Fund would be in a position to extend credits in the currencies required. Thus, such nations would have an incentive to integrate their Fund quotas with their reserves. The use of Fund drawings to finance shifts of short-term funds would greatly reduce the possibility of an exchange crisis. Such an arrangement would also provide an incentive to surplus countries to adopt policies to reduce their surpluses. They would have an incentive to increase their imports of goods and services, or engage directly in international aid or investment, rather than to provide funds to the IMF for the use of other countries. The fact of borrowing from the Fund, plus the cost, would give deficit countries an incentive to take steps to eliminate the deficit.

For some years ahead, increased reliance on the Fund, plus new gold production, could cover the needs for increasing liquidity. If necessary, it would be possible to increase country quotas, as was done in 1959. As I said earlier I do not believe that there is any immediate problem of a shortage of overall liquidity in the sense that world reserves of gold and foreign exchange will be inadequate to finance the potential expansion in trade.

At the same time we must not lose sight of this as a longrun problem. Forecasts in this field are notoriously hazardous and unreliable, so I would hesitate to make the judgment that increased reliance on the Fund can solve for all time the problem of liquidity. But I do feel that it can be sufficient in the years immediately ahead. I would caution only that this is a problem that must be kept under surveillance.

A WORLD CENTRAL BANK

It is implicit in what I have said that I do not believe we need go to the extreme of a world central bank, as proposed by Professor Triffin, to deal with the problem of liquidity in the years immediately ahead. Looking into the distant future, it may well be that we should work toward the eventual development of a world central bank. Virtually all national banking systems have evolved toward a central banking system as the most effective and efficient way to operate a financial mechanism. However, I doubt that the world has reached a point where the member nations of a central bank could be counted on to maintain the discipline in their financial policies needed to make such a bank successful.

Moreover, I believe the Triffin proposal has a number of serious disadvantages. I am sure you have heard the general arguments against the Triffin plan so I will mention some of them only briefly, and then turn to its effects on the New York money market.

To my mind, the most telling general arguments against the Triffin proposal can be summed up in the following manner:

First, the cost to the United States would be high in terms of reducing our freedom of action in financing any balance-of-payments deficits. If the Triffin plan had been in effect, the United States would have been under great pressure to reduce its payments deficits in recent years. Yet the fact that foreign recipients of dollars have been willing to hold a good part of them has enabled this country to carry on programs of foreign aid, investment, and military assistance that have been in the national interest. In the future, the Triffin plan would mean that the United States would give up the possibility of financing at least a part of a temporary balance-of-payments deficit through the further buildup of dollar holdings by other countries.

Second, the gold guarantee of deposits in the Fund-Bank and of its investments imposes a high price on the United States. Circumstances could arise under which it would severely constrict our freedom of action because of our large liabilities to foreign holders of dollars. The fact of this huge commitment might push us into restrictive domestic policies well before such policies would be genuinely needed.

A third general objection is that the political and technical problems involved are formidable. It is far from clear that the technical knowledge exists to operate a world central bank without complicating unduly the problems of maintaining prosperity and growth without inflation throughout the free world. I doubt whether most countries, including the United States, would be willing at this time to delegate to an international agency the powers necessary to operate a world central bank.

Over time, many of these problems might be overcome, given the continued cooperation among members of the world financial community. To a large extent the problems are political as well as technical. Certainly nothing like a world central bank would be feasible unless or until a closer economic alliance had been achieved, at least within the Atlantic community. At the same time I feel that there are many technical and operational problems that would have to be solved before a world central bank could operate properly. Thus, I believe the proper approach is one of evolution through increased international cooperation along the lines I suggested earlier.

IMPACT ON NEW YORK BANKS

Some of the technical problems involved can be highlighted by considering the impact of the Triffin plan on the New York money market. As a practical matter the first problem would arise during the extended period of delicate negotiation which would be involved in trying to work through an agreement to establish a world central bank. This would be a period of great uncertainty, in which an upsetting move out of key currencies into gold might develop. The New York banks would face the possibility that their foreign deposits—as much as 15 percent of their total deposits—might be withdrawn on short notice. Even if the Federal Reserve should move to counter such a withdrawal if it occurred, such action would affect the banking system as a whole and New York banks could face a painful readjustment.

Assuming that the Triffin plan were put into operation with no such anticipatory moves, foreign central banks would transfer to the new Fund-Bank almost $2 billion of foreign official deposits now held in New York by commercial banks, plus a substantial amount of short-term investments (Treasury bills, acceptances, etc.) held by these banks for their foreign correspondents. From that point on, additional dollars secured by foreign central banks would be deposited with the Fund-Bank.

Thus, the New York banks would be in a position of dealing with the Fund-Bank rather than with central banks around the world. Each commercial bank's share of international deposits would depend, not on its competitive ability and the quality of the service it rendered, but on the decision of the Fund-Bank acting in agreement with U.S. authorities. Long-established relationships based on mutual confidence and services rendered over many years would be disrupted. In all probability, the Fund-Bank's deposits in the United States would be allocated on some quota basis which would act to penalize banks that had performed the larger share of the services involved in international banking.

One such service is the loans New York City banks have made to both Government institutions and private organizations abroad. In many cases these credits filled pressing needs which could not have been met from any other source. It was possible for New York City banks to extend them because of long-standing relationships abroad and because of the large deposits which foreign central banks and official institutions have maintained in New York. If the banks held such deposits for the account of the Fund, rather than for foreign banks directly, it is very doubtful that New York City banks could continue to assist foreign countries with necessary credits to the degree they have in the past.

Another source of uncertainty would relate to what the Fund-Bank might do with its deposits and how its operations might affect nonofficial foreign dollar holdings. The Fund-Bank's right to liquidate its dollar holdings, even if it were used sparingly or not at all, would introduce a new dimension of uncertainty into the New York money market. While it would undoubtedly be possible to adjust over time to such changes, the adjustment would certainly not be easy, and it could interfere with the ability of the New York banks to provide their traditional services to domestic and oversea customers.

ROLE OF NEW YORK

This brings me to a question posed in the letter of invitation to appear before this subcommittee: Is the role of New York as an international financial center a source of strength or weakness to the United States? I would say that it is an important source of strength. I believe the United States must exercise a role of leadership in international financial matters. This is a part—an important part—of our role in contributing to the defense and development of the free world.

I believe that the New York commercial banks, and the New York money market institutions, are now making a considerable contribution to these broad national objectives. A major part of the financing of our exports and imports of goods and services—a total of some $50 billion a year—is handled in New York. This involves a tremendous amount of detailed work and expert knowledge. Financing foreign trade is a business for specialists who possess the knowledge, ability, and experience to handle transactions throughout the world. These skills have played an important part in making the United States the world's largest trader. And it should be remembered that our foreign trade is many times the size of our foreign aid, so our impact on the rest of the world through our trade and its financing is a most significant part of our overall foreign relations.

In addition, New York commercial banks and investment houses have provided the means through which many foreign governments and foreign businesses have obtained funds essential to their financial and economic progress. At the end of 1960 private loans and portfolio investments from the United States to other countries amounted to no less than $15 billion, and the great bulk of this financing was organized through the financial community in New York.

New and flexible means are constantly being sought to increase the effectiveness of international financing. One such development has been the formation of venture capital investment companies. These companies perform a unique role in setting up joint ventures to develop private business abroad. Typically, such a venture might include participation by a U.S. manufacturing corporation to provide technical knowledge as well as part of the capital, the venture capital company, and investors from the host country. The Chase Manhattan Bank has had such a facility operating in the past few years in the form of an Edge Act subsidiary, the Chase International Investment Corp. There are also a number of similar ventures. Another example is provided by the efforts now underway by commercial banks and insurance companies to work out procedures to provide export credit insurance and medium-term export credits in cooperation with the Export-Import Bank.

Finally, New York City provides the institutional mechanism necessary to make the United States the great reserve currency center of the world. It is not only the banks which are involved, but the money market as a whole—the Government securities market and the dealers who are an integral part of it, the market for commercial paper, acceptance and other short-term paper. This complex mechanism provides safe, liquid investments which attract and retain foreign exchange reserves from foreign commercial and central banks from all over the world. The dollar in consequence of this, and because of the basic strength of the United States, is used as a currency to finance trade, investments, and other transactions in many areas of the world.

All of these matters not only have important economic implications for the United States but they also add to the political strength and position of leadership of the United States in world affairs. Today New York City in many ways is the financial center of the world. That is an inevitable accompaniment of the Nation's position in political and military affairs. We cannot have the one without the other.

Mr. ROCKEFELLER. What I propose to do in my remarks this afternoon is primarily to deal with the problem of international liquidity and to the changes in the international financial structure that may be necessary to deal with this problem. In doing so, I do not in any way wish to minimize the gravity of the balance-of-payments problem our Nation faces, or the urgency of effective steps to achieve a viable balance in our international payments accounts. However, your invitation suggested that I include a discussion of the role of New York as an international reserve center. Thus, I feel it might be advisable to concentrate on the problem of what may need to be done to improve the world payments mechanism, since it seems to me that ties in closely to the questions you have posed.

A the outset, it seems to me important that we recognize that our Nation faces two separate tasks in the international financial area. We must first deal with our balance-of-payments problem, for I do not believe there are any effective devices which could long withstand large continuing deficits on the part of the world's biggest trading Nation and major reserve currency center.

However, success in bringing our basic payments position into balance will not solve the problem of international liquidity. That problem can be defined this way: We seek a world financial structure which will withstand short-term pressures against key currencies and meet the longer term need for an adequate supply of assets acceptable in international payments.

The immediate problem is to improve the world payments mechanism to prevent short-term capital movements from becoming disruptive. In normal times, such movements perform a constructive function in financing international payments. However, short-term capital movements can place excessive pressure on any key currency where the country involved is experiencing temporary balance-of-payments deficits. Such capital movements are also highly sensitive to differentials in short-term interest rates. This fact restricts the ability of monetary authorities to ease money and credit in a recession since such action could drive down short-term interest rates and encourage an outflow of short-term capital. Consequently, we will face a problem of international liquidity even after our basic payments position has been righted.

This problem of short-term liquidity has arisen for two reasons. First, the spread of convertibility among industrial nations has made it possible to shift short-term funds from one market to another in response to interest rate differentials, or in response to changes in the appraisals which holders of such funds make of prospects in various money markets. In many ways, this is a healthy development. Currency convertibility has been one of our foreign policy goals because of the benefits it brings in the form of more effective competition and enlarged trade. The greater mobility of short-term capital makes it possible to handle a much larger volume of trade and investments than was the case before the spread of convertibility. However, it does pose the problem I mentioned earlier of finding ways to keep such capital shifts within proper bounds.

A second reason for concern over the problem of short-term international liquidity lies in the change in the position of the United States. In the earlier postwar period, the dollar was universally regarded as invulnerable. The dollar was the leading reserve currency since dollar holdings could earn interest and were convertible into gold at a fixed price. Thus, foreign dollar holdings were built up from $8.6 billion to $21.4 billion between 1950 and the end of 1960.

This buildup in U.S. short-term liabilities, which has supplied a massive dose of needed international liquidity, now poses problems to the United States. The dollar is no longer invulnerable to any and all circumstances, as is shown clearly by developments of the past 2 years when the dollar has been under pressure.

In a sense, the position of our Nation is somewhat like that of a commercial bank. The United States had demand liabilities at the end of last year amounting to $21.4 billion. Against these liabilities the Nation held $17.8 billion of gold, of which nearly $12 billion was earmarked to back Federal Reserve notes and deposits. U.S. long-term foreign investments are, of course, very substantial. But these long-term investment cannot be liquidated to cover short-term claims against the United States.

Thus, the United States has reached a point where it must be concerned about the pace and extent of the increase in its short-term foreign liabilities. The Nation's reserves are large in relation to our trade and our short-term liabilities. Yet they are not so large in relation to the pressures that could be placed on them by short-term capital movements as to leave room for any complacency. For that reason, the United States has a genuine interest in measures to improve the world financial mechanism to deal with the problem of short-term international liquidity.

If such a mechanism can be developed, the longer term liquidity position of the world would appear to be satisfactory for at least the near-term future. Much has been made of the fact that official gold stocks have been growing at an average annual rate of 2 percent while world trade has been expanding at a 5-percent rate. However, there is no simple and mechanical relationship between the growth of trade and reserves. In large part because of the massive injections of dollars into foreign reserves in recent years, world liquidity is high in relation to world trade. As I shall say later, this may be a problem to watch in the years ahead. But it does not appear to me to be the problem to focus on at the present moment.

What, then, should be done about the short-term liquidity problem? Four approaches have been suggested to improve the world's financial mechanism:

In the first place, it has been suggested that we increase the price of gold.

And secondly, it has been suggested that we strengthen the present mechanism by internal measures and by increasing cooperation among key currency nations;

Thirdly, it has been suggested that we expand the scope of the International Monetary Fund by increasing quotas and enlarging its powers to borrow currencies in surplus;

And, finally, the suggestion has been made to convert the International Monetary Fund into a World Central Bank.

While an increase in the price of gold would appear to be a simple and direct solution, it actually has significant disadvantages. The gains from a markup in the price of gold would accrue chiefly to South Africa and the Soviet Union, the two largest gold producers, and to the Western industrial nations which hold gold. Lesser developed nations would receive minor benefits since they hold little gold. Nations holding their reserves in key currencies would find that these reserves would be worth less in terms of gold. Any hint of a possible gold price change would set off a widespread and disruptive speculative move. Consequently, in my opinion, the case against raising the price of gold is most persuasive.

A second approach which I have already mentioned would involve building on the present mechanism to bolster the ability of key currencies to withstand pressures. Since the dollar is a key currency, it is important to consider what might be done to strengthen the position of the United States as an international banker. There are a number of steps which could be taken unilaterally, and then several others which would require international cooperation.

A first step which we could take would be to remove the requirement that gold be held against the note and deposit liabilities of the Federal Reserve banks. The Commission on Money and Credit discussed this problem at length and concluded that this would be a desirable step for Government to take.

As a second measure I believe that continued efforts should be made to hold prices on the London gold market from rising unduly and thereby encouraging increased speculation.

U.S. domestic economic policies can also be adapted to reduce the pressure of short-term capital outflows in a period of recession. Such outflows are importantly influenced by differentials in short-term interest rates as between the United States and other industrial nations. The Federal Reserve can supply necessary reserves to the banking system by open market purchases of intermediate-term securities, thus reducing short-term rates less than would be the case if short-term securities were purchased. The Federal Reserve has been following this policy in recent months and I believe the record shows that it has been a generally successful policy.

At the same time, greater reliance on fiscal measures could reduce the amount of monetary ease needed to facilitate business recovery. The resulting deficits could be financed with short-term securities, which would help keep short-term interest rates from declining to unusually low levels. The use of short-term financing by the Treasury is an appropriate procedure in a recession, especially in the downward phase of the recession.

And then there is the question of regulation Q, under which the Federal Reserve sets ceilings on interest rates which commercial banks can pay on time deposits, I believe this should be revised to enable commercial banks to compete more effectively with interest rates abroad, and thus be better able to retain holdings of foreign dollars in the United States. This is particularly important in the case of large dollar holdings of foreign central banks and official institutions, some of which might otherwise be converted into gold.

Several other steps could be taken by agreement among the six or eight countries which are the main holders of foreign currencies. Central banks could agree to hold other currencies for limited periods rather than convert them into gold. This would reduce the possibility of an exchange crisis arising from large shifts of short-term funds. Such cooperative arrangements among central banks have been used in part to cover the shifts in funds following the recent German revaluation, and I think used with considerable success.

It seems to me that the key currency approach is a constructive one. The experience now being accumulated through cooperative efforts could pave the way for further steps to improve the world financial structure.

However, I believe we must soon actually take such further steps to develop a structure that will withstand the massive movements of short-term funds which are now possible, as well as to meet eventual needs for a growing volume of international reserves. I believe the most effective approach lies through strengthening the International Monetary Fund along the general lines which you have just heard Mr. Bernstein outline.

It seems to me that these proposals would, if they could be adopted on the proper scale, deal with the problems we confront in the foreseeable future. It would be possible for key currency countries to rely on drawings from the Fund to finance temporary exchange deficits, since the Fund would be in a position to extend credits in the currencies required. Thus, such nations would have an incentive to integrate their Fund quotas with their reserves. The use of Fund drawings to finance shifts of short-term funds would greatly reduce the possibility of an exchange crisis. Such an arrangement would also provide an incentive to surplus countries to adopt policies to reduce their surpluses. They would have an incentive to increase their imports of goods and services, or engage directly in international aid or investment, rather than to provide funds to the IMF for the use of other countries. The fact of borrowing from the Fund, plus the cost, would give deficit countries an incentive to take steps to eliminate the deficit.

For some years ahead, increased reliance on the Fund, plus new gold production, could, in my opinion, cover the needs for increasing liquidity. If necessary, it would be possible to increase country quotas, as was done in 1959. As I said earlier I do not believe that there is any immediate problem of a shortage of overall liquidity in the sense that world reserves of gold and foreign exchange will be inadequate to finance the potential expansion in trade.

It is implicit in what I have said that I do not believe we need go to the extreme of a world central bank, as proposed by Professor Triffin, to deal with the problem of liquidity in the years immediately ahead. Looking into the distant future, it may well be that we should work toward the eventual development of a world central bank. Virtually all national banking systems have ultimately evolved toward a central banking system as the most effective and efficient way to operate a financial mechanism. However, I doubt that the world has yet reached a point where the member nations of a central bank could be counted on to maintain the discipline in their financial policies needed to make such a bank successful.

Moreover, I believe the Triffin proposal has a number of serious disadvantages. I am sure you have heard the general arguments against the Triffin plan so I will mention some of them only very briefly, and then turn to its effects on the New York money market, in which you expressed a particular interest.

To my mind, the most telling general arguments against the Triffin proposal can be summed up in the following manner:

First, the cost to the United States would be high in terms of reducing our freedom of action in financing any balance-of-payments deficits. If the Triffin plan had been in effect, the United States would have been under great pressure to reduce its payments deficits in recent years.

Yet the fact that foreign recipients of dollars have been willing to hold a good part of them has enabled this country to carry on programs of foreign aid, investment, and military assistance that have been in the national interest, and that couldn't possibly have been accomplished otherwise. In the future, the Triffin plan would mean that the United States would give up the possibility of financing at least a part of a temporary balance-of-payments deficit through the further buildup of dollar holdings by other countries.

Second, the proposed gold guarantee of deposits in the Fund-Bank and of its investments imposes a high price on the United States. Circumstances could arise under which it would severely constrict our freedom of action because of our large liabilities to foreign holders of dollars. The fact of this huge commitment might push us into restrictive domestic policies well before such policies would be genuinely needed internally.

A third general objection is that the political and technical problems involved are formidable. I doubt whether most countries, including the United States, would be willing at this time to delegate to an international agency the powers necessary to operate a world central bank.

Over time, many of these problems might be overcome, given the continued cooperation among members of the world financial community. To a large extent the problems are political as well as technical. Certainly nothing like a world central bank would be feasible unless or until a closer economic alliance had been achieved, at least within the Atlantic Community. At the same time I feel that there are many technical and operational problems that would have to be solved before a world central bank could operate properly. Thus, I believe the proper approach is one of evolution through increased international cooperation along the lines I suggested earlier.

Some of the technical problems involved can be highlighed by considering the impact of the Triffin plan on the New York money market. As a practical matter the first problem would arise during the extended period of delicate negotiation which would be involved in trying to work through an agreement to establish a world central bank. This would be a period of great uncertainty, in which an upsetting move out of key currencies into gold might well develop. The New York banks would face the possibility that their foreign deposits—which in some cases amount to as much as 15 percent of their total deposits—might be withdrawn on short notice. Even if the Federal Reserve should move to counter such a withdrawal if it occurred, such action would affect the banking system as a whole and New York banks could face a painful readjustment.

Assuming that the Triffin plan were put into operation with no such anticipatory moves, foreign central banks would transfer to the new Fund-Bank almost $2 billion of foreign official deposits now held in New York by commercial banks, plus a substantial amount of short-term investments (Treasury bills, acceptances, etc.) held by these banks for their foreign correspondents. From that point on, additional dollars secured by foreign central banks would be deposited with the Fund-Bank.

Thus, the New York banks would be in a position of dealing with the Fund-Bank rather than with central banks around the world. Each commercial bank's share of international deposits would depend, not on its competitive ability and the quality of the service it rendered, but on the decision of the Fund-Bank acting in agreement with U.S. authorities. Long-established relationships based on mutual confidence and services rendered over many years would be disrupted. In all probability, the Fund-Bank's deposits in the United States would be allocated on some quota basis which would act to penalize banks that had performed the larger share of the services involved in international banking.

One such service is the loans New York City banks have made to both government institutions and private organizations abroad. In many cases these credits filled pressing needs which could not have been met from any other source. It was possible for New York City banks to extend them because of long-standing relationships abroad and because of the large deposits which foreign central banks and official institutions have maintained in New York. If the banks held such deposits for the account of the Fund, rather than for foreign banks directly, it is very doubtful that New York City banks could continue to assist foreign countries with necessary credits to the degree they have in the past.

Another source of uncertainty would relate to what the Fund-Bank might do with its deposits and how its operations might affect nonofficial foreign dollar holdings. The Fund-Bank's right to liquidate its dollar holdings, even if it were used sparingly or not at all, would introduce a new dimension of uncertainty into the New York money market. While it would undoubtedly be possible to adjust over time to such changes, the adjustment would certainly not be easy, and it could interfere with the ability of the New York banks to provide their traditional services to domestic and oversea customers.

This brings me to a question posed in the letter of invitation to appear before this subcommittee: Is the role of New York as an international financial center a source of strength or weakness to the United States? I would say that it is an important source of strength. I believe the United States must exercise a role of leadership in international financial matters. This is a part—an important part—of our role in contributing to the defense and development of the free world.

I believe that the New York commercial banks, and the New York money market institutions, are now making a considerable contribution to these broad national objectives. A major part of the financing of our exports and imports of goods and services—which totals somewhere in the neighborhood of $50 billion a year—is handled in New York. This involves a tremendous amount of detailed work and expert knowledge. Financing foreign trade is a business for specialists who possess the knowledge, ability, and experience to handle transactions throughout the world. These skills have played an important part in making the United States the world's largest trader. And it should be remembered that our foreign trade is many times the size of our foreign aid, so our impact on the rest of the world through our trade and its financing is a most significant part of our overall foreign relations.

In addition, New York commercial banks and investment houses have provided the means through which many foreign governments and foreign businesses have obtained funds essential to their financial and economic progress. At the end of 1960 private loans and portfolio investments from the United States to other countries amounted to no less than $15 billion, and the great bulk of this financing was organized through the financial community in New York.

New and flexible means are constantly being sought to increase the effectiveness of international financing. One such development has been the formation by a number of the commercial banks of venture capital investment companies. These companies perform a unique role in setting up joint ventures to develop private business abroad. Typically, such a venture might include participation by a U.S. manufacturing corporation to provide technical knowledge as well as part of the capital, the venture capital company, and investors from the host country. The Chase Manhattan Bank has had such a facility operating in the past few years in the form of an Edge Act subsidiary, The Chase International Investment Corp. There are also a number of similar ventures. Another example is provided by the efforts now underway by commercial banks and insurance companies to work out procedures to provide export credit insurance and medium-term export credits in cooperation with the Export-Import Bank.

Finally, New York City provides the institutional mechanism necessary to make the United States the great reserve currency center of the world which it is. It is not only the banks which are involved, but the money market as a whole, the government securities market and the dealers who are an integral part of it, the market for commercial paper, acceptance and other short-term paper. This complex mechanism provides safe, liquid investments which attract and retain foreign exchange reserves from foreign commercial and central banks from all over the world. The dollar in consequence of this, and because of the basic strength of the United States, is used as a currency to finance trade, investments and other transactions in many areas of the world.

All of these matters not only have important economic implications for the United States but they also add to the political strength and position of leadership of the United States in world affairs. Today New York City in many ways is the financial center of the world. That is an inevitable accompaniment of the Nation's position in political and military affairs. We cannot have the one without the other.

Therefore, I would suggest, let us not do anything which would weaken New York as a financial center.

Representative REUSS. Thank you, Mr. Rockefeller.

Senator Bush?

Senator BUSH. Mr. Rockefeller, I express my appreciation along with that of the chairman, for your coming down here to testify today.

I know it is a difficult chore to prepare such an excellent statement as you have given.

And I am particularly impressed with your comments about the so-called Triffin plan. Professor Triffin is a friend of mine, a professor up at Yale University, with whom I have talked a good deal, and I have puzzled over his plan a good deal without being convinced that it was the right approach to this thing.

I think your argument as to what it would do to our financial center of this country, in New York City, is the best I have seen. I think you have made also a very eloquent—I will not say defense—but a very eloquent statement on behalf of our financial community, and particularly those great institutions that have been engaged in the field of international finance, of which your own institution has been outstanding, of course, for a great many years.

I do not have any questions, Mr. Chairman. But I again say I am very grateful to Mr. Rockefeller for coming down.

Mr. ROCKEFELLER. Thank you very much, Senator.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. I would like to ask Mr. Rockefeller, in your statement, Mr. Rockefeller, you have framed this first step in the currency approach somewhat differently from the second measure. You say,

> A first step which we could take would be to remove the requirement that gold be held against the note and deposit liabilities of the Federal Reserve banks.

And then on the second measure you say:

> I believe that continued efforts should be made to hold prices in the London gold market.

I just wanted to be sure that this first is what it seems to be, a clear recommendation on your part that we do give up the gold backing.

Mr. ROCKEFELLER. The reason I phrased it as I did was that the first one happens to be a very clearcut recommendation of the Commission on Money and Credit of which I was a member. I completely associate myself with the recommendation of the Commission.

Senator PROXMIRE. Then, you say:

> The Federal Reserve can supply necessary reserves for the banking system.

This is down in the second paragraph, the third sentence:

> The Federal Reserve can supply necessary reserves to the banking system by open-market purchases of intermediate term securities, thus inducing short-term rates less than would be the case if short-term securities were purchased.

Now, you are taking the position that the Federal could adopt a policy of increasing their purchase of intermediate term securities over their present policy, or is this a position supporting the present policy?

You see what I am getting at is that we have had Mr. Martin appear, and it is his position that they have abandoned their bills-only policy. It is my position at least that they are still overwhelmingly in bills.

Now, are you taking the position that under the present circumstances that they could constructively follow a policy of buying more intermediate term securities than they are?

Mr. ROCKEFELLER. I felt that the change in their policy which was initiated several months ago has been working rather well and rather effectively. And I really am more supporting the general trend of their recent policies in this regard as contrasted with the bills-only policy which they have followed for a number of years previously.

Incidentally, another recommendation of the Commission on Money and Credit is that the bills-only policy should not be adhered to in any rigid sense—that there should be a departure from it whenever it appears to be in the interest of national policy.

And I think that recent experience provides a good illustration of an instance where it is in the interest of the national well-being to depart from it.

Senator PROXMIRE. Then you feel that this is a policy that they can constructively follow in the coming years in view of the international monetary situation which has seemed to develop, that they can follow this policy by and large over the next few years?

Mr. ROCKEFELLER. From time to time when the circumstances warrant.

I have the feeling that it will be more effective if they adhere as a regular rule to bills-only and depart from it only in special circumstances. If they depart from bills-only too much of the time, it will be less effective than doing it from time to time as a special indication of what they are trying to accomplish.

Senator PROXMIRE. Of course, I look at it a little differently, I am looking at it from the standpoint of the taxpayer, that buying longer term securities might be advantageous.

Mr. ROCKEFELLER. Of course, the interest cost of the public debt is a factor which certainly ought to be weighed very carefully by our Government. But it is only one of the considerations, it seems to me, and I would feel that it perhaps was less important than some of our other national objectives, such as, for example, relative price stability, and the maintenance of a reasonably even balance of payments, which would be very much influenced by this.

Senator PROXMIRE. We could have a discussion on that.

But after you discuss—somehow throughout this I miss several other steps that we might take to strengthen the dollar, one of which at least was mentioned by Mr. Bernstein, and that is keeping our costs down. And another that might have somewhat the same effect is the balanced budget.

I notice you make this statement, that we might push ourselves into restrictive domestic policies. And I am wondering if you feel that under the present circumstances that we don't have to pay quite as much attention to keeping costs down and balancing the budget as a means of strengthening the dollar.

Mr. ROCKEFELLER. Indeed I do think it is important to balance our budget, at least in times of prosperity. The reason that I didn't mention the two points that you raise here was the fact that in the beginning I was dealing primarily with international liquidity rather than the balance of payments.

Senator PROXMIRE. I understand that. But you were also dealing with the key currency approach, and you discussed ways that we can strengthen the dollar.

Mr. ROCKEFELLER. I would accept your amendment of added ways to strengthen the dollar, and very importantly, to keep our domestic economy in order, and maintain a stable price level.

Senator PROXMIRE. You feel that a balanced budget would be useful and would not be unduly restrictive under these circumstances?

Of course, we can always generalize that prosperity is desirable, but the grim and contradictory facts are that we do have as you know 5 million unemployed, but on the other hand, we do have a high income and considerable personal spending, and so forth.

Mr. ROCKEFELLER. This is why I think I would prefer to put emphasis on the maintaneance of reasonable price stability rather than the balanced budget, because I think that should be something that should fluctuate with the business cycle.

Senator PROXMIRE. There is just one more question, and that is, the objection to going off the 25-percent gold backing. It seems to be a psychological objection, but that does not mean it is less valid.

Mr. ROCKEFELLER. Going what, sir?

Senator PROXMIRE. The 25-percent backing of gold. I am just wondering if there isn't a great deal of validity in the notion that we lose the discipline that we have, the feeling that so long as we have that 25-percent backing we have an anchor which tends to provide real monetary stability, and a confidence which is very useful. Do you not think we are surrendering some of this when we give it up?

This is the argument that I understand has been made by the Wall Street Journal and others who feel very strongly about it.

Mr. ROCKEFELLER. I know that there are people who feel very strongly that that is important. I was rather impressed by the newspaper accounts of Secretary Dillon's and Mr. Heller's testimony yesterday on that point, pointing out the huge gap that there is between our present reserve and how much they could expand the currency before they had to call on this reserve. In other words, I don't really believe that financial discipline and integrity depends to any significant extent at all on the reserve requirement.

And my own feeling is that gold in the present-day world is more useful as a means of facilitating and financing international trade and investment than it is in terms of domestic policy.

Senator PROXMIRE. And you feel that there is no general feeling in the financial community that this is necessary to the integrity and the stability of the dollar?

Mr. ROCKEFELLER. Well, I would hesitate to speak for the financial community as a whole.

Senator PROXMIRE. If you can't, it is hard to find someone who can.

Mr. ROCKEFELLER. I think there are differences of opinion. I believe that a number of my colleagues in New York have expressed themselves as I have here today in favor of amending the gold reserve requirements—Mr. Henry Alexander, for example, did several months ago.

On the other hand, I am sure that you wouldn't have to look too far to find some who would take a different view.

Representative REUSS. Senator Javits?

Senator JAVITS. Mr. Rockefeller, we are very glad to welcome you here. I join my colleagues in that. And the excellence of this statement is, by us in New York, expected.

Perhaps that is the best thing that anyone could say about your presentation.

I also appreciate very much your emphasis upon the place of New York in the financial life of the country and the world. There is a tendency around here often to feel and say that New York draws everything down from the country, kind of siphons it off, but very little and very rarely—but very little is said, all too rarely, about its functions, and how essential it is to our operations, and the fact that in every country there must be a center—in our country it is New York, not Washington—the economics of our country. And I think you make a very good case on the constructive leadership that New York has given, certainly in modern times, to the financial stability of the country, and in giving it the material with which to progress and develop.

As a Senator from New York, I am very grateful to you for giving us this appraisal, and I think it would be very helpful.

I do have a few questions which your statement brings to mind.

One, in which you juxtapose our demand liabilities to our holdings of gold, which you properly say are the final and ultimate way in which those short-term liabilities could be repaid, the demand liabilities, do you have an opinion as to the maintenance by us of the reserve for the currency which you called attention to that was taking $12 billion—there was some feeling, and if I recall it correctly, I saw it favorably commented on in the newsletter of one of your sister institutions in New York, the First National City Bank—raising the point that this amount of reserve in gold tied up for that purpose is probably more than we need under present conditions, and we are in a sense restricting ourselves because of it.

Do you have any opinion you would like to give us on that?

Mr. ROCKEFELLER. I believe that is the question to which I addressed myself, where I said that I would favor the complete abolition.

Senator JAVITS. The complete abolition?

Mr. ROCKEFELLER. Yes.

Senator JAVITS. And that would be helpful.

Now, also, I would like to call your attention to the four approaches that you have suggested. And I would like to be sure we understand precisely your recommendations. I gather you rejected the idea of an increase in the price of gold as a solution to the problem.

Mr. ROCKEFELLER. Yes.

Senator JAVITS. You do see something in strengthening the present mechanism by internal measures such as, for example, the abolition of the reserve against currency, and by increased cooperation among key currency countries, and you expanded from that a little later on.

I gather you do favor expanding the role of the IMF very much as recommended by Mr. Bernstein who preceded you on the stand, but you reject the conversion of the IMF into a world center bank, or the establishment really, as Triffin suggests, of a world Federal Reserve System?

Mr. ROCKEFELLER. For the foreseeable future.

Senator JAVITS. For the foreseeable future.

That about represents your recommendation.

Now, turning to your statement, I gather you call for legislation by us, or a change at least, in respect to regulation "Q."

Mr. ROCKEFELLER. I am not sure that would require legislation, Senator. I have been told that this could be done by action on the part of the Federal Reserve Board.

Senator JAVITS. And that, I gather, you feel would be to President Kennedy's desire to deal with the question of what he would like to see, the climbing long-term rates and competitive short term?

Mr. ROCKEFELLER. I don't know that it would be specifically in harmony with that. The reason that I would advocate the removal of these restrictions on interest rates which commercial banks can pay on time deposits is that in times of relatively high interest rates, when interest rates are higher in Europe than they are here, we are estopped from maintaining balances in this country because there is a ceiling, and higher rates are paid abroad, and it seems to me that this is against the best interests of the United States to see those short-term capital funds flow.

Certainly not all of the funds would have been stopped had the ceiling been removed, but I think that a fair percentage of them might have stayed in this country.

Senator JAVITS. Now, the President in his message, one of his messages, made the point that he would like to see short-term interest rates competitive in the way that you have described. He also made the point that he would like to see long-term interest rates on the whole lower.

Now, do you think that this can be done?

Mr. ROCKEFELLER. I think it is, frankly, going somewhat against the laws of supply and demand.

I don't see really myself how over any extended period of time one could hope to hold long-term rates low and allow short-term rates to go higher, short of infusing a tremendous amount of inflationary credit into the system.

Of course it is possible to peg rates, and this was done in wartime.

But I should think this would not be a wise course to follow, to hold long-term rates artificially low by pumping Federal Reserve credit into the system.

Senator JAVITS. Now, there seems to be a popular conception that all bankers want interest rates to stay high. What do you think about it?

Mr. ROCKEFELLER. We would like to see them fluctuate in response to the pressures of demand and supply of credit. Just as we feel that the whole flexible price system is a healthy thing in an enterprise economy, we feel that interest rates should be responsive in much the same sense as other prices should be.

Senator JAVITS. And is it not a fact that to a bank money is a commodity, and, therefore, if you sell more of it, or in your case lend more of it, even at lower rates, you could still do very well?

Mr. ROCKEFELLER. Precisely.

But if our demand for loans is greater than our supply of available funds, the natural way to control that is through higher rates, and this is what happens in the market, and the reason, frankly, that interest rates in the New York and general banking markets of this country have not gone down in the recent recession is that loan demand in the country generally has remained remarkably high relative to deposits.

Senator JAVITS. Do you see the various measures which you do recommend as contrasted with those that you reject as giving us a better base for a greater availability of credit, and, therefore, in a very constructive way leaning toward lower interest rates, and by broadening the base for the credit of the Western World generally as you recommend here?

Mr. ROCKEFELLER. I do think that the recommendations would be in the general interest of the country and the world.

Senator JAVITS. That this would be a very constructive path on our part, and it would work better in your view—I am using a leading question in order to save time, although I think I understand your point of view—would work better from our point of view than the artificiality that would be involved rather than leave short-term interest rates to find their own levels, rather than trying to hold down long-term interest rates?

Mr. ROCKEFELLER. I would personally feel that it is in the best interests of the country to allow both to seek their own levels.

Senator JAVITS. But you give the conditions in which levels are likely to move lower because of a broad base such as based upon those recommendations; am I correct in that?

Mr. ROCKEFELLER. Yes, sir.

Senator JAVITS. Thank you very much.

Mr. ROCKEFELLER. You are welcome.

Representative REUSS. Senator Pell?

Senator PELL. Mr. Rockefeller, I would like to add my thanks for your coming down. Not being too well educated myself, I guess, in economics, I find your testimony particularly interesting, because it was clear, and I understood it.

Mr. ROCKEFELLER. Thank you very much, Senator.

Senator PELL. I was also struck by the fact that you put up such a vigorous defense for New York. To my knowledge, over the past few years one finds more forward thinking, in spite of popular misconceptions, coming out of Wall Street and the most progressive establishments there. Perhaps some indication of that is that four out of the five Senators on this panel have had some background on Wall Street.

Representative REUSS. And even the member who has no connection with Wall Street finds that you can't kick it around any more with the same gusto that you used to.

Mr. ROCKEFELLER. I hope that my testimony might encourage some to come back to Wall Street after they finish their terms in Washington. They would be most welcome.

Senator PELL. With regard to the question of interest rates, regulation "Q," that you mentioned, what is the degree of differences you think would be advisable? Would you like to see the regulation lifted entirely?

Mr. ROCKEFELLER. I would go along with the recommendations of the Commission on Money and Credit on this point, and their recommendation is that the ceiling be removed altogehter, but that the Federal Reserve maintain a standby authority to impose them again in case of some real emergency or crisis.

Senator PELL. What level do you think would be reached in times of intense demand?

Mr. ROCKEFELLER. It is hard to say.

Interest rates paid in the London and European markets for time money is in recent months perhaps as high as 4 or 4½ percent. Of course, in previous periods, in the late 1920's, they went very much higher.

And I would think that there would be moments in which it might be necessary to reimpose a ceiling.

But I think as a general rule it is better not to have an arbitrary ceiling.

Senator PELL. Actually, I guess, there would be a legal limitation, in that New York State—Senator Javits is more informed than I am—has a 6 percent limit in its own law, isn't that right?

Senator JAVITS. Usury is above 6 percent, but it doesn't apply to corporations, and hence for the practical purpose of dealing with banks and banking as Mr. Rockefeller is testifying to, I don't think it would be really pertinent.

Mr. ROCKEFELLER. Also doesn't it apply to money people borrow from banks rather than deposit in banks?

Senator JAVITS. Yes.

Mr. ROCKEFELLER. As a practical matter, I don't think there is any danger of it going that high.

Senator PELL. You want the ceiling removed as a means of strengthening your competitive position vis-a-vis the banks abroad?

Mr. ROCKEFELLER. This is the most important reason for the change, at least in the context of this present discussion, as I see it.

Senator PELL. And then a final question:

I notice in your statement you mentioned the fact that gold is predominantly produced in South Africa and the Soviet Union, which are obviously areas over which we do not have complete control as to the supply.

I was wondering what your view was with regard to the importance of preserving the gold standard as it is. Do you see the possibility of actually working out some form of currency that can be pegged around a standard other than the gold standard?

Mr. ROCKEFELLER. Of course, as you know, Senator, we have not had the gold standard, strictly speaking, since 1933 in this country.

Senator PELL. But still on a practical scale——

Mr. ROCKEFELLER. What I was suggesting here was that gold still has some usefulness and importance in terms of international economic and monetary relations, and I feel it could and should be reserved for that purpose.

But I feel its usefulness in terms of our domestic economy is very much less, and that is the reason for the recommendation that it be no longer used as a basis for our currency.

Senator PELL. Thank you.

Representative REUSS. Mr. Rockefeller, am I right in thinking that you were not only a member of the Commission for Money and Credit but you were a chairman of the Subcommittee on the International Monetary Fund?

Mr. ROCKEFELLER. I was chairman of the Task Force on the International Monetary Fund, yes.

Representative REUSS. And the recommendations of your task force are embodied in the chapter——

Mr. ROCKEFELLER. Yes, although, frankly, the task force chairman did not identify separate recommendations from the report as a whole, in fact all of the work of the task forces was brought before the Commission as a whole, and the final recommendations represented the combined thinking of the entire group, not of a particular task force.

Representative REUSS. I think that the recommendations on international monetary matters were particularly cogent, and if you want to avoid receiving these plaudits you may——

Mr. ROCKEFELLER. Thank you.

Representative REUSS. I want to ask about some of them, not all of which are specifically mentioned in the statement this afternoon.

One of the recommendations in the CMC report was that since this country has forbidden its nationals to hold gold abroad, we should, therefore, move through whatever channels are open to us, OECD perhaps, to get other like-minded countries to impose a similar prohibition on their nationals.

Mr. ROCKEFELLER. Yes, it was. And this is in harmony with the recommendations I mentioned a moment ago to Senator Pell; namely, that we feel that gold should be used primarily for international purposes, and we shouldn't be the only country to do so. It would much more be effective if all countries prevent the nationals from holding gold. And, of course, this is not now the case and therefore a considerable amount of gold is hoarded by individuals in certain countries, and if that gold becomes available, it would contribute considerably to the total fund of international liquidity.

Representative REUSS. I certainly agree with that recommendation, although I can see many practical and political difficulties in getting it on the statute books of other countries and of getting it enforced thereafter.

However, there is a somewhat more limited recommendation which the Commission didn't explicitly make, but which I think might do a large part of the job, and I would like your views on it.

Suppose we attempt to secure the agreement of our leading trading partners, not to sell gold to private persons, that is, to sell gold only to other central banks and governments? This would mean that while you might not get the gold out of present hoards, you could at least prevent the free world stock of monetary gold from being depleted by sales to private persons.

And this is something that could be controlled.

Would you agree that this might be a more realistic and practical recommendation?

Mr. ROCKEFELLER. It might very well. Of course, there is always the sale for industrial purposes, which would have to be authorized, anyway, I suppose.

Representative REUSS. We do that here, though, do we not?

Mr. ROCKEFELLER. We do that here as well. Whether one would run into laws in some of the countries which would prevent that, I do not know. But certainly, if it could be done, I would see no reason why it would not be a very good way of handling it. We recognize that our recommendations were even more gratuitous in this case than they were in the others involving the Congress of the United States.

Representative REUSS. Well, I think you are on the right track in suggesting it.

Mr. ROCKEFELLER. We felt it was worth mentioning because it is relevant to the total picture.

Representative REUSS. In the CMC report, it is recommended that, at times like the present, we should place greater reliance on fiscal measures. This would reduce the need for monetary ease in facilitating recovery.

Mr. ROCKEFELLER. We have in mind such things as taxation and Government spending.

Representative REUSS. You quite courageously faced up to the need for greater deficits than would otherwise be the case. Do I understand that you and your colleagues believe a budgetary deficit would not prove disconcerting to foreigners nor, in and of itself, cause a flight from the dollar?

Mr. ROCKEFELLER. Well, this, again, is a function of the business cycle policy. We certainly do not favor persistent deficits. But we did feel that in periods of large unemployment and a very low rate of economic growth, budgetary deficits can be a useful and important measure in dealing with those problems.

Representative REUSS. Reliance on fiscal measures rather than monetary measures to get out of a recession tends to emphasize the public sector of the economy over the private sector, does it not? If you use monetary ease, businessmen are encouraged to borrow to build inventories, private plants, and equipment. If you use fiscal means, you spend on schools, dams, and the like.

Mr. ROCKEFELLER. This is certainly true.

Representative REUSS. Is this a consequence which you evaluated and still decided was a price worth paying?

Mr. ROCKEFELLER. At certain times, to achieve certain objectives. What we recognize is that the United States has multiple economic objectives, and that at certain phases in the cycle or in our history, one becomes more important to be dealt with than another, and depending on which is uppermost at the moment, one has to select the instruments and the measures which would be most effective to deal with that particular problem.

Representative REUSS. Did you think of attacking the problem of disparity in interest rates from the other side? That is to say, you have shown a commendable willingness to make recommendations which have to be implemented by other countries, like the prevention of private gold-holding. If we could induce our trading partners, our free world allies who now have restrictive monetary policies and high interest rates, which causes some of the capital flow out of our country, to rely more on fiscal means and less on monetary means to fight their incipient inflations might it not be a more useful way of reducing differences in interest rate structures?

Mr. ROCKEFELLER. It could be.

Representative REUSS. Senator Javits, do you have any questions?

Senator JAVITS. I have nothing.

Senator PELL. I have none.

Representative REUSS. I may have one or two more.

In your very interesting discussion about New York as an important economic and financial center, I want to try to sort out the portions of your remarks which were directed at questioning certain aspects of the Triffin plan and those which were merely to the general point of whether or not New York is important to the economy.

This subcommittee and individual members of it, I hasten to say, have not, I am sure, made up their minds on the mechanics of the Triffin plan, the Bernstein plan, or any of the others; that is the point of these hearings. The Triffin plan would, it is true, substitute the Fund Bank as the depositor in New York banks for the individual foreign central banks, with whom you have built up close working relationships over the years.

However, adoption of the Triffin plan would not, I should think, in and of itself, in any way impair New York's present eminence as a financial center for long-term capital investment, for the money market, or for the financing of foreign trade.

Mr. ROCKEFELLER. To the extent that the plan resulted in a diminution of deposits held by the New York banks from foreign central banks, it would inhibit our ability to make loans and to finance trade abroad. Inasmuch as the New York market, the New York banking system, has been declining percentagewise relative to the rest of the country, in terms of the deposits that they hold, these foreign balances are of very considerable, even crucial importance.

Therefore, I would not underestimate the impact that a plan such as the Triffin plan might have in diminishing the New York banking system's effectiveness in the world market.

Representative REUSS. Well, I never thought, in my reading of the Triffin plan, that the amount of deposits held in New York by the Fund Bank would necessarily be less than the present total of deposits by the central banks.

Mr. ROCKEFELLER. Maybe so. I think that when one institution has full control, somehow it is very tempting to cut down. Certainly, this is our experience from mergers of companies, or when mergers of companies or banks take place, that by and large one almost never gets the combined deposits of the two institutions that have been merged. My guess would be that the same would apply here. One would see a diminution of the total deposits held, because you are perfectly right, there is no absolute reason why this would have to happen.

Representative REUSS. If it did happen, and it appeared desirable to make a compensating adjustment, could not the Federal Reserve reduce reserve requirements for central reserve city banks?

Mr. ROCKEFELLER. Yes, but you see, the differentials between the different groups of banks are being eliminated, between the central reserve and the——

Representative REUSS. The Congress, of course, given such a situation, could reinstate it.

Mr. ROCKEFELLER. It could reinstate it, but unless it does and unless it does it specifically for the central reserve city banks, it would help all the banks equally, and our relative position would still be impaired.

Representative REUSS. Thank you very much, Mr. Rockefeller. We appreciate your help.

The subcommittee will now stand adjourned until 10 o'clock tomorrow morning in room 1301 of the New House Office Building.

(Whereupon, at 4:40 p.m., the subcommittee was recessed, to reconvene at 10 a.m., Wednesday, June 21, 1961.)

INTERNATIONAL PAYMENTS IMBALANCES AND NEED FOR STRENGTHENING INTERNATIONAL FINANCIAL ARRANGEMENTS

WEDNESDAY, JUNE 21, 1961

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND
PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Committee met, pursuant to recess, at 10 a.m., in room 1301, New House Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss, Senators Douglas, Proxmire, Pell, Bush, and Javits.

Also present: John W. Lehman, deputy executive director and clerk; and Emile Despres, Lorie Tarshis, and William Salant, staff consultants.

Representative REUSS. The Subcommittee on International Exchange and Payments will be in order.

Because of a hearing now being conducted by the Appropriations Committee on the budget of the Joint Economic Committee, most of my brethren are detained.

I note the appearance here of a panel of four distinguished international economists. All four have submitted papers.

Copies of the paper by Mr. Harry Johnson of the University of Chicago have unfortunately been delayed in the mails so that we were unable to make it available this morning.

I think what I shall do is to order that all four papers, including Mr. Johnson's when it arrives, be admitted to the record at these hearings. In order that we may have a discussion of the points raised by the papers, I would like to ask each of you to give the substance of his paper from the panel table.

I will leave it entirely to you how fully and to what extent you wish to do that.

Mr. Johnson's paper, I am told, is fairly brief and, because we do not have copies here, I would appreciate, Mr. Johnson, if you would read rather fully from your copy of the paper so that we can get the full benefit from it.

We should have some sort of time target, since we are on for 2 hours this morning. You gentlemen are busy, and I do want to excuse you after that. I think we ought to have at least an hour for dialogue, which comes to something like 15 minutes each. You aren't going to be killed if you use a little more or a little less, but I think we should have something to shoot at.

Would you start out, Mr. Danielian, since you are on the right, and give us the benefit of either your full presentation or a summary of it?

Mr. DANIELIAN. Mr. Chairman, I expected to be the last on this panel, for a very selfish reason. However, I shall be delighted to take on the introductory statement.

I do want to make one point. My prepared statement is somewhat longer than 10 minutes. Perhaps I could plead for some tolerance, because in so many of the committee's hearings many hours have been devoted primarily to presentation of a central banking and monetary point of view, and not enough attention has been given to the basic industrial and economic factors. I shall not ask for equal time, because that would be unfair to the committee, but I would like the opportunity of reading as much of this statement as you would show indulgence for.

Representative REUSS. Surely, although you understand that the entire paper has been admitted in the record and will appear in our committee hearings and reports.

Mr. DANIELIAN. Yes.

Representative REUSS. Proceed, Mr. Danielian.

Mr. DANIELIAN. I shall try to skip parts that are not necessary to the argument.

(The statements referred to are as follows:)

STATEMENT OF N. R. DANIELIAN BEFORE THE SUBCOMMITTEES ON INTERNATIONAL EXCHANGE AND PAYMENTS

I appear today in my individual capacity. None of the ideas expressed in this paper have been submitted, cleared, or approved by any member of the International Economic Policy Association. I do not know if they will condone or condemn my appearance and expressions here. But I feel strongly that, in the national interest, some of the issues confronting this country in its international economic policies are so serious that they deserve a candid appraisal.

I shall, therefore, confine this brief discussion to an analysis of the causes for the balance-of-payments deficits of the United States, their effect upon our reserve situation, and the applicability of the remedies being recommended.

We are all familiar with the conditions which bring this inquiry into focus. The United States has run cumulative balance-of-payments deficits from 1950 to 1960 inclusive, of over $23 billlion. Of this, over $6 billion have been taken out in gold. In the same interval, the gold reserves of the country have diminished from about $24.1 billion to less than $18 billion. Of the remaining gold supplies, about $12 billion are committed to sustaining the reserve requirements of Federal Reserve deposits and notes, leaving a little less than $6 billion of free gold to pay outstanding international short-term claims against the United States under our gold exchange standard. In the meantime, these claims against the United States have increased to over $20 billion.

The wonder is not that these things have happened, but that we have allowed this situation to develop without taking corrective action. In June 1959, I urged the Treasury Department to speak out on this subject at a conference our organization gave in Washington on "The U.S. Economy and International Relations." There was understandable reticence; for, in September 1959, when the Secretary of the Treasury warned the meeting of the Board of Directors of the International Monetary Fund of the dangers of this developing situation, and in October 1959, the Development Loan Fund established the policy of U.S. procurement, there was unanimous criticism by the press, the academic profession, reasearch organizations, and even by spokesmen for other departments of the Government. As a result, even the Treasury Department became gun shy—until after the November 1960 election.

Anyone traveling in foreign countries in 1959 and 1960 could have easily anticipated the impending crisis. After such a trip, a garden variety economist like mystelf was able to predict it.[1]

But U.S. economists and financial leaders alike chose to underplay the problem until the eye-opening gold crisis of October and November 1960. Since then, we have been besieged by a plethora of panaceas.

The reason we failed to anticipate and take corrective action is that the analytical tools that are applied are no longer applicable to the present-day conditions. And, of course, influential vested interests have developed for continuance of the policies that were originally designed to resolve the postwar dollar shortage abroad. We economists have abdicated to public relations experts, and they have become purveyors of academic platitudes which even we have come to believe, and the decisionmaking power in our Government it often paralyzed.

EXPENDITURES ABROAD

The first step toward better understanding would be to recognize the fact that the United States, as the Secretary of the Treasury stated on Monday, is going through a transitional period in its international economic and financial relations. In the immediate post-World War II period, the primary, recognized, international economic policy of the United States was the reconstruction and rehabilitation of our former allies and some of our former enemies. This was the period during which dollar shortage and dollar gap were the focal points of attention, and to correct this, we adopted certain economic and financial policies, all of them designed to put dollars into needy countries, such as:

(1) Transfers of massive amounts of U.S. dollars through Government grants and loans;

(2) Offshore procurement by U.S. governmental agencies;

(3) Military expenditures abroad;

(4) Reduction of tariffs by the United States to permit other countries to sell here and acquire dollars.

Foreign economic aid from July 1, 1945, through December 31, 1960, amounted to \$50 billion (\$49,939 million); military expenditures abroad, 1946 through 1960, are reported to be \$30 billion (\$29,821 million); military assistance, of which it is said that only 10 percent is procured offshore, \$28 billion (\$27,842 million). The Government spent another \$3¾ billion for miscellaneous services abroad. The total in these categories alone amounts to \$111¾, or roughly \$112 billion.[2]

It will be said that much of the foreign aid and military assistance was procured in the United States. This was certainly true in the early years, when this country was almost the sole available supplier, and it is still true as far as military assistance is concerned (except for the 10 percent which the executive departments admit is still procured abroad). As for economic aid, it is quite clear from the record that a diminishing proportion has been spent on U.S. procurement. From 1954 to 1960, the proportion of ICA expenditures, just to cite one example, spent in the United States, went down from 74 to 37 percent.[3] Of course, most of the direct U.S. military expenditures abroad has been a net outflow of dollars. The result, of course, has been large contributions to our balance-of-payments deficits which, since 1950, have amounted to \$23 billions.

The task that the United States set out to accomplish in 1945 has been surpassed. But our concepts have not adjusted to the changing circumstances. There is a tendency, in economic thinking in this country, to apply the concepts of free trade, or so-called liberal trade policies, to procurement under these massive outpayments of dollars by Government. But there is nothing free or voluntary about the decisions that lead to these expenditures. They are forced savings, through the taxing power, and the form and area of application are moti-

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[1] Before the Foreign Affairs Committee of the House, Mar. 3, 1960, on the mutual security program:

"We have an obligation as the world's banker to maintain the strength of the American dollar. If continued gold outflow leads dollar-holding nations to even suspect that we may face devaluation of the dollar at some future date, we may find those nations stepping up their gold withdrawals."

[2] U.S. Department of Commerce, "Foreign Grants and Credits by the U.S. Government," December 1960 quarter, table 1A. U.S. Department of Commerce, "Balance of Payments Statistical Supplement," 1958, p. 13. U.S. Department of Commerce, "Survey of Current Business," November 1959, p. 15. U.S. Department of Commerce, "Survey of Current Business," December 1960, p. 20.

[3] U.S. Department of State, "An Act for International Development, A Summary Presentation," June 1961, p. 175, table 2.

vated purely by political and military considerations. It is only when the question of procurement comes up that there is a hue and cry about "liberal trade" policies, and "the most effective utilization of resources," two currently favorite cliches.

There is no economic theory and no precedent that covers this entirely new and unequaled undertaking by the people of the United States since World War II. It is unique; it is gigantic in dimensions, and it is completely unprecedented in history.

In 1960, alone, U.S. direct payments abroad, exclusive of unrecorded transactions, and not including any Public Law 480 or other aid money spent in the United States and exclusive of Government purchases through subsidiaries of foreign corporations or importers, amounted to $4.6 billions.

There is no economic theory, or principle of international trade and finance. that addresses itself to this question: How does a people, a country, or a government, transfer massive amounts of purchasing power from its shores to other countries, for military, political, or humanitarian reasons?

The paucity of economic theory to cover this new activity by Government is due to the fact that economic theory on international trade and finance, as it is taught today, antedates World War II; indeed it goes back to 19th century British economic thought in its sources and inspiration.

What has happened, certainly since 1950, is that the ordinary pricing mechanism, the competitive relations between countries, and the existing financial institutions, including the gold exchange standard, have not been able to absorb the impact of those governmentally motivated programs of massive transfers of purchasing power from the United States to other countries.

As you well know, there has been and there still exists a highly critical attitude toward U.S. procurement under our Government aid programs. There is a tendency to consider these illiberal and retrogressive. Yet a reading of the recommendations of economists working in this field does not reveal a practical program of accomplishing this transfer of massive amounts of purchasing power or capital from the United States to other countries, except the traditional one of bringing about a recession in the United States in order to depress prices to a level competitive with the rest of the world. Of course, they do not call for a recession; they call for an adjustment of prices and wages to a level that would be competitive with other countries. The classical method of bringing this about, of course, is outflow of gold in response to balance-of-payments deficits; high-interest rates and contraction of credit at home, curtailment of industrial expansion, with attendant unemployment, in the hope that prices and wages will decline to a competitive level.

The only trouble is that even this will not work in the United States, because of the inflexibility of both the wage and price structures, not to mention the fact that it would be both humanly and politically unacceptable. It does not work abroad, either. Classical theory would call for expansion of credit and inflation and rising prices in balance-of-payments-surplus countries which receive our gold exports. This has not happened, because governments abroad in fact have discouraged expansion of credit.

The question that really confronts this committee is, therefore, to decide whether (assuming that the classical solution of price and wage readjustments as the answer to this problem is found impractical), the proposals being advanced with regard to elimination of the monetary reserve requirement, or the reforms of the International Monetary Fund structure, will in any way accomplish the desired result, and permit us to continue these massive outpayments of dollars without the requirement of procurement in the United States as one of the conditions of such programs, and without redistribution of military expenditures.

In the end, we must realize that the only way a country can continue to transfer purchasing power abroad is in gold, goods, or other evidences of property ownership. Ultimately, these are the only forms in which a country can export purchasing power or capital.

If other countries will not buy current production, there are two alternatives; to buy gold or to buy evidences of indebtedness or investments. The proposals before this committee are designed to solve this problem by making more gold available for export, or by making it more desirable for those who acquire dollar reserves to invest them in the United States. I submit that these alternatives cannot be continued indefinitely; they may only buy time, perhaps 4 to 5 years. In the end, we are still going to be faced with the same fundamental question; how to continue to transfer massive and growing amounts of purchasing power. Only last week the administration launched its "decade of development" of foreign aid, in addition to continuing commitments on military expenditures abroad. I think we must face the basic question and have an answer to fit. If the traditional concepts of the competitive price mechanism and the gold exchange standard will not absorb these massive transfers of purchasing power, as has been the case since 1950, what alternatives are there?

Exports of gold, or transfer of ownership into foreign hands of evidences of indebtedness or investment, are not responsive to the challenge of the present day. The struggle in the world is between productive systems. The United States must prove to the rest of the world the supremacy of our competence and genius in this field. Our aid and investment programs abroad must make our productive capacity, factories and labor alike, to accomplish the tasks that the President has laid out for the Congress in his foreign aid message. In the long run, it can be done no other way.

Unfortunately, this basic truth is not fully recognized even today. Witness section 604, the procurement section of the foreign aid bill now before Congress,[4] and the continued channeling of the U.S. aid funds through international institutions, each one of which has a charter provision which prohibits the agency from designating the sources of procurement in the use of its loans.[5]

CHANGING TRADE PATTERNS

There is a second major change taking place in our international economic relations which is inadequately recognized by students of economics. This is the changing pattern of our international trade, particularly in exports and imports. On the import side, as time goes on, the United States is going to need more and more imports of raw materials in order to supply its industrial machine. Whether this can be controlled by the development of substitutes remains a matter of national policy of highest priority. The fact is, in the meantime, that since World War II, we have developed a very large negative influence in our balance-of-payments situation because of growing dependence on imports. Again, in the field of exports, the tendency toward regionalization of trading blocs and the localization of productive units to serve proximate markets, such as the Common Market in Europe and emerging free trade areas in other parts of the world will continue to change these patterns of trade, and I am not sure that this influence will be in the direction of improving our balance-of-payments position. These changes already appear in certain major industry categories.[6]

It is said that the changing composition of our foreign trade should not necessarily mean a handicap, in the long run, because new and improved products will always take the place of old markets lost. But this is a pure assumption. With improved education and communication, high degree of mobility of capital and management, and even identical and perhaps better technology being established in some of the other advanced countries, are there any valid grounds to assert, as a basic theoretical underpinning of national policy, that we are always going to be in the vanguard in quality and variety of products and costs of production, in sufficient numbers of items and in large enough markets, to earn the necessary foreign exchange, to pay for our military expenditures abroad, and the foreign aid, and the necessary imports, which will be of growing dimensions. Again, I do not believe we economists and those that are advancing the measures being considered here have really confronted this revolutionary change in international competitive conditions arising from the transferability of capital, technology, management, and the more widespread educational efforts to train personnel and workers everywhere around the world.

When the art of economic thinking (I hesitate to call it a science, as it is so individual, as this paper proves) was developed in 19th century England, and free trade based on "comparative advantages" became accepted doctrine, England

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[4] S. 1983, 87th Cong., 1st sess., sec. 604(a), pp. 33, 34. "Funds made available under this act may be used for procurement outside the United States unless the President determines that such procurement will result in adverse effects upon the economy of the United States or the industrial mobilization base, with special reference to any areas of labor surplus or to the net position of the United States in its balance of trade with the rest of the world, which outweigh the economic or other advantages to the United States of less costly procurement outside the United States."

[5] A typical provision is that in the World Bank charter, repeated in substance in the charters of other international agencies: "(a) The Bank shall impose no conditions that the proceeds of a loan shall be spent in the territories of any particular member or members." "Articles of Agreement," p. 6.

[6] See tabulations in appendix.

was in a unique position; it had a substantial control on both capital and technology, and was discerning in the export of both. We have an entirely different outlook. We are engaged as a national policy in positive steps to export capital, know-how, management and technology, by both private and governmental agencies.

We did this with Western Europe and Japan. The long-range consequences of this development on our balance of payments is only now gradually emerging. The successful culmination of the Common Market during this decade, and the possible acceptance of England and perhaps other members of the Free Trade Association into it, giving, in addition to technology, management and capital, also the advantages of large-scale production, encouraged and promoted by U.S. national policy, will have, inevitably, pronounced effects upon our balance of payments, and even, perhaps on our balance of trade. The classical adjustments, here, too, are not available—recession, decline of prices and wages. The concept of the Atlantic union, perhaps the most promising from a political and military viewpoint as a defense of Western civilization, founder upon the shoals of incompatible economic theories.

We have adopted in this country theories of trade without accepting the basic conditions and premises which must go with them to make them valid. I feel a sense of envy toward the European economists who drafted the Treaty of Rome, because they realized that free or liberal trade amongst their countries insure not only transfers of capital and technology, but acceptance of all the underlying conditions, such as freedom of movement of labor between countries, uniformity of regulations and legislation in the treatment of labor, with the ultimate expectation that this would result in uniformity of basic conditions of employment.

Here, therefore, I pose the second question. Will the proposals before this committee resolve the possible long-range discrepancies that may arise in our trade relations because of the transferability of capital, technology and skills without the attendant adjustments in labor and wages which would retain or regain our competitive advantage?

This again, poses the problem of whether such uniformity of wage levels, say between the North Atlantic Alliance and the United States, would be acceptable politically. In the absence of necessary mobility to bring about competitiveness of costs, we shall face, in the long run, the problem of balance-of-trade deficits. I do not share the enthusiasm of some statisticians about our balance-of-trade surpluses, because upon examination, you will find that agricultural surpluses sold under Public Law 480 and ICA, as well as other Government-induced exports through grants, aids, and subsidies, are included in the Department of Commerce export surplus figure. Therefore, the export surplus that is touted monthly in statistical press releases from the Department of Commerce are not dollar earning surpluses necessarily. In fact, in 1959, after deducting these Government-induced exports, we probably had a substantial balance-of-trade deficit.

In economic theory, the principle of comparative advantage, developed in 19th century English thought, was based on locational and climatic advantages for natural resources, or upon technological advantages in manufactures that were jealously guarded. We are going to see the technological advantages disappearing, and this situation will become even more severe when the Communist bloc comes into world markets. Present-day economic thinking has not faced this issue, and I am quite sure that the proposals being advanced before this committee do not in themselves supply long-range solutions to this problem.

DEVELOPMENT OF UNDERDEVELOPED COUNTRIES

There is a third factor which is now entering into this picture. It is, in fact, an extension of the second issue just mentioned, but it will become much more severe as time goes on. This is the announced policy of a decade of economic development in underdeveloped countries, to be brought about through Government aid, by the export of U.S. and Western technology, know-how, and capital. I have supported and I continue to support the principle of aiding underdeveloped countries, and I believe that giving them opportunities to create wealth through enterprise is the best means of improving their standard of living. However, if we transfer the most up-to-date technology, know-how, and our own capital resources to achieve this, under our trade policies as they stand today, we are going to be confronted with the return flow of those goods to the United States. There will be a wide range of products that can be produced in these underdeveloped countries, but under labor and cost conditions far lower than in the United States.

Here again, the classical theory; namely, outflow of gold, credit restriction, depression of price and possible unemployment, with a view to lower wage costs, to a level where American labor can be competitive with labor in underdeveloped countries, is simply unacceptable politically and economically in the United States. The solution suggested—readjustment of labor through Government-subsidized retraining and relocation programs, does not answer this problem, because as time goes on, more and more U.S. industries are going to be under such pressure from imports coming in from underdeveloped countries, and the solutions offered either in readjustment or unemployment compensation merely cause an increase in the cost of production, either through taxation or inflation. It is, therefore, no way to become more competitive in the world markets, particularly with competitive industries developed in low-wage countries with our aid.

The dilemma of our development and trade policies toward underdeveloped countries is perhaps best illustrated by the predicament in which the Under Secretary of State for Economic Affairs found himself this week. He testified before the committee on Monday:

"It is essential that the less-developed countries obtain enlarged markets in the industrial countries for their traditional exports. This means lowering existing trade barriers and resisting pressures for new ones. Moreover, the industrial countries must find constructive solutions to the problems that have arisen, and will inevitably grow more pressing, as a result of the economic advances of the less-developed countries. The fruits of economic development will appear, in part, as new exportable products, increasingly in the field of manufactures. These products represent hard-won economic gains, to which our taxpayers have contributed their money and our Nation its influence. If markets cannot be found for them, much of the common effort will go to waste."

Tuesday morning's papers carried the story that he, the Under Secretary, was hopeful of securing a voluntary quota limitation of 30 percent on the exports of textiles from Hong Kong to the United States. If the economic theory enunciated in general statements is good, and valid, why ask Hong Kong or Japan or any other country for voluntary or even mandatory quotas. If the theory is not valid, why keep enunciating it instead of developing a new and more applicable concept. It is interesting that Hong Kong does not get U.S. aid, and therefore the industries are established on a purely commercial basis. Many of the workers are refugees from Communist China. If any condition deserves our sympathetic approach, it is the situation in Hong Kong, and yet, there seems to be something unworkable in our professed theories that puts a very sincere and devoted advocate of liberal trade in an embarrassing position of asking various governments not to practice what he preaches.

This situation will become more general as the decade of development of this Government expands to encompass much of the underdeveloped world. Mr. Paul Hoffman stated last week that there are 1,300 million people (plus 700 million in Red China if they should ever come into free world associations), in these countries that must be helped at an estimated total cost of $7 billion a year for 10 years. Nearly every speaker in the Conference on World Economic and Social Development, including the President and the Secretary of State, took the position that we can do this job in the coming decade, and help underdeveloped countries into sustained economic growth.

This is the great challenge of this decade, and it is a tribute to the humanitarian instincts of the American people that this thinking has become, under the leadership of the President, national policy. One can only pray that peace will last long enough to make our maximum contribution to the improvement of human welfare, and if disarmament should ever become a reality, more and more capital would be available to devote to this challenging enterprise.

The difficulty, however, is that we have not developed an economic theory which will make it possible for us to export these growing amounts of capital to help develop self-sustaining industries in underdeveloped countries, then supply them with markets, and, at the same time, insure the strength of the U.S. economy. Today this problem afflicts us in the textile industry; tomorrow it will be aluminum when the projects in Africa are developed. If ever there is discovered iron ore and coal in economic conjunction in any underdeveloped country, and the steel industry is subjected to massive competition under conditions of differential cost advantages, then I think the United States would certainly have something to worry about under its present trade policy concepts.

Is the problem of textile imports an exception coming to the front because of political pressures, or is it a generic economic problem that the country is going to face in industry after industry as the underdeveloped countries progress with our help. It is reassuring that the Secretary of Treasury, before the Ways and Means Committee, admitted that there was a problem here, and that the administration is looking into it. Until we develop a set of rules that will have universal application, we are going to find ourselves professing one thing and practicing another. In the meantime, the balance-of-payments situation of the United States will continue to deteriorate. Will the proposals to create greater liquidity in international payments resolve such a problem without a more fundamental resolution of the issues we face in the coming decade?

CONCLUSION

I conclude, therefore, that economic theory, as practiced and advocated today, has not solved the problem of massive exports of capital under foreign aid programs, and outpayments for military expenditures abroad. It has not yet solved the problem of the increasing import needs of this country, and the necessary means to pay for them. It falls far short of solving the problems raised by a reequipped, resurgent, Western Europe and Japan, including the Common Market and Free Trade Association. And it has not confronted the inconsistencies between our foreign economic aid programs in the development of industries in underdeveloped countries, and our trade policy.

Within this context, to say that our primary need is liquidity, and that this liquidity can be achieved by permitting the export of all our gold supply, or by making it desirable or almost even compulsory for other countries to keep part of their growing dollar earnings in investments through the IMF, or directly in U.S. Government bonds and other assets, does not solve the basic imbalance that has already asserted itself and will continue to grow if we follow the present policies. They may gain us time; they may lull us into complacency, but I view the primary issue before Congress as the resolution of these inconsistencies in international economic policies, because if we do not confront this issue today, we are bound to complicate our international financial situation; create greater instability for the dollar, and perhaps even create conditions of crisis for our economy and possibly political reaction, with undesirable consequences.

I express no opposition to these devices that are proposed; I only say that they are not solutions to the issues that confront the country in this field. They anesthetize the symptoms; they do not cure the causes.

APPENDIX

TABLE 1.—*Animals and animal products, edible—Exports and imports:1956–60*

[In millions of dollars]

	Imports	Exports	Net imports (−)		Imports	Exports	Net imports (−)
1950	376	235	−141	1957	539	372	−167
1951	430	384	−46	1958	781	294	−487
1952	399	263	−136	1959	822	341	−481
1953	424	254	−170	1960, to Dec. 1	668	315	−353
1954	325	283	−42				
1955	434	332	−102	Total	5,629	3,477	−2,152
1956	431	404	−27				

Source: U.S. Bureau of the Census, "Statistical Abstract of the United States," 1955 and 1960.

TABLE 2—*Animals and animal products, inedible—Exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net imports (−)		Imports	Exports	Net imports (−)
1950	365	139	−226	1957	303	299	−4
1951	408	180	−228	1958	321	260	−61
1952	292	157	−135	1959	423	298	−125
1953	270	202	−68	1960 (to Dec. 1)	369	292	−77
1954	246	244	−2				
1955	287	277	−10	Total	3,594	2,637	−957
1956	310	289	−21				

Source: U.S. Bureau of the Census, "Statistical Abstract of the United States," 1955 and 1960.

TABLE 3.—*Automobiles including engines and parts—Exports and imports: 1946–59* [1]

[In millions of dollars]

	Imports	Exports	Net exports (+)		Imports	Exports	Net exports (+)
1946–50 average	16.2	821	+804.8	1956	144.7	1,357	+1,212.3
1950	23.0	723	+700.0	1957	337.2	1,309	+971.8
1951	37.8	1,191	+153.2	1958	554.4	1,083	+528.6
1952	56.9	987	+930.1	1959	843.8	1,136	+292.2
1953	52.9	963	+910.1				
1954	53.3	1,036	+982.7	Total, 1950–59	2,188.8	11,023	+8,834.2
1955	84.8	1,238	+1,153.2				

[1] Excludes military exports.

Source: Department of Commerce, "Statistical Reports," pt. 3, No. 60-6, and U.S. Bureau of the Census "Statistical Abstract of the United States: 1960."

TABLE 4.—*Chemicals and related products—Exports and imports: 1956–60*

[In millions of dollars]

	Imports	Exports	Net exports (+)		Imports	Exports	Net exports (+)
1950	170.4	710.7	+540.3	1957	275.8	1,398.4	+1,122.6
1951	300.6	980.9	+680.3	1958	282.0	1,363.7	+1,081.7
1952	243.9	801.3	+557.4	1959	347.1	1,491.1	+1,144.0
1953	292.9	800.2	+507.3	1960, to Dec. 1	323.3	915.8	+592.5
1954	249.3	983.0	+733.7				
1955	255.1	1,077.4	+822.3	Total	3,014.6	11,773.0	+8,758.4
1956	274.2	1,250.5	+976.3				

Source: U.S. Department of Commerce, "Statistical Reports," Total Export and Import Trade of United States, January–December 1956 and 1959.

TABLE 5.—*Copper and manufacturers—Exports and imports: 1946–59*

[In millions of dollars]

	Imports	Exports	Net imports (−)		Imports	Exports	Net imports (−)
1946–50 average	186	88	−98	1956	502	266	−236
1950	243	88	−155	1957	384	299	−85
1951	280	101	−179	1958	246	214	−32
1952	411	156	−255	1959	297	107	−190
1953	433	117	−316				
1954	363	199	−164	Total, 1950–59	3,614	1,765	−1,849
1955	455	218	−237				

Source: U.S. Bureau of the Census, "Statistical Abstract of the United States: 1960."

TABLE 6.—*Cotton—Unmanufactured exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net exports (+)		Imports	Exports	Net exports (+)
1950	43	1,024	+981	1957	62	1,059	+997
1951	42	1,146	+1,104	1958	25	661	+636
1952	40	873	+833	1959	29	452	+423
1953	42	521	+479	1960—to Dec. 1	26	847	+821
1954	29	738	+759				
1955	42	477	+435	Total	404	8,577	+8,173
1956	24	729	+705				

Source: U.S. Bureau of the Census, "Statistical Abstract of the United States," 1955 and 1960.

TABLE 7.—*Cotton—Semimanufactured exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net exports (+)		Imports	Exports	Net exports (+)
1950	16	36	+20	1957	6	60	+54
1951	12	87	+75	1958	6	46	+40
1952	8	58	+50	1959	6	51	+45
1953	7	57	+50	1960—to December 1	12	49	+37
1954	8	52	+44				
1955	9	51	+42				
1956	7	54	+47	Total	97	601	+504

Source: U.S. Bureau of the Census, "Statistical Abstract of the United States," 1955 and 1960.

TABLE 8.—*Cotton manufactures exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net imports (−) exports (+)		Imports	Exports	Net imports (−) exports (+)
1950	64	227	+163	1957	136	253	+117
1951	68	390	+322	1958	149	233	+84
1952	59	312	+253	1959	202	223	+21
1953	73	272	+199	1960—to December 1	234	210	−24
1954	76	265	+189				
1955	123	242	+119				
1956	154	240	+86	Total	1,338	2,867	+1,529

Source: U.S. Bureau of the Census, "Statistical Abstract of the United States," 1955 and 1960.

TABLE 9.—*Iron ore exports and imports: 1938 and 1950–60*

[In millions of gross tons and millions of dollars]

	Imports		Exports		Net imports	
	Gross tons	Value	Gross tons	Value	Gross tons	Value (−)
1938	2.1	$5.3	0.5	$1.9	1.6	−$3.4
1950	8.3	44.0	2.6	15.7	5.7	−28.3
1951	10.1	59.5	4.3	31.0	5.8	−28.5
1952	9.8	82.9	5.1	37.4	4.6	−45.4
1953	11.0	96.8	4.3	32.4	6.8	−64.4
1954	15.8	119.4	3.1	24.8	12.6	−94.7
1955	23.5	177.3	4.5	37.0	19.0	−140.3
1956	30.4	250.5	5.5	49.0	24.9	−201.7
1957	33.6	285.1	5.0	49.0	28.6	−235.7
1958	27.6	231.6	3.6	34.9	23.9	−196.8
1959	35.6	312.3	2.9	33.9	32.6	−278.5
Total	205.7	1,659.4	40.9	345.1	164.5	−1,314.3

Source: Department of Interior, reprint from "Bureau of Mines Yearbook," 1953, 1955, 1957, and 1959.

TABLE 10.—*Iron and steel—Mill products exports and imports: 1946–59*

[In millions of dollars]

	Imports	Exports	Net imports (—) exports (+)		Imports	Exports	Net imports (—) exports (+)
1946–50 average	19	625	+606	1956	305	1,075	+770
1950	140	472	+332	1957	313	1,377	+1,064
1951	363	611	+248	1958	328	665	+337
1952	238	621	+383	1959	735	538	−197
1953	283	495	+212	Total, 1950–59	3,060	7,188	+4,128
1954	156	516	+360				
1955	199	818	+619				

Source: U.S. Bureau of the Census, "Statistical Abstract of the United States," 1960.

TABLE 11.—*Machinery—Electrical apparatus exports and imports: 1950–60*

[In millions of dollars]

	Imports[1]	Exports[2]	Net exports (+)		Imports[1]	Exports[2]	Net exports (+)
1950	9.4	443.0	+433.6	1957	143.5	1,029.8	+886.3
1951	18.0	636.9	+618.9	1958	166.7	1,020.0	+853.3
1952	27.3	751.8	+724.5	1959	245.6	954.5	+708.9
1953	43.8	893.2	+849.4	1960, to Dec. 1	243.8	915.8	+672.0
1954	46.0	869.6	+823.6	Total	1,099.3	9,374.4	+8,275.1
1955	55.7	843.3	+787.6				
1956	99.5	1,016.5	+917.0				

[1] Imports include: Electric lamps, electric household equipment, machines having electrical elements as essential features.

[2] Exports include: Generators, batteries, transforming and converting apparatus, transmission and distribution switch gear, electrical measuring and testing instruments, electrical motors, portable electric tools, electrical household equipment (irons, refrigerators, stoves), electronic equipment and parts, telephone and telegraph apparatus.

Source: U.S. Department of Commerce, Statistical Reports, total export and import trade of United States, January to December 1956 and 1959.

TABLE 12.—*Petroleum and products exports and imports: 1946–59*

[In millions of dollars]

	Imports	Exports	Net imports (—) exports (+)		Imports	Exports	Net imports (—) exports (+)
1946–50 average	379	559	+180	1956	1,286	766	−520
1950	592	499	−93	1957	1,548	994	−554
1951	601	783	+182	1958	1,625	558	−1,067
1952	692	793	+101	1959	1,529	480	−1,049
1953	762	692	−70	Total, 1950–59	10,490	6,869	−3,621
1954	829	658	−171				
1955	1,026	646	−380				

Source: U.S. Bureau of the Census, Statistical Abstract of the United States: 1960.

TABLE 13.—*Vegetable products—Inedible exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net imports (−) exports (+)		Imports	Exports	Net imports (−) exports (+)
1950	886	601	−285	1957	733	1,196	+463
1951	1,278	812	−466	1958	638	1,071	+433
1952	1,042	650	−392	1959	884	1,280	+396
1953	729	761	+32	1960, to Dec. 1	780	1,304	+524
1954	628	815	+187				
1955	809	935	+126	Total	9,177	10,483	+1,306
1956	770	1,058	+288				

Source: U.S. Bureau of the Census, Statistical Abstract of the United States, 1955 and 1960.

TABLE 14.—*Wood and paper—Wood pulp exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net imports (−)		Imports	Exports	Net imports (−)
1950	240.2	0	−240.2	1957	273.4	0	−273.4
1951	352.4	0	−352.4	1958	277.5	0	−277.5
1952	271.8	0	−271.8	1959	314.6	0	−314.6
1953	263.1	0	−263.1	1960, to Dec. 1	284.0	0	−284.0
1954	251.7	0	−251.7				
1955	277.3	0	−277.3	Total	3,103.5	0	−3,103.5
1956	297.5	0	−297.5				

Source: U.S. Department of Commerce, Statistical Reports, total export and import trade of United States, January to December 1956 and 1959.

TABLE 15.—*Wood and paper—Newsprint exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net imports (−)		Imports	Exports	Net imports (−)
1950	453.0	0	−453.0	1957	657.0	0	−657.0
1951	513.3	0	−513.3	1958	613.9	0	−613.9
1952	571.8	0	−571.8	1959	665.7	0	−665.7
1953	595.0	0	−595.0	1960, to Dec. 1	630.0	0	−630.0
1954	595.4	0	−595.4				
1955	613.3	0	−613.3	Total	6,596.2	0	−6,596.2
1956	687.8	0	−687.8				

Source: U.S. Department of Commerce, Statistical Reports, total export and import trade of United States, January–December, 1956 and 1959.

TABLE 16.—*Wood and paper, paper base stocks, exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net imports (−)		Imports	Exports	Net imports (−)
1950	273.8	16.0	−257.8	1957	317.5	102.5	−215.0
1951	414.1	50.6	−363.5	1958	310.2	84.1	−226.1
1952	325.8	38.5	−287.3	1959	346.1	102.6	−243.5
1953	301.1	27.5	−273.6	1960, to Dec. 1	313.0	150.2	−162.8
1954	289.0	66.9	−222.1				
1955	319.3	97.3	−222.0	Total	3,552.2	826.3	−2,725.9
1956	342.3	90.1	−252.2				

Source: U.S. Department of Commerce, Statistical Reports, Total Export and Import Trade of United States, January–December, 1956 and 1959.

TABLE 17.—*Wood and paper, paper and manufacturers, exports and imports: 1950–60*

[In millions of dollars]

	Imports	Exports	Net imports (−)		Imports	Exports	Net imports (−)
1950	473.5	90.3	−383.2	1957	717.9	221.1	−496.8
1951	546.1	179.1	−367.0	1958	674.6	219.7	−454.9
1952	602.1	154.5	−447.6	1959	743.3	234.5	−508.8
1953	635.5	125.2	−510.3	1960, to Dec. 1	699.0	232.6	−466.4
1954	637.3	161.7	−475.6				
1955	665.6	194.6	−471.0	Total	7,144.8	2,011.1	−5,133.7
1956	749.9	197.8	−552.1				

Source: U.S. Department of Commerce, Statistical Reports, total export and import trade of United States, January–December, 1956 and 1959.

STATEMENT BY HARRY G. JOHNSON, PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO, ON THE INTERNATIONAL LIQUIDITY PROBLEM

The present international monetary system is a gold exchange standard, under which the leading trading countries maintain fixed exchange rates by holding reserves in the form of gold and holdings of national currencies convertible into gold. Both historical experience of the collapse of the gold exchange standard in the interwar period and the recent balance-of-payments problems of the United States illustrates that this form of international monetary system has two serious weaknesses: its reliance on a national currency—the U.S. dollar, and to a lesser extent the pound sterling—to provide international reserves, and its reliance on newly mined gold plus further expansion of reserve currency holdings to provide for growing liquidity needs. The use of a country's currency as other countries' reserves exposes that country to the risks of sudden and sharp balance-of-payments deficits on short-term capital account prompted by interest-rate differentials or speculative factors, risks which limit its freedom of domestic action. These limitations could have a seriously crippling effect on the economic strength of the United States in future, both because confidence in a reserve currency tends to be governed by superficial judgments of a strongly conservative kind rather than by rational economic analysis, and because in the next decade the United States will have to make substantial economic adjustments to the industrial recovery of Europe and the spread of industrialization around the world, adjustments which could be seriously impeded by the need to command foreign confidence and retain foreign short-term capital in the country. Dependence on further growth of reserve currency holdings to satisfy growing liquidity needs involves the risk that reserves may not increase adequately, so threatening the constriction or collapse of the nondiscriminatory multilateral system of trade and payments that the United States has been seeking to reestablish since the war.

There are two alternative measures that would solve or remove both weaknesses simultaneously. One is the traditional solution of the gold standard, an increase in the world price of gold. The objections to this solution are that the resulting increases in reserves would be most inefficiently distributed, that it would give undeserved permanent income gains to the gold-producing countries, and that it would confirm in the international sphere a principle deliberately abandoned in the domestic monetary management of all advanced countries—that the supply of money should be governed by the quantity of gold. The other solution would be to abandon the system of adjustable fixed exchange rates in favor of floating exchange rates. There is much to be said for this solution, especially from the standpoint of U.S. national interests; but since it would amount to replacing the present international monetary system, I judge that it lies outside the scope of the subcommittee's inquiry.

There is a variety of unilateral actions that the United States could take to strengthen its international financial position and the international monetary system. These include removing the anachronistic 25 percent reserve requirement against Federal Reserve notes and deposits; using the existing U.S. credit with the International Monetary Fund and U.S. drawing rights on the Fund as international reserves; altering the presentation of its international accounts to give a clearer picture of its international banking position; and strengthening the inducement to foreign monetary authorities to hold dollars by offering securities carrying a gold guarantee and special rates of interest. To remedy the two main weaknesses of the present international monetary system, however, would require some form of international collaboration.

With respect to the weakness resulting from the use of national currencies as international reserves, there is a choice between two approaches—strengthening the reserve currencies in question against the dangers of short-term capital outflows, and replacing national currency reserves by international credit reserves. The first approach could be informal, through a strengthening of present collaboration between the leading central banks; this would include coordination of interest rate policies to avoid giving interest-rate incentives to outflows of short-term capital from reserve currency centers, and the lending back to the reserve currency centers of accessions to reserves resulting from such capital outflows. Reliance on such collaboration would involve entrusting central banks with a great deal of power; and past experience suggests that it would be difficult to achieve and likely to break down in a crisis, since it requires that the central banks of nonreserve currency countries accept and approve the monetary and economic policies of the reserve currency countries. Some of these difficulties would be avoided by a more formal approach on the lines of the Bernstein plan, according to which the leading countries would oblige themselves to lend substantial amounts of their currencies to the International Monetary Fund, to be relent to a reserve currency country suffering an outflow of short-term capital.

Both close central bank collaboration and the Bernstein plan have the practical attraction of recognizing the crucial fact that what matters in international monetary affairs is the behavior of the handful of large international trading and reserve-holding countries. But this fact itself points to the limitations of this approach: the holding of a country's currency as an international reserve gives it financial and economic leadership in the world economy; and to ask other nations to strengthen its position by guaranteeing to keep their funds invested with it is to ask them to recognize and support its dominance, a request which commercial rivals are unlikely to find congenial, especially when their relative economic strength is growing.

The alternative approach is to substitute an international credit currency for holdings of national currencies as reserves. This approach seems preferable, both because it would avoid the dangers and potential conflicts inherent in the use of national currencies as international reserves, and because it would constitute another step toward the replacement of the gold standard by a more sensible and manageable international monetary standard. One possibility would be the formation of an Atlantic Payments Union, on the lines of the now defunct European Payments Union. This scheme would conform to present political and military alliances, but it would involve the creation of yet another international institution and might in practice foster division between the advanced and the underdeveloped nations. A scheme more likely to be feasible, because it starts with an already established international institution, is Triffin's proposal to convert the International Monetary Fund into a genuine international reserve bank, in which members would undertake to deposit 20 percent of their reserves and be induced to deposit more by the offer of interest, and to which they would transfer their reserve holdings to key currencies, in return being permitted to draw more liberally on the Fund for settling international balances of indebtedness. The main objection to this scheme is the surrender of sovereignty to the International Monetary Fund that it would entail, together with the loss of influence by the reserve currency countries; but some surrender of sovereignty is the inevitable price of binding other countries to cooperation, and the influence achieved by international banking can easily prove a snare and delusion.

The second major weakness of the present international monetary system is its dependence on new gold production and the growth of reserve holdings in national currencies to provide the increasing reserves required by expanding world trade. The International Monetary Fund study to the contrary, these sources of additional international reserves look like being inadequate to the needs of the next 10 years. Reserves might be increased above prospective levels by a determined effort by the leading countries to squeeze gold out of nonmonetary uses; but the quantitative results would probably be small, and the methods required might have undesirable side effects, including the stimulation of speculative gold hoarding. The expansion of international credit reserves is a much more promising solution. The Bernstein plan calls for enlargement of quotas in the International Monetary Fund. But enlargement of the Fund in its present form would be inefficient, because various countries would be likely to obtain the gold required by drawing on dollar and sterling balances and because quotas in the Fund as presently operated are not fully equivalent to gold and dollar reserves. If the Fund were reorganized on Triffin's lines, additional reserves would be provided by annual open market purchases by the Fund. But in the course of time event a fund so reconstituted might run into difficulties, since the 20-percent reserve requirement on members would still allow gold to be drained from the Fund. If a shortage of gold began seriously to threaten the liquidity of the international economy, the logical solution would be to demonetize gold and base national currencies on inconvertible deposits in the Fund.

STATEMENT OF TIBOR SCITOVSKY, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY, CALIF., ON THE SUPPLY OF INTERNATIONAL RESERVES

In the modern world, where economic growth and full employment have become important aims of national economic policy, one must reconcile oneself to the virtual absence of market forces that would tend automatically to maintain or restore balance-of-payments equilibrium. Today, deliberate economic policy is the main instrument of balance-of-payments adjustment; and it usually takes the form of fiscal, monetary, and foreign trade policies. Under these circumstances, to have an adequate and adequately growing supply of international liquidity seems essential, more essential than it has been in the past, although every sign indicates that over the past half century the supply of reserves has become progressively more inadequate to meet the fast growing need for reserves.

Needless to say, an adequate supply of international reserves would not, ipso facto, solve this country's balance-of-payments problems. It would, however, ease the problem, lessen the danger of similar problems recurring; and there is at least one way of adding to the supply of international reserves that would, in my opinion, provide a partial solution to the present U.S. balance-of-payments deficit. I should like to concentrate, therefore, on the problem of international liquidity.

An adequate supply of international liquidity would have two advantages. First, it would provide deficit countries with more time in which to frame and carry out policies designed to eliminate their balance-of-payments deficits. There are many different ways in which to improve the balance of payments; and the more satisfactory ones are usually also those that need the most time to be implemented and become effective. Hence the advantage of the longer breathing space provided by larger reserves.

Secondly, an adequate supply of international liquidity would create an incentive for the surplus countries to share and thus lighten the burden of adjustment of the deficit countries. Since this advantage is seldom discussed or even mentioned, I should like to enlarge upon it a little.

A balance-of-payments surplus indicates that part of the country's productive resources is used neither for current consumption (public or private) nor for investment in its economic growth, but is used instead for accumulating international reserves. This is useful as long as the country's already existing reserves are considered inadequate; but sooner or later they will reach a level considered adequate. To continue running a payments surplus and accumulating reserves beyond this level is a waste, very similar to that incurred by a person who builds up his checking account way beyond what he needs for convenience and safety. He loses what might otherwise have been interest on savings deposits, or dividends and capital gains on equities, or the gain and added convenience of owning instead of renting his house. A country that accumulates excessive reserves uses unproductively resources that could otherwise be used to promote faster economic growth, assure a higher standard of living, or combat inflationary pressures.

An idea of the orders of magnitude involved can be gained from the example of Western Germany. Over the past few years, she has been adding an annual DM3 billion to her international reserves, which is over 2 percent of her national income and well over 10 percent of her private capital formation. It is true that even so she achieved the fastest rate of growth in Western Europe; nevertheless, having started from a low level and still having far to go, she can undoubtedly find good and productive use for an additional DM3 billion in her domestic economy as soon as she has accumulated enough reserves. For it is up to the Germans themselves to decide when their international reserves are adequate, and when, accordingly, they should start taking measures designed to end their balance-of-payments surplus and thus increase the availability of resources for domestic use.

With the present world supply of international reserves, countries cannot build up external reserves to levels they consider adequate without thereby drawing down other countries' reserves to dangerously low levels. One purpose, therefore, of expanding the world supply of reserves is to enable them to do so. An adequate world supply of international reserves can be defined as the sum of what in each country is considered an adequate supply of that country's reserves. If the world supply of reserves were adequate, the drawing down of some countries' reserves to unduly low levels would be matched by some other countries' excessive accumulation of reserves, and the desire to eliminate balance-of-payments deficits in the former would be matched by the desire to eliminate surpluses in the latter. To bring about such a situation, in which surplus and deficit countries are equally concerned over balance-of-payments disequilibrium and equally anxious to pursue policies aimed at eliminating it, is the most important argument in favor of increasing the supply of international liquidity.[1] This is so, because simultaneous action by deficit and surplus countries is the most hopeful way of dealing with the balance-of-payments problem. Such action would greatly reduce each country's burden of adjustment; moreover, since more and better means of adjustment are available to surplus than to deficit countries, it would restrict world trade very much less than if deficit countries alone were making adjustments.

This is well known, of course. Already in the 1930's, the tremendous reduction in world trade and the great economic difficulties of the deficit countries were generally blamed on the surplus countries' failure to do their share in eliminating the balance-of-payments disequilibrium. The lessons of the 1930's were incorporated in the scarce currency provision of the International Monetary Fund Charter, which was designed to compel surplus countries to cooperate in eliminating their surplus, but which failed to achieve this aim. The political pressure brought to bear on surplus countries by the U.S. Government not so long ago has also failed. Hence, my belief that the best chance of achieving this aim is to increase the supply of international reserves.

At present, international reserves consist of gold, key currency assets, and the availability of gold or foreign currency loans from the International Monetary Fund, although these latter, the so-called second line of reserves, are not reserves proper.

The inadequacy of the world's supply of monetary gold needs no discussion here; neither will I repeat the arguments against raising the price of gold. Key currency reserves, which supplement gold under our present gold-exchange standard, have the sole advantage of having been developed and accepted by the banking community. They are also supposed to have the further advantage of increasing spontaneously, in response to increasing demand; but this is not quite so. Key currency reserves increase or decrease in supply, depending on whether the key currency countries happen to be running balance-of-payments deficits or surpluses and quite independently of the growth in need or demand for international liquidity. Even the persistent and substantial U.S. deficit of the last 10 years has increased combined gold and currency reserves only at the very insufficient average rate of 1½ percent per annum; and our success in reducing or eliminating this country's deficit would, of course, further reduce or completely eliminate this source of additional world liquidity. Another shortcoming of the gold-exchange standard is that it is a fair weather standard, which tends to break down and has in the past repeatedly broken down as soon as confidence in a key currency is shaken. The Bernstein's proposals aim to remedy only this last defect; and while to my mind their usefulness is limited, I will not discuss them, since I understand that Professor Kenen will do so at length.

The availability of loans from the IMF differs as much from international reserves proper as a person's access to a moneylender differs from a credit balance on his bank account. Up to the limit of a country's gold contribution (the so-

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[1] There is bound to be quite a gap between the point below which reserves are considered inadequate and that above which they are considered excessive. An adequate world supply of reserves, therefore, cannot be defined as an exact level but is more likely to be a wide range.

called gold tranche), a loan from the IMF adds nothing to a country's reserves, since it merely amounts to getting back what the country has lent the IMF in the first place. Beyond the gold tranche, an IMF loan does add to a country's reserves; but the mere fact that the total of such loans granted by the IMF during its 15 years of operation has amounted to only $1.9 billion already suggests the serious limitations of this second line of reserves. Indeed, beyond the gold tranche, a country's unutilized quota in the IMF is not an unconditional emergency reserve, additional to its gold and currency reserves. Quite apart from the limited rate at which it can be drawn upon, the granting of loans within this part of the quota is contingent upon the proceedings being used to finance, not long-term capital flows, but only bona fide short-term balance-of-payments deficits. This condition may be variously and flexibly interpreted; but it does mean, especially for the major countries, that this part of their quota is not always available to them. For example, it probably would not be available to the United States at the present time.

The conditional availability of IMF loans is a serious limitation, and one which neither the recent nor a contemplated further extension of IMF quotas can change or remove. For it is essential to impose some sort of balance-of-payments discipline; and unconditional loans would remove such discipline, at least to the extent of [200 percent of] each country's quota. In this respect, international reserves proper differ greatly from IMF loans; for they impose balance-of-payments discipline not when spent, but when acquired. Reserves are acquired at a cost, consisting of the resources that produce the surplus which leads to the accumulation of the reserves. The need to incur this cost constitutes the balance-of-payments discipline; but once this cost is incurred, the reserves are paid for and their use need be restricted no further. By contrast, the acquisition of IMF loans involves no cost whatever, which is why their reckless use must be guarded against by imposing conditions on their availability.

In view of the above difference between reserves and loans, there are two reasons for preferring the former to the latter. First of all, the availability of external reserves for any purpose and under any conditions whatsoever is a great advantage and is so regarded in every country. Although reserves have to be paid for when acquired, the behavior of all the surplus countries shows that they are willing to pay this price for the advantage of unconditional use. The second reason for preferring reserves proper to loan availabilities is that they alone can, when accumulated in sufficient volume, induce countries with balance-of-payments surpluses to adopt policies aimed at restoring external balance. Why this is so is obvious: only when the acquisition of reserves involves a cost will the wisdom of acquiring an excessive volume of them be called into question. The availability of IMF loans therefore, while useful as emergency or second-line reserves, fails completely to fulfill one of the functions of international reserves and is an imperfect substitute of reserves proper even as far as their other function is concerned.

The Triffin plan envisages yet another type of international reserves, to take the place of currency reserves. These new reserves would consist of deposits with a central bankers' central bank, which is what the IMF would become under this plan. Professor Triffin's plan would outlaw the holding of central bank reserves in key currency assets and require instead that these be held on deposit with a new IMF, such deposits to be accepted as equivalent to gold, at least up to a certain proportion of each country's total external reserves. This would add to the present functions of the IMF that of an international clearing agency;[2] it would abolish the dubious gold exchange standard with all its shortcomings; and it would give the proposed new International Monetary Fund the power to control the world supply of international reserves. The plan has shortcomings and has called forth a number of objections; but all of these seem minor and easily remedied or countered. Rather than to discuss these, I should like to deal with the control of reserve supply under the Triffin plan and propose a slight modification, which I believe would directly help to solve our present balance-of-payments problems.

The conversion of currency reserves (and part of gold reserves) into deposits of the proposed new IMF would freeze the total volume of such reserves outstanding; and from then onward, the volume of IMF deposits could be changed only by the deliberate policy of the Fund itself. The Fund could increase the supply of international reserves either by responding to loan applications from

[2] This would be very similar in operation to the now defunct, but in its day very successful, European Payments Union.

deficit countries, or through open-market operations. The former should remain what it is now, an emergency measure, a second line of reserves. The regular expansion of supply therefore, in step with the expanding demand for reserves, would have to be based on the open-market buying of assets by the new Fund.

Professor Triffin has suggested a tentative rate at which the Fund's deposit creation could proceed but has said little about the nature or nationality of the assets by whose purchase the new Fund would create additional deposits. And yet, this is crucial; for it determines the beneficiaries of the increase in reserve supply.

The obvious solution would be for the new IMF to build up a balanced portfolio—balanced with respect to the nationality of assets. The best one can say for this is that it would be neutral. No one could object to it much, but it would do little if anything to relieve payments difficulties while additional liquidity was being built up. Balance-of-payments disequilibrium would be minimized if the new IMF invested mainly or solely in assets of the deficit countries and so reduced these countries' losses of reserves. This, indeed, is what the present currency-reserve system accomplishes when the key-currency countries run deficits. The objection, however, both to such a plan and to the present arrangement is that they weaken balance-of-payments discipline and dampen the deficit countries' incentive to improve their payments balance. (Our present and recent payments difficulties might well have been smaller had the accumulation of dollar reserves not hidden for so long our chronic deficit of the last 10 years.) The new Fund should certainly have the right, in a particular situation, to relieve a deficit country by buying its assets; and the possibility of such open-market purchases, joined to the availability of loans for deficit countries, would form two lines of defense against major payments difficulties. But the routine open-market buying of the new IMF; i.e., that part of its functions aimed at increasing reserves in step with the secularly rising demand for them, should be done in a way that does not lower any country's incentive to balance its international payments. This can only be done by the purchase of the bonds of the World Bank and its subsidiaries.[3] Triffin mentions this as a mere possibility; but it seems to be the most satisfactory form that his plan can take from the point of view both of this country and of the free world at large.

Continued and expanded development aid to underdeveloped countries seems a necessity in the free world; and the U.S. administration has expressed its readiness to underwrite a large part of it. This is likely to maintain or even add to the drain on the U.S. balance of payments, despite the fact that some forms of aid impose no such drain. It is all the more essential therefore to assure an adequate supply of international reserves; and if the new Fund did this through the open-market purchase of World Bank bonds, this would ipso facto and by that (or almost that) amount relieve the U.S. balance of payments. For if development funds are obtained through the open-market buying of the IMF, the resources for development aid come, in effect, from the countries with balance-of-payments surpluses—and that is exactly where ideally they should come from. In the past, the U.S. Government has tried with not much success, to put pressure on surplus countries to make greater contributions to development aid; and if they were reluctant, it was not because they begrudged giving their resources, but because they wanted to use them instead for building up their international reserves. Under the Triffin plan as here interpreted, a surplus country could add to its reserves, and the very same resources it paid for acquiring them would be made available for development purposes.

In the past, the granting of IMF loans to underdeveloped countries has sometimes been criticized on the ground that these countries especially should not be freed from a balance-of-payments discipline; but this objection does not apply to the above proposal. For the World Bank and its subsidiaries, the International Development Association and the International Finance Corporation, have an established and well-functioning machinery for appraising and supervising the engineering and economic soundness and feasibility of the projects for which loan or development-credit applications are made; and the continued use of this machinery should guarantee against the misuse of these loans.

If a new IMF along the lines of the Triffin plan were established and concentrated its portfolio on the assets of the World Bank and its subsidiaries as

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[3] At present only the Bank can issue bonds; its subsidiaries, the International Development Association and the International Finance Corporation, are not empowered to do so. In connection with the Triffin plan, however, it would be desirable that at least the IDA should be empowered to issue bonds.

here proposed, their scope of operation could and should be expanded. One can gain an idea of the orders of magnitude involved from Triffin's estimates that an annual 3-percent increase in the world supply of reserves would imply $800 to $900 million annual open-market purchases by the new Fund, a 4-percent increase would imply $1.4 billion, a 5-percent increase would imply $2 billion annual additions to the Fund's portfolio of assets. If a large part of this were invested in development bonds, it would go a long way toward solving this country's international-payments problem, and would do this in a way that does not discriminate in favor of the United States (as the purchase of dollar assets would) and cannot be objected to on that ground by the other 70 members of the IMF.

On political grounds, two things can be said in favor of the above plan. First of all, as far as the provenance or channeling of development aid is concerned, it would be an advantage I think if a greater part of it came from or through those international agencies that have come to represent the economic resources of the free world as a whole. Secondly, under the Triffin plan, with the new IMF expanding its activities and engaging in open-market operations, the way in which the latter distributes its favors could well become a political issue, and this too would be eliminated or minimized by the above plan.

STATEMENT BY PETER B. KENEN, ASSOCIATE PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY

Mr. Chairman, in my brief oral statement this morning, I propose to touch upon several aspects of the international financial situation. I shall not ask that you accept a longer statement for the record, but would be grateful if you would order the insertion of three exhibits I have prepared and distributed to the members of the subcommittee. I shall refer to them during my statement.

I should like to begin by asking that you consider a farfetched example: Suppose that the commercial banks of the United States were owned and operated by steel companies and that each bank's balance sheet was consolidated with that of its parent company. If a steel company were to run a loss, it would draw upon the cash assets of its bank. The bank, then, would lose cash (without paying off depositors) whenever its parent company had a bad year; it would gain cash (without adding to its deposit liabilities) whenever its parent company had a good year. Under these strange arrangements, those of us who had put our savings in a bank owned by a steel company suffering persistent losses would someday stage a run on that bank.

These unusual arrangements are expressly forbidden by our laws. Yet they are closely analogous to the present relationship between the U.S. balance of payments and the U.S. position as a banker to other governments and businesses abroad. Our balance of payments affects our balance sheet as a banker in the same way that the steel company's profit-and-loss statement would affect the balance sheet of its bank. When we run a payments deficit, we lose gold or build up debts to foreigners. We thereby impair our cash position as an international banker, damaging confidence in the dollar.

No reform of these financial arrangements can help us to cope with a payments deficit. But reform could give us time to undergo lasting, effective therapy.

We should therefore seek ways to limit the flows of short-term capital that occur during business cycles and that ordinarily have a large gold content.

We should devise interim arrangements that would conserve gold during deficits or return it to the United States on loan from the governments gaining it. This would help us to fend off the speculative pressures that arise when a country's stock of reserve-assets starts to dwindle.

Finally, we should espouse a sweeping reform of monetary arrangements that would relieve the United States of its task as a banker and would therefore, free our gold reserves for unstinting use in times of payments deficit.

I should like to deal briefly with each of these three possibilities.

Our payments experience during 1960 gave vivid testimony to the risks that can attend certain kinds of payments deficit. Our deficit during the second half of 1960 was mainly due to an outflow of short-term private capital. That outflow was sparked by a decline in U.S. interest rates at the outset of the recent recession. An outflow of capital due to differences in interest rates would normally be self-limiting, even self-reversing. In the event, however, that outflow triggered a large migration of speculative capital. The initial outflow had masked an improvement in our basic payments position, giving the erroneous impression that we were still in grave difficulty on current-"cum"-long-term capital account. In addition, it took more gold with it than had that earlier basic deficit because it transferred dollars to European countries whose governments normally buy gold with all or part of any increment in their reserve-assets.

A deficit that had little long-run significance was, therefore, the cause of a cumulative speculative exodus of capital. I would pause to emphasize that governments as well as private parties engage in hedging or speculation against the dollar. The data I have developed and submitted as exhibit B yield disturbing evidence that central banks abroad were buying gold with a frequency and in amounts at striking variance with previous behavior. Some, to be sure, held back, thereby showing an enlightened concern for the stability of the existing financial regime. Others, however, bought large amounts of gold from the United States.

We are bound to experience similar capital movements during future business cycles. Some observers have, therefore, proposed the "coordination" of national monetary policies, presumably to narrow differences in short-term interest rates. We should not expect too much progress in this direction. Central banks may be loath to surrender close control over domestic money markets, if, indeed, they are willing to concede that they can exercise control acting independently or in concert. It may, therefore, be better to operate at the other end of arbitrage—to intervene in the forward foreign-exchange markets. By buying dollars "forward" the Federal Reserve or Treasury could increase the cost of "covering" capital movements against exchange-rate risks and could thereby offset the interest-rate differences that inspire capital flows and give rise to gold movements. I call your attention to the chart in exhibit A, which shows that the forward price of the dollar did not rise as rapidly or as far as required to cut off interest arbitrage during the second half of 1960. I doubt that official intervention would have been feasible in October or November when the "gold rush" was at its height. The very speculative pressures that were depressing the price of forward dollars might then have required massive intervention. But modest purchases early in the summer might have forestalled the "gold rush" by halting the flow of capital that gave rise to it.

Recent press reports indicate that our Government has begun to intervene in forward foreign-exchange markets, but only in very special circumstances. I would hope that it will continue and broaden its operations and that we may find forward foreign-exchange operations a useful addition to the authorities toolkit.

In the best of circumstances, however, we will experience occasional deficits in the balance of payments, deficits due to shifts in tastes or productivity, variations in rates of national economic growth, changes in interest rates, and political crises. The impact of these deficits upon the stability of monetary arrangements would be reduced if other governments, especially those of Western Europe, would agree to accept larger dollar balances, even temporarily. Here a formula may be appropriate to require that governments defer the conversion of any increment in their dollar balances for at least 6 months. Here, too, however, some form of exchange-rate guarantee may be required.

We cannot continue to ask other governments to accept additional dollar balances unless we undertake to indemnify them for the losses they would suffer were we to devalue the dollar. In some circumstances, after all, devaluation may be the least obnoxious of the financial remedies available to the United States.

I prefer some such formula to defer conversion, with an exchange-rate guarantee, to Mr. Bernstein's "Reserve Settlement Account." The latter would serve the same purpose, albeit by creating a new layer of special intergovernmental debt. The Bernstein proposal, however, would involve a new commitment by each major country without quid pro quo. To be sure, the commitments would be reciprocal, but the United States and the United Kingdom would be the major beneficiaries. Deferred conversion, by contrast, could be "purchased" by the United States and the United Kingdom with exchange-rate guarantees on existing and new dollar and sterling balances.

At the outset, Mr. Chairman, I spoke of these as interim arrangements: I did so because they fall short of what we need. Unless all of the major governments partake of the arrangements I have already described, gold could still flow from this country in large quantities. Even if all of them participate, moreover, gold could still escape into private hands. Finally, any such arrangement would ask the governments concerned to take on additional dollars precisely when the prospects for the dollar were at their nadir.

Ultimately, Mr. Chairman, the United States should espouse a complete reform of the gold-exchange standard. We should seek to sever the connection between the U.S. balance of payments and the world's stock of reserve assets.

In "Gold and the Dollar Crisis," Professor Triffin based his plea for reform upon the need for an increase in international liquidity. Under existing arrangements, he argued, such an increase could only be accomplished at the expense of the U.S. reserve position. This is as true now as in 1958. In exhibit C, I have traced out an expansion of reserve assets and shown the implications for our reserve position. At present, our gold stock is just equal to our short-term debt (net of our debt to the IMF). An expansion of reserves at 3 percent per year would reduce our gold stock and enlarge our debt until, in 1975, U.S. gold holdings might fall to just 60 percent of U.S. short-term debt. This prospect, however, is not the compelling reason for financial reform. There may still be need for a redistribution of reserve assets; the underdeveloped countries are, as always, short of gold and dollars. But there is no need for a general increase in reserve holdings. Our deficits since 1958 have greatly enlarged world reserves. The present need is rather for consolidation. U.S. liabilities may already be too large relative to U.S. gold holdings. U.K. liabilities are assuredly excessive compared to Britain's gold stock.

The case for the Triffin plan, or for some variant of it, is not now that an expanded IMF could safely add to world reserves. It is that a reform of the IMF would entail a funding of U.S. short-term debt that would improve our "reserve" position.

Although I favor reform, I would not urge adoption of the Triffin plan as hitherto propounded. It goes too far in some directions, but not far enough in others. Let me conclude, Mr. Chairman, with three brief comments on Triffin's proposal.

First, I fear the consequence of any attempt to link the IMF with development financing. An agency that is to serve as custodian of the world's monetary standard ought not to hold large amounts of long-term debt, even debt issued by the World Bank. Still less should it accept debt instruments issued directly by the underdeveloped countries to raise capital for domestic investment.

Second, and in the same vein, I would hope that any reform will empower the IMF to disembarrass itself of unwanted currencies, especially inconvertible currencies. Triffin has proposed that the IMF arrange an "amortization" of excessive holdings. I would suggest that the IMF be authorized to sell such currencies on the open market—in effect, to force a devaluation of any currency it may accumulate by way of lending or clearing operations. I concede that this would give the Fund great power indeed, even if an "excessive accumulation" was defined most liberally. But I cannot see how to satisfy those who fear a powerful Fund, yet to pacify those who fear that the IMF would become an engine of inflation or that it would relieve governments of the "discipline" imposed by the present regime.

Finally, Mr. Chairman, I would hope that we shall treat gold more boldly than Triffin does in his prosopal. Triffin has written that:

"Nobody could ever have conceived of a more absurd waste of human resources than to dig gold in distant quarters of the earth for the sole purpose of transporting it and reburying it immediately afterward in other deep holes, especially excavated to receive it and heavily guarded to protect it."

Yet Triffin gives gold an important role in his proposal and gives the governments rights respecting gold that could expose an expanded IMF to inordinate risks. The second table in exhibit C describes an increase of reserves under the Triffin plan, showing that an expanded IMF could be exposed to a run very similar to that which threatens the dollar. The governments' convertible deposits could come to exceed the Fund's gold holdings in 10 years. Triffin discounts this danger, but I am not satisfied by his assurances. I would propose that a reform of the IMF provide for the gradual demonetization of gold, at least in respect of international transactions. This could be accomplished by planning for a gradual increase of "reserve requirements" at the IMF—for an increase from the 20 percent Triffin proposes toward 40 percent in 10 years and 80 percent (or something near it) in 20 years. Little will be lost by breaking the link with gold—a link that can have no purpose but to remind us of our kinship with those other creatures that delight in burying their treasures.

EXHIBIT A. INTEREST-ARBITRAGE AND THE FORWARD EXCHANGE RATES, 1959-61

This exhibit is designed to illustrate the case for official intervention in the forward foreign-exchange markets. Such intervention could be designed to offset international differences in interest rates by enlarging the forward premium on the currency of the country with low interest rates.

Many of the financial institutions and corporations that send funds abroad to earn a larger interest income cover themselves against the risk of an exchange-rate change while their money is abroad by entering into forward foreign-exchange contracts. These contracts commit the investor to deliver the foreign-currency proceeds of his investment when it matures in return for a specified sum of the investor's home currency. If the forward exchange rate (the rate at which this swap will occur) is sufficiently different from the "spot" exchange rate at which the investor can buy foreign exchange to make his investment, the prospective profit from an investment abroad will vanish entirely.

Note, now, that if arbitrageurs were the only participants in the forward foreign-exchange market the investor's own currency would rise to a sufficient forward premium very soon after an interest-rate change in one country had produced an opportunity for interest-arbitrage. The investors' demand for home currency delivered forward would rise apace with their demand for foreign exchange with which to exploit the difference in interest rates. The arbitrageors would bid up the premium while seeking to cover their new investments in the country with the higher interest rates.

In fact, however, there are other participants in forward foreign-exchange transactions—dealers in goods and services and outright speculators. The former buy foreign exchange forward to protect themselves against an appreciation of the currency they must acquire to pay for goods bought abroad and sell foreign exchange forward to protect themselves against a depreciation of the currency they will acquire as payment for goods they have sold abroad. Speculators will sell foreign exchange forward when they expect that the currency they thereby contract to deliver will depreciate before the contract matures. Changes in the volume or direction of these other forward foreign-exchange transactions can prevent the forward foreign-exchange rates from moving to offset an opportunity for international interest-arbitrage. This is especially apt to happen when the currency of the country with low interest rates is under suspicion. Speculative sales of that currency will drive it to a discount forward or, at the least, prevent it from rising to a sufficient premium.

This sort of speculative pressure seems to have beset the market for forward dollars in 1960. Chart A-1 describes the course of the 3 months' forward premium on U.S. dollars swapped for sterling. It also shows that level of the premium (the "no profit" premium) which would have offset the difference between Treasury bill rates in the United Kingdom and the United States. The no-profit premium is calculated from the following formula:

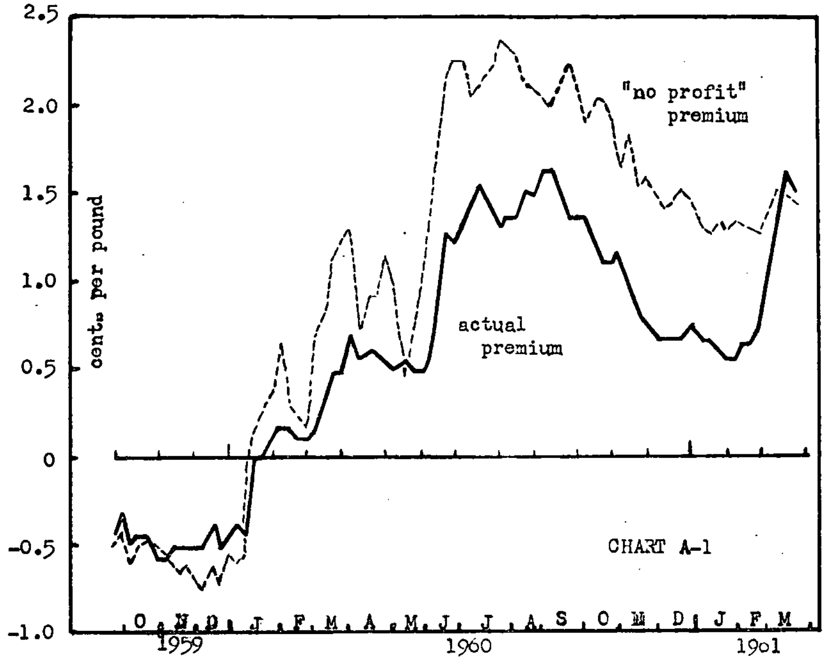
$$X(I_L - I_N)/(4 + I_L) = Z'$$

where X is the spot dollar-sterling exchange rate (quoted in cents per pound), I_L and I_N are the London and New York 3-month Treasury bill rates (quoted in percent per annum), and Z' is the no-profit forward premium (quoted in cents per pound). The formula is derived by manipulation of the better known equation:

$$(I_L - I_N)/4 - (Z/X)(1 + I_L/4) = P$$

which gives the profit, P, in percent per quarter that may be obtained by sending funds from New York to London.[1] We set $P = O$ and solve for Z $(=Z')$.

[1] The following data were employed to construct chart A-1: Friday quotations for spot and 3 months' forward dollars (as quoted in the London Economist), the average rate of discount on new British Treasury bills (Fridays, from the Economist), and the yield on new United States Treasury bills (Thursdays, from the Federal Reserve Bulletin).


2.5
2.0
1.5
1.0
0.5
0
-0.5
-1.0
cents per pound
"no profit"
premium
actual
premium
CHART A-1
O N D J F M A M J J A S O N D J F M
1959
1960
1961

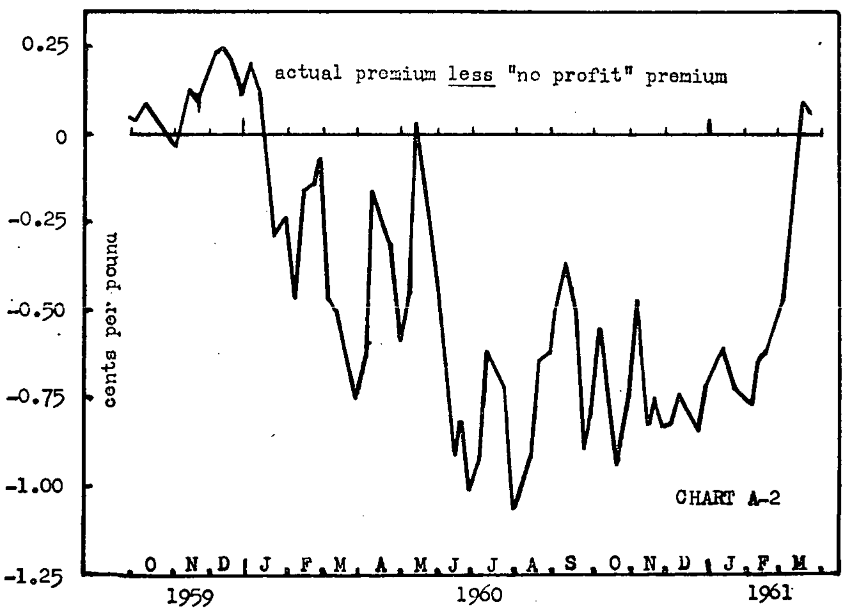

0.25
0
-0.25
-0.50
-0.75
-1.00
-1.25
cents per pound
actual premium less "no profit" premium
CHART A-2
O N D J F M A M J J A S O N D J F M
1959
1960
1961

Chart A–2 shows the weekly gap between actual and no-profit premia for the same 18-month period spanned by chart A–1. The 1-cent gap reached late in July 1960 is roughly equivalent to a profit of 1.4 percent per annum on interest-arbitrage.

It is usually conceded that a gap as small as five-tenths of 1 percent per annum is sufficient to induce a flow of funds.

The data in charts A–1 and A–2, then, suggest that the opportunity for profitable interest-arbitrage was unduly prolonged in 1960—that speculative pressures on the dollar depressed the forward premium, leaving a large margin of profit on transfers of funds from New York to London. Prompt official intervention (United States or United Kingdom purchases of forward dollars) would have raised the premium and might thereby have stemmed the capital outflow from the United States before it had gained sufficient momentum to trigger larger speculative movements.

EXHIBIT B. RESERVE-ASSET PREFERENCES AND U.S. GOLD LOSSES IN THE FOURTH QUARTER OF 1960

INTRODUCTION

This memorandum seeks to identify the causes of recent U.S. gold losses and to appraise their significance for the future of international monetary arrangements. It draws upon materials generated in a larger study of official reserve-asset preferences, still underway. The results summarized here are, therefore, preliminary and to be revised after refinement of the basic data and application of more sophisticated statistical techniques.

Popular discussions of the 1960 gold outflow have attributed the large U.S. losses to the continuing U.S. payments deficit or to speculation. These explanations are too imprecise to be useful. The United States ran as large a payments deficit in 1959 as in 1960, yet its gold loss was less than half as large; it also ran a sizable deficit in the first half of 1960, but lost only $144 million of gold, contrasted with $1,558 million in the second half (table B–1). The variation in U.S. gold losses around the payments deficit has been more striking than the correlation between them.

A part of the large gold outflow may be directly attributed to private speculation. The large private demand for gold manifest in European markets forced up gold prices and caused governments to sell gold to stabilize prices. These governments then drew upon U.S. stocks to replenish their gold holdings. Britain bought $550 million of gold from the United States during the second half of 1960, but British official gold holdings rose only $275 million (table B–2); much of the missing $275 million probably flowed into the London market to be bought by private parties and other governments. Similarly, France bought $173 million of gold from the United States, but French official holdings rose only $90 million; some of the remaining $83 million was probably sold to private buyers.

TABLE B-1.—*The U.S. payments deficit and gold losses, 1959–60*

[Millions of dollars]

Item	1959 [1]	1960	1960 (quarterly) I	II	III	IV
(1) Payments deficit (−) on account of goods, services, and long-term capital [2]	−4,520	−1,703	−555	−522	−607	−19
(2) Private short-term capital outflow (−), net	−89	−1,228	−55	−160	−442	−571
(3) Errors and omissions, net	783	−905	−6	−145	−144	−610
(4) Total payments deficit (−)	−3,826	−3,836	−616	−827	−1,193	−1,200
(5) Increase (+) in privately held dollar balances [3]	1,452	−171	363	213	−144	−603
(6) Increase (+) in official reserve assets (through the U.S. deficit) [4]	2,364	4,007	253	614	1,337	1,803
(6a) Dollar balances	1,633	2,305	203	520	700	882
(6b) Gold	731	[5] 1,702	50	94	637	[5] 921

[1] Excludes the $1,375-million U.S. subscription to the International Monetary Fund.
[2] Includes short-term public capital; excludes foreign purchases of U.S. Government securities.
[3] Includes the unallocated changes in foreign dollar holdings, amounting to $210 million in 1959 and $9 million in 1960. These were mainly changes in foreign holdings of U.S. Government securities maturing in more than 1 year.
[4] Includes international organizations, but excludes the $1,375 million increase due to the U.S. subscription to the International Monetary Fund.
[5] The increase of foreign governments' gold holdings was $1,221 million; the International Monetary Fund sold $300 million of gold to the United States in the fourth quarter of 1960.

Source: U.S. Department of Commerce, "Survey of Current Business."

TABLE B-2.—*Gold purchases (+) by selected governments, 1960*

[Millions of dollars]

Country	January-June Total	January-June From the United States	July-September Total	July-September From the United States	October-December Total	October-December From the United States
Argentina	−1	0	29	30	20	20
Austria	0	1	1	0	0	0
Belgium	55	51	−97	7	76	83
France	261	0	76	56	14	117
Germany	135	0	117	0	82	34
Italy	248	0	189	0	17	0
Japan	0	0	3	15	0	0
Mexico	0	0	−21	0	15	20
Netherlands	99	35	115	110	105	105
Portugal	1	0	1	0	3	0
Spain	10	0	20	33	80	81
Switzerland	−160	0	206	160	205	165
United Kingdom	25	0	150	200	125	350
Other (net) [1]	−255	39	−111	21	74	201
All countries [2]	384	126	678	632	816	1,176

[1] Calculated as the difference between the enumerated changes and the total for "all countries." Differences in coverage as between the 2 sets of "all countries" data will be reflected in this entry.
[2] Total purchases from the IFS. Foreign assets summary; purchase from the United States from the "Federal Reserve Bulletin." Both sets of data exclude changes in the gold holdings of the IMF and Bank for International Settlements.

Sources: IMF, "International Financial Statistics," and Board of Governors of the Federal Reserve System, "Federal Reserve Bulletin."

Private speculation also contributed indirectly to the large U.S. gold loss. It altered the composition and destination of the U.S. deficit, and centered the official demand for gold upon the U.S. Treasury.

During the second half of 1960, the U.S. deficit on account of transactions in goods and services and long-term private capital export shrank strikingly. But this "basic deficit" was replaced by a large outflow of short-term private capital that was induced by interest-rate differences and speculative considerations and that was reflected in the large adverse swing of net "errors and omissions" as well as in recorded capital exports (table B-1). Banks, businesses, and individuals abroad added to the strain by running down their dollar balances, rather than enlarging them as they did in 1959. These movements of private money greatly increased the U.S. deficit to be financed by an increase of foreign official reserve assets. Concomitantly, they focussed the U.S. deficit upon Western Europe where, it will be seen, governments evince a strong preference for gold.

Because private speculation (and the cessation of Soviet gold sales) helped to drive European gold prices higher than the Treasury's fixed official selling price, many governments bought gold from the Treasury that would normally have bought what they wanted on European markets. Few governments bought gold from the Treasury in the first half of 1960, although they were acquiring large amounts in toto (table B-2). They were able to obtain what they desired from new gold production coming onto world markets and from countries selling gold on the markets as they lost reserves. In the third and fourth quarters, however, many governments bought gold from the U.S. Treasury and the Treasury supplied most of what was purchased.

Thus, the large private capital flows and private gold purchases that occurred late in 1960 help to explain the increase of U.S. gold losses relative to the U.S. deficit, relative to the increase of official reserve assets through the U.S. deficit, and relative to the global increase of official gold holdings. But are they sufficient to explain all that happened? Note that the total of official gold holdings rose by larger and larger amounts during 1960—by $384 million in the first half, by $687 million in the third quarter, and by $816 million in the fourth. Part of this acceleration can be attributed to the change in the character of the U.S. deficit—to the outflow of U.S. capital that shifted the flow of reserve assets toward governments that usually hold gold. But these governments bought more gold in the third quarter than in the fourth, whereas the global increase in government gold holdings was much larger in the fourth.

One issue, then, remains for study: Was the large official demand for gold altogether unexceptional, or did some governments join the "gold rush" in 1960? The rest of this memorandum seeks to answer this important question—to appraise the possibility that official reserve-asset preferences are unstable so that governments may add to the strains upon the world's monetary standard when, as in 1960, that standard is attacked by private speculation or shaken by fluctuations in the flow of newly mined gold.

OBSERVED RESERVE-ASSET PREFERENCES

In the course of a study now in progress, the gold and foreign-exchange holdings of 57 governments have been examined in an effort to extract evidence on official reserve-asset preferences.[1] The data used span 19 quarters, from December 1955 through September 1960. The 57 countries have been classified according to two criteria:

1. The extent of absolute stability in gold holdings (measured by the frequency of changes in gold stocks during the 19 quarters under study).
2. The extent of relative stability in gold holdings (measured by the simple correlation between gold stocks and total reserve holdings).

The results of this analysis are set out in table B-3.

1. *Absolute Stability.*—The 57 countries under study have been classified into four groups:

Group I includes 11 countries that neither bought nor sold gold during the 19 quarters. Five of these (subgroup IA) hold no gold whatsoever; six are members of the sterling area (Burma, Ceylon, Ghana, Malaya, India, and Ireland). The 11 countries in this group accounted for $2.02 billion of the $34.79 billion in reserves held by the 57 countries in September 1960.

Group II includes 9 countries that altered their gold stock in fewer than 4 of the 19 quarters, (subgroup IIA), and 5 others that made more frequent changes, but that fall into this same category when one excludes the several changes smaller than $0.3 million. These fractional changes were excluded because comparable changes would not show up in the statistics presented by countries

[1] The data employed were those provided by the IMF on the country pages of International Financial Statistics. In several cases, the data were adjusted to exclude holdings of inconvertible currency, EPU credit balances, and other assets that countries could not turn into gold no matter what their preference. In a few cases, the foreign-exchange series was estimated from fragmentary data. The more important modifications in the International Financial Statistics data are described by a note at the end of this exhibit.

that provide data rounded to the nearest $1 million.[2] The countries in group II account for $2 billion of reserves.

Group III includes another 19 countries that varied their gold holdings frequently, but not continuously. Some of these bought gold only after a large and prolonged increase in reserves; some of them sold gold only in conjunction with a precipitous decline in reserves. Several have bought gold regularly, as at annual intervals. Two countries (Norway and Sweden) gained or lost gold in consequence of transactions with the European Payments Union; their gold holdings moved passively with their EPU position and have not changed frequently since the termination of the EPU. The countries in Group III acount for $7.43 billion of reserves.

TABLE B-3.—*Countries classified by frequency of changes in official gold holdings and regression results, quarterly data, December 1955 through September 1960*

Category, country, and frequency of changes in gold holdings (+,−,0)	Regression result (when significant) [1]			Reserve-asset holdings September 1960 (in millions of dollars)	
	R^2	G_o	B_{gr}	Reserves	Gold [3]
GROUP I. NO VARIATION IN GOLD HOLDINGS					
A. No gold					
Burma (0,0,19)				143.9	0
Ceylon (0,0,19) [2]				97	0
Ghana (0,0,19) [2]				106.7	0
Malaya (0,0,19) [2]				465	0
Panama (0,0,19) [2]				29.6	0
Total (0,0,95)				842.2	0
B. Constant gold					
Costa Rica (0,0,19)				13.6	2.1
Denmark (0,0,19) [2]				239.3	31
Honduras (0,0,19) [2]				13.8	0.1
Iceland (0,0,19)				14	1
India (0,0,19) [2]				646	247
Ireland (0,0,19) [2]				254	18
Total (0,0,114)				1,180.7	299.2
GROUP II. INFREQUENT VARIATION (3 OR FEWER CHANGES) [4]					
A. Without excluding fractional changes					
Egypt (1,1,17) [2]				280	174
Ethiopia (0,1,18) [2]				56.4	3.7
Finland (2,1,16) [2] [3]	0.7903	31.9	0.020	308.2	38.1
Haiti (0,2,17)				3.9	0.7
Iran (1,2,16)	.3413	124	.060	178	131
New Zealand (2,0,17) [2]	.3143	32	.007	277	35
Nicaragua (0,2,17)				8.5	0.4
Thailand (0,1,18) [2]				329	104
Turkey (0,1,18)				242	135
Total (6,11,154)				1,683.0	619.9
B. Excluding fractional changes					
Dominican Republic (1,5,13; 1,2,16)	.3406	14.6	−.080	45.1	10.4
Ecuador (1,5,13; 0,3,16)				43.7	20
El Salvador (1,7,11; 1,2,16) [2]				34.1	30
Guatemala (1,3,15; 0,2,17)	.4441	21.6	.078	45.5	23.6
Korea (6,0,13; 0,0,19)	.7105	5.9	.008	149.3	1.8
Total (12,17,66; 2,9,84)				317.7	85.8

See footnotes at end of table.

[2] It should be noted that none of the omitted changes, separately or in sequence, would have affected similarly rounded data. Changes as large as $0.3 million, however, sometimes affect the rounded data; it was for this reason that they were not also excluded.

TABLE B-3.—*Countries classified by frequency of changes in official gold holdings and regression results, quarterly data, December 1955 through September 1960*—Continued

Category, country, and frequency of changes in gold holdings (+,−,0)	Regression result (when significant) [1]			Reserve-asset holdings September 1960 (in millions of dollars)	
	R^2	G_o	B_{gr}	Reserves	Gold
III. FREQUENT VARIATION (4 TO 16 CHANGES)					
Argentina (1,14,4) [3]				658	84
Austria (11,0,8) [3]	.8507	−187	.640	702	293
Brazil (5,2,12) [3]				426	287
Chile (8,6,5)				118.6	42.5
China (2,2,15)				105	7
Colombia (11,3,5) [3]				163	75
Cuba (0,7,12) [2]	.7571	−95	.469	286	3
Greece (11,1,7)				229.7	30.8
Indonesia (2,9,8)				348	33
Iraq (5,0,14) [2]				272.9	83.9
Israel (3,5,11) [3]				175.5	0
Japan (6,0,13)	.7376	171	.286	1,658	247
Lebanon (4,0,15)	.8106	28.6	.582	137.6	101.7
Norway (5,8,6) [2]	.7188	70.8	−.143	269.3	30.5
Pakistan (4,1,14)				288	52
Peru (4,6,9)	.6462	8.5	.431	57.8	27.3
Spain (3,1,7)				479	98
Sweden (3,5,11) [3]				478	171
Venezuela (4,5,10)	.6277	306	.332	575	462
Total (92,75,186)				7,427.4	2,128.7
IV. CONTINUOUS VARIATION (17 OR MORE CHANGES)					
Australia (15,3,1) [2]				950	159
Belgium (11,8,0)	.9660	110	.847	1,219	1,094
Canada (4,14,1)	.4324	−851	1.010	1,822	894
France (10,4,1)	.8147	171	.599	2,110	1,627
Germany (17,2,0) [2 3]	.8298	−337	.570	6,796	2,889
Italy (17,1,1)	.9613	−494	.767	3,083	2,186
Mexico (8,10,1)	.2406	96	.146	351	121
Netherlands (11,7,1)	.9549	104	.764	1,549	1,346
Philippines (13,6,0)	.4879	1	.116	142	13
Portugal (15,3,1)	.7247	−23	.687	782	550
Switzerland (11,8,0)	.9834	−248	1.062	2,110	1,980
Union of South Africa (11,7,1)	.6440	111	.316	272	204
United Kingdom (10,7,2)	.9006	−145	.928	3,108	2,675
Total (153,80,10)				23,344	15,579

1 The parameters listed in these columns are (with 1 exception) significantly different from zero at the 0.05 level of significance. The exception is G_o for the Philippines, which is not significantly different from zero.
2 Reserve asset data include holdings of long-term securities.
3 Reserve asset data include net payments-agreement balances.
4 The countries in this group are subdivided as between those that showed 3 or fewer variations of any sort and those that showed 3 or fewer variations after excluding the $0.1 million and $0.2 million changes. Changes this small were not always reported in the International Financial Statistics data, as these are frequently rounded to the nearest $1,000,000. For the 5 countries that enter this class after excluding the fractional changes, 2 sets of data are given in the parentheses: the number of changes in gold holdings, inclusive of fractional changes; then, the number of changes exclusive of fractional changes.

Source: Quarterly data on gold and reserve assets from the International Financial Statistics country pages, adjusted to exclude European Payments Union credits (where included in gross assets) and, when possible, other payments-agreement balances. Additional notes on the individual countries are attached to this memorandum.

Group IV includes 13 countries, most of them in Europe, that vary their gold holdings continuously. Twelve of the 13, it will be noted, evince stable relationships as between gold and total reserves.[3] This group accounts for $23.34 billion of reserves.

No attempt has been made to employ extra information about the countries studied here. One is tempted to reclassify Norway and Sweden as countries evincing infrequent gold stock changes because their gold holdings have been very stable since the termination of the EPU. One might also be tempted to

3 The one exception (Australia) might show a similar pattern if one could extract the private holdings of foreign exchange that are included with the official balances but that may fluctuate in a different fashion.

exclude those gold stock changes that can be linked to the 1959 increase in IMF subscriptions. Some such attempts may be made in the final study, but with the reservation that any effort to explain away certain fluctuations is open to challenge. Many other gold stock changes may also be due to special circumstances that cannot be as easily detected. The response to special circumstances, moreover, reflects an official judgment or preference. Countries that bought gold to make payments into the Internationl Monetary Fund thereby displayed a different attitude from those that paid in a part of the government's own gold stock.

2. *Relative stability.*—In each of the 57 cases, the gold and reserve asset data were correlated, and in those that displayed a significant linear relationship, the parameters G_o and B_{gr} were estimated to yield the equation:

$$\text{Gold}=G_o+B_{gr}\times\text{Reserves}.$$

The significant correlation coefficients (squared) and the parameters G_o and B_{gr}, are given in the first three columns of table B–3.

One must at once observe that these computations fall far short of what might desired. They are based on time series, which frequently produce spurious relationships and often introduce serious bias.[4] They correlate one variable (reserves) with a second (gold) that is often a large component of the first. In later work, attempts will be made to cope with these and other statistical difficulties.

Few of the countries in groups I and II displayed a significant relative stability in the 19 quarters under study. Those that did, moreover, produced parameters B_{gr} that are not far from zero, even though significantly different from zero. Several of the countries in group III, however, displayed significant relationships, and most of these had correlation coefficients higher than 0.8 (R^2 higher than 0.64). One (Norway) showed a strange negative correlation between gold and total reserves, perhaps for the reasons described above.[5] As noted earlier, 12 of the countries in group IV displayed significant correlation coefficients.

AN ANALYSIS OF THE FOURTH QUARTER

During the fourth quarter of 1960, 30 of the 57 countries changed their gold holdings:

All of the countries in group IV changed their holdings; 10 of them buying gold, 3 selling.

Thirteen of the 19 countries in group III changed their holdings; 9 of them buying, 4 selling.

Six of the 14 countries in group II changed their holdings; 2 of them buying, 4 selling.

None of the 11 countries in group I changed their holdings in the fourth quarter.

The data developed in table B–3 can be employed to appraise these gold stock changes. They can be used to determine whether the number of changes was abnormally high and to determine whether the separate changes were abnormally large.

1. *The frequency of changes.*—The data on past gold purchases may be used to compute the probability that any one country will buy gold in any one quarter. This probability may then be employed to determine the probability that X or more countries will buy gold in one quarter.

One could begin by computing a separate probability for each country. To use these separate estimates, however, one would then have to employ a generalized binomial distribution. Here, therefore, a separate probability has been computed for each group of countries and applied to the whole group. This procedure allows the use of the binomial distribution and supplies a larger sample for the computation of the basic probabilities. But it requires us to assume that all of the countries in one group display identical preferences and that each transaction is independent of every other.

To illustrate the procedure described, consider the data on countries in group IV. The 19 quarters ending with September 1960 provide 243 observations on

[4] Thus, the computed residuals were sometimes serially autocorrelated; this introduces a bias into the parameter B_{gr}.

[5] Hence, the corresponding estimators, G_o and B_{gr}, are not used below.

the conduct of these countries.[6] In 153 of the 243 instances, countries purchased gold. Hence, the computed probability that one country will buy gold in any one quarter works out at 153/243, or 0.63. In the event, 10 of the 13 countries bought gold during the fourth quarter. The probability of this joint outcome is given by the formula:

$$\frac{13!}{10!\ 3!}\ (.630)^{10}\ \ (.370)^{3}\ =.143$$

By similar computations, one can determine the probability of 11, 12, and 13 purchases, and by addition of the separate probabilities, the probability that 10 or more countries in group IV would buy gold in one quarter. This sum works out at 0.230; the outcome in the fourth quarter would be predicted in 23 out of 100 quarters on the basis of previous experience. Such an outcome could not be regarded as extraordinary, nor as cause for concern.

TABLE B-4.—*Applications of the binomial distribution to gold purchases in the 4th quarter of 1960, countries showing infrequent and frequent changes in gold holdings*

Item	As classified in table B-3		Alternative classification	
	Infrequent (II) [1]	Frequent (III)	Infrequent (IIA)	Frequent (IIB, III) [2]
(1) Number of quarterly observations, December 1955 through September 1960	266	353	171	448
(a) Increases in gold holdings	8	92	6	104
(b) Decreases in gold holdings	20	75	11	92
(c) No change in gold holdings	238	186	154	252
(2) Computed probability that any one country will buy gold in any one quarter	.105	.473	.099	.437
(3) Number of countries that bought gold in the 4th quarter	[3] 2	[4] 9	[3] 2	[4] 9
(4) Computed probability that as many or more countries would buy gold in any one quarter	.064	.102	.037	.204

[1] Countries in group IIB included after omitting fractional changes.
[2] Countries in group IIB included without omitting fractional changes.
[3] Finland, $2,900,000; and Turkey, $1,000,000.
[4] Argentina, $20,000,000; Chile, $2,600,000; Colombia, $3,000,000; Greece, $45,400,000; Indonesia, $24,000,000; Iraq, $14,100,000; Lebanon, $17,500,000; Peru, $15,100,000; and Spain, $80,000,000.

Sources: Basic data from sources listed after table B-3; computations outlined in text.

The countries in group I also performed according to expectation. None of them had bought gold in the preceding 19 quarters; none of them did so in the fourth quarter. But the countries in groups II and III present a different situation. The calculations for group II are summarized in the first column of table B-4. They show that 2 or more purchases would only occur in 6 out of 100 quarters, given previous experience, hence, the countries in group II bought gold more frequently than one would readily anticipate. Similarly, nine or more purchases, as by countries in group III, would not be predicted from previous experience in more than 10 out of 100 quarters.

As some may object to the exclusion of fractional gold stock changes (subgroup IIB), the countries in that catgeory are transferred to group III in the "alternative classification" at the extreme right of table B-3 (and the corresponding fractional changes in gold holdings are included in the 19-quarter sample). Note that this change renders the actual fourth-quarter outcome for the "infrequent" category still less likely (reducing the computed probability to 0.037), but that it raises the computed probability for the "frequent" category from 0.102 to 0.204.

One may also object that the techniques used here makes no allowance for the direction of fourth-quarter changes in reserves. Table B-5 deals with this problem. There, the total of 857 observations on countries in groups II, III and IV are divided as between instances in which reserves rose and instances in

[6] This total is smaller than 19 x 13. The discrepancy testifies to gaps in the data for 1955 and 1956.

which they fell (or were constant). Then, the corresponding changes in gold holdings are tabulated, and the probability computed that one country gaining reserves will buy gold (0.405) and that one country losing reserves will do so (0.197). In the event, 24 countries gained reserves during the fourth quarter; 11 of these bought gold. The probability that as many or more would buy gold, given previous experience, is 0.382. This result, then, cannot be viewed as rare or alarming. But 8 of the 21 countries that lost reserves also bought gold. The probability that as many or more would do so works out at only 0.060, suggesting that this many purchases must be regarded as rare.[7]

TABLE B-5.—*Applications of the binomial distribution to gold purchases in the 4th quarter of 1960, countries (in groups II, III, and IV) gaining and losing reserves* [1]

Item	Gaining reserves	Losing reserves [2]
(1) Number of quarterly observations, December 1955 through September 1960	482	375
(1a) Increases in gold holdings	195	74
(1b) Decreases in gold holdings	67	113
(1c) No change in gold holdings	220	188
(2) Computed probability that any 1 country will buy gold in any 1 quarter	.405	.197
(3) Number of countries in category in the 4th quarter	24	21
(4) Number of countries that bought gold in the 4th quarter	[3] 11	[4] 8
(5) Computed probability that as many or more countries would buy gold in any 1 quarter	.382	.060

[1] Excludes Thailand, which had not published reserve data for the 4th quarter at the time this tabulation was prepared.
[2] Or (occasionally) constant reserves.
[3] Belgium, $76 million; Finland, $2.9 million; Germany, $82 million; Mexico, $15 million; Netherlands, $105 million; Peru, $15.1 million; Portugal, $2 million; Spain, $80 million; Switzerland, $205 million; Turkey, $1 million; and the United Kingdom, $125 million.
[4] Argentina, $20 million; Chile $2.6 million; Colombia, $3 million; France, $14 million; Greece, $45.4 million; Indonesia, $24 million; Iraq, $14.1 million; Italy, $17 million; Lebanon, $17.5 million; and the Philippines, $2 million.

Sources: Basic data from sources listed after table B-3; computations outlined in text.

TABLE B-6.—*Predicted and actual gold holdings, December 1960*

[Dollars in millions]

Country	Predicted [1] (G′)	Actual (G)	(G–G′)	SG′	(G–G′)/SG
Austria	260	293	33	38.4	0.36
Belgium	1.314	1,170	−144	32.0	[2] −4.50
Canada	1,003	885	−118	59.0	−2.00
Cuba	0	1	1	30.1	.03
France	1,411	1,641	230	165.7	1.39
Germany	3,766	2,971	−795	334.2	[2] −2.39
Italy	1,868	2,203	335	157.0	[2] 2.13
Japan	693	247	−446	62.7	[2] −7.11
Lebanon	108.3	119.2	10.9	5.3	2.04
Mexico	153	136	−17	12.5	−1.36
Netherlands	1,442	1,451	8	47.2	.17
Peru	38.1	42.4	4.3	4.6	.92
Philippines	14	15	1	4.5	.22
Portugal	522	552	30	24.0	1.25
Switzerland	2,218	2,185	−33	42.5	−.77
Union of South Africa	187	178	−9	14.4	−.63
United Kingdom	2,853	2,800	−53	147.5	−.36
Venezuela	491	398	−93	86.5	−1.08

[1] Calculated from the regression equation $G' = G_o + B_{gr} \times R$, using the coefficients G_o and B_{gr} given in table B-3 and reserve (R) data for December 1960 given in the I.F.S.
[2] Statistically significant at the 0.05 level.

Sources: Basic data from sources listed after table B-3.

2. *The size of changes.*—Table B-6 presents the result of a final calculation comparing predicted and actual gold holdings at the end of 1960. The predic-

[7] Note, however, that this result (and others presented above) may testify to lags in portfolio adjustments or to fluctuations within one quarter that yield anomalous end-of-quarter figures.

tions employ the calculated parameters G_o and B_{gr} (Table B–3) and the actual data on total reserves for December 1960. The gap between outcome and prediction (G—G′) is divided by the standard error of forecast ($s_{G'}$) to determine whether the predictions are significantly different from outcome. In four instances, the differences are significant; Italy bought gold although her reserves were falling, while Germany and Belgium held down their purchases, and Japan did not buy gold at all. If, then, this set of tests yields any inference, it must be that some of the major countries abstained from buying as much gold as the increase in their reserves would normally have dictated.

This test, however, is far from decisive. Some of the individual standard errors of forecast are as large as 20 percent of gold holdings, and the deviations reported sometimes reflect a cumulative disparity as between prediction and outcome, as in the case of Japan. They are not accurate measures of experience in the fourth quarter, but may rather testify to somewhat larger and longer gold-conserving shifts in asset preferences.

NOTES ON THE GOLD AND RESERVE-ASSET DATA

Except as noted below, the data used in this memorandum are central bank holdings of gold and foreign exchange, as given on the country pages of International Financial Statistics. The data for 1958–60 come from the October 1960 I.F.S. and more recent issues; earlier data are from the October 1958 issue. There are occasional discrepancies between the 1960 I.F.S. and 1958 I.F.S. entries for December 1957 (where the two sets of data overlap). In these instances, the 1960 I.F.S. entries are used in the correlation analysis and to compute changes in the first quarter of 1958, but the 1958 I.F.S. entries are used to compute changes in the last quarter of 1957. Whenever possible, payments-agreement balances, including net EPU cerdit positions, have been excluded from the reserve-asset estimates so that the latter may most closely represent assets freely convertible into gold. It should be added that changes in the European exchange regime, especially at the end of 1958, affect the continuity of the reserve-asset data and that some apparent changes in gold or reserve-asset holdings may actually reflect changes in coverage or in methods of valuation.

Note these additional peculiarities:

Australia: holdings of Reserve Bank, Government, and check-paying banks; are net of check-paying banks' foreign-exchange liabilities.

Brazil: holdings of Bank of Brazil through December 1957, monetary authorities thereafter.

Burma: holdings of Union Bank and Government.

Canada: holdings of monetary authorities and Government.

Ceylon: holdings of Central Bank, Government, and official entities.

Chile: reserve-asset data include central bank holdings for the account of others.

China (Taiwan): holdings of Bank of Taiwan, Government, and state-owned commercial bank.

Cuba: reserve-asset data include sums pledged as collateral for foreign loans.

Egypt (UAR): reserve-asset data exclude throughout the $56 million transferred to the Sudan in 1957.

Ethiopia: gold holdings for 1956–57 posted at the end-year values given in the 1960 I.F.S.

France: holdings of Bank of France and Exchange Stabilization Fund; quarterly data for 1957 supplied by the IMF (not available for 1955–56).

India: holdings of Reserve Bank and Government.

Iran: holdings of National Bank, including assets held for the account of the Government.

Italy: holdings of Bank of Italy and Exchange Office; foreign-exchange component of reserve-assets estimated for March, June, and September, 1956 and 1957 are estimated (estimates are 1958 I.F.S. estimates less an interpolation of the difference between the 1958 I.F.S. and 1960 I.F.S. end-year estimates).

Japan: holdings of Bank of Japan and Exchange Fund; foreign-exchange component of reserved assets for March, June, and September 1956 are estimated (estimates are 1958 I.F.S. estimates less open-account balances less an interpolation of the difference between the 1958 I.F.S. and 1960 I.F.S. end-year estimates, both net of open-account balances); it is assumed that gold holdings did not change during 1956.

Korea: holdings of Bank of Korea, including assets held for the account of others.

Lebanon: total official holdings.

Malaya: holdings of monetary authorities; reserve-assets include those held as cover the Singapore and Brunei currency issues.

Mexico: holdings of Bank of Mexico and, after 1954, government holdings of short-term dollar securities.

Pakistan: reserve-asset data exclude $102 million claim on India; foreign-exchange component of reserve-asset data estimated (for method, see note on Italy).

Panama: private holdings listed as official.

Philippines: reserve-asset data exclude "immobilized" dollar balances, include claims on Japan (nil after 1956).

Spain: holdings of monetary authorities; quarterly data not available for 1956 and 1957.

Switzerland: data exclude Treasury holdings (included in the 1960 I.F.S. series).

Thailand: holdings of monetary authorities.

United Kingdom: holdings of Exchange Equalization Account; foreign-exchange component of reserve-asset data expanded to include convertible European currencies after September 1958; also to include the $104 million in "waiver account" at December 1956; gold data (Federal Reserve estimates) apparently rounded to the nearest $25 million.

Venezuela: holdings of Central Bank, including assets held for the account of the Government.

The data and tests presented in this memorandum suggest that several governments participated in the 1960 "gold rush." Some bought gold that had rarely done so; some (including France and Italy) bought while losing reserves. A number of countries, however, seem to have abstained from purchases as large as might have been expected, notably those that could have caused vast damage had they begun to convert their dollar holdings. Experience in the fourth quarter would, therefore, suggest that asset-preferences are unstable at the periphery of the world economy and, perhaps, less stable than one would have hoped at some points near the center, but that the major countries have shown self-restraint and, one may hope, will continue to do so in forthcoming periods of strain.

Exhibit C. Reserve-Asset Creation and the Liquidity of the Financial Center, 1960 to 1975

INTRODUCTION

This exhibit presents a pair of tables that describe tendencies inherent in the process of creating international reserve assets. The first describes the evolution of U.S. liquidity as an international banker, using assumptions frequently encountered as to the need for new reserve assets and as to the way in which they might be created under existing financial arrangements. The second describes the evolution of IMF liquidity after its transformation into an international central bank of the sort Triffin has advocated.

Both of the tables assume that global reserves must grow at 3 percent per annum, the figure most often quoted in discussions of this sort. The recent U.S. deficit may have obviated the need for this growth, at least for the time being. At some not too distant date, however, the growth of reserves must resume, and at that time, the processes described by these tables may begin. Neither of the tables, it should be emphasized, constitutes a prediction of the reserve position a decade or more hence. Each describes the set of events that would follow from one set of assumptions as to the evolution of the monetary standard.

RESERVE-ASSET CREATION UNDER EXISTING ARRANGEMENTS

Table C-1 describes the growth of total reserve-assets and the evolution of U.S. reserves on three assumptions:

1. That the stocks of official and private reserve assets will grow at 3 percent per annum, but that monetary gold stocks will grow by only $650 million a year.
2. That the asset-composition of total reserves will not change during the next 15 years.
3. That the United Kingdom will successfully maintain the present ratio of U.K. gold to sterling liabilities.

TABLE C-1.—*World liquidity and the U.S. reserve position, end year, 1960–75*

[In billions of dollars]

Item	1960 (actual)	1965	1970	1975
(1) Official reserves (growing at 3 percent per year) [1]	29.40	40.46	46.90	54.37
(1a) Gold (50 percent of official reserves)	17.44	20.22	23.44	27.17
(1b) Dollar balances (29.7 percent of official reserves)	10.38	12.03	13.95	16.17
(1c) Sterling balances (20.3 percent of official reserves)	7.08	8.21	9.51	11.02
(2) Privately held balances (growing at 3 percent per year)	10.83	12.55	14.55	16.86
(2a) Dollar balances (growing at 3 percent per year) [2]	7.03	8.15	9.45	10.96
(2b) Sterling balances (growing at 3 percent per year) [3]	3.80	4.40	5.10	5.91
(3) U.S. liabilities (1b plus 2a)	17.41	20.18	23.40	27.13
(4) U.K. liabilities (1c plus 2b)	10.88	12.61	14.61	16.93
(5) World gold stock (growing at $0.65 per year) [4]	38.11	41.36	44.61	47.86
(5a) U.S. gold stock (5 less 1a less 5b)	17.80	17.89	17.40	16.32
(5b) U.K. gold stock (25.8 percent of 4)	2.80	3.25	3.77	4.37
(6) U.S. "reserve ratio" (5a divided by 3)	102	89	74	60
(7) U.K. "reserve ratio" (5b divided by 4) [5]	26	26	26	26

[1] Total gold, dollar, and sterling holdings of governments (other than the United States and United Kingdom). Gold as reported in the I.F.S. foreign-assets summary; dollar balances as reported on the U.S. country page (less U.K. foreign-exchange holdings assumed here to be U.S. dollars); sterling balances as reported on the U.K. country page.

[2] Includes private U.K. dollar holdings.

[3] Includes private U.S. sterling holdings.

[4] The $650 million annual increase is about equal to recent annual gold production plus net Soviet sales, less net disappearances into private hoards and industrial use.

[5] If U.K. holdings of convertible foreign exchange are added to U.K. gold holdings, the U.K. reserve ratio rises to 30 percent at the end of 1960.

Source: Data from IMF. "International Financial Statistics."

Under these assumptions, each of the components of official reserves (lines 1a, 1b, and 1c in the table) must increase at 3 percent per annum, as must the separate components of private cash (lines 2a and 2b), U.K. and U.S. liabilities (lines 3 and 4), and the U.K. gold stock (line 5b). The United States emerges as the residual supplier of liquidity—as, indeed, it has been in recent years.

Starting from the actual position in December 1960, U.S. gold holdings would rise slightly through 1965, then would decline at an increasing rate through 1975. The U.S. reserve ratio (gold divided by liabilities to foreign governments, banks, and businesses) would decline throughout, however, falling from 102 percent in December 1960 to 60 percent in December 1975.

Note that this table implies that the United States will run a very small annual-payments deficit in each year of the 15-year period. The deficit is the excess of the increase in U.S. liabilities over the increase in the U.S. gold stock. It would average $53 million annually from 1960 through 1965, $74 million from 1965 through 1970, and $93 million from 1970 through 1975. If the United States were to run a larger deficit (thereby adding more to reserves), the U.S. reserve ratio would decline more rapidly.

Two tendencies may be at work to modify this projection. On the one hand, there may be no need for the rapid increase in reserves contemplated here. On the other, we may be witness to a drift into gold that would raise gold holdings above one-half of total official reserve assets. It is difficult to predict the joint outcome of these two tendencies. The first would ease the strain on the U.S. position, but the second could lead to a deterioration in the U.S. reserve position, which could hasten the drift into gold, causing the system to break down.[1]

RESERVE-ASSET CREATION WITH AN EXPANDED IMF

Table C-2 describes a process analogous to the one just outlined, but after reform of the present International Monetary Fund along lines suggested by Triffin. The first column in the table is, indeed, an adaption of Triffin's presentation ("Gold and the Dollar Crisis," table 19) brought forward from 1958 to 1960. It assumes that each country (including those that are not now members of the IMF) will establish a deposit at the IMF equal to 20 percent of gross reserve assets (including the country's "net position" at the Fund, where that position is positive). It will establish its deposit by paying in foreign exchange

[1] I have explored this possibility in a theoretical analysis, "International Liquidity and the Balance of Payments of a Reserve-Currency Country," "Quarterly Journal of Economics," November 1960.

or, if its foreign-exchange balances are inadequate to the purpose, by paying in gold. IMF gold holdings (line 1a) are therefore equal to the Fund's present holdings plus large gold deposits by Switzerland and the United States (the countries lacking sufficient foreign exchange) and small deposits by other countries. IMF holdings of national currencies and Government debt (line 1b) are equal to present Fund holdings plus the new payments that are required to raise national deposits to 20 percent of national reserves. The data under "national monetary reserves" are actual reserves at the end of 1960 plus "net positions" at the IMF; the breakdown of reserve assets assumes that each country has purchased an IMF deposit equal to 20 percent of reserves, in the manner described above.

The United States and United Kingdom "reserve ratios" are derived by dividing the relevant reserve data (lines 2a and 2b) by dollar and sterling liabilities, respectively. The data on liabilities are actual indebtedness at the end of 1960 less the dollar and sterling payments other countries must make to the IMF. Note that the U.S. "reserve ratio" rises from 102 percent under the present regime (line 6 of table C-1) to 165 percent under the Triffin plan. The United Kingdom reserve ratio rises from 26 percent (or from 30 percent, if United Kingdom foreign-exchange holdings are included in the numerator) to 37 percent under the Triffin plan.

TABLE C-2.—*World liquidity and the asset structure of an expanded International Monetary Fund, 1960–70*

[Billions of dollars]

Item	1960	1970
(1) IMF assets (equal deposit liabilities)[1]	12.36	20.48
(1a) Gold	5.13	5.13
(1b) National currencies and Government debt	7.23	15.35
(2) National monetary reserves [2]:		
(2a) United States	19.37	19.37
(2a.i) Gold	15.50	15.50
(2a.ii) IMF deposits	3.87	3.87
(2b) United Kingdom	3.72	5.00
(2b.i) Gold	2.80	3.82
(2b.ii) IMF deposits	.74	1.00
(2b.iii) Foreign exchange	.18	.18
(2c) All other countries	38.70	52.04
(2c.i) Gold	18.36	23.84
(2c.ii) IMF deposits	7.75	15.61
(2c.iii) Foreign exchange	12.59	12.59
(3) Required IMF deposits (20 percent of reserves)	12.36	15.28
(4) Excess IMF deposits (1 less 3)	------------	5.20
(5) Ratio of gold to reserves (all other countries) percent	47	46
(6) U.S. "reserve ratio" [3] do	165	(5)
(7) United Kingdom "reserve ratio" [4] do	37	(5)

[1] In 1960, 20 percent of national reserves; gold holdings equal to actual IMF holdings plus payments by countries holding their reserves in gold and, therefore unable to satisfy the 20-percent reserve requirement by payments of foreign exchange. In 1970, enlarged sufficiently to provide a 3-percent annual increase in national reserves (other than those of the United States), assuming that official foreign-exchange holdings remain constant and that national gold holdings increase by $650 million per year.

[2] These data do not match the entries in table C-1, as they are derived (following Triffin) from the national reserve statistics rather than from the United States and United Kingdom data and include the net IMF position (where positive) of each member country. U.S. reserves are assumed to grow at 3 percent per year and the United Kingdom, as a reserve center, is assumed to hold a minimal balance at the IMF and all of the rest of the increase in gold. The reserves of other countries also increase at 3 percent per year; they absorb the rest of the increase in gold supplies, hold their foreign-exchange balances constant, and accept IMF deposit obligations to round out the increase in their reserves.

[3] U.S. reserves divided by U.S. liabilities. Reserves as in the line 2a of table C-2; liabilities as in line 3 of table C-1, less $5.70 billion of payments to the IMF by other countries having to satisfy the 20-percent reserve requirement. It is assumed that all such payments are made in dollars, except for those of the sterling area countries.

[4] United Kingdom reserves divided by United Kingdom liabilities. Reserve as in line 2b of table C-2; liabilities as in line 4 of table C-1, less $0.74 billion of sterling payments to the IMF by sterling area countries having to satisfy the 20-percent reserve requirement.

[5] Will depend upon the rate of increase of private foreign-exchange holdings.

Source: Adapted from Triffin ("Gold and the Dollar Crisis," table 19), using data from IMF "International Financial Statistics."

The projection to 1970 is accomplished on assumptions very similar to those used before:

(1) That the total of reserves (other than those of the United States) must rise by 3 percent per annum, but that monetary gold stocks will grow by only $650 a year, while official foreign-exchange holdings will not grow at all.

(2) That governments exercise a first claim on new gold production to keep their gold holdings stable relative to their reserves.

(3) That the United Kingdom participates in the growth of reserves and holds as much of the increment as possible in the form of gold.

Under these assumptions, the IMF replaces the United States as the residual supplier of reserve assets. Its deposit liabilities rise to $20.48 billion by 1970, while its holdings of national currency rise to $15.35 billion. United States and United Kingdom deposits at the Fund remain at the minimum (20 percent of gross reserves), but those of other countries climb to $15.61 billion. Thus, national deposits at the IMF come to exceed required deposits by $5.20 billion, a sum larger than the Fund's gold stock. Governments could stage a dangerous run on the Fund's gold holdings.

If Triffin's proposal is to provide a lasting monetary standard, all or part of the increment in national reserves would have to be frozen as required balances at the IMF. This could be accomplished by raising the reserve ratio above 20 percent or, more sensibly, by restricting the convertibility of all or some deposits at the Fund.

STATEMENT OF N. R. DANIELIAN, PRESIDENT AND DIRECTOR, INTERNATIONAL ECONOMIC POLICY ASSOCIATION, WASHINGTON, D.C.

Mr. Danielian. I appear today in my individual capacity. None of the ideas expressed in this paper have been submitted, cleared, or approved by any member of the International Economic Policy Association. I do not know if they will condone or condemn my appearance and expressions here. But I feel strongly that, in the national interest, some of the issues confronting this country in its international economic policies are so serious that they deserve a candid appraisal.

I shall, therefore, confine this brief discussion to an analysis of the causes for the balance-of-payments deficits of the United States, their effect upon our reserve situation, and the applicability of the remedies being recommended.

We are all familiar with the conditions which bring this inquiry into focus. The United States has run cumulative balance-of-payments deficits from 1950 to 1960 inclusive, of over $23 billion. Of this, over $6 billions have been taken out in gold. In the same interval, the gold reserves of the country have diminished from about $24.1 billions to less than $18 billions. Of the remaining gold supplies, about $12 billions are committed to sustaining the reserve requirements of Federal Reserve deposits and notes, leaving a little less than $6 billions of free gold to pay outstanding international short-term claims against the United States under our gold exchange standard. In the meantime, these claims against the United States have increased to over $20 billions.

The wonder is not that these things have happened, but that we have allowed this situation to develop without taking corrective action. In June 1959, I urged the Treasury Department to speak out on this subject at a conference our organization gave in Washington on the U.S. economy and international relations. There was understandable reticence; for, in September 1959, when the Secretary of Treasury warned the meeting of the Board of Directors of the International

Monetary Fund of the dangers of this developing situation, and in October 1959, the Development Loan Fund established the policy of U.S. procurement, there was unanimous criticism by the press, the academic profession, research organizations, and even by spokesmen for other departments of the Government. As a result, even the Treasury Department became gun shy—until after the November 1960 election.

Anyone traveling in foreign countries in 1959 and 1960 could have easily anticipated the impending crisis.

But U.S. economists and financial leaders alike chose to underplay the problem until the eye-opening gold crisis of October and November 1960. Since then, we have been besieged by a plethora of panaceas.

The reason we failed to anticipate and take corrective action is that the analytical tools that are applied are no longer applicable to the present-day conditions. And, of course, influential vested interests have developed for continuance of the policies that were originally designed to resolve the postwar dollar shortage abroad. We economists have abdicated to public relations experts, and they have become purveyors of academic platitudes which even we have come to believe, and the decisionmaking power in our Government is often paralyzed.

The first step toward better understanding would be to recognize the fact that the United States, as the Secretary of the Treasury stated on Monday, is going through a transitional period in its international economic and financial relations. In the immediate post-World War II period, the primary, recognized, international economic policy of the United States was the reconstruction and rehabilitation of our former allies and some of our former enemies. This was a period during which dollar shortage and dollar gap were the focal points of attention, and to correct this, we adopted certain economic and financial policies, all of them designed to put dollars into needy countries, such as:

(1) Transfers of massive amounts of U.S. dollars through Government grants and loans;

(2) Offshore procurement by U.S. governmental agencies;

(3) Military expenditures abroad;

(4) Reduction of tariffs by the United States to permit other countries to sell here and acquire dollars.

Incidentally, Mr. Chairman, I supported all of these measures during that period.

Foreign economic aid from July 1, 1945, through December 31, 1960, amounted to $50 billions; military expenditures abroad, 1946 through 1960, are reported to be $30 billions; military assistance, of which it is said that only 10 percent is procured offshore, $28 billions. The Government spent another $3¾ billions for miscellaneous services abroad. The total in these categories alone amounts to $111¾, or roughly $112 billions.

It will be said that much of the foreign aid and military assistance was procured in the United States. This was certainly true in the early years, when this country was almost the sole available supplier, and it is still true as far as military assistance is concerned, except for the 10 percent which the executive departments admit is still procured abroad. As for economic aid, it is quite clear from the record that a diminishing proportion has been spent on U.S. procurement. From 1954 to 1960, the proportion of ICA expenditures, just to cite one example, spent in the United States, went down from 74 to 37 percent. Of course most of the direct U.S. military expenditures abroad has been a net ouflow of dollars. The result, of course, has been large contributions to our balance-of-payments deficits which, since 1950, have amounted to $23 billion.

The task that the United States set out to accomplish in 1945 has been surpassed. But our concepts have not adjusted to the changing circumstances. There is a tendency, in economic thinking in this country, to apply the concepts of free trade, or so-called liberal trade policies, to procurement under these massive outpayments of dollars by Government. But there is nothing free or voluntary about the decisions that lead to these expenditures. They are forced savings, through the taxing power, and the form and area of application are motivated purely by political and military considerations. It is only when the question of procurement comes up that there is a hue and cry about "liberal trade" policies, and "the most effective utilization of resources," two currently favorite cliches.

There is no economic theory and no precedent that covers this entirely new and unequaled undertaking by the people of the United States since World War II; it is unique, it is gigantic in dimensions, and it is completely unprecedented in history.

In 1960, alone, U.S. direct payments abroad, exclusive of unrecorded transactions, and not including any Public Law 480 or other aid money spent in the United States, and exclusive of Government purchases through subsidiaries of foreign corporations or importers, amounted to $4.6 billions.

There is no economic theory, or principle of international trade and finance, that addresses itself to this question: How does a people, a country, or a government, transfer massive amounts of purchasing power from its shores to other countries, for military, political, or humanitarian reasons?

The paucity of economic theory to cover this new activity by government is due to the fact that economic theory on international trade and finance, as it is taught today, antedates World War II; indeed it goes back to 19th century British economic thought in its sources and inspiration.

What has happened, certainly since 1950, is that the ordinary pricing mechanism, the competitive relations between countries, and the existing financial institutions, including the gold exchange standard, have not been able to absorb the impact of those governmentally motivated programs of massive transfers of purchasing power from the United States to other countries.

As you well know, there has been and there still exists a highly critical attitude toward U.S. procurement under our Government aid programs. There is a tendency to consider this illiberal and retrogressive. Yet a reading of the recommendations of economists working in this field does not reveal a practical program of accomplishing this transfer of massive amounts of purchasing power or capital from the United States to other countries, except the traditional one of bringing about a recession in the United States in order to depress prices to a level competitive with the rest of the world. Of course they do not call for a recession; they call for an adjustment of prices and wages to a level that would be competitive with other countries. The classical method of bringing this about, of course, that is classical in economic theory, is outflow of gold in response to balance-of-payments deficits, high interest rates and contraction of credit at home, curtailment of industrial expansion, with attendant unemployment, in the hope that prices and wages will decline to a competitive level.

The only trouble is that even this will not work in the United States, because of the inflexibility of both the wage and price structures, not to mention the fact that it would be both humanly and politically unacceptable. It does not work abroad, either. Classical theory would call for expansion of credit and inflation and rising prices in balance of payments surplus countries which receive our gold exports. This has not happened, because governments abroad in fact have discouraged expansion of credit.

The question that really confronts this committee is, therefore, to decide whether, assuming that the classical solution of price and wage readjustments will not work, the proposals being advanced with regard to elimination of the monetary reserve requirement, or the reforms of the International Monetary Fund structure, will in any way accomplish the desired result, and permit us to continue these massive outpayments of dollars without the requirement of procurement in the United States as one of the conditions of such programs, and without redistribution of military expenditures.

In the end, we must realize that the only way a country can continue to transfer purchasing power abroad is in gold, goods, or other evidences of property ownership. Ultimately, these are the only forms in which a country can export purchasing power or capital.

If other countries will not buy current production, there are two alternatives; to buy gold or to buy evidences of indebtedness or investments. The proposals before this committee are designed to solve this problem of making more gold available for export, or by making it more desirable for those who acquire dollar reserves to invest them in the United States. I submit that these alternatives cannot be continued indefinitely; they may only buy time, perhaps 4 to 5 years. In the end, we are still going to be faced with the same fundamental question; how to continue to transfer massive and growing amounts of purchasing power. Only last week the administration launched its "Decade of Development" of foreign aid, in addition to continuing commitments on military expenditures abroad. I think we must face the basic question and have an answer to fit. If the traditional concepts of the competitive price mechanism and the gold exchange standard will not absorb these massive transfers of purchasing power, as has been the case since 1950, what alternatives are there?

Exports of gold, or transfer of ownership into foreign hands of evidences of indebtedness or investment, are not responsive to the challenge of the present day. The struggle in the world is between productive systems. The United States must prove to the rest of the world the supremacy of our competence and genius in this field. Our aid and investment programs abroad must make our productive capacity, factories and labor alike, able to accomplish the tasks that the President has laid out for the Congress in his Foreign Aid message. In the long run, it can be done no other way.

Unfortunately, this basic truth is not fully recognized even today. Witness section 604, the procurement section of the foreign aid bill now before Congress, and the continued channeling of the U.S. aid funds through international institutions, each one of which has a charter provision which prohibits the agency from designating the sources of procurement in the use of its loans.

There is a second major change taking place in our international economic relations which is inadequately recognized by students of economics. This is the changing pattern of our international trade, particularly in exports and imports. On the import side, as time goes on, the United States is going to need more and more imports of raw materials in order to supply its industrial machine. Whether this can be controlled by the development of substitutes remains a matter of national policy of highest priority. The fact is, in the meantime, that since World War II, we have developed a very large negative influence in our balance of payments situation because of growing dependence on imports. Again, in the field of exports, the tendency towards regionalization of trading blocs and the localization of productive units to serve proximate markets, such as the Common Market in Europe and emerging free trade areas in other parts of the world, will continue to change these patterns of trade, and I am not sure that this influence will be in the direction of improving our balance of payments position. These changes already appear in certain major industry categories.

It is said that the changing composition of our foreign trade should not necessarily mean a handicap, in the long run, because new and improved products will always take the place of old markets lost. But this is a pure assumption. With improved education and communication, high degree of mobility of capital and management, and even identical and perhaps better technology being established in some of the other advanced countries, are there any valid grounds to assert, as a basic theoretical underpinning of national policy, that we are always going to be in the vanguard in quality and variety of products and costs of production, in sufficient numbers of items and in large enough markets, to earn the necessary foreign exchange, to pay for our military expenditures abroad, and the foreign aid, and the necessary imports, which will be of growing dimensions. Again, I do not believe we economists and those that are advancing the measures being considered here have really confronted this revolutionary change in international competitive conditions arising from the transferability of capital, technology, management and the more widespread educational efforts to train personnel and workers everywhere around the world.

When the art of economic thinking was developed in 19th century England, and free trade based on "comparative advantages" became accepted doctrine, England was in a unique position; it had a substantial control on both capital and technology, and was discerning the export of both. We have an entirely different outlook. We are engaged as a national policy in positive steps to export capital, know-how, management and technology, by both private and governmental agencies.

We did this with Western Europe and Japan. The long-range consequences of this development on our balance of payments is only now gradually emerging. The successful culmination of the Common Market during this decade, and the possible acceptance of England and perhaps other members of the Free Trade Association into it giving, in addition to technology, management and capital, also the advantages of large scale production, encouraged and promoted by U.S. national policy, will have, inevitably, pronounced effects upon our balance of payments, and even, perhaps on our balance of trade. The classical adjustments, here, too, are not available—recession, decline of prices and wages. The concept of the Atlantic Union, perhaps the most promising from a political and military viewpoint as a defense of Western civilization, foundering upon the shoals of incompatible economic thories.

We have adopted in this country theories of trade without accepting the basic conditions and premises which must go with them to make them valid. I feel a sense of envy toward the European economists who drafted the Treaty of Rome, because they realized that free or liberal trade amongst their countries insure not only transfer of capital and technology, but acceptance of all the underlying conditions, uniformity of regulations and legislation in the treatment of labor, with the ultimate expectation that this would result in uniformity of basic conditions of employment.

Here, therefore, I pose the second question. Will the proposals before this committee resolve the possible long-range discrepancies that may arise in our trade relations because of the transferability of capital, technology, and skills without the attendant adjustments in labor and wages which would retain or regain our competitive advantage?

This, again, poses the problem of whether such uniformity of wage levels, say between the North Atlantic Alliance and the United States, would be acceptable politically. In the absence of necessary mobility to bring about competitiveness of costs, we shall face, in the long run, the problem of balance of trade deficits. I do not share the enthusiasm of some statisticians about our balance of trade surpluses, because upon examination, you will find that agricultural surpluses sold under Public Law 480 and ICA, as well as other Government-induced exports through grants, aids, and subsidies, are included in the Department of Commerce export surplus figure. In fact, in 1959, after deducting these Government-induced exports, we probably had a substantial balance of trade deficit.

In economic theory, the principle of comparative advantage, developed in 19th century English thought, was based on locational and climatic advantages for natural resources, or upon technological advantages in manufactures that were jealously guarded. We are going to see the technological advantages disappearing, and this situation will become even more severe when the Communist bloc comes into the world markets. Present-day economic thinking has not faced this issue, and I am quite sure that the proposals being advanced before this committee do not in themselves supply long-range solutions to this problem.

There is a third factor which is now entering into this picture. It is, in fact, an extension of the second issue just mentioned, but it will become much more severe as time goes on. This is the announced policy of a decade of economic development in underdeveloped countries, to be brought about through Government aid, by the export of U.S. and Western technology, know-how, and capital. I have supported and I continue to support the principle of aiding underdeveloped countries, and some other sections of the foreign-aid bill before Congress, and the continued channeling of the U.S. aid funds. I appeared before the Senate Foreign Relations Committee yesterday to do so, and I believe that giving them opportunities to create wealth through enterprise is the best means of improving their standard of living. However, if we transfer the most up-to-date technology, know-how, and our own capital resources to achieve this, under our trade policies as they stand today, we are going to be confronted with the return flow of those goods to the United States. There will be a wide range of products that can be produced in these underdeveloped countries, but under labor and cost conditions far lower than in the United States.

Here again, the classical theory, namely, outflow of gold, credit restriction, depression of price and possible unemployment, with a view to lower wage costs, to a level where American labor can be competitive with labor in underdeveloped countries, is simply inacceptable politically and economically in the United States. The solution suggested—readjustment of labor through Government-subsidized retraining and relocation programs, does not answer this problem, because as time goes on, more and more U.S. industries are going to be under such pressures from imports coming in from underdeveloped countries, and the solutions offered either in readjustment or unemployment compensation merely cause an increase in the cost of production, either through taxation or inflation. It is, therefore, no way to become more competitive in the world markets, particularly with competitive industries developed in low-wage countries with our aid.

The dilemma of our development and trade policies toward underdeveloped countries is perhaps best illustrated by the predicament in which the Under Secretary of State for Economic Affairs found himself this week. He testified before the committee on Monday:

> It is essential that the less developed countries obtain enlarged markets in the industrial countries for their traditional exports. This means lowering existing trade barriers and resisting pressures for new ones. Moreover, the industrial countries must find constructive solutions to the problems that have arisen, and will inevitably grow more pressing, as a result of the economic advances of the less developed countries. The fruits of economic development will appear, in part, as new exportable products, increasingly in the field of manufactures. These products represent hard-won economic gains, to which our taxpayers have contributed their money and our Nation its influence. If markets cannot be found for them, much of the common effort will go to waste.

Tuesday morning's papers carried the story that he, the Under Secretary, was hopeful of securing a voluntary quota limitation of 30 percent on the exports of textiles from Hong Kong to the United States. If the economic theory enunciated in general statements is good, and valid, why ask Hong Kong or Japan or any other country for voluntary or even mandatory quotas. If the theory is not valid, why keep enunciating it instead of developing a new and more applicable concept. It is interesting that Hong Kong does not get U.S. aid, and therefore the industries are established on a purely commercial basis. Many of the workers are refugees from Communist China. If any condition deserves our sympathetic approach, it is the situation in Hong Kong, and yet, there seems to be something unworkable in our professed theories that puts a very sincere and devoted advocate of liberal trade, such as the Under Secretary, in an embarrassing position of asking various governments not to practice what he preaches.

This situation will become more general as the decade of development of this Government expands to encompass much of the underdeveloped world. Mr. Paul Hoffman stated last week that there are 1,300 million people (plus 700 million in Red China if they should ever come into free world association), in these countries that must be helped at an estimated cost of $7 billion a year for 10 years. Nearly every speaker in the Conference on World Economic and Social Development, including the President and the Secretary of State, took the position that we can do this job in the coming decade, and help underdeveloped countries into sustained economic growth.

This is the great challenge of this decade, and it is a tribute to the humanitarian instincts of the American people that this thinking has become, under the leadership of the President, national policy. One can only pray that peace will last long enough to make our maximum contribution to the improvement of human welfare, and if disarmament should ever become a reality, more and more capital would be available to devote to this challenging enterprise.

The difficulty, however, is that we have not developed an economic theory which will make it possible for us to export these growing amounts of capital to help develop self-sustaining industries in underdeveloped countries, then supply them with markets, and, at the same time, insure the strength of the U.S. economy. Today this problem afflicts us in the textile industry; tomorrow it will be aluminum when the projects in Africa are developed. If ever there is discovered iron ore and coal in economic conjunction in any underdeveloped country, and the steel industry is subjected to massive competition under conditions of differential cost advantages, then I think the United States would certainly have something to worry about under its present trade policy concepts in order to protect the strength of our economy, the military as well as economic strength.

Is the problem of textile imports an exception coming to the front because of political pressures, or is it a generic economic problem that the country is going to face in industry after industry as the underdeveloped countries progress with our help? It is reassuring that the Secretary of Treasury, before the Ways and Means Committee, admitted that there was a problem here, and that the administration is looking into it. Until we develop a set of rules that will have universal application, we are going to find ourselves professing one thing and practicing another. In the meantime, the balance-of-payments situation of the United States will come to deteriorate. Will the proposals to create greater liquidity in international payments resolve such a problem without a more fundamental resolution of the issues we face in the coming decade?

I conclude, therefore, that economic theory, as practiced and advocated today, has not solved the problem of massive exports of capital under foreign aid programs, and outpayments for military expenditures abroad. It has not yet solved the problem of the increasing import needs of this country, and the necessary means to pay for them. It falls far short of solving the problems raised by a reequipped, resurgent, Western Europe and Japan, including the Common Market and Free Trade Association. And it has not confronted the inconsistencies between our foreign economic aid programs in the development of industries in underdeveloped countries, and our trade policy.

Within that context, to say that our primary need is liquidity, and that this liquidity can be achieved by permitting the export of all our gold supply, or by making it desirable or almost even compulsory for other countries to keep part of their growing dollar earnings in investments through the IMF, or directly in U.S. Government bonds and other assets, does not solve the basic imbalance that has already asserted itself and will continue to grow if we follow the present policies. They may gain us time; they may lull us into complacency, but I view the primary issue before Congress as the resolution of these inconsistencies in international economic policies, because if we do not confront this issue today, we are bound to complicate our international, financial situation; create greater instability for the dollar, and perhaps even create conditions of crisis for our economy and possibly political reaction, with undesirable consequencies.

I express no opposition to these devices that are proposed; I only say that they are not solutions to the issues that confront the country in this field. They anesthetize the symptoms; they do not cure the causes.

Representative REUSS. Thank you, Mr. Danielian. You have sprinkled some paprika on the fairly bland stew that we have been considering so far.

The next expert to participate in the panel discussion is Mr. Harry Johnson, of the University of Chicago.

Would you proceed, Mr. Johnson?

STATEMENT OF HARRY M. JOHNSON, UNIVERSITY OF CHICAGO, CHICAGO, ILL.

Mr. JOHNSON. Mr. Chairman, the present international monetary system is a gold exchange standard, under which the leading trading countries maintain fixed exchange rates by holding reserves in the form of gold and holdings of national currencies convertible into gold. Both historical experience of the collapse of the gold exchange standard in the interwar period and the recent balance-of-payments problems of the United States illustrate that this form of international monetary system has two serious weaknesses: its reliance on a national currency—the U.S. dollar, and to a lesser extent the pound sterling—to provide international reserves, and its reliance on newly mined gold plus further expansion of reserve currency holdings to provide for growing liquidity needs. The use of a country's currency as other countries' reserves exposes that country to the risks of sudden and sharp balance-of-payments deficits on short-term capital account prompted by interest-rate differentials or speculative factors, risks which limit its freedom of domestic action. These limitations could have a seriously crippling effect on the economic strength of the United States in future, both because confidence in a reserve currency tends to be governed by superficial judgments of a strongly conservative kind rather than by rational economic analysis, and because in the next decade the United States will have to make substantial economic adjustments to the industrial recovery of Europe and the spread of industrialization around the world, adjustments which could be seriously impeded by the need to command foreign confidence and retain foreign short-term capital in the country. Dependence on further growth of reserve currency holdings to satisfy growing liquidity needs involves the risk that reserves may not increase adequately, so threatening the constriction or collapse of the nondiscriminatory multilateral system of trade and payments that the United States has been seeking to reestablish since the war.

There are two alternative measures that would solve or remove both weaknesses simultaneously. One is the traditional solution of the gold standard, an increase in the world price of gold. The objections to this solution are that the resulting increases in reserves would be most inefficiently distributed, that it would give undeserved permanent income gains to the gold-producing countries, and that it would confirm in the international sphere a principle deliberately abandoned in the domestic monetary management of all advanced countries—that the supply of money should be governed by the quantity of gold. The other solution would be to abandon the system of adjustable fixed exchange rates in favor of floating exchange rates. There is much to be said for this solution, especially from the standpoint of U.S. national interests, but since it would amount to replacing the present international monetary system, I judge that it lies outside the scope of the subcommittee's inquiry.

There is a variety of unilateral actions that the United States could take to strengthen its international financial position and the international monetary system. These include removing the anachronistic 25 percent reserve requirement against Federal Reserve notes and deposits; using the existing U.S. credit with the International Monetary Fund and U.S. drawing rights on the Fund as international reserves; altering the presentation of its international accounts to give a clearer picture of its international banking position; and strengthening the inducement to foreign monetary authorities to hold dollars by offering securities carrying a gold guarantee and special rates of interest. To remedy the two main weaknesses of the present international monetary system, however, would require some form of international collaboration.

With respect to the weaknesses resulting from the use of national currencies as international reserves, there is a choice between the two approaches—strengthening the reserve currencies in question against the dangers of short-term capital outflows, and replacing national currency reserves by international credit reserves. The first approach could be informal, through a strengthening of present collaboration between the leading central banks; this would include coordination of interest rate policies to avoid giving interest-rate incentives to outflows of short-term capital from reserve currency centers, and the lending back to the reserve currency centers of accessions to reserves resulting from such capital outflows. Reliance on such collaboration would involve entrusting central banks with a great deal of power; and past experience suggests that it would be difficult to achieve and likely to break down in a crisis, since it requires that the central banks of nonreserve currency countries accept and approve the monetary and economic policies of the reserve currency countries. Some of these difficulties would be avoided by a more formal approach on the lines of the Bernstein plan, according to which the leading countries would oblige themselves to lend substantial amounts of their currencies to the International Monetary Fund, to be re-lent to a reserve currency country suffering an outflow of short-term capital.

Both closer central bank collaboration and the Bernstein plan have the practical attraction of recognizing the crucial fact that what matters in international monetary affairs is the behavior of the handful of large international trading and reserve-holding countries. But this fact itself points to the limitations of this approach: The holding of a country's currency as an international reserve gives it financial and economic leadership in the world economy; and to ask other nations to strengthen its position by guaranteeing to keep their funds invested with it is to ask them to recognize and support its dominance, a request which commercial rivals are unlikely to find congenial, especially when their relative economic strength is growing.

The alternative approach——

Representative REUSS. I did not quite hear that sentence, to ask them to support what?

Mr. JOHNSON. To ask them to strengthen the position of a reserve currency country by underwriting its holdings of reserves is to ask them to recognize and support the dominance of this country in the international economy, and this they are unlikely to do if they are commercial rivals, especially when their relative economic strength is growing.

The alternative approach is to substitute an international credit currency for holdings of national currencies as reserves. This approach seems preferable, both because it would avoid the dangers and potential conflicts inherent in the use of national currencies as international reserves and because it would constitute another step toward the replacement of the gold standard by a more sensible and manageable international monetary standard. One possibility would be the formation of an Atlantic Payments Union, on the lines of the now defunct European Payments Union. This scheme would conform to present political and military alliances, but it would involve the creation of yet another international institution and might in practice foster division between the advanced and the underdeveloped nations. A scheme more likely to be feasible because its starts with an already established international institution is Triffin's proposal to convert the International Monetary Fund into a genuine international reserve bank, in which members would undertake to deposit 20 percent of their reserves and be induced to deposit more by the offer of interest, and to which they would transfer their reserve holdings of key currencies, in return being permitted to draw more liberally on the Fund for settling international balances of indebtedness. The main objection to this scheme is the surrender of sovereignty to the International Monetary Fund that it would entail, together with the loss of influence by the reserve currency countries; but some surrender of sovereignty is the inevitable price of binding other countries to cooperation, and the influence achieved by international banking can easily prove a snare and delusion.

The second major weakness of the present international monetary system is its dependence on new gold production and the growth of reserve holdings in national currencies to provide the increasing reserves required by expanding world trade. The International Monetary Fund study to the contrary, these sources of additional international reserves look like being inadequate to the needs of the next 10 years. Reserves might be increased above prospective levels by a determined effort by the leading countries to squeeze gold out of nonmonetary uses; but the quantitative results would probably be small and the methods required might have undesirable side effects, including the stimulation of speculative gold hoarding. The expansion of international credit reserves is a much more promising solution. The Bernstein plan calls for enlargement of quotas in the International Monetary Fund. But enlargement of the Fund in its present form would be inefficient, because various countries would be likely to obtain the gold required by drawing on dollar and sterling balances and because quotas in the Fund as presently operated are not fully equivalent to gold and dollar reserve. If the Fund were reorganized on Triffin's lines, additional reserves would be provided by annual open-market purchases by the Fund. But in the course of time even a Fund so reconstituted might run into difficulties, since the 20-percent reserve requirement on members would still allow gold to be drained from the Fund. If a shortage of gold began seriously to threaten the liquidity of the international economy, the logical solution would be to demonetize gold and base national currencies on inconvertible deposits in the Fund.

Representative REUSS. Thank you, Mr. Johnson.

The next witness will be Tibor Scitovsky, of the University of California.

STATEMENT OF TIBOR SCITOVSKY, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. SCITOVSKY. Mr. Chairman, I should like to begin by saying a few words on the advantages of increasing the present inadequate world supply of reserves.

This would not solve our balance-of-payments problem. But it would, I think, go quite a ways toward solving it. For one thing, the process of adding to the supply of reserves could, if properly done, relieve the U.S. balance-of-payments deficit. For another thing, the larger supply of reserves would render the balance-of-payments problems easier to handle.

First, it would provide the deficit countries with more time in which to frame and carry out policies desired to eliminate their balance-of-payments deficits. The main advantage of this is that most of the more satisfactory means of eliminating balance-of-payments deficits tend to be those that take quite a long time to frame and carry out.

Secondly, an adequate supply of international liquidity would create an incentive for the surplus countries to share and thus to lighten the burden of the deficit on the deficit countries.

I think it is well to remember that a balance-of-payment surplus indicates that part of the country's productive resources is used neither for consumption, public or private, nor for investment in economic growth, but is used instead, as we know, for accumulating international reserves. And this, of course, is useful so long as the country's already existing reserves are considered inadequate, but sooner or later they do become adequate, and to continue with a payment surplus and accumulating reserves beyond this level is a waste, and the country that accumulates excessive reserves does use wastefully resources that would otherwise be used to promote faster economic growth and assure a higher standard of living, or combating inflation.

I would like to mention the example of Western Germany, which over the last 9 or 10 years has been adding an annual average of 3 billion marks to her international reserves. This was over 2 percent of her national income, and well over 10 percent of her net capital accumulation.

While it is true that even so she achieved a faster rate of economic growth than the rest of the European countries, still she started from a very low level, she has a long way yet to go, and she can undoubtedly find very good and very productive uses for an additional 3 million marks in her domestic economy as soon as she has accumulated enough reserves.

I do, however, think that it is up to the Germans themselves to decide when their international reserves are adequate, and when, accordingly, they should start taking measures designed to end their balance-of-payments surplus.

If you look at their present reserves, you will find that they are not nearly as great as we have sometimes argued in this country. As compared to their annual imports, or as compared to their national income, they are still not too high.

One purpose, therefore, of expanding the world supply of reserves is to enable surplus countries to reach the stage where they feel that their reserves are becoming excessive and so to encourage such countries to do something against it.

If the world supply of reserves were adequate, the drawing down of some countries' reserves to unduly low levels would be matched by some other countries' excessive accumulation of reserves, and the desire to eliminate balance-of-payments deficits in the former would be matched by the desire to eliminate surpluses in the latter. To bring about such a situation, in which surplus and deficit countries are equally concerned about the balance-of-payments situation, and equally anxious to pursue policies aimed at eliminating it, is, I think, the most important argument in favor of increasing the supply of international liquidity.

I do think that the simultaneous action of deficit and surplus countries is the most hopeful way of dealing with the balance-of-payments problem, partly because such action would greatly reduce the burden of adjustment on each individual country, and also because the surplus countries have much better and a greater number of means of adjustment available to them than the deficit countries, so that world trade, I think, would be very much less restricted if surplus and deficit countries cooperated than if the deficit countries had to bear all the burden of adjustment.

This, of course, is well known, and I think it is worth bearing in mind that already in the late 1920's and early 1930's the tremendous reduction in world trade and the problems of the deficit countries were usually blamed on the failure of the surplus countries to do their share in eliminating the balance-of-payments equilibrium.

The scarce currency clause of the International Monetary Fund charter was designed to learn the lessons of the 1930's and to compel surplus countries to cooperate in eliminating their surplus, but it has failed.

The U.S. Government not so long ago has tried to bring political pressure to bear on surplus countries that they should cooperate in doing something toward eliminating the balance-of-payments disequilibrium and that also has largely failed.

This is why I believe that the best chance of achieving this aim is to increase the supply of international reserves.

Now, we have a variety of international reserves. We have gold, and I don't have to go into the impracticability of increasing gold reserves; secondly, we have key currency reserves, and I feel, as I believe Professor Johnson does, that this is an inadequate form of reserves. It is a fair weather standard which tends to break down at times of stress, at times when confidence is shaken in the soundness of the key currencies.

Loans from the International Monetary Fund are also a kind of international reserve, and I feel that this is inadequate, too, simply because it is a conditional reserve, not available unconditionally when a country wants it, but available only on certain conditions, which very often are not fulfilled. In fact, I would like to remind you of the fact that during its 15 years of operation the total loans of the International Monetary Fund, the loans it has made to all its member countries over and above the gold tranche has amounted to no more than $1.9 billion. I think this in itself is a strong indication of the very limited use of the conditional reserves that the Fund offers.

Of course, the quotas of the Fund have been increased. There is talk of possibly increasing them yet further. My personal feeling is that so long as these reserves are conditional, increasing the quotas of the Fund will not accomplish very much good.

At the same time, I also feel very doubtful about the wisdom of making the availability of Fund quotas unconditional, simply because we have to impose some kind of discipline on countries which have these loans available to them, and I think it probably is a wise part of the provisions of the IMF not to make these loans available too easily.

For all these reasons, I do feel rather like Professor Johnson feels, that the more satisfactory way of adding to the world supply of liquidity would be the Triffin plan. This plan envisages the conversion of key currency reserves and part of gold reserves into deposits of a proposed new International Monetary Fund, and this, of course, would freeze the total volume of such reserves outstanding. From then on, the volume of IMF deposits could only be changed by the deliberate policy of the Fund itself.

Now, the Fund could increase its supply of reserves either by responding to loan applications from deficit countries or through open market operations.

I think that responding to loan applications should remain what it is now, an emergency measure, a kind of second line of reserves. So the regular expansion of the world supply of liquidity should, I think, be based on the open market buying of assets by the new Fund, and this, I believe, is also Professor Triffin's idea. He has suggested a tentative rate at which the Fund's deposit creation could proceed; but he said practically nothing about the nature or nationality of the assets by whose purchase the new Fund would create additional deposits. And, yet, this is very important because this would determine which countries would benefit in the increase in reserve supply.

Now, an obvious solution, of course, would be for the IMF to build up a balanced portfolio and buy assets of member countries according to some quota, maybe the present quotas. I don't think much can be said for this except that it seems fair and equitable to all countries, but it wouldn't do much to help the balance-of-payments problem.

An alternative solution might be to get the new Fund to invest mainly in the assets of the deficit countries. This is really what is happening presently under the gold exchange standard. It would undoubtedly help the United States balance-of-payments deficit, but on the other hand, I think that there are objections to it which were outlined by Professor Johnson. It puts the key currency countries into an unduly favorable position and this may well be objected to by the other countries.

I do think, however, that there is a third alternative, which is by far the best, and which is to make the Fund do most of its own market buying in the form of buying the bonds issued by the World Bank and the subsidiaries of the World Bank. This, I think, has a number of advantages. For one thing, from the point of view of this country it has the advantage that it would indeed help our balance-of-payments deficit without this action being discrimination in favor of the United States of a type which the buying of United States assets would imply, or of the type that exists under the old exchange standard.

I think we are all aware of the necessity of continued and possibly expanded development aid to underdeveloped countries. This country has taken the major responsibility to supply such aid, and by making a new IMF do a large part of its open-market buying in the form of buying the development bonds of the international agencies, the United States would be relieved to quite an extent of its self-imposed obligation to aid the underdeveloped countries. To this extent, our balance-of-payments problem would be relieved.

Another advantage of this scheme is that under these conditions the real resources for development aid, at least that part of development aid which came through the open-market buying by the Fund of World Bank bonds, would be actually coming from the countries that were running a balance-of-payments surplus. This is exactly where these resources should be coming from.

Indeed, the U.S. Government has in the past tried to put pressure on some of our allies that have balance-of-payments surpluses that they should take a larger share in helping underdeveloped countries; but this pressure has not been as effective as it might have been. And the reason why it hasn't been so effective was not that they begrudged giving their resources, but because they wanted to use their resources instead for building up international reserve.

Under the Triffin plan, as I interpret it, a surplus country could add to its reserves, but at the same time the very same resources it paid for acquiring reserves would be available for development purposes.

Now, it is true that in the past the International Monetary Fund has been criticized for giving loans to underdeveloped countries because it has been felt that they especially should not be freed from what is called the balance-of-payments discipline. I don't think this objection applies to this proposal, because the World Bank and the International Development Association and the International Finance Corporation have a very well functioning and well-established machinery for looking into the technical and economic feasibility of loan applications for development projects. And so long as these continue to be used, as I think they should be, this would be adequate guarantee that such loans would not be wasted and used for the wrong purposes. This would imply, of course, that the scope of operations of the International Bank would have to be expanded, and the same would hold true of the International Development Association which, after all, is a new agency which has just started its operations.

But I do think that also politically there might be advantages in these international agencies taking a greater part of the share of giving development loans to the free world, for they have come to represent the combined resources of the free world as a whole.

There is maybe one more point to be said in favor of this plan, which is the following: If the International Monetary Fund expanded its activities, either under the Triffin plan or any other plan, the problem automatically would arise which way the new IMF distributes its favors. This would be a political problem, and I think that this problem too would be solved if the IMF expanded its reserves primarily through buying the assets of the International Bank and its subsidiaries.

Thank you, Mr. Chairman.

Representative REUSS. Thank you, Mr. Scitovsky.

We will now hear from Peter Kenen, of Columbia University.

STATEMENT OF PETER B. KENEN, COLUMBIA UNIVERSITY, NEW YORK, N.Y.

Mr. KENEN. I would like to begin, Mr. Chairman, by asking that you consider what may seem to be a farfetched example. Suppose for a moment that the commercial banks in the United States were owned and operated by steel companies, and that each bank's balance sheet was consolidated with that of its parent company. If a steel company were to run a loss, it would draw upon the cash assets of its bank. If a company were to make a profit, it would deposit it in the bank. The bank, then, would lose cash, without paying off depositors, whenever the parent company had a bad year; it would gain cash, without adding to its deposit liabilities, whenever its parent company had a good year. Under these strange arrangements, those of us who had put our savings in a bank owned by a steel company suffering persistent losses would someday stage a run on that bank, in the belief that its position was deteriorating.

These unusual arrangements are expressly forbidden by our laws. Yet they are closely analogous to the present relationship between the U.S. balance of payments and the U.S. position as a banker to other governments and business abroad. Our balance of payments affects our balance sheet as a banker in the same way that the steel company's profit-and-loss statement would affect the balance sheet of its bank. When we run a payments deficit, we lose gold or build up debts to foreigners. We thereby impair our cash position as an international banker, damaging confidence in the dollar.

Our payments experience during 1960 gave vivid testimony to the risks that can attend certain kinds of payments deficit under these financial arrangements. Our deficit in the second half of 1960 was mainly due to an outflow of short-term private capital. That outflow was sparked by a decline in U.S. interest rates at the outset of the recent recession. An outflow of capital due to differences in interest rates would normally be self-limiting, even self-reversing. But the outflow triggered a large migration of speculative capital in 1960 because the initial outflow had masked an improvement in our basic payments position, giving the erroneous impression that we were still in grave difficulty on current-cum-long-term capital account. In addition, it took more gold with it than had the earlier and larger basic deficit because it transferred dollars to European countries whose governments normally buy gold with all or part of any increment in their reserve assets. A deficit that had little longrun significance was, therefore, the cause of a cumulative speculative exodus of capital.

I would pause to emphasize that governments as well as private parties engage in hedging or speculation against the dollar. The data I have developed and submitted as exhibit B yield disturbing evidence that central banks abroad were buying gold with a frequency and in amounts at striking variance with previous behavior. Some, to be sure, held back, thereby showing an enlightened concern for the stability of the existing financial regime. Others, however, bought large amounts of gold from the United States.

We are bound to experience similar interest-induced capital movements during future business cycles. Some observers have, therefore, proposed the "coordination" of national monetary policies, presumably to narrow differences in short-term interest rates. We should not expect too much progress in this direction. Central banks may be loath to surrender close control over domestic money markets, if, indeed, they are willing to concede that they can exercise control acting independently or in concert. It may therefore be better to operate at the other end of arbitrage—to intervene in the forward foreign exchange markets. By buying dollars "forward" the Federal Reserve or Treasury can increase the cost of "covering" capital movements against exchange-rate risks and can thereby offset the interest-rate differences that inspire capital flows and give rise to gold movements.

I call your attention to the chart in my exhibit A which shows that the forward price of the dollar did not rise as rapidly or as far as required to cut off interest arbitrage during the second half of 1960. I doubt that official intervention would have been feasible in October or November, when the "gold rush" was at its height. The very speculative pressures that were depressing the price of forward dollars might then have required massive intervention. But modest purchases early in the summer might have forestalled the "gold rush" by halting the flow of capital that gave rise to it.

Recent press reports indicate that our Government has begun to intervene in forward foreign-exchange markets, but only in very special circumstances. I would hope that it will continue and broaden its operations and that we may find forward foreign-exchange operations a useful addition to the authorities' toolkit.

In the best of circumstances we will experience occasional deficits in the balance of payments. The impact of these deficits upon the stability of monetary arrangements would be further reduced if other governments, especially those of Western Europe, would agree to hold larger dollar balances, even temporarily. Here, a formula may be appropriate, to require that governments defer the conversion of any increment in their dollar balances for at least 6 months. Here, too, however, some form of exchange-rate guarantee may be required. We cannot continue to ask other governments to accept additional dollar balances unless we undertake to indemnify them for the losses they would suffer were we to devalue the dollar. Hence, we may have to offer an exchange-rate guarantee.

I prefer some such formula to defer conversion, with an exchange-rate guarantee, to Mr. Bernstein's Reserve Settlement Account. The latter would serve the same purpose, albeit by creating a new layer of special intergovernmental debt. The Bernstein proposal, however, would involve a new commitment by each major country without quid pro quo. To be sure, the commitments under the Bernstein proposal would be reciprocal, but the United States and the United Kingdom would be the major beneficiaries. Deferred conversion, by contrast, could be "purchased" by the United States and the United Kingdom with exchange-rate guarantees on existing and new dollar and sterling balances.

Deferred conversion and the Bernstein plan are, at best, interim arrangements. They fall short of what we need. Unless all of the major governments partake of the arrangements I have described, gold could still flow from this country in large quantities. Even if all of them participate, moreover, gold could still escape into private hands. Finally, these arrangements ask other governments to take on additional dollars precisely when the prospects for the dollar are at their nadir, a point made by both of the witnesses who preceded me.

Ultimately, Mr. Chairman, the United States should espouse a complete reform of the gold-exchange standard. We should seek to sever the connection between the U.S. balance of payments and the world's stock of reserve assets.

Professor Triffin based his plea for reform upon the need for an increase in international liquidity. Under existing arrangements, he argued, such an increase could only be accomplished at the expense of the U.S. reserve position. This is as true now as in 1958, when he wrote his book. But our deficits since 1958 have greatly enlarged world reserves. The present need is for consolidation, not expansion. U.S. liabilities may already be too large relative to U.S. gold holdings. United Kingdom's liabilities are assuredly excessive compared to Britain's gold stock.

The case for the Triffin plan, or for some variant of it, is not that an expanded IMF could safely add to world reserves. It is that a reform of the IMF would entail a funding of U.S. short-term debt that would improve our reserve position.

Although I favor reform, I would not urge adoption of the Triffin plan as hitherto propounded. It goes too far in some directions, but not far enough in others. Let me conclude, Mr. Chairman, with two brief comments on Triffin's proposal.

First, I would hope that any reform will empower the IMF to disembarrass itself of unwanted currencies, especially inconvertible currencies. Triffin has proposed that the IMF arrange an "amortization" of excessive holdings. I would suggest that the IMF be authorized to sell such currencies on the open market—in effect, to force a devaluation of any currency it may accumulate by way of lending or clearing operations. I concede that this would give the Fund great power indeed, even if an "excessive accumulation" were defined most liberally. But I cannot see how to satisfy those who fear a powerful Fund, yet to pacify those who fear that the IMF would become an engine of inflation or that it would relieve governments of the discipline imposed by the present regime.

Second, Mr. Chairman, I would hope that we shall treat gold more boldly than Triffin does in his proposal. Triffin gives gold an important role and gives the governments rights respecting gold that could expose an expanded IMF to inordinate risks.

The second table in exhibit C describes an increase of reserves under the Triffin plan, showing that an expanded IMF could be exposed to a run very similar to that which threatens the dollar. The governments' convertible deposits could come to exceed the Fund's gold holdings in 10 years. Triffin discounts this danger, but I am not satisfied by his assurances. I would propose that a reform of the IMF provide for the gradual demonetization of gold, as other witnesses have suggested, at least in respect of international transactions. This could be accomplished by planning for a gradual increase of "reserve requirements" at the IMF—for an increase from the 20 percent Triffin proposes toward 40 percent in 10 years and 80 percent (or something near it) in 20 years.

Thank you, sir.

Representative REUSS. I would like to address some questions to the panel, or perhaps to conduct a poll of the panel.

From the testimony we have had thus far in our hearings it appears that the only arrangement for handling extraordinary strains on balance of payments deficits countries brought about by convertibility and the ease in moving short-term funds, is an ad hoc working arrangement among the free world central bankers, which came about as a result of speculative capital movements attending the mark and guilder revaluations of March 1961. Is there any member of the panel who thinks that the present ad hoc arrangements are a satisfactory solution of our problem?

Would he raise his hand?

I see no hands raised.

Mr. DANIELIAN. May I comment, Mr. Chairman?

I think in rather extraordinary situations consultation among the central banks could certainly alleviate pressures. I think where central banks themselves or other bankers within each country may be motivated by fears, if they get together and act collectively I think they can alleviate those fears momentarily. This applies to movements of hot money and transfers of capital that are motivated by other considerations than economic considerations, like fear, I think that such consultations would be very useful.

Representative REUSS. My question was whether the free world's problems due first to short-term capital movements, and second, to longer range needs for monetary reserves, are being adequately met by currently adopted measures, and I gather that no member of the panel thinks they are.

The next question is whether any member of the panel thinks that the proposals as now reported by the press for dealing with these two problems are adequate. The two problems, again, are the short-term capital movement problem and how to prevent its resulting in an exchange crisis, and the longer term problem of assuring adequate monetary reserves.

According to the press, there is a proposal whereby under the aegis of the International Monetary Fund, balance-of-payments-surplus countries would lend their currencies to balance-of-payments-deficit countries.

Does any member of the panel think that this proposal alone is sufficient to cope with the twin problems with which we are confronted?

Mr. Scitovsky?

Mr. SCITOVSKY. Mr. Chairman, I think that as to the first problem it may be adequate if there is some kind of agreement—this, I think is very much the same as the Bernstein plan, or maybe part of the Bernstein plan—that the surplus countries should obligate themselves to lend in some form, in the form of debentures or otherwise, to the deficit countries.

I can see that this would solve or might solve the first problem; namely, the problem created by hot money, by the movement of gold out of the United States for fear of—well, as the result of rumors.

Representative REUSS. May I interrupt you at that point?

I see Mr. Johnson nodding affirmatively at that point.

Mr. JOHNSON. I think it depends very much, Mr. Chairman, on how much they obligate themselves.

The danger in this, as I see it, is a repetition of what happened in the 1930's, when central banks were prepared to give each other all aid short of help; that is, the amounts proved inadequate. I would be worried that insofar as it involves agreement by a surplus country to lend to a deficit country, it gives the surplus country the power to judge the policy of the deficit country, and to impose conditions which might be unsatisfactory, or to provide insufficient funds, and, in effect, to appear to be accepting obligations without actually accepting them.

Representative REUSS. Would you accept those qualifications, Mr. Scitovsky?

Mr. SCITOVSKY. I would.

Representative REUSS. I interrupted you. You were then proceeding to consider the second point I raised, the need for adequate long-term liquidity.

Mr. SCITOVSKY. I was just going to say that so far as that is concerned, I don't think that the present arrangements or contemplated arrangements are adequate.

Representative REUSS. And I gather no other member of the panel thinks that they are adequate.

Mr. Danielian, of course, as I understand his testimony, takes the position that you could have perfect arrangements for meeting short-term hot money crises, perfect arrangements for providing long-term liquidity, but that these would be a corn plaster over a sore that is not healing, and that more fundamental adjustments have to be made; is that right?

Mr. DANIELIAN. Yes. There is no solution for the problem of a continued increase in our indebtedness; that is what it comes to, and sooner or later we will have to balance our international transactions. And none of the programs that are advanced really tackle that problem.

And this will require more basic economic readjustments both internally and perhaps externally.

I think we are less inclined to face up to the external readjustments that are necessary because of our worldwide responsibilities. But we are not going to solve this problem merely by making it easier for us over the longer period to keep on getting into more and more debt.

Representative REUSS. Mr. Johnson?

Mr. JOHNSON. Mr. Chairman, I don't think that the other three of us really disagree upon this. Our view, I think, is rather that the question of liquidity is separate from the need to balance the balance of payments.

Professor Scitovsky's point is that if you are short of reserves, you then have to use methods which have to be quick and which may be inefficient; it is impossible to take the time you need to make the right kind of adjustments. I would say that already our experience has been that the United States has been forced into methods, such as asking the Germans for things that they were not willing to do, which would not have been necessary had the liquidity position been better.

But none of us means that more liquidity would solve the balance-of-payments problem, rather if we had adequate liquidity we could make longrun adjustments which would promote the efficiency of the economy, rather than shortrun ones which distort the economy.

Mr. DANIELIAN. May I comment on this?

I think the danger is that you would get into a complacent mood.

For instance, the $18 billion or so of gold that we have can really last us for 6 or 7 years if it were withdrawn in driblets like a billion or a billion and a half a year. And if I were the holder of $20 billion in reserves and balances in the United States, I would like the security of being able to withdraw that gradually over the years.

At the present time, with only $6 billion left, and the other $12 billion retained as U.S. reserves, I would be rather hesitant to start a run on gold, because if we should stop payment after the $12 billion mark is reached, the other $14 billion of reserve that they would have would certainly depreciate in value, because the dollar would be devalued.

So there would be less inclination to start a run on gold with the present situation than if we eliminated the reserve requirements.

Now, I have no objection to financing our defense and foreign-aid programs by mere export of gold; that is perfectly satisfactory if that is what we decide to do; if other countries are satisfied to keep gold in their vaults which do not earn any income, well and good; we can finance a part of our military expenditures and foreign aid by the export of gold.

But I think that the real result would not be that; the real result would be in the longrun a devaluation of the dollar, which would, of course, increase the dollar purchasing power of the gold that they have acquired.

Now, I don't see that the United States can become more liquid by these devices. We can become more liquid only by means of earning more abroad or spending less. And this is a fundamental issue, and these others are just temporary arrangements to make the transition less painful, perhaps, but I don't think they are a solution to liquidity, even in the basic sense of our ability to pay for the services we get abroad.

Representative REUSS. However, you wouldn't disagree that it is necessary to have interim iron-lung-type solutions in order to permit the fundamental readjustments which you see as necessary?

Mr. DANIELIAN. No; I think there would even be an argument for postponing the crisis.

Representative REUSS. Before we go on, I call on Senator Douglas.

I think Mr. Johnson has indicated with his head a rather firm disagreement on the point of whether repeal of the 25-percent gold cover law would or would not encourage demands for gold. Is that right?

Mr. JOHNSON. My disagreement was more basic than that.

Mr. Danielian argues as if someone individually holds this $20 billion of U.S. liability, and this is not the case. There are a great many different depositors, and they are in the position of depositors in a bank, each of whom feels that if he gets his money out now he won't stand any loss, the other fellows will stand a loss. And this seems to me the flaw in his argument. Nobody is going to say, "I am going to keep my $20 billion there, because if I do the United States will remain solvent, and it will be convertible, and if I take it out it will lose value," instead each will be in the position of saying, "If I get out now I will get out before the money loses value."

And this is really the problem, and this is why I think the whole of the gold reserve should be available instead of the 6 billion, because there are still some people who think that the United States is bound by this law, and has only got $6 billion to go out before it has to devalue the dollar. And that misapprehension could be cleared up by putting the whole of the gold reserves against the international liabilities.

Mr. DANIELIAN. May I ask a question on that?

Am I correct in the assumption that the United States makes gold available only to other central banks and other governments?

If I am correct in this, then private individuals in other countries can withdraw their gold only through their central banking system. And if we have an understanding among the central banks, a possible revision even of their statutes internally so that private individuals cannot hold gold, then that danger of a private run on our gold reserves can be controlled.

Representative REUSS. We do not now have such an understanding, and the prospects of getting one seem to me dim.

I am going to call on Mr. Kenen briefly.

Mr. KENEN. I wanted to comment very briefly on two points.

The first is the thought that we could allow gold to flow out steadily. There is a tendency under the present regime for reserves to flow out faster the lower they get. You cannot allow reserves to flow out freely without encountering a rapid acceleration in the rate of outflow, to the point where it becomes almost impossible to deal with the outflow.

Beyond that, Mr. Chairman, there is another point that has to be made. You cannot quite as easily stop a flow of gold into private hands as some comments seem to suggest.

Suppose for a moment that we were to say to the Bank of England that we would not like the bank to sell the gold it has purchased from the United States on the London gold market to private individuals. There was talk that this might be done at one point last year.

If we were to do so, the price of gold would rise to a premium on the London market, and the entire official demand for gold then would be focused upon the United States. In addition, most of the new gold supplies would not flow into official holdings, but would instead flow into private hands.

We would still be inviting a large official demand for U.S. gold were we to allow the free market price of gold to rise in centers like London. We cannot quite so easily disassociate ourselves from the Bank of England's responsibilities toward the London gold market.

Representative REUSS. I see other hands up, and I would like to prolong the discussion, and we will, before we are through, get in all the material we now have on our minds.

Senator Douglas has generously said that we should go ahead.

So would you proceed, then, Mr. Scitovsky?

Mr. SCITOVSKY. Mr. Chairman, I only wanted to add to Professor Kenen's point, that as a matter of fact last fall when there was a very substantial rise in the price of gold, and the rise in the price of gold was received with perhaps even exaggerated attention by the press, I think it was generally felt that this could have been stopped, and it would have been much better to stop it if the Federal Reserve System had asked, say, the Bank of England to enter through an agent, the London gold market, and start selling gold. At very little cost they would have been able to keep the price of gold from rising quite as much. And I think it was generally felt by everybody afterward, and at least by some few people even beforehand, that this would have been by far the best thing to do, because it would have nipped in the bud this gold scare which at the time was quite serious.

Representative REUSS. I am going to argue with you two gentlemen for a moment. And I would like you to address yourselves to the following proposition:

If we accomplish some of the other reforms that have been discussed, why should it matter at all to the trading nations if on some very thin free market in London or Zurich, or some other place, various ill-informed idiots choose to bid up the price of gold to $60 or $100, particularly if we should include among these reforms a provision which wouldn't require us to buy all the gold that is presented, but would simply allow us to buy all the gold that is presented.

Mr. SCITOVSKY. I agree with you, Mr. Chairman, that if some of these reforms do become reality, the importance of gold as a form of reserve would automatically decline, and I quite agree that the less importance we attach to gold as a reserve, the less important it becomes that the price of gold happens to be rising on a tiny and unimportant market.

Representative REUSS. Mr. Johnson?

Mr. JOHNSON. I think the difficulty there is how far you go with these other arrangements. If you can cut the monetary link with gold then this proposition is certainly valid. The trouble is that so long as you have some monetary link with gold, and so long as you have people whose views of monetary matters are not inspired by the fullest possible confidence in the policies of the countries of the world, there will always be some implication when the price of gold rises on an important free market. We have had experience with small free markets in other parts of the world where the price of gold has been well above the United States dollar at par without inducing speculation against the dollar; but if it is the London market particularly there will always be some implication that a premium on gold betokens a possible rise in the world price of gold, or the devaluation of the dollar.

So far as the other measures are able to make that ineffective, then the proposition is perfectly all right.

But there is a danger, I think, that you may not have enough support for currencies from these other measures to rule out some people thinking that gold is going to rise in value and speculating on that.

Representative REUSS. Aren't the two choices presented to monetary authorities of the free world the following: One, we can adopt this cloak and dagger approach and dash in and out of the London and Zurich markets under various cloaks of incognito, with effects that I am not at all sure that I can predict, or, second, we could try to do an educational job throughout the world so that buyers of gold in these markets would have a pretty good hunch that it really wouldn't profit them very much to bid up the price, because they are going to succeed only if there is going to be an increase in the price of gold or a devaluation of one of the key currencies.

And if by your thought, word, and deed you make it clear that these alternatives aren't going to happen, then couldn't the free world monetary authorities sit by with as much equanimity when the price of gold goes up in London to $60 or $80, as indeed it did in 1951, without causing any flurries, as if the price of cigarettes in occupied Germany went up to $100 a carton?

Mr. JOHNSON. Yes. The question, though, is how difficult it is to do this educational job, and how far you can make it stick with supporting measures of the kind that we have been discussing.

After all, many of these people who are speculating are American citizens who are speculating one way or the other, and if the U.S. Government can't convince the American citizens that the dollar is going to stay where it is, how do you expect to convince the Germans or the Swiss, for example?

It seems to me a hard thing to convince them unless there are really substantial changes in the international monetary system.

Representative REUSS. Of course it costs money to go into the London market. We supply gold to the British Treasury at $35 an ounce, and they sell it at $40 an ounce, and we lose $5 an ounce.

Mr. JOHNSON. Then we could go in directly and sell at $40 an ounce.

Representative REUSS. But that is not in the rules of the game, we figure it is worth $35.

Mr. KENEN. But no one who is concerned with such matters is fooled when a central bank goes into the market, except perhaps the press. All of those people who are concerned are well aware of what is going on. There is one central bank which disguises all its transactions by elaborate devices, but everyone is aware of what that central bank is doing.

It seems to me that you do not fool anyone by these elaborate transactions, by going in yourself or through someone else.

Representative REUSS. Mr. Salant?

Mr. SALANT. Mr. Reuss, in order to defend the British Government against the implied charge of Government profiteering, may I add that there were press reports that any such profits associated with sales by the British Government in the London market of gold purchased from the U.S. Treasury were split with the U.S. Stabiliaztion Fund.

Senator PROXMIRE. Was that true?

Mr. SALANT. I can only report what the press said on this.

Representative REUSS. Split 50–50?

Mr. SALANT. Yes.

Representative REUSS. That sounds like the old story, shall I keep it or shall I split with my partner?

Mr. DESPRES. In order to clarify the general issue. I think that the underlying question is this: If there were agreement among the central banks and governments that they would sell gold only to each other, so that the outside markets for gold had on the supply side, only, let us say, Soviet sales, and the newly mined gold, then the outside price would be free to fluctuate, and in periods when hoarding demand was high, it might be at a premium above the official price. There is a widespread theory today that if you attack the symptom; that is, in the case of the gold market the premium for offerings of gold in the free market, or if there happens to be speculation in the mark, you attack the symptom, the premium on forward markets, that this will remove the speculative tendency.

Do you agree with this theory that small amounts of intervention by central banks or governments involving very small sums, if done sufficiently discreetly, either on the bullion market or on the forward exchange market, you will alter the chain of speculative attitudes?

Representative REUSS. Mr. Kenen, among other things, there is the question of whether it would be a good idea to attempt to persuade our trading partners to adopt domestic laws and regulations so that their treasuries and central banks would sell, not to private persons, but just to central banks and treasuries, except for such stabilization activities as are agreed upon by mutual consultation.

Mr. KENEN. If, Mr. Chairman, we hold to your initial assumption that some of the reforms that we were talking about earlier are to be adopted, I think there is little danger in that kind of arrangement. There is much to be gained by some such agreement.

As I suggested in my statement, I would go further and say that unless you demonetize gold, or come somewhat close to that, the reforms that we have been talking about cannot work and cannot survive over the long run. The reforms themselves depend for their ultimate success upon a fundamental change in the role of gold in the primary trading countries.

If you can do that, if we can go that far, then there is very little to be lost by declining to stabilize private markets in gold, by forbidding private purchases or sales of gold.

I don't think, however, that you can move into a halfway position, on the one hand to retain gold in its present central monetary role among the major countries and on the other hand to pretend that fluctuations in the price of gold on private markets do not matter. They do affect Soviet sales and South African sales. These people are perfectly capable of holding back gold if they themselves expect the price of gold to rise. They do matter so long as gold is central to monetary arrangements. But they would not matter if, as I think the reforms themselves predicate, the role of gold were fundamentally changed.

Representative REUSS. All of the reforms we are talking about, the Bernstein-Triffin variations, do move away to some extent from the primacy of gold, do they not?

Mr. KENEN. I don't think that the Triffin plan, as presented in Triffin's book, or Bernstein's plan, go nearly far enough in this respect.

I suggested, I think, in my statement, and others have suggested the same thing, that the Triffin plan has to go very much further in its treatment of gold in order to work. It has to be much more radical in its treatment of gold than Triffin indicates. One of the difficulties with Triffin's proposal is that he is concerned, on the one hand, to pacify critics, and on the other hand, to present a symmetrical, neat and workable plan or arrangement. His attitude on gold reflects his concern to win support. Yet the fundamental symmetry of his proposals requires that gold be treated very differently.

Representative REUSS. Mr. Johnson?

Mr. JOHNSON. I think the essential point is, Mr. Chairman, that if you are going to allow the free price of gold to fluctuate in this fashion, you have to have international monetary arrangements which can absorb any reduction in the supply of gold going into monetary uses; that is, your arrangements must be able to replace gold which is diverted to nonmonetary uses or hoarding.

And, also, unless you have that, letting the price of gold move freely will threaten your monetary system.

Representative REUSS. Mr. Danielian?

Mr. DANIELIAN. The safest place to keep gold is in Fort Knox, and the safest hands in which to keep it is in U.S. possession.

And the only reason why anybody should want to take it out of here is lack of confidence in the value of the dollar. So I think perhaps we could alleviate the speculative interests—and the greatest speculation in the world is gold, as you realize, because if the dollar is devalued, these billions of dollars in gold are going to go up in value by 25 to 50 percent, probably.

So that gold is an exceedingly good speculation, if there is a danger of devaluation of the dollar.

Therefore, it seems to me that to eliminate these aberrations in the gold market, and to eliminate the possible withdrawal of gold from the United States, and to improve the liquidity we should pay attention to the simple question of how we can improve our international balance of payments by between $2 and $3 billion a year. If we do that, I don't think any of these other problems are going to arise.

Representative REUSS. Senator Douglas?

Senator DOUGLAS. First, Mr. Chairman, if I may, I would like to amplify the published record as to yesterday on the relative adequacy or inadequacy of increases of gold supply.

In my questioning of Mr. Coombs we developed the fact that the current total production of gold outside the Soviet bloc was between $1.1 and $1.2 billion a year, and that the seepage from the Soviet bloc into the free world was something in the order of $200 million to $300 million a year.[1]

If we disregard the nonmonetary uses of gold, which we had not intended to be done in the colloquy, this would give an increase of about

[1] See testimony of Charles A. Coombs, June 20, 1961, pp. 83–107.

1½ percent in terms of the total gold and exchange holdings of $74 billion and somewhere around 2 percent of the $60 billion of gold in exchange holdings outside of the International Monetary Fund.

Even this would seem to be inadequate. But it is a fact, of course, that the nonmonetary uses of gold have been running at the rate, so far as I can tell, of around $700 million a year, and in some cases higher.

So that the net increase in the total monetary supply of gold in the free world is between $400 million and $500 million a year, or less than 1 percent, in fact about one-half of 1 percent.

And even if you increase it, take into account the seepage from the Soviet bloc, you get not more than 1 percent.

So I think from the evidence that it needs to be made very clear, not just taken for granted, that the increase in the monetary supply of gold is much less than the increase in the real gross national product, to say nothing of the increase, as the chairman pointed out yesterday, the increase in the volume of foreign trade. And, as an elucidation of what was said, an addition to international reserves.

But I wanted to address my question, if I may, to the fundamental point, which I think Mr. Danielian raised, which tends to be ignored, namely, that we have a very real problem here, not merely that our foreign aid is partly abroad and doesn't consist merely of commodities shipped from the United States, but in demands created upon the United States in part for the liquid funds provided by these countries that we spend outside our borders.

Also, we have the problem of great differences in the cost of production.

Now, as far as I can tell, the average wage in Germany is approximately 80 cents an hour, including fringe benefits. The average wage in Japan does not exceed 16 or 18 cents an hour, and I think that includes fringe benefits, which are relatively slight. The average American wage is approximately $2.40 an hour. This does not include fringe benefits.

Now, in times past when we have had a comparison of the low hourly rates in foreign countries as compared to the high hourly rates here, we have been able to toss this off by saying, "Well, but technology is primitive in these countries, and therefore the real test is cost per unit not cost per hour." And this, of course, is correct.

But in recent years it has appeared, as you all know, that technology has become international, not national, and that in many cases the techniques in Japan and Germany are more efficient than those in the United States, because their obsolete capital was destroyed during the war, and they started fresh.

In addition to this, we have built up the productive capacity of these countries both by capital loans and by technical assistance. So that I think we must now face the fact that in many industries their unit costs of production are appreciably lower than ours.

This is what we face in textiles.

And Mr. Danielian has said it is what we may shortly face in aluminum, and we may face it in steel, and so on.

Now, in times past we could say, "Yes, but those things will ultimately be solved under the international gold standard, we will have a flow of imports into this country which will require the export of gold. This will raise prices abroad and cause prices to fall at home. This will choke off our imports and expand our exports."

But we no longer have the international gold standard. As a matter of fact, the domestic price levels are controlled more or less independent of gold reserves, not completely, but largely. We do not even have flexible exchange rates, we have more or less frozen exchange rates.

And this is the question that I would like to ask: To what degree can there be an adjustment of these international disparities in unit labor costs through the operation of the present price mechanisms of the various countries, and could this be achieved through the adoption of flexible exchange rates, and, if so, how, and would the cost of flexible exchange rates be greater than the advantages?

Now, I would like to ask Mr. Danielian to start the discussion of this, because he was obviously feeling his way in this direction, but while criticizing all existing systems he did not offer any constructive suggestion of his own.

Mr. DANIELIAN. I haven't considered flexible exchange rates, or what in our case would amount to letting the dollar be devalued on the international markets, as a solution. As a matter of fact, because we are a reserve currency country, it would be a hardship on the commerce of the rest of the world if the value of the dollar were allowed to depreciate on account of our possible lack of disciplines in other directions.

I would rather apply myself to the practical problem of how to save $2 or $3 billion a year in our international payments. And I think it can be done.

For instance, the foreign aid bill that is before us—last year 37 percent of ICA purchases were spent in the United States, as against 74 percent in 1954. Now, it is stated that 80 percent is going to be spent in the United States, but there is no proof of that.

And only last week the Secretary of the Treasury appeared before the Foreign Relations Committee to say that in spite of all these arrangements, $575 million of the foreign aid bill would still be spent abroad.

Now, $575 million is a good chunk of money——

Senator DOUGLAS. Out of a total of how much?

Mr. DANIELIAN. The total foreign aid appropriations, you mean?

Senator DOUGLAS. Yes; $575 million out of how much?

Mr. DANIELIAN. The annual amount is $4.8 billion for next year.

Senator DOUGLAS. Then would that mean that only approximately 11 percent would be spent abroad?

Mr. DANIELIAN. That is the theoretical figure. I don't think we are going to be able to approach that.

Senator DOUGLAS. That is a very great decrease as compared to the present.

Mr. DANIELIAN. I don't know how they are going to achieve it from July 1960 to the present, up from 37 to 90 percent.

Senator DOUGLAS. I don't want to shut off, but you are saying that one of the remedies is to decrease the amount of foreign aid which is made available for the purchase of commodities outside the United States, is that right?

Mr. DANIELIAN. I think the whole scheme of offshore procurement of the Government needs reexamination.

Now, we have seen some other steps such as the elimination of the exemption of tourists, which is estimated to save us about $150 million. We have a tax proposal here which I consider antithetical to the balance-of-payments interest, because I think in the long run what we have to do is invest—to make income-bearing investments in the hard currency countries, because if we make income-bearing investments in hard currency countries, then the return, the invisible income of dividends and interest is going to help our long-range, balance-of-payments situation.

Now, the European governments realize this. That is why I think many of these suggestions, particularly those that are related to the withdrawal of gold on the one hand, or the methods of investing the reserves in secure investments in the United States with the guarantee of the International Monetary Fund, and so on, are all to their advantage, because if they can increase income-bearing investments in the safest place in the world where there is no danger of expropriation, if they can get 4 or 5 percent on their money by investing there, that will improve their position.

I think we, in turn, ought to continue investment in hard currency countries, and in the long run it is going to be a contribution to our balance-of-payments problem. In this respect, I think the Treasury is mistaken in its approach to the tax question.

Now, there are other possibilities, I think.

What I am afraid of is that these temporary devices may eliminate the urge to redistribute the military expenses.

We spend about $400 to $500 million a year in Germany on military expenses. If we ease the situation by these temporary devices, maybe they will say, "Well, you don't have to do it this year, you can do it next year, there is no urgency about it."

I think we ought to impart a sense of urgency to the problem of sharing the military expenses.

This is why I am concerned that these temporary devices, the play with institutional changes, may divert attention from the fundamental problem of the country. And it is going to be a growing problem, because next, I think, we are going to be confronted with this problem, how do we pay for our imports?

And there we are going to have to earn more money abroad in order to pay for our imports. And that is one of the reasons why I put in some of these tabulations, industry by industry, in my statement. And you will find in certain industries a change has taken place since World War II, and that there is a growing drain upon our external earnings on account of these changes.

Now, we can pay for these things by making more gold available for awhile. But it is not a fundamental solution. And I am not quite sure that making that gold available in the immediate future, when they have $20 or $21 billion in quick assets—if I had that much money in a bank, and I knew that it was only 30 percent liquid in its assets, and there was danger of its closing, and I would have the choice if I were a large depositor of either nursing that bank along and not rocking the boat, or if the bank said, "Well, we have opened up our vaults, we have some assets here in gold that you can take out," then I think I would be more inclined to say, "Well, as an insurance for the future, I had better take out some of the hard assets of this institution."

So that I am of the opinion that many of these requested changes have taken the aspect of a concerted effort. And it is due to the fact that there is a reluctance to make these other necessary adjustments in our fiscal and monetary and procurement and military expenditure policies.

Senator DOUGLAS. As I understand you, you are proposing more institutional changes fostered by government to correct the unfavorable balance of payments. And I think that these may well be adequate in the next few years. And I may be indulging in the purely theoretical, but I don't think I am, if I ask some of the other members whether we have any mechanism under the existing systems of internal demonetization of gold and frozen exchange rates whereby the price systems of the various countries can more or less automatically produce in the long run a balance between exports and imports, and, if so, whether this can be done without too great a social cost for a nation with high wages rates to bear.

Mr. SCITOVSKY. I think, Senator Douglas, the answer is "No"; my answer certainly would be "No," that we do not have such a mechanism.

Senator DOUGLAS. You mean the present price mechanism cannot make these adjustments?

Mr. SCITOVSKY. I do believe that; yes.

Senator DOUGLAS. Mr. Johnson, do you agree with that?

Mr. JOHNSON. No; I don't agree with that, Senator Douglas. I believe that the price system is perfectly capable of taking care of this in a long enough run. The main obstacle I see is the one that Professor Scitovsky discusses in his paper, that with a shortage of international reserves, all the pressure falls on the deficit countries. I see, for example, that in the underdeveloped countries the wages are low. This is not from preference, this is from necessity.

Japan has low wages. It also has balance-of-payments problems.

These countries are anxious to develop, to increase their standard of living; if they can earn resources by trade, I am sure they will invest them, and this will create a demand for goods that we can produce. We do face an adjustment problem. We are in effect losing a monopoly that we have had of advanced technology. A free enterprise system is supposed to be able to absorb these costs.

Senator DOUGLAS. But what is the mechanism by which it does absorb them, that is the point, and how great are the costs?

Mr. JOHNSON. The mechanism that I see mostly for the future is rising incomes in other countries as they become richer.

Senator DOUGLAS. And, therefore, have a greater demand for American goods?

Mr. JOHNSON. Providing they use those for a demand of goods. And competition should help raise their wages and prices and hold ours down. We don't like that particularly when it focuses on particular industries, but that is the way the price system is supposed to work. The danger is a double one; the first, associated with our international monetary role, is that in trying to keep the dollar strong will make our economy weak, because we will be forced to have tight money, and deflationary policies which will weaken our economy. And the other danger is that with a shortage of international reserves other countries want to accumulate gold rather than raise their standard of living. And that is why I think provision of more international reserves is a basic requirement for operating this kind of system.

Now, in my paper I think I made the same comment that you did, that flexible exchange rates would solve this problem. But this would involve a very revolutionary change in the international monetary system. I am quite prepared to envisage that myself.

But I am not really decided in my own mind whether a system of fixed exchange rates in the international sphere is the parallel of our domestic monetary system, of a dollar being the same all over the country. Operating a world-free trading system may imply a system of fixed exchange rates and variable wages and prices in different parts of the world rather than of getting the same flexibility by a system of flexible exchange rates.

We have a choice, I think, either we have flexible exchange rates, or we have a fixed rate system plus sufficient liquidity to permit long-run adjustments to work themselves out.

Mr. KENEN. I think, Senator, that there is a further point, to which you yourself alluded earlier when you talked about the spread of technology. There is the possibility, a very strong possibility, of adjustments by way of technological innovation, product change and industrial diversification.

We have had these adjustments in the United States. We had the competition from European cars matched by style and product innovations within the United States. We have lost what seemed to be a monopoly of advanced technology. But I do not think of that as an irreparable loss for us, because I do not think that you can regard technology as something static.

We have lost an advantage that we had, but we can pursue new advantages in other areas. And as a matter of fact, there is a powerful built-in adjustment mechanism at work here. It may well be that we do not have international monetary adjustment by way of general price and wage level changes. But we still have the power of competitive response. Firms, when they lose a market, diversify, change their product, respond by some new competitive device.

After all, the counterpart of a decline in our exports or an increase in our imports is a decline in the sales of some American firms. And the response of that firm is still a strong response, one that can carry us through a good deal of the process of adjustment to which you are referring.

Senator DOUGLAS. I would like to put this question to the panel. Which would you favor, flexible exchange rates, or fixed exchange rates, with the understanding that you would have to work out other methods of adjusting differences in unit labor costs. How many would be in favor of flexible exchange rates under those conditions?

Mr. JOHNSON. I would be in favor of flexible exchange rates, but my feeling is that the monetary institutions and banks and traders, and so on, prefer fixed rates. And that being so, I would rather spend my time on how to make that system work, than on advocating a system which doesn't seem to have much chance of being accepted.

Senator DOUGLAS. Do the others prefer fixed exchange rates, and achieving equilibrium by other methods?

Mr. SCITOVSKY. I think, Senator, I do prefer fixed exchange rates, perhaps for somewhat similar reasons as Mr. Johnson prefers them. I do prefer fixed exchange rates, because I do think that it could be made to work with reforms that would certainly be less drastic than the reform of instituting flexible exchange rates. So I have a feeling that fixed exchange rates do have important advantages. They do encourage international economic contacts, which I think could be discouraged by flexible exchange rates. I do think that international economic contacts have very important merits, and I think that even at fixed exchange rates, the systems would be made to work with some reforms. And these reforms may be drastic, but they would be very much less drastic than flexible exchange rates.

Senator DOUGLAS. What would be some of these reforms?

Mr. SCITOVSKY. Well, I have been advocating one, as a matter of fact, which was substantially increased supplies of international liquidity. I do think this would help, and I think Professor Johnson was agreeing with me that it would help, as a matter of fact he made it, I think, more strongly than I did. I suspect that this by itself would go a pretty long way to help make the system work. I think a certain amount of cooperation——

Senator DOUGLAS. In other words, if we had more reserves we could pay for the increase in imports coming from countries with low labor costs and low production costs?

Mr. SCITOVSKY. I think that we could actually cope with it. It would give quite a lot of leeway for the adjustment of relative price levels and incomes in the different countries, which I don't think is very automatic, it doesn't work very fast. But by a greatly increased supply of international liquidity, I think it will actually make it work fairly well, I should say.

Senator DOUGLAS. Now, Dr. Danielian, or perhaps it was Mr. Johnson, said that one effect of this would be to keep wage rates down in this country, and would presumably lead to an increase in wage rates in the low-cost countries. Do you think that those are inevitable results?

Mr. JOHNSON. I would think so in the long enough run, Senator Douglas. I see no reason why the Japanese worker should prefer to live on the standard of living he is living on, and I think in fact, that Japan in about 10 years' time will be a country having balance of payments difficulties because its wages have risen too fast, rather than the other way around. The same, I think, goes for Germany. So I think these mechanisms work, providing that you don't have this pressure on countries to keep their wages down in order to build up their international reserves at each other's expense.

That is why the system broke down in the 1930's, and that, as I see it, is the danger in the future.

Senator DOUGLAS. Does this carry as a corollary that wages should not be increased in this country, or should be reduced?

Mr. JOHNSON. That, I think, depends on the circumstances. I think that we have a different situation in this country, because at the present time trade is a very small proportion of national income, therefore the pressure of international competition is very weak on large sectors of the economy, and wages can easily get out of line and stay out of line.

Senator DOUGLAS. You say the pressure is going to be increasingly great in the future?

Mr. JOHNSON. And I would expect that as it becomes greater it would be more effective. That is, my view is that U.S. industry has been protected by the war devastation of Europe from facing a fully effective foreign competition, that that has sprung up on us since 1957, that it has been sudden because of Suez and the oil problem, and so on, and that we are in a transitional phase in which our businessmen haven't got used to this competition.

And I think, as Professor Kenen was saying, that they will become more aggressive competitors, and they will really explore markets, and so on.

I think we need time to adjust to that situation, and that seems to me to be the case for larger international reserves.

Mr. DANIELIAN. May I address myself to this question?

First, as a purely theoretical economist, I fail to see how Professor Johnson achieves the end result without facing to the premises and the intermediate steps that are necessary to bring about that end result.

In theoretical economics this adjustment that he is talking about must be achieved through what you described previously, an outflow of gold, a contraction of the economy, possible unemployment, and reduction in costs in the United States, wage costs. And the present trade policy could best achieve this result if it was consistent enough to say, "Well, there should also be an equalization of labor supply between countries," and that would—in other words, the possibility of migration between countries, so that the wage levels—I am now talking purely as a theoretical economist——

Senator DOUGLAS. In the European Common Market. But as a practical matter, you will not get complete freedom of migration in the United States.

Mr. DANIELIAN. Yes. But eliminating the social impediments to such adjustments, for the moment as a theoretical economist, I do not see why we do not face up to this basic premise. And then we immediately run over into a generalized conception, things are going to be all right.

Now, with the widespread dissemination of technology, willful export by our Government and our private people, this problem is going to be aggravated until we are willing to confront the basic results of this which, I think, will be first in the balance-of-payments situation, and next in the possible monetary crises in international exchanges and, third, a possible internal economic crisis.

Now, this thing may not happen in a given time like "Black Friday"; it will probably happen gradually. And one of the expressions of it is the slow rate of growth in this country, the slow rate of the economic growth in this country.

Now, I think we have the obligation to develop a trade policy which gives our allies and our friends around the world an open market here, and we ought to try and make that market as large as possible to meet their needs.

But, on the other hand, I think we have to confront the problem of, how do we adjust ourselves to that circumstance?

And I say that the programs advanced in legislation like the labor readjustment approach is not going to solve that problem.

Now, I think that there is a second difficulty to what Professor Johnson indicated. We say we are going to expand our exports to the rest of the world. If you look at the world today, you have got to divide it into three classes of countries, the Iron Curtain countries, the underdeveloped countries, and the industrialized countries of Japan and Western Europe.

Now, we can't expect to expand our export to Iron Curtain countries by too much in order to absorb some more gold production——

Senator DOUGLAS. I wouldn't expand them any.

Mr. DANIELIAN. So that avenue is not available to us.

The next is the underdeveloped countries. They don't have the dollar exchanges with which to buy our goods, so we have to give the dollars to them. That is the purpose of the foreign aid program. They are not going to earn us hard dollars. So the only place we can earn hard dollars is mostly in the industrialized countries.

Suppose you try to expand your exports to these industrialized countries from $2 billion to $3 billion a year. The balance-of-payments surplus that they have enjoyed would immediately turn into a balance-of-payments deficit for them. In other words, I don't think their economies would be willing to accept, or will be able to absorb, the kind of export promotion program that we are now trying to undertake, because that is where the hard money sales are.

Now, a corollary of this is that these countries have got to earn money abroad in order to import their raw materials, their fibers, their fuel, and so on. They have to have investments in countries like the United States.

Now we have a national policy of trying to get them to pick up some of the soft-currency, foreign-aid programs. We meet resistance. The reason why we meet resistance is that it is contrary to the balance-of-payments interest and it is contrary to their national need.

So it seems to me that we have to stop trying the impossible and try to solve these problems within the context of resources and devices and measures available to us.

Senator DOUGLAS. I have just this comment: Unless Government officials and economists come up with answers—and I do not think the economists have in the past come up with very adequate answers on this question—we are going to be driven into a protective-tariff policy, which I can see already gathering. We are going to be driven into quotas and increases in tariffs on textiles, both against Hong Kong and Japan, and tariffs on steel, tariffs on aluminum, and tariffs on chemicals, and tariffs on plastics, and so forth. All these things will be developing. So I hope the economists will take these things a little more seriously than they have in the past.

Senator PROXMIRE. I am in the same position, perhaps, as Senator Douglas. I am most impressed by the very excellent technical presentation by you gentlemen.

But I say this because I am going to start off, at least, questioning Dr. Danielian, and perhaps others can comment.

I have a question for Professor Scitovsky also.

We should strike beyond the technical aspects of the situation to what appears to me to be the fundamental problem here. So I want to start where you say—

> The United States must prove to the rest of the world the supremacy of our competence and genius in this field. Our aid and investment programs abroad must make our productive capacity, facilities, and labor alike accomplish the task that the President has laid out in his foreign-aid message.

Then you go to—

> Unfortunately, this basic truth isn't recognized today—

and you quote from the procurement section of the foreign-aid bill before Congress, and also point out that there are international institutions which prevent discrimination in procurement, and indicate that this is preventing us from establishing our supremacy. I recognize all of the very real economic problems posed by the previous colloquy with Senator Douglas. But if we are going to prove our productivity and our superiority, we have to do it without discrimination, we have to do it without having——

Mr. DANIELIAN. Technology is not responsible for the price level differential in this country. What has happened since World War II as a result of the accumulated deficits of war expenditures and subsequent developments has put us in a high-cost-of-production basis in terms of dollars, which is not the responsibility of the technology.

Now, I think that our industries are just as efficient as any other that can be established. So it is not a technological problem.

Senator PROXMIRE. It depends on what you mean by efficiency. If you measure efficiency by——

Mr. DANIELIAN. Unit of production per unit of labor time, I think we can match that, we can match the Hong Kong people or the Japanese people on that.

Senator PROXMIRE. It depends upon how you pursue physical output per man-hour, which is the suggestion of Senator Douglas.

Mr. DANIELIAN. I think you have to consider all cost factors, power, raw materials, labor, and so forth.

Senator PROXMIRE. Well, if a Japanese worker can live on less, this is an element, it seems to me, of fundamental efficiency, there are valid reasons why we may not want to consider it, but it is a fact of life, that if a productive unit—and, of course, labor is a fundamental productive unit—can and is willing to make sacrifices and is willing to get along on less, that is an element of fundamental efficiency in competition.

Mr. DANIELIAN. Yes, but one of the fundamental premises of economic theory in regard to wages—I approach this subject with great humility in the presence of a great authority on wage theory, Senator Douglas—but one of the primary premises is that wages are determined by productivity, and, therefore, labor in Japan and Hong Kong should receive the same wages as that in South Carolina or North Carolina producing the same units of product per man-hour. But that isn't—that certainly is not borne out by the facts of life.

I think one of the facts you have to recognize is that wages are determined by supply of labor, and when there are 10 people waiting for the same job, the man at the machine is paid less than when there is close to full employment in the country.

Senator PROXMIRE. Let me interrupt to say that I think there are factors—we have unemployment in this country which is substantial, but there is very little unemployment in Europe and in West Germany and these other countries. We have very effective and aggressive labor unions, and they have docile unions over there.

It seems to me the suggestion made by the AFL–CIO makes sense, that we should try to relate quotas to wages, and insist that they pay their labor better, and the rate at which they can get the part of the American market will depend on how much they increase the wages of the people who work.

This is a direct and immediate way, it seems to me, of trying to handle a situation which unfortunately we can't do in a competitive way, because of the great structural differences between a labor union movement here which is vigorous and strong and one from other countries which seems to me very feeble.

I see Mr. Johnson shaking his head. I would like his comments.

Mr. JOHNSON. The comment that came to me at that moment is that we don't really know that our trade union movement is responsible for our high wages.

Senator PROXMIRE. Of course not. There are many other things.

But I just say that this is one element, and a very important element and obviously distinct and different.

Mr. JOHNSON. I don't think we even know that. It would seem to me that if there is a demand for labor in these countries, wages will tend to rise; in fact, in Europe they have been rising.

Senator PROXMIRE. I don't want to interrupt, and I want to hear what you say here.

But the people I have visited in Germany, both management and labor, tend to agree overwhelmingly that the difference between our unions and the unions in West Germany are perfectly tremendous, that there it is a matter pretty much of cooperation with management to try and get as much efficiency as possible.

Over here there is some of that cooperation, but there is also a fundamental obligation to the workingman to get as much high wages and fringe benefits as he can possibly get. There is a real difference.

Don't you recognize that?

Mr. JOHNSON. I think there is a difference in the way they relate themselves to management; I don't think that necessarily means that they will hold wages down when they see a chance of raising them. Wages in Germany have been rising pretty rapidly. It has been a fact that in the background there was a lot of unemployment to begin with, and a large amount of unemployment of labor tends to hold wages down anywhere when it occurs. And I would expect that wages would tend to rise more rapidly in the future. There has also been a very rapid rise in productivity which has allowed prices to be held down as wages rose.

I would expect that under the pressure of international competition our own trade unions would change their ways and would not ask for such large wage increases, and would also become more productivity conscious. This relates to what Mr. Danielian was saying earlier, putting this problem in terms of an outflow of gold, deflation, and so on; it seems to me the forces of competition operate much more widely, that industry becomes conscious of competition at the moment when we begin to pay money for imports rather than buy domestic goods, and you don't have to wait for a gold outflow before you begin to get some pressure on prices and wages.

Senator PROXMIRE. Professor Kenen?

Mr. KENEN. I think there is another point to be made in this discussion of comparative wages. Earlier today, someone talked briefly about the fact that a change in wage rates and a change in exchange rates are alternatives. There are two elements in the price of Japanese goods delivered to the United States. One is the Japanese wage expressed in terms of Japanese currency. The other is the rate at which you convert Japanese currency into dollars and thereby price these goods in U.S. dollars. It is odd that we always think of wage rates in relation to one another without taking into account the more relevant position of one country vis-a-vis the other, that is, its balance of payments position. We speak of the absolute differences in wage rates as between the two countries without relating them to the balance of payments positions of the two countries, one against the other. Yet we always talk about exchange rates in relation to the balance of payments.

These two numbers are alternatives—you can move one or move the other. It may be easier to move one than the other, but logically they are alternatives. But if they are alternatives, then we have to compare wage rates just as we would analyze exchange rates, in the light of the overall payments position of one country opposite to the other.

Now, the Japanese balance of payments, while far stronger than it was a few years back, is not yet comfortable, certainly not as comfortable as that of West Germany. But Japanese wages are always cited as the prominent example of cheap labor. British wages are similarly below those of the United States, but if any country suffers persistent balance-of-payments problems, it is Britain. Germany and one or two other countries that have relatively low wages have balance-of-payments surpluses but I don't think we can talk of the German wage rate as being a decisive factor in studying the relationship between Germany and the United States, no more than we can talk about the Japanese wage rate alone, comparing it with the American rate and saying that this is a source of difficulty.

The real test, it seems to me, of whether or not a country's wages are out of line in international competition is whether the country is in balance-of-payments surplus or balance-of-payments deficit. This is how we would determine whether exchange rates are out of line.

Senator PROXMIRE. Are you telling me that the clear and complete alternative to some adjustment of the wage rates and exchange rates which are well adjusted—is it possible, then, to solve this tremendous dilemma which has confronted us in Congress for so long and seems to be getting far more acute in recent year and seems to be getting more acute in coming years by simple adjustment of the exchange rates? Do we do this as a substitute for either a wage reduction, or at least a wage cost reduction here, and an increase, substantial increase in wage cost abroad?

Mr. KENEN. They are not perfect substitutes, Senator. There are many differences in the impact of the two. But I think that by and large, if there is a large disparity as between wages, perhaps the least painful way of handling the problem may be an exchange rate change. I am talking now about the once-over disparity, not the one that is going to keep creeping ahead of you no matter what you do. If you have a large disparity, it may call for a once-over exchange rate change.

Senator PROXMIRE. Does it have to be artificial or not? This is difficult for me, because this is somewhat beyond my ken. I am not familiar with this kind of relationship. And it is so often debated that it is the difference in wage rates, and it is rarely considered that it is the relationship to exchange rates.

Mr. KENEN. When we talk about differences in wage rates we are talking about those differences expressed in dollars, which means that we have already used an exchange rate to convert the Japanese wage into dollars. You are really talking about the exchange rate when you are talking about international difference in wage rates, although it doesn't appear explicitly in the computation.

Senator PROXMIRE. There are statistics available which will give you conversion factors so that you are comparing the same things?

Mr. KENEN. Yes. In fact, what you are doing is using a conversion factor, an exchange rate, when you talk about the Japanese wage being 16 cents.

Senator PROXMIRE. Are they available, so that instead of talking about 11 cents an hour or 16 cents an hour, we can talk about comparable adjusted differences in exchange rates, the difference of wage rates between our country and Japan?

Mr. KENEN. I don't think you can do that quite in the way that you are suggesting. I think that you can do this, though. You can consider appreciating the Japanese currency, doubling the value of the Japanese currency in terms of the dollar, and ask what would be the consequence of such an appreciation for Japan's balance of payments. You can take the result as a first approximation to saying what would happen if we doubled Japanese wage rates.

Now, when you talk about the Japanese exchange rate, most people would immediately say that a doubling would cause the Japanese irreparable damage—that they cannot manage it as they are not yet in a position to cope with their balance-of-payments problems. But if you rule out an appreciation of the Japanese currency, then likewise you have to rule out a doubling of the Japanese wages. I don't think you can play around with the numbers in such a way as to give you an independent test of the propriety of the wage rate relationships.

Senator PROXMIRE. I see now what you are getting into. I think this is perhaps because many of us have closed our minds, as I pretty much have, to the notion that we could take an action ourselves, or that we should take any action, at least, to devalue the dollar. I have pretty much rejected that, although maybe I shouldn't have done so. Anyway, this is the alternative you have suggested—revaluation abroad and/or a devaluation in this country. We had a little approach to that, of course, in Germany, but it was modest and limited.

Mr. DANIELIAN. Senator, one point should be clarified. I think we should talk about total cost of production and not merely wages.

Senator DOUGLAS. Labor cost per unit of output, or total cost per unit of output.

Mr. DANIELIAN. The Senator pointed out that there was a 3-to-1 differential between German wages and American wages, but I am not sure that the differences in total cost are that much, maybe 25 percent or 40 percent lower in that area.

Second, I question the statement that you could make an exchange revaluation without harmful effects in the United States, because it takes a 25-percent revaluation in order to adjust for a 25-percent differential in cost. What happens to our imports? We are beginning to import more steel and iron ore and oil, and so on, into the United States. Now, the price of those things would go up immediately by that same percentage. And then of course our exports would diminish. The dollar cost of our military and foreign aid abroad would increase. There would be a net effect upon the real income of the American people if you put it in that way. Actually the net result would be the same whether you took your adjustment through an internal revaluation of the income or real income, or through some other device.

So that the only way——

Senator PROXMIRE. It would be quite different in detail the way it would work out, if you have the alternative of adjusting in one of three ways, a higher tariff, lower wages, higher wages abroad, or a devaluation. All would have very different effects. But they would all have the same fundamental purpose in looking at the economy overall. You might say that given the same force they might all have the same general consequence.

Now, it seems to me that all of these alternatives have great difficulties, and it would also seem to me that the one that has been suggested of trying to relate our trade policy to an increase in wages abroad has attraction in terms of the human impact, and also in terms of being more acceptable to many people who are deeply interested in this country abroad.

Go ahead if you want to say something else.

Mr. DANIELIAN. I think this question illustrates the very real problem that we are confronted with. I think it is an adjustment of real income between this country and other countries. This is a point that isn't realized in all this discussion.

Now, what we are truly looking for is a way of maintaining our real income here and maintaining an economic growth rate that will absorb the increment of the labor force every year, and at the same time help these other countries through the improvement of their productive system and the improvement of their standard of living. In other words, is it going to be at the expense of sharing in your welfare through these economic devices, or is there a system whereby we can maintain a high rate of production here and high wage rates, and so on, and at the same time help other countries come up in their standard of living and increase their production?

Now, I think this is a primary issue, both of domestic as well as foreign policy.

Senator PROXMIRE. I have one more suggestion I would like to make that is this—you say:

> With improved education and communication, high degree of mobility of capital by management, and even identical and perhaps better technology being established in some of the other advanced countries, are there any valid grounds to assert, as a basic theoretical underpinning of national policy, that we are always going to be in the vanguard in quality and variety of products and costs of production, in sufficient numbers of items, and in large enough markets to earn the necessary foreign exchange * * *

and so forth.

Now, it seems to me that it is exactly this mobility, this improved education and communication that can give the free world the immense advantage of a real division of labor and enormously improve our strength in all kinds of ways, our standard of living, our military potential, our ability to resist and stand up to communism, and so forth. And I think that this should be encouraged in every possible way by our country. The problem is how to find a way to do it, how to encourage it, foster it, improve it. In view of our emphasis on the fact that we have corrected for the great efficiency and other cumulated advantages we had in this country, by massive exports of aid in the past isn't now the time to bring the Western European countries and Japan as quickly as possible into this export into the underdeveloped countries with foreign aid, into the NATO pact to a greater extent than they have been? And today they can make a much greater contribution than they have in the past. Isn't this the solution? We have already begun to take great steps on this in our loan to India. Isn't this a fundamental way of doing what we admittedly could do in the middle fifties?

Mr. DANIELIAN. I agree with you fully. And I appeared yesterday before the Foreign Relations Committee supporting the foreign aid program. I think that our sudden representations as to what Western Europe and Japan can do are too optimistic. We must sympathetically appreciate and face up to their problems. They cannot afford to make gifts and grants, because they have a balance-of-payments problem——

Senator PROXMIRE. Did you say Western Europe?

Mr. DANIELIAN. No.

Senator PROXMIRE. How about West Germany?

Mr. DANIELIAN. They can only to the extent that we make millions of dollars available to them for military expenditures. In other words, military expenditures or aid dollars spent in Western Europe probably account for most of the balance-of-payments surpluses that they have.

Senator PROXMIRE. Don't you have to be specific and talk about what countries—certainly this wouldn't be true of Western Germany.

Mr. DANIELIAN. Yes, I think that you will find statistically that the military expenditures are—U.S. military expenditures are—in the amount of about $500 million, aren't they?

I might have to be corrected on that.

Senator PROXMIRE. You mean a contribution almost as large as the West German contribution to the Indian loan this year?

Mr. DANIELIAN. This is a military expenditure for our troops, and so on.

Senator PROXMIRE. I understand.

Mr. DANIELIAN. Then there is a good portion of foreign aid money that is spent in the procurement of German goods. I do not know the exact figures, but it must be approximately in the neighborhood of $78 million.

Senator PROXMIRE. Let's assume all that. Nevertheless, you have painted us a very dark picture of how we are competing under circumstances which are adverse to us, and our difficulty is because of foreign aid and military expenditures. What has happened is that these other countries are developing these great balance-of-payment advantages over us. Why don't we try to meet this problem by bringing these great prosperous, free countries into the defense of the free world both in terms of foreign aid and military.

Mr. DANIELIAN. What I am saying is that even if we could agree with West Germany that the equivalent of our military expenditures and foreign aid expenditures indirectly for procurement of German goods should be available, they should make that available as grants to underdeveloped countries, let us say that we got them to that point, if they have $600 million a year balance-of-payment surplus, and that is due to these governmental programs of ours, and then we said, "Well, we have an alternative of cutting this off, or you make an equivalent amount available to underdeveloped countries," if they did that, that would not necessarily resolve our balance-of-payments problem unless it was a substitute for our aid to underdeveloped countries, because if we keep on making these expenditures, and they are spent offshore, it doesn't necessarily follow that an equivalent contribution by Western Europe would solve that balance-of-payments problem, unless the money they make available is spent in the United States, which is not likely to happen on account of the cost differentials.

Senator PROXMIRE. Not necessarily. The money they make available may be spent in their own country, but that would reduce our offshore procurement. Why not? What is the matter with that?

Mr. DANIELIAN. Not if we still maintain our loans to India and India spends in Germany, for instance.

Senator PROXMIRE. But now we are maintaining loans—what we have done in the past, we have loaned to India, and they would spend a portion of that in Germany. And now, what we do under this proposal is, Germany will loan to India, and then India will spend that portion in Germany.

Mr. DANIELIAN. Yes; but as long as we continue spending money in India which they spend in Germany, and we do not have a reverse direction of it, a balance-of-payments deficit will continue.

Senator PROXMIRE. Do you want to comment on that?

Mr. SCITOVSKY. I think, Senator, that the point is this. If we can somehow or other induce Western Germany or any other surplus country to contribute to giving development aid to underdeveloped countries, this would lower the pressure on us to give such aid ourselves. So I should say that, never mind where they spend it, to the extent that they are willing to give more loans or more aid, to that extent we will feel able—maybe not to reduce our foreign aid program by an equivalent amount, but to reduce our foreign aid program by some amount. This will be a relief on our balance-of-payments situation, independent of where they spend it. If they spend it here that would be so much the better.

Mr. DANIELIAN. But that is not the proposal before Congress. The proposal before Congress is to increase foreign aid. We have got to face the fact that probably in the next decade there will be at least the present level if not a greater level of foreign aid.

Senator PROXMIRE. I am not so sure. Of course, what the administration, various administrations and various parties propose to Congress, and what Congress actually does is quite different. I think you have to make the one assumption or the other. If you assume that foreign aid and free world defense are going to be greater, certainly our international financial problems would be somewhat alleviated if we get greater participation in foreign aid and the military defense from Western European countries than if we do not. Do you disagree with that?

Mr. DANIELIAN. Not on our balance-of-payment situation, unless that contribution of Western Europe is spent in the United States, unless you want to reduce your expenditures, as the gentleman here has suggested.

Senator PROXMIRE. Well, we would reduce our expenditures as compared with what they would be, say, in 1965. They may be higher than they were in 1960 and 1961.

Mr. DANIELIAN. Then your deficits are going to be lower than they would be otherwise.

Senator PROXMIRE. Just one more question, Mr. Chairman, and this is for Professor Scitovsky. On page 4 you say, Professor:

> An adequate world supply of international reserves can be defined as the sum of what in each country is considered an adequate supply of that country's reserves.

Now, I am just wondering if the definition doesn't put us into a position where if we provide this adequacy of reserves, we have all everybody wants, why isn't this inflation?

Mr. SCITOVSKY. Senator, I think the answer is the following: I have been very much concerned with this problem, and I am aware of the fact that whenever anyone advocates an increased supply of world reserves, the argument is that this is inflationary. My feeling about this is the following: The question is to ask is Where, in what country, would this be inflationary? And I think the answer is that it can only be inflationary in a country that is running a balance of payments surplus. And I would argue that if in a country that has a balance-of-payments surplus there are inflationary pressures, I would, to some extent, welcome these, because if there are inflationary pressures in such a country, the monetary and fiscal authorities will feel compelled to do something against it. Now, the best thing they can do against it is to take the variety of measures that are going to reduce this balance-of-payments surplus and bring them nearer to balance-of-payments equilibrium. And my feeling is, which I think is probably shared by some of my colleagues here, that one of the main advantages of having a larger supply of international reserves is that by doing this they would be putting some pressure on the balance-of-payments surplus countries. They should cooperate, they should do their share, not necessarily cooperate, but they should independently of or in cooperation with the deficit countries do something to eliminate their balance-of-payments surplus.

To the extent that they do this, they make the tasks of the deficit countries that much simplier. And I think if one thinks about this for a while, one thing that one finds is that it is only the surplus countries that will feel inflationary pressures and not the countries with a balance-of-payments deficit. A balance-of-payments deficit can be recorded as a price-stabilizing situation. The very fact that we have a balance-of-payments deficit means that we are consuming more than we are producing, our total consumption is in excess of our income to some extent, and this is a price-stabilizing situation. So that the only place where you can have inflationary pressures is in the surplus countries. And I would agree that if there are inflationary pressures—it is not certain that there will be—but if there are, then this will presumably induce the monetary authorities who are concerned with inflation to do something against it, and it is desirable that they should do something against it, because what they are most likely to do against it is the kind of thing that will probably help the balance-of-payments situation. It won't necessarily help it, but it is likely to help it.

Senator PROXMIRE. I am afraid I just don't follow this, because it seems to me that you are tending to eliminate this corrective device that you otherwise would have. If countries have adequate reserves at all times, regardless of what the circumstances may be, don't you tend to eliminate discipline, any necessity for them to correct——

Mr. SCITOVSKY. My point on page 4 was not that all countries, in the sense of each country individually, would have adequate reserves; my point was that if the sum total of all countries' reserves were adequate, then the kind of balance-of-payments disequilibrium we would be facing is that, if some countries have inadequate reserves, this would automatically be matched by some other countries having excessive reserves. These other countries having excessive reserves might experience inflationary pressures; and when they feel that they have excessive reserves and inflationary pressures, they are very likely to try to do something against it.

Senator PROXMIRE. What you have said is that the inadequate world supplies of international reserves can be defined as the sum of what in each country is considered an adequate supply of that country's reserve. So that this means that sometimes a particular country might have a deficiency of reserves.

I understand now.

Mr. Johnson.

Mr. JOHNSON. I think the point can be put in a slightly different way, that the country which has a surplus and is using that to accumulate reserves is putting a deflationary pressure on the rest of the world through its export competition and the fact that its imports are less than its exports, and so long as it continues to build up its reserves by this means, it will be exercising a deflationary measure elsewhere.

Senator PROXMIRE. Here is where—it seems to me that if you eliminate the deflationary effect, that certainly we have had a long-range tendency toward inflation, and if you eliminate that lower deflationary influence, that discipline, and competition, aren't you working yourself into a position where the forces would tend to be internationally inflationary, or at least less stable?

Mr. JOHNSON. No. The point of the argument, I think, is that when you have a deficit—say, for example, simplify it by taking two countries—then you have a deflationary pressure on the country of deficit, and you want to have a matching inflationary pressure on the country of surplus to induce it to correct that situation, so long as there is a shortage of reserves overall you can't arrive at an equilibrium, the deficit country has a deflationary pressure on it automatically, and if the other country wants to continue the growth of its reserves it will exert a deflationary pressure too, and you have only one of the processes working.

Senator PROXMIRE. Let me interrupt. I think I see now. The reason we have inflation in spite of this is because there are institutional factors, unions and combines and trusts, and so forth, which tend to push prices up. And it may be that the shortage of reserves just serve the purpose of somewhat restraining the march of inflation, but perhaps not, perhaps it just works an injustice, and the march of inflation goes on at roughly the same rate, but in a less just way.

Mr. JOHNSON. Yes. I was going to add a concrete example. We have countries now in the world which are surplus countries but which are maintaining restriction on imports, quotas, high tariffs, and so forth. And we put the argument to them, "You are a surplus country; you ought to reduce your tariffs, you ought to lower your interest rates; you ought to do this thing to help us solve this surplus."

And they say, "We can't do this until we build up our reserves to a more adequate level."

And, therefore, they continue with these policies even with their surpluses. And the proposal here is that unless you have an adequate overall level of reserves you can't expect these countries to take the kind of measures they ought to take.

Senator PROXMIRE. Thank you very much.

Representatives REUSS. I would like to address a question to the three neo-Triffinites.

Witnesses before this committee yesterday, notably Mr. David Rockefeller, of the Chase-Manhattan Bank, in their criticism of the so-called Triffin plan pointed out what they regarded as its possible harmful effects upon New York as an international financial center. One criticism was that the deposit of foreign exchange reserves in New York by one agency, i.e., the Triffin Bank Fund, would disturb relationships built up over the years by private New York banks with a larger number of foreign official depositors. Second, it was objected that the concentration of foreign exchange reserves in the fund bank rather than diffused among a large number of central banks might mean that total deposits in New York would be smaller, and hence New York would lose importance as a financial center.

I would welcome any comment you three gentlemen may have on either of these two specific points, or any other observations concerning the effect of current proposals upon New York as a world financial center.

Mr. Johnson.

Mr. JOHNSON. Mr. Chairman, I would like to speak to that point with great enthusiasm.

As a Chicago dweller, I would like to point out that the strength of this country does not depend upon New York as a financial center, but on the productive power of the economy.

And also as a person who has lived 11 years in England, I would like to point out to the committee the great dangers of letting your policy be dominated by an international banking business. The problem of the British over the past 30 or 40 years has been to reconcile the interests of the banking business and the economy, and their policy has run into a great deal of difficulty from trying to manage the two simultaneously. I think that the position of New York as a banking center for the world—which is a position, I should point out, which has grown up without any conscious planning and without any governmental policy of assuming the responsibilities—is a serious threat to the future strength of this country, because, in order to run a banking business, you have to have a conservative, strong economy, which tends to mean that our domestic policies are restricted by the necessity of commanding confidence, that we may have to raise interest rates at various times when domestic circumstances would warrant a reduction of them, and generally that a conflict is imposed on economic policy which can be very serious. I don't think that the gain that a country gets from having these funds on deposit is a gain worth having, and I do think that its restrictive effect on domestic policy is very serious. And I would like to see New York lose all the responsibilities of an international banking center, because I think this responsibility might be a very serious danger to the future strength of this country.

Representative REUSS. Mr. Scitovsky.

Mr. SCITOVSKY. May I just add this, that as a son of a banker I think it is worth pointing out—I don't know the exact figures—but at least half of the total foreign short-term assets held in New York today are not central bank assets, but assets of foreign commercial banks. So I would say that the inauguration of the Triffin plan, or something like that, would really affect only about half or possibly less than half of the total foreign assets, which I think is an important consideration.

Representative REUSS. Are there any other comments?

Mr. KENEN. I suppose I should feel obliged to defend New York against Chicago, but I really do not, sir. I would go even further than Professor Johnson and point out that the U.S. Government has huge cash deposits at commercial banks, but we have not heard, at least I have not heard, any very loud complaint about the way that this tremendous body of cash is centralized and managed by the Government. It is managed by the Government in a rather efficient, and I should think, fair way. I can see no reason why the International Monetary Fund could not manage its deposits similarly, taking these deposits over from central banks, leaving them where they are for the time being, and then gradually reorganizing its cash holding on what could be a very equitable basis. There would be a minimum of disruption in New York, much less disruption than we have had from time to time, as in the fourth quarter of 1960, when huge private and official flows took place between commercial banks, the Treasury bill market, and between New York and other centers. These private movements have not been easy to handle. They have involved serious technical problems for the New York Federal Reserve Bank, from what I can understand.

The commercial banks have had frequent occasion to complain about the way in which foreign funds have moved in and out of the New York banks, and it would seem to me that their life would be much more predictable and stable, and not very much less profitable, if this whole arrangement were reorganized under the aegis of the International Monetary Fund.

Mr. DANIELIAN. I hope the record will indicate my complete neutrality in this very admirable expression of institutional and regional loyalties.

Representative REUSS. Mr. Kenen, Mr. Scitovsky, and Mr. Johnson, each of you in his own way—and you differ considerably among yourselves—has suggested that some new institutional arrangement to handle the problem of long-term liquidity is necessary. I think it would be very helpful if we could have a short and specific action program from each of you on what he thinks this country ought to do, what ought we to do with the IMF, what ought we to do with OECD, and what ought we to do unilaterally and through bilateral conversations with other countries.

Is this a reasonable request? Are each of you willing to present to us an additional paper along the lines discussed?

Mr. Kenen, can you do so?

Mr. KENEN. Yes, sir.

Representative REUSS. Mr. Scitovsky?
Mr. SCITOVSKY. Yes, sir.
Representative REUSS. And Mr. Johnson?
Mr. JOHNSON. Yes, sir.
Representative REUSS. That will immeasurably help our deliberations.
(The following replies were later received for the record:)

AN ACTION PROGRAM TO STRENGTHEN THE INTERNATIONAL MONETARY SYSTEM

(By Harry G. Johnson, University of Chicago)

A. UNILATERAL ACTION BY THE UNITED STATES

(1) Abolish the legal requirement that the Federal Reserve System hold a minimum gold certificate reserve of 25 percent against its note and deposit obligations.
(2) Authorize the Treasury to issue securities carrying a gold convertibility guarantee, for holding by foreign monetary authorities.
(3) Use the net credit, of the United States in the International Monetary Fund (approximately $1.56 billion) to buy back Fund holdings of U.S. Treasury bills ($800 million) and to buy currencies of the countries that have accumulated gold most rapidly in the past year (Germany, France, Netherlands, Switzerland), using these currencies to acquire gold for the U.S. Treasury or to reduce foreign official dollar holdings as convenient.
(4) Use the U.S. drawing rights on the International Fund as a first line of reserves to meet balance-of-payments deficits in future.

B. INTERNATIONAL COOPERATIVE ACTION

(1) Convert the International Monetary Fund into an international reserve bank in which members are obligated to hold a certain minimum percentage (say 20 percent) of their international reserves on deposit and encouraged to hold a larger proportion of their reserves on deposit by the offer of interest on deposits surplus to reserve requirements.
(2) Transfer official holdings of reserve currencies (dollars and sterling) to deposit with the reformed International Monetary Fund, making provision for the gradual and orderly liquidation and reinvestment by the Fund of the dollar and sterling assets so acquired.
(3) Provide for the growth of international reserves required to support the expansion of world trade by obliging the Fund to undertake open market purchases of securities on a scale sufficient, together with whatever increase in the supply of monetary gold occurs, to increase aggregate international reserves by an agreed percentage each year. I suggest an increase in international reserves of 3 percent per year, with provisions for adopting a larger percentage annual increase if this seems called for; whatever the percentage specified, it should be an automatic rule imposed on the Fund, the Fund having discretion with respect to the types of securities acquired but not to the amount of the annual investments.
(4) Oblige the Fund, in conducting its open market purchases, to give preference to the securities of the International Bank and kindred institutions for financing economic development; but leave it freedom to provide international reserves by means of loans to member countries.
(5) To avoid the danger of the Fund becoming illiquid through the accumulation of its security holdings and the absorption of gold in national reserve holdings outside the Fund, provide for a steady increase in the minimum proportion of national reserves obligatorily held on deposit in the Fund. An appropriate rule might be that this proportion should increase by 1 percentage point per year.

UNIVERSITY OF CALIFORNIA,
Berkeley, Calif., July 9, 1961.

Hon. HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR MR. REUSS: This is in response to your request that members of the panel appearing before your subcommittee on June 21, 1961, each state the proposals or arrangements that in our opinion would best contribute to improving the international monetary framework in relation to the major foreign policy and domestic economic objectives of the United States. The second half of the written statement I submitted did set forth my convictions on the subject; but I am glad to restate them.

I favor increasing the supply of international reserves in any form over no such increase or over an increase in loan availabilities only. Since the need for increasing reserves is a continuing need—and also because we do not know and have no way of knowing how much additional liquidity would be adequate—I favor a method of increasing reserves that is flexible and allows for a continuous addition to reserves, as against an E.P.U. type of arrangement, which would increase reserves by one fell swoop and require the cumbersome machinery of renegotiation and new international agreements for each further increase in reserves. This means that I favor the establishment of a central bankers' central bank, along such lines as those suggested in the Triffin plan. Finally, I favor increasing international reserves in such fashion that not only would the additional reserves once created ease the pressure on deficit countries but that already the way in which the new reserves are created and distributed would alleviate balance-of-payments difficulties. This, in my opinion, would best be accomplished by the plan outlined at the end of my written statement, namely, by the central bankers' central bank creating deposits mainly through the purchase of international development bonds.

Yours sincerely,

TIBOR SCITOVSKY,
Professor of Economics.

MEASURES TO STRENGTH INTERNATIONAL MONETARY ARRANGEMENTS

(By Peter B. Kenen, associate professor of economics, Columbia University)

The following are the measures I would recommend to strengthen the international position of the dollar and the international monetary regime:

I. MEASURES TO STRENGTH THE U.S. BALANCE OF PAYMENTS

Although there has been an improvement in the U.S. balance of payments in recent months, I would still urge action to enlarge receipts and to curb certain outlays. A further improvement is required because the recent gains could be dissipated by the recovery of business activity in the United States or by a recession in Western Europe. Measures to strengthen financial arrangements cannot succeed if one of the reserve-currency countries suffers persistent or recurrent payments difficulty. I therefore suggest:

(*a*) An intensification of the administration's export-promotion program.

(*b*) A greater emphasis on Government expenditure to promote economic growth, inasmuch as the import-content of Government expenditure on needed public facilities is apt to be smaller than the import-content of an equivalent private outlay.

(*c*) Adoption of the proposed tax credit for investment to stimulate business spending on plant and equipment and thereby enhance the competitiveness of American industry.

(*d*) Adoption of the proposed changes in taxation of foreign-source income to remove an incentive to foreign investment that may do damage to the competitive position of the United States and may adversely affect the balance of financial transactions between the United States and American companies abroad.

(*e*) Regular official intervention in the forward foreign-exchange market to absorb speculative pressure against the dollar and thereby to allow a faster adjustment of the forward foreign-exchange rate toward its interest-rate parity.

(*f*) A widening of the margins within which currencies may fluctuate, possible to 3 percent on either side of par, so that day-to-day pressures that are presently reflected in official foreign-exchange reserves may instead be absorbed by exchange-rate movements and so that the forward foreign-exchange rates will be free to move over the range required to offset interest-rate differences.

II. MODIFICATIONS IN FINANCIAL ARRANGEMENTS

The proposals that follow are designed to strengthen the reserve position of the United States. I discussed several of them in my statement before the subcommittee:

(*a*) Immediate elimination of the 25-percent gold-cover requirement to remove whatever doubts may remain concerning our capacity to combat speculation.

(*b*) Gradual reduction of the U.S. creditor position at the International Monetary Fund, by small but regular drawings on the Fund.

(*c*) The issue of special Treasury notes, bearing a gold guarantee, to foreign central banks and governments.

(*d*) Negotiations to provide for central-bank cooperation during any future exchange-rate crisis. The United States should seek:

(1) An agreement by other governments to defer the conversion of newly acquired dollars for 6 months or more, or to spread gold purchases over a 6-month period following an acquisition of dollars, or

(2) Consolidation of the Basle agreements and their extension to cover the dollar as well as the pound; or

(3) Establishment of the reserve settlement account proposed by E. M. Bernstein.

(*e*) Consultations with other governments, looking toward a thorough reform of the International Monetary Fund along the lines suggested by Robert Triffin, but with the modifications described in my testimony. Such a reform would provide for the orderly increase of international liquidity and would eliminate the need for the arrangements described at D, above, which could easily break down when they are most needed.

Mr. DANIELIAN. Before the termination of the proceedings I have a suggestion to make for the consideration of the committee.

The discussion today indicated that a good many of these problems perhaps are related to the basic costs of production between the countries. Unfortunately there is no definitive study on that subject Most of the discussion on the subject has been in terms of index numbers of wages from 1950 to 1959. Unfortunately index numbers do not explain what is happening, because the base years may have relationships to each other that would explain the end result, but very little reference is made to either the dollars and cents costs there at the beginning or at the end of the period. So that one of the greatest needs of the Federal Government today is statistics as to the exact cost of products by countries, and also price studies of selected products in third markets.

And I think of this as such an extensive job that only a congressional committee, or the U.S. Treasury by request of the congressional committee, could undertake it. And I hope that before next year some basic studies will be forthcoming on this subject.

Representative REUSS. Thank you for the suggestion, which we certainly will consider.

And I want again to express my gratitude to all four members of this suspended panel for a very stimulating discussion.

The subcommittee will now stand adjourned until 2 o'clock this afternoon in this place, when we will hear Emilio G. Collado, of New York.

(Whereupon, at 1:08 p.m. the committee adjourned to reconvene at 2 p.m. of the same day.)

AFTERNOON SESSION

Representative REUSS (presiding). The Subcommittee on International Exchange and Payments will be in order.

This afternoon the first witness is Mr. Emilio G. Collado, a director of the Standard Oil Co. of New Jersey. Mr. Collado has been a great contributor to thinking about international monetary affairs. He was most recently chairman of a subcommittee of the CED which published a study on "The International Position of the Dollar." I remember reading about him in Mr. Harrod's biography of John Maynard Keynes. He was with the U.S. delegation to the Bretton Woods Conference.

We are delighted to have you here, Mr. Collado.

STATEMENT OF EMILIO G. COLLADO, DIRECTOR, STANDARD OIL CO. OF NEW JERSEY

Mr. COLLADO. My name is Emilio G. Collado. I am a director of Standard Oil Co. (New Jersey).

I welcome this opportunity to discuss with you certain aspects of the international monetary structure with particular relation to international movements of capital. I should like to say at the outset that I believe that private foreign capital investment is essential to the economic welfare of the United States; that freedom of international capital movements is desirable; that the development of international financial centers is on balance a useful thing even though the rise of several alternative financing and reserve centers introduces additional problems of maintaining equilibrium; and that the international monetary system has worked tolerably well and with relatively modest evolutionary modifications should continue to do so for some years.

I shall not this afternoon attempt to present all the reasons why international investment is good for the United States. They have been put forward in a number of statements by the CED including one entitled "The International Position of the Dollar," which was prepared by a subcommittee of which I was chairman.

Moreover, I discussed this subject rather fully only 2 weeks ago before another committee of the Congress and, therefore, do not feel it necessary to take up the time of this committee with a detailed development of the argument.

Briefly stated, the case for maximum freedom of private international capital movement is that it facilitates the optimum allocation of resources, creates employment opportunities in the United States, strengthens our balance of payments, promotes the economic progress of the less-developed nations, and encourages the free market economy rather than Government ownership and control. I am, therefore, opposed to any measures of tax policy or administrative control designed to discourage U.S. private foreign investment or to interfere with the free flow of capital abroad.

The balance-of-payments developments of the past year have aroused concern in certain quarters that international capital movements may put an excessive strain on the international monetary system. It has been said that, while long-term capital movements are beneficial, short-term money movements are unnecessary, undesirable, or even dangerous and disruptive of the world payments mechanism.

I cannot accept this broad distinction. Of course, speculative capital flight, in anticipattion of exchange restrictions or changes in exchange rates on the price of gold, is usually disturbing. On the other hand, several other forms of short-term capital movement greatly facilitate the smooth functioning of the international trade or investment process. Some of these become virtually indistinguishable from long-term and direct-investment capital movements.

For example, many so-called hot money movements are a highly conventional form of short-term money flows between major money centers in response to interest rate differentials. Before World War I, a major function of monetary policy was to regulate and direct the flow of short-term funds between money centers. These short-term movements tided a country over a temporary adverse development in its basic balance of payments and provided a breathing spell in which more fundamental adjustments could take place. In the last 10 years this technique has come back into use and has been employed, particularly by the British, with considerable success. I believe proper management of these capital flows though central bank cooperation can be an important instrument for maintaining payments equilibrium among the countries of the free world.

Another form of short-term money movement is closely related. The financing of world trade, through overdrafts, I O U's and bills of exchange, also tends to shift between money centers in response to interest rate differentials. A high interest rate relative to other money centers, therefore, strengthens a country's balance of payments in two ways: by attracting short-term funds for portfolio investment and by encouraging liquidation of the commercial debt incurred by other countries.

Finally, some forms of short-term money movements become virtually indistinguishable from long-term capital movements for direct investment abroad. I am referring to short-term financing provided by U.S. parent companies to their branches and subsidiaries abroad. Interest rate differentials have a very definite effect on the volume and timing of capital flows for direct investment abroad.

Except for speculative capital flows, Jersey Standard, the company with which I am associated, has been involved in all of these forms of capital movement. It may be useful for me to refer briefly to the evolution of our financial policy to illustrate some of my remarks on types of capital flow.

For example, since the early fifties we have invested a portion of our cash funds in British and Canadian Treasury bills when it was attractive to do so. Last year, the yield differential between United Kingdom and United States Treasury bills rose as high as 1.36 percent even after allowing for the cost of forward cover; without forward cover the yield differential was as much as 3.2 percent in favor of the United Kingdom. At the present time, the cost of forward cover more than offsets the interest differential, and we have allowed certain weekly maturities to run off.

Sources of financing for the working capital requirements of our foreign affiliates have shifted very drastically over the years. In the early fifties, some of our affiliates, especially in Europe, had recourse to the New York money market for financing of imports from the dollar area. Local credits were not always available in adequate volume, or were too costly, and other foreign credits were not to be had. These credit arrangements in New York have now been terminated. On the other hand, new low-cost draft financing facilities have in the intervening years opened up in London, Switzerland, and the Netherlands. Last year, our European affiliates borrowed in Switzerland by discounting of commercial drafts some $20 million at an interest rate of 3½ percent or less as compared to short-term financing rates as high as 6 percent in Germany and Sweden. Our affiliates have also been able to effect substantial interest savings by borrowing dollars in the so-called Euro-Dollar Market. The low-cost Swiss and Dutch money markets became particularly important to us last year when the increase of the British bank rate in midsummer and the rising costs of forward cover made borrowing in the London money market increasingly expensive.

The heavy capital investments of our Western European affiliates were financed, until convertibility, to a maximum extent through local borrowing. The uncertain outlook for European currency, the attendant risk of devaluation, the difficulty experienced with repatriation of profits and capital all justified this policy. Because long-term capital was frequently not available, the affiliates relied heavily on semipermanent borrowing of short-term funds. Parent company financing was provided as required by foreign governments to cover the foreign exchange costs of capital projects and to strengthen the capital structure of the local affiliates. In general, parent company financing was provided in the form of loans which were capitalized as needed to preserve a reasonable capital structure. With the risk of devaluation now sharply reduced for most major currencies, we are now more influenced by differential costs of money—both at short and long term.

My principal point is that the line between long-term capital financing and a large portion of short-term capital movements is indistinct, shifting, and of little real importance to analysis and policy. In general, a company such as ours looks to the most desirable method of financing its foreign operations on a corporate basis—that is, encompassing both investment and working capital requirements—rather than project by project. With the reconstruction of the international monetary system and the increased strength and convertibility of most major currencies, trade and investment have more and more tended to be financed in those centers where funds could be obtained cheaply and on generally satisfactory terms. These remarks, of course, primarily apply to operations in the more developed areas; the development of financial mechanisms and institutions has been more uneven in the less-developed countries.

A look at the balance sheet of Jersey Standard reveals the manner in which these principles of financing trade and investment have been applied by our group. At the end of 1960 our net equity amounted to $6.8 billion. The consolidated long-term debt was conservative; at $808 million it was equal to 11.8 percent of the net equity. Of this debt, $397 million was issued in the United States; about $327 million, or the equivalent of $327 million, was attributed to borrowing in Western Europe by affiliates in those countries; the remainder to Canadian and other foreign affiliates. The financial position was strong; consolidated cash amounted to almost $1.4 billion of which $1.2 billion was held by the parent company. The current ratio was 2.09 to 1. Short-term debt amounted to $236 million. Jersey and its affiliates have had no recourse recently to U.S. sources of short-term funds; virtually the entire short-term debt is by foreign affiliates abroad. Jersey Standard and its affiliates thus had borrowed abroad at long and short term $647 million.

Judging by our experience, the restoration of convertibility has been highly successful. The rise of other major money markets as alternative financing centers for world trade has been generally beneficial to the international payments position of the United States. The increasing interdependence of major money and capital markets is advantageous to the U.S. investor. Convertibility of national currencies for capital account transactions and free access by foreign borrowers to local capital markets have been and continue to be worthwhile objectives of our foreign economic policy.

I have thought it useful to describe certain types of long and short term capital movements with which I am familiar with a view to relating them to the broader problems of liquidity and monetary structure which you are considering. I have not conceived it to be my role in these hearings to present a detailed review of the international monetary structure, the adequacy of international liquidity, and the several proposals that have been made for strengthening or modifying the monetary system. I should, of course, be prepared to try to answer questions or discuss any of these subjects to the best of my knowledge and ability.

I should like in conclusion to make a few points regarding certain aspects of the problem of international liquidity:

1. While the rise of several major money markets is definitely desirable, it entails risks for the stability of the system arising out of sudden large-scale shifts of funds between countries and financial centers.

2. The fear of such shifts is a source of concern as to the adequacy of international reserves and the position of the so-called key currencies.

3. How are we to appraise the adequacy of international liquidity?

Obviously, this is really a problem of the adequacy of reserves of the developed countries and more particularly the major trading nations. One must agree with Mr. Bernstein that the level of required reserves must depend in large measure on possible cumulative incidence of balances or imbalances of payments among such major trading nations. For the near future there appears to be no problem of general inadequacy of liquidity.

4. It is not desirable to try to separate all or certain types of short-term capital movements for limitation or direction by specific controls, prohibitory taxes, or the like.

5. It should be possible to handle short-term capital movements—even of the speculative and "hot money" types—by use of existing international resources including recourse to the IMF, supplemented by cooperation among monetary authorities of the sort being currently discussed within the OECD and the IMF.

6. The widening of exchange margins, recommended in certain quarters, would, if carried far enough, resemble a system of fluctuating exchange rates. Whatever the merits of such recommendations, it seems probable that such a system would greatly complicate international investment and trade.

7. The proposals of Mr. Triffin and others have been developed primarily in terms of official and normal working bank balances. These proposals have generally not paid sufficient attention to how the recommended changes would affect the functioning of major international money centers and capital markets and the movement of funds for private investment.

8. Some alleviation of tendencies toward large-scale, short-term capital flows as well as strengthened ability to sustain such flows should result from careful choice of the mix of budgetary and monetary policies. Different combinations of budgetary and monetary policies may be equivalent in their general domestic economic effects and yet quite different in their balance-of-payments effects. Moreover, there is at least some room for maneuver in the relationship of short- and long-term interest rates, and recent efforts of the Federal Reserve authorities in this area are highly desirable.

9. The problems of the underdeveloped countries are only in secondary degree problems of liquidity. Their real problems are of transfer to them of real resources from abroad. These generally transcend the buffer aspects of liquidity, and large, continuous increases in the reserves of underdeveloped countries generally are not to be expected. Thus, most of the discussions and proposals relating to the international monetary structure and liquidity, except that of Mr. Maxwell Stamp, have very little to do with the problems of the underdeveloped countries.

In conclusion, I may quote the CED statement referred to above:

> The present international financial system is the product of long evolution plus agreements reached at Bretton Woods in 1944. The Bretton Woods agreements were a major step forward. They did not, however, represent the end of possible inventiveness in this field. We are confident that thorough reexamination of existing arrangements in the light of postwar experience will reveal opportunities for improvement.

Thank you.

Representative REUSS. Thank you very much, Mr. Collado.

I would like to take you back to some of the specific points you make here.

I might as well start at point No. 9 and work backward.

You say in point 9 that the general worldwide liquidity problem, such as it is, is primarily a problem affecting the industrialized nations rather than the underdeveloped countries; is that a correct characterization?

Mr. COLLADO. I think so, yes.

Representative REUSS. If that is so, does not that suggest that institutional arrangements for alleviating future liquidity problems might better be concentrated in an organization like the OECD, which is a creature of the industrialized countries, rather than the IMF, which is worldwide?

Mr. COLLADO. Well up to a certain point, it probably does not matter too much whether you do it one way or the other.

My own preference would be to use the IMF simply because in it one has a functioning organization, a large staff, and an organization that in recent years has developed to a very important and formidable position in this field. I think by having the IMF as a center in which to do these things, that a fairly modest proposal along the lines of that of Mr. Per Jacobsson, or possibly that of Eddie Bernstein, in that general direction, probably is more workable than trying to set up an independent organization.

Also, the line between the operations that you would enter into in the new organization and the traditional operations of the IMF is, at best, a very fine one, and I would think that it would be preferable to have them concentrated in the same organization.

I do not think that this is a question on which I have a very firm opinion, but I would lean in that direction.

Representative REUSS. It might be that there would be room for some coordinated action by both the OECD and the IMF in this field, might there not?

Mr. COLLADO. Well, I think the question about the OECD is whether you use it as a forum or use the BIS with some countries added to it; it is almost the same thing.

There are some differences in membership you have got to look to when you look at these institutions.

Representative REUSS. The OECD is a government forum, whereas the BIS is a forum for central banks, is that right?

Mr. COLLADO. That is right.

Although, I think, in terms of the mechanics of operations, rather than policy formulation, it is possible for the central banks to act as agents for the treasuries and so forth, as, in fact, the Federal Reserve Bank of New York tends on many occasions to act for our monetary authorities in Washington.

Representative REUSS. I now go on to your point 8, in which you call for a careful choice of the mix of budgetary and monetary policies with which to minimize short-term capital flows. This recommendation, in its actual application to a country like West Germany, which now has a fairly high interest rate structure, would mean that it should rely somewhat more on budgetary discipline, that is, tax more and spend less, and somewhat less on monetary discipline, so that interest rates are lower than they would be with continuing heavy reliance on monetary policy.

Conversely, if you have a country such as the United States which finds itself in a recession as well as in a deficit balance-of-payments position, it, too, should rely more on budgetary means in getting out of the recession rather than on reducing interest rates quite as low as they have gone in previous recessions. Is this what you are driving at, Mr. Collado?

Mr. COLLADO. That is certainly the general area that I was driving at. In this particular numbered point I have drawn very heavily on the CED paper drafted by a committee of which I happened to be the chairman, and in which Mr. Salant was one of the very active helpers in the drafting; I am not sure he did not write the words.

And I think that it is there that we expounded this in some further detail. With respect to the United States, you are quite right. Our view is certainly that, to rely so heavily on interest rate policy, particularly at the short end, to do various things in the domestic field that we would like to do, that is, getting the economy to a higher level of activity, is likely to induce these interest rate differentials that we have been talking about, and, consequently, to induce an outflow of funds that bears on the U.S. balance of payments.

This is the sort of situation in which balance of payments and internal economy considerations have been moving in somewhat different directions. Consequently, it is clear that under these circumstances, if you can rely more heavily on budgetary policy in the United States than on monetary policy, that will help.

The second part of my remark was devoted to the attempt of the authorities to try to hold up the short rates and prevent the long rates from going up, if not actually reducing the long-term rates.

I think they have been quite successful in at least keeping the status quo. If you will look at the rates, they are almost exactly where they were some months ago; they put about a billion dollars into the market, and I think it is clear that if they had not done so, the long rates would have been considerably higher.

I think all of these steps are probably in the right direction. But when you come around to the other side of your statement, the German side, I would agree with you that the antithesis should be true.

I think, however, the German problem is a little bit more than merely avoiding inflation. The German problem has been partly institutional. The structure of longer term interest rates in Germany has been a very inflexible one, and long-term interest rates are still, by most people's standards, much too high in Germany.

For a country with the degree of prosperity and development and reserves and everything else that Germany has, long-term interest rates are just high. And one of the reasons why our own company is minimizing its local borrowing at long term in Germany is that it is very expensive there.

On the short-term end, of course, they have recently reduced bank rates down to 3 percent, so that the interest differential vis-a-vis the United States is not very great any more.

On the other hand, I think that the Germans, in the long run, have got to import more goods and export more capital. And I am not sure that is completely consistent with the budgetary policy that you were suggesting. Maybe it is and maybe it is not.

I think the problem in Germany is perhaps not to worry quite so much about inflation, but let the economy expand in the sense of a little bit more for the population, as well as a little bit more for export of capital than they have permitted in the past.

Representative REUSS. But it certainly is true that whatever the cause, high interest rates in a country like Germany would do well to come down from the standpoint of easing this flight of short-term capital.

Mr. COLLADO. Yes.

I would say that one of our points in the CED study is that an imbalance on the surplus side in many respects is just as distressing and just as disturbing to equilibrium and to the local economy as an imbalance on the deficit side.

I think people are happier with surpluses, but they should not be.

Representative REUSS. Senator Bush?

Senator BUSH. Mr. Collado, you say:

> I am, therefore, opposed to any measures of tax policy or administrative control designed to discourage U.S. private foreign investment or to interfere with the free flow of capital abroad.

In his recommendations dealing with the balance-of-payments problem the President earlier this year, among other recommendations, as I recall it, suggested that the taxation of earnings of American corporations abroad should be, henceforth, on the same basis as though they were located within the United States.

Heretofore, I believe that corporations, American corporations operating abroad, were not subject to our income tax until they transferred their earnings to the United States. Is that right?

Mr. COLLADO. That is true on a foreign subsidiary corporation.

Senator BUSH. On a foreign subsidiary corporation.

Mr. COLLADO. Not on a branch.

Senator BUSH. And his recommendation was directed toward those, was it not?

Mr. COLLADO. Yes.

Senator BUSH. Now, what effect do you think the implementation of his recommendation would have upon American corporation subsidiaries abroad now, and what effect do you think it would have upon the establishment of other corporations—of other branches or foreign locations of American corporations?

In other words, in the light of your broad experience, your company having operated in some countries, how do you assess the importance of this recommendation, particularly as to its effect on American industry?

Mr. COLLADO. Well, I would like to try to answer that question, Senator, quite carefully. The testimony that I gave 2 weeks ago in the House Ways and Means Committee was directed exactly to this problem. I have a copy of it here, and, if you wish, I could give it to you.

Senator BUSH. Yes, I would like to have it. I could get it out.

Mr. COLLADO. I have it here. I referred to it in the opening paragraphs of this testimony, but I did not want to go into the whole thing all over again in my prepared statement.

My own opinion is that this measure which was put forward as related in some way to the balance of payments crisis, if you want to call it that, of several months ago, which is somewhat alleviated or at least has gone away temporarily—my own opinion is that the changing in the direction of American foreign investment—and, as you recall, the proposal was designed to hold back investment in developed countries, but not to hold it back in underdeveloped countries. In my opinion, this measure, if imposed, would have very little impact on the U.S. balance of payments.

I think it is a very ill-advised measure, and I think it flows, frankly, from a failure to consider carefully what the balance of payments effects of foreign investment are.

Now, I went into that for about 15 pages, but if you would like, I can summarize it briefly here. I think it is this.

The first point I would make is that these foreign subsidiary corporations are usually created for reasons that have very little to do with the tax structure. The tax structure has an incidence on the result of creating them, but I am sure that the basic reasons for creating them are quite different.

I pointed out that our principal affiliates in Western Europe are all local corporations, country by country. This is the normal way to do business.

In some of those countries you would have no alternative; you could not do business except with a local company. In other countries you locally probably could do business with an American corporation, but there are all sorts of business and other reasons why it would be an unlikely decision of any management to go that route.

Finally, I pointed out that in the case of our own affiliates, most of them were created about 1880 or 1890, long before there was an income tax, and clearly the income tax laws did not have much to do with why we created these companies.

Now, these companies in many cases have local shareholders; they have large local borrowings. I referred in my statement to the fact that our company alone has borrowed $640 million abroad.

A corporation cannot borrow heavily in the London money market and remit home all of its earnings. That is what is implicit, I think, in this Treasury proposal: That you should bring home all the earnings, have them all taxed at home, and thus benefit the balance of payments.

You do not borrow $250 million in the London market, as we have, and bring home every penny of earnings as earned. No banker would lend to a corporation that paid out all of its earnings currently at all times; it is just not the way business is being done, nor the way banking is being conducted.

There are many other objections. Local shareholders undoubtedly would not like to have all the proceeds paid out in dividends and no funds left in a company for growth.

These are some of the reasons why I question the sense of going after the foreign subsidiary as if it were something unusual. This is a normal way of doing business.

Now, we tax income in the United States, and this is true of almost all the major countries in the world, only when it is received by an American taxpayer.

We do not tax income when it is imputed to some operation and not in our own control.

Consequently, the retained earnings of foreign corporations have never been taxed by this country, nor by the British, nor by the Dutch, nor by any other country that I know of.

This is a very unusual proposal that has been made.

Now, in terms of the impact on the balance-of-payments, it happens that if you look at the Commerce Department statistics, all of the American subsidiaries in developed countries in the manufacturing industry bring home each year more dividends than the new capital investment.

The culprit—although everybody waves the oil industry aside when they talk about foreign investment—the culprit, if there is any, is the oil industry; the subsidiaries in Europe of the oil companies do not bring home as much dividend income as the new capital investment.

The reason for that is very simple. I can quote from our own company's case. We do not make much money in Europe, unfortunately. The pricing and competitive situation is such that our European affiliates in the refining and marketing business have a relatively low return on a very heavy capital investment.

You ask why we make the capital investment? That is very simple. That is where we sell the crude oil. The balance-of-payments impact is very simple. The oil companies draw from Western Europe, from Canada, from Japan, from Australia, the very developed countries that the Treasury is talking about, literally billions of dollars in payment for oil that is sold in those countries.

That money flows basically back after local operational expenses and all that sort of thing, local taxes and all the rest of it, flows back through the parent trading companies, and eventually goes in payment to the oil producing countries for the oil that has its origin in the Caribbean and the Middle East and Libya and North Africa and so forth.

And that is the flow, the balance-of-payments; the money comes out of Europe and ends up, some of it here, and most of it in Venezuela, the Middle East, and so forth.

The earnings of the oil companies happen to be attributed, corporatewise, to the functions that do not take place in Europe. And, in my opinion, the statistics are all completely controverted by the facts; they just do not reflect the facts. And if you take the statistics and unwind them, you will see that U.S. investment in every year brings back home, even in the subsidiaries in the developed countries which the Treasury is talking about, a lot more money than goes out.

In addition to that, we showed in the case of our own company, and we have seen the data for other companies not only in the oil business but in manufacturing and other lines. I may say the testimony before the House Ways and Means Committee is replete with this, and it is very good and very factual. We have seen that on the average some 60 percent of the new capital investment each year goes out of this country in the form of capital goods exports and services that are directly related to those investments.

So that even on that account there is a very small margin that is not already in the form of a directly connected export of goods and services.

I have not any question about it. I think that this investment is a very desirable thing.

The other point I would like to make is:

I do not think that geographical destina makes any sense. We are interested in the development of OECD. We are interested in the problems of the Common Market and the free-trade areas. We are interested in seeing to it that the private enterprise philosophy which exists in this country and in Canada and in Western Europe is given as free a chance to move abroad and help in the general development of the underdeveloped world as possible.

And I think that if we try to limit this form of investment in developed countries we are necessarily going to reduce, also, investment in underdeveloped countries, and at the same time increase the already very strong tendencies toward government control and direction of enterprise in those developing countries.

Senator BUSH. Thank you. I think that is a very interesting summary.

I think this is one of the very important recommendations that deserves the most careful scrutiny.

Representative REUSS. Senator Pell?

Senator PELL. Mr. Collado, I would like to pursue that subject further for one moment.

Am I correct in saying that the advantage given to foreign corporations is a moratorium on payments, on profits, and on income until they are repatriated, which is a moratorium that went into effect after World War II, and before that time you did pay?

Mr. COLLADO. No, that is not correct, sir. U.S. tax law, from the imposition at the outset of an income tax, has never taxed income of foreign corporations except insofar as the dividends received by Americans from the corporations are concerned.

This goes back to the very beginning of the income tax history. There never was any other treatment than that accorded today.

Senator PELL. But was not the doctrine of delaying payment of taxes on profits or income until repatriation occurred one that came in with the income tax at that time?

Mr. COLLADO. No.

As I understand this, as our tax lawyers have instructed me very fully, the income tax law dates back, if I recall it, to 1913.

At the outset the rates were very low, and the problems were not very great. But by 1918 it was clearly established that there was no taxation except insofar as dividends were brought back from the foreign-owned corporation, and it has been the same ever since.

There have been many other modifications in the tax law, but not in this aspect of it.

Senator PELL. It excluded American subsidiaries, American-owned corporations abroad?

Mr. COLLADO. That is right.

Senator PELL. Because it certainly was a new law as it applied to individuals, whereas, you know, the first $25,000 of earnings outside the United States was exempt.

Mr. COLLADO. I think that you are correct.

I am not so familiar with that. But there have been many changes in the taxation of income of individuals, but I am not expert in that field.

Senator PELL. But, in general, then, you would be opposed to this proposal?

Mr. COLLADO. I wonder if I could expand very briefly on this.

Senator PELL. I wish you would.

Mr. COLLADO. There is a point that I think has been maybe a point of misapprehension. Actually, since World War II, there has been virtually no legislation affecting the taxation of the foreign income of American corporations either from branches or subsidiaries abroad. There has been a great deal of talk about legislation, but there has been almost no legislation at all.

If I am correct in my recollection, the 1954 legislation, which was the big revision of the Internal Revenue Code, had some trifling modifications of detail in connection with the Western Hemisphere Trade Corporation, and, in fact, did nothing at all about foreign subsidiaries.

The Randall Commission made a number of recommendations, none of which were adopted. Senator Bush was a member of the Commission, and he will recall that. But nothing was done about them.

Then, through the years since 1954, there have been any number of proposals, including the large omnibus proposal that Mr. Boggs introduced a year or so ago, and one thing, and only one thing, I believe, came out of that, which was a bill known as, if I recall the number, 10087, which is for the overall limitation to be possible of election by a corporation instead of the per country limitations.

And I think that is the only change of any real significance in the income tax law since sometime before 1946 or 1947.

There were some changes made back around 1940, including the establishment of the Western Hemisphere Trade Corporation.

There has been a lot of discussion of the fact that in the postwar period we encouraged investment. Well, I think we encouraged it by exhortation and by words, but I do not think we encouraged it by anything more substantial than that.

And there is no question but that people were told that it was American foreign policy to make foreign investments, but no tax relief was accorded.

Senator PELL. Thank you.

Representative REUSS. Senator Javits?

Senator JAVITS. Dr. Collado, I am delighted to welcome you here. I might say that I was late and will have to go immediately, because I have got a date with the SEC reorganization on the Senate floor.

I might tell my colleagues that Dr. Collado is a member of the advisory group on American business which has helped us with the work on NATO parliamentarianism; he is a very distinguished and very active member.

I was interested in one aspect of your statement, which I read, which seems to me makes a very important point. It is a sentence which appears at page 6, the first full paragraph, which says:

> Convertibility of national currencies for capital account transactions and free access by foreign borrowers to local capital markets have been and continue to be worthwhile objectives of our foreign economic policy.

Now, I gather that what you infer is that the problems of imbalances in our international payments represent the capability or lack of capability of the more developed countries to deal with their affairs; that they really do not, or they should not, affect the capabilities of the less developed countries for getting capital, getting economic aid, technical assistance, or whatever else they need; and that, therefore, when we think about the imbalance of international payments, we should not get confused; that is a problem of the countries that are well able to manage it, if they lick the problems of organization and machinery.

Do I draw the right conclusion from that statement?

Mr. COLLADO. Well, in considerable measure. Of course, I suppose that the problem of transfer of resources from the developed countries to the underdeveloped countries is part, certainly, of the process of the economic development of the underdeveloped countries.

And if that transfer is made in real terms—I do not think the proper word is "cost" or "sacrifice"—but there is a certain outmovement from the economic resources of the major trading countries.

I think we are all sure that it is a good idea to do these things, and if it takes 1 percent, or whatever it is, of our GNP, the results are well worth it.

They may not be well worth it in dollars and cents in the short run, but we are sure they are well worth it over a period of time. And, to the extent that transfer is real and not encumbered by complications of the payments system, I think it is one that we can handle without too much trouble. Obviously, if we try to transfer, instead of a small percentage of our GNP, a very large one, that has other economic impact, and that may unsettle the balance of payments as well as the domestic economy in one way or the other. There are those people who think that even such a large percentage could be a good thing for the country.

The trouble comes when the flow to underdeveloped countries of financial resources is not related to real transfer. In other words, if we have a small amount of real transfer and a very big amount of financial transfer, and the result is that a great deal of our money and claims against us end up in the hands of other trading countries, then the problem is a little more complicated than the way you put it. This is the problem of burden sharing that has been talked about so much in the last year or two.

Beyond that, I think the biggest problems of imbalance are still, as you suggest, in the area of the relationships in the balances between the major trading countries.

Our problems are mostly with England and France and Germany and Italy and a few other countries.

Senator JAVITS. Therefore, it is the end point of your thinking that that aspect of the problem, that character of the problem, is susceptible of being dealt with through the IMF international agreement, and does not require a sweeping away of the present substructure of international finance and the substitution of a new one, whether it is Triffin or someone else?

Mr. COLLADO. I am certain essentially of that basic principle. You will notice in my concluding paragraph, where I quoted from the report we prepared in CED, that we should not, however, fail to continue to study these problems, and undoubtedly there will be further evolution. I am certainly not in favor of an early, radical change in the financial arrangements.

Senator JAVITS. And your judgment is a composite of history, very large company experience, and economic judgment?

Mr. COLLADO. I hope it is. I thank you for putting it this way. At least it is my judgment, based on whatever I have learned or read or studied over the years.

Senator JAVITS. Thank you, Mr. Chairman.

Representative REUSS. In your point No. 7, Mr. Collado, you refer to the effects of the Triffin proposal on the functioning of major international money and capital markets. Can you spell that out a little?

Why would the Triffin plan——

Mr. COLLADO. Well, this is a rather complicated point, and I may say one that I almost omitted from the last draft of my text.

My observation of the various books and articles and other statements which I have seen in this field is that the principal emphasis given by most of the authors, including Mr. Triffin, whom I know quite well and admire has been to the official monetary authority and other movements of funds rather than to trade financing and the various forms of investment financing which I have tried to describe in terms of my own experience.

A good part, you notice, of our financing and of our capital movements would appear in the balance-of-payments nomenclature as short term, and, yet, they are very closely related and frequently become transformed in time to long-term capital. That is one of the reasons why the definition "short term" is, I think, not a very useful one. It has seemed to me that the sort of thing that causes people like ourselves to move funds around the world and to do financing in the course of ordinary trade and investment would be rather broadly affected, but I am not sure whether beneficially affected, by some of the more sweeping changes proposed.

At best, I think, our lives would be considerably complicated, and in some cases it might tend to put a damper on some of the things we do.

In other cases maybe there would be just no impact at all. I have not felt that these proposals have been thoroughly worked out in terms of the realities of the movements of funds between money centers. That is all.

Representative REUSS. Thank you very much.

Any further questions?

(No response.)

Representative REUSS. We appreciate your helpfulness here, and we will study your statement with great interest. Thank you very much.

(The following was later received for the record:)

JUNE 26, 1961.

Hon. PRESCOTT BUSH,
U.S. Senate,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BUSH: It was a pleasure to meet with you and your colleagues of the Joint Economic Committee on Wednesday and I am enclosing a copy of the two documents referred to in my testimony: the CED study[1] on the balance of payments which was prepared by a subcommittee of which I was chairman, and my own testimony before the House Ways and Means Committee on June 5 in respect of the taxation of foreign income.

In my oral testimony before the Ways and Means Committee at the point on page 5 at which I referred to dividend payout, I interpolated the following comment with respect to Jersey Standard:

"About two-thirds of our consolidated net income in recent months has been from abroad. Net retained earnings in foreign subsidiaries and branches have, over the last 5 years, amounted to less than 10 percent of foreign earnings, although the figure would be larger for certain individual affiliates and offset by higher rates of dividends and profits remitted to the parent company by other affiliates. In recent years we have paid out 70 to 80 percent of our consolidated net earnings to our shareholders in parent company dividends. Thus in 1960 we paid out $485 million in dividends, of which two-thirds was attributable to foreign income.

"We may be sure that many millions of dollars in U.S. taxes were paid by Jersey's shareholders on such income."

On page 6 after discussing the interdependence of U.S. foreign investment and foreign operations in developed and underdeveloped countries, I interpolated:

"Again referring to Jersey Standard, we sell in the advanced countries 70 percent of the oil which we market outside the United States; this of course is a result of their high levels of economic activity. Most of this oil originates in the developing countries. The flow of funds is thus mainly from Europe and the other advanced areas to the producing areas. Funds thus derived from the advanced countries, although in the usual statistical compilations attributed to the developing countries, are sufficient, for our company alone, to overturn the balance-of-payments data presented by the administration."

If you have any further questions regarding any of this material, I should be very happy to try to answer them.

With best regards.

Sincerely yours,

EMILIO G. COLLADO.

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[1] The CED study referred to is made a part of the record and is in the files of the committee.

JUNE 26, 1961.

Hon. CLAIBORNE PELL,
U.S. Senate
New Senate Office Building, Washington, D.C.

DEAR SENATOR PELL: It was a pleasure to meet with you and the other members of the Joint Economic Committee on Wednesday, June 21, and I thought it might be helpful if I sent to you the two documents which were referred to in my formal testimony and which were discussed some in the hearing. They are the report entitled "The International Position of the Dollar" of the CED prepared by a subcommittee of which I was chairman and to which Mr. William Salant was consultant, and my own testimony before the House Ways and Means Committee on June 5, 1961, on the taxation of income arising from foreign investment.

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Following up on our discussion of the history of U.S. taxation of foreign income, I have asked our tax department to prepare for me a memorandum summarizing briefly developments in the taxation by the United States of income arising from foreign investment of foreign corporations. This memorandum is enclosed. As I told you, I have not personally followed closely questions relating to the taxation of income of American individuals resident abroad. My tax advisors have indicated that you were correct in suggesting that there have been changes over the years in the law relating to this type of income although the basic principle of full exemption from tax has remained since original enactment in 1926.

Sincerely yours,

EMILIO G. COLLADO.

[Memorandum from tax department, Standard Oil Co. of New Jersey]

TAXATION OF FOREIGN INCOME CORPORATIONS UNDER U.S. INCOME TAX LAW

From the beginning of modern U.S. income taxation in 1913 the U.S. income tax law has followed the principle of taxing foreign corporations only on income derived within the United States and of taxing U.S. shareholders of such corporations only on dividends paid to them by such corporations. The Congress has never deviated from this principle except to enact measures in the 1930's to combat the use of personal holding companies, including those incorporated abroad, to protect the revenue against this form of incorporated pocketbook.

Standard Oil Co. (New Jersey) has today an interest in approximately 200 foreign corporations. Many of the larger, mature units were in existence at the time the first U.S. income tax was enacted in 1913.

We have actually ascertained in the case of 12 leading countries that none imposes an income tax on foreign corporate profits in the manner recommended currently by the administration. We do not believe that any developed country does this.

SUMMARY OF TESTIMONY OF EMILIO G. COLLADO ON TAX RECOMMENDATIONS RELATING TO FOREIGN INCOME [1]

Standard Oil Co. (New Jersey) fully supports the administration's objectives to reduce the deficit in the U.S. balance-of-payments and to increase the rate of domestic investment. The company, however, is convinced that the administration's basic proposals for changes in the taxation of U.S. foreign investment will not contribute to achieving these objectives. Moreover, these proposals, if enacted, would render more difficult the job of assisting in the economic development of developing nations and would weaken, rather than strengthen, the economic unity of the free world.

A policy designed to reduce the rate of U.S. foreign investment will weaken, rather than strengthen, the balance-of-payments position of the United States. Income from direct foreign investment has consistently exceeded the outflow of direct investment capital, the surplus amounting to almost $900 million in 1960. Furthermore, the dividend record of U.S. foreign subsidiaries does not support the argument that the additional earnings generated by new foreign investment are largely retained abroad. For the period 1957 through 1959, these subsidiaries distributed an average of 47 percent of their earnings to their U.S. parents and for subsidiaries in Western Europe the percentage was 55 percent.

There is no reason to believe that U.S. private foreign investment can be redirected from the industrially developed to the developing countries. The location of foreign investment is largely determined by basic considerations of markets, costs, and sources of supply, and will not be affected by marginal tax incentives. Furthermore, particularly in such extractive industries as petroleum, investments in the industrially advanced countries are required to provide markets for the output of operations in the developing countries.

There is no evidence that in the aggregate U.S. investment abroad has affected adversely the level of investment and employment in the United States. On the other hand, U.S. foreign investment helps protect our share of the world market and creates substantial employment opportunities in the United States by helping to maintain and increase foreign demand for U.S. goods.

The foreign investor faces unusual risks in carrying on business abroad and is confronted with non-U.S. competitors whose income tax burden is exclusively determined by the effective rate of taxation of the foreign country in which business is done. Furthermore, under the administration proposals, U.S. foreign subsidiaries would be treated less favorably than branches which enjoy certain benefits not allowed U.S. subsidiaries.

The proposal to levy a tax against shareholders on undistributed earnings of bona fide subsidiaries is contrary to U.S. income tax principles of long standing. It is without precedent in any of the industrialized countries of the world, many of which offer tax inducements to encourage foreign investments by their nationals. Concerning so-called tax havens, there is a question as to how real this problem is. The committee would render a valuable service in analyzing the real nature of the operations described loosely as involving tax havens and their impact on the national interest.

TESTIMONY OF EMILIO G. COLLADO ON TAX RECOMMENDATIONS RELATING TO FOREIGN INCOME [1]

INTRODUCTION

My name is Emilio G. Collado. I am a director of Standard Oil Co. (New Jersey).

I appreciate this opportunity to appear before your committee to discuss with you administration proposals to modify the taxation of income earned abroad by U.S. investors. At the outset I should like to emphasize that Jersey Standard fully supports the administration's views that the deficit in our balance of payments should be reduced and that the rate of domestic investment should be increased. However, putting aside for the moment the question of so-called

[1] Before the House Ways and Means Committee, June 5, 1961.

tax havens, we do not believe that the basic proposals for changes in the taxation of U.S. foreign investment will contribute to achieving these objectives. On the contrary, it is our view that such action not only would fail to stimulate domestic investment but also would weaken the U.S. balance of payments. Furthermore, it would be in conflict with the objectives of U.S. foreign economic policy which has been consistently directed toward encouraging international trade and investment and promoting the economic development of underdeveloped nations.

FOREIGN ECONOMIC POLICY CONSIDERATIONS

Maximum freedom in international trade and unrestricted worldwide mobility of investment capital are interrelated; one cannot be attained without the other. A retreat by the U.S. Government from its present policy toward U.S. foreign investment would intensify pressure in this country for the return to more protectionist policies. Abroad the United States would weaken its claim to leadership in promoting the free international movement of goods and capital. The administration would be in a weaker position to urge other industrial countries to remove the remaining trade-and-payments restrictions against the dollar area, to persuade the Common Market countries to lower their external tariffs, and to encourage the inflow of private foreign capital to the United States.

Only recently the United States passed a milestone in its foreign economic policy by joining the OECD—an organization set up to promote greater economic unity of the Western countries and to mobilize more effectively their resources for assisting in the economic progress of the underdeveloped areas. The proposals before this committee are incompatible with the purpose and spirit of the new organization. By discriminating against OECD member countries they go counter to the avowed purpose of the organization to strengthen the economic unity of the Western countries. Further, if enacted, they would inevitably discourage U.S. investment in the less-developed parts of the world and thereby strengthen the tendency already evident in many of these countries to move away from the free market economy toward increased reliance on Government ownership and control.

FOREIGN INVESTMENT AND THE BALANCE OF PAYMENTS

The administration states that its foremost consideration in recommending a change of policy toward U.S. foreign investment is the deficit in our balance of payments. Actually, the capital outflow for investments abroad has been more than offset by the dollars returned in the form of dividends and in payment for exports of equipment and supplies.

I may illustrate this from the experience of my company. Income receipts from foreign investments have exceeded our net outflow of investment capital by an average of $300 million annually in recent years. For the 5-year period 1956 through 1960, this surplus has reached a cumulative total of $1.5 billion. In addition, a sizable portion of the funds that Jersey Standard and its affiliates budget for capital expenditures abroad is spent in the United States on capital goods, engineering services, and supplies. Last year, Jersey affiliates operating abroad spent about $100 million in the United States on procurement required for their various capital expenditures. These purchases alone accounted for more than 60 percent of the company's total net capital outflow for new direct investments in that year.

In case it be asserted that Jersey Standard's experience is not typical of that of other U.S. investors, I should like to consider briefly the relationship of total investment income and capital outflow in the U.S. balance of payments. Table I which you have before you shows the pertinent figures for the 5-year period 1956 through 1960. You will note that, contrary to a widespread impression, there has been no consistent increase in the outflow of direct investment capital since 1956. In 1960, this outflow was only moderately higher than in 1959 and was significantly less than that in 1956 and 1957. Of course, year-to-year changes in the figures are greatly influenced by nonrecurring transactions and by business conditions abroad. As examples, I may cite the payments for Venezuelan oil leases in 1956 and 1957, the European recession in 1958, and the general tightness of the European capital markets in 1960.

Concerning income receipts from foreign investments, the first point to recognize is that the level of earnings, like the outflow of investment capital, fluctuates with business conditions abroad. However, it is clear that receipts of investment income, our second largest source of foreign exchange, have shown a very favorable trend, reaching a level of $2.4 billion in 1960. These income receipts have consistently exceeded the outflow of investment capital, the surplus amounting to almost $900 million in 1960.

This brings me to the argument that the substantial favorable contribution of foreign investment to our balance of payments could be further increased by subjecting to tax the earnings of U.S. subsidiaries abroad. This position, which has been presented so eloquently and ably before this committee, recognizes the benefits of foreign investment in generating a rapidly increasing earnings stream for the United States. However, it holds that under the present tax system these additional earnings are largely retained abroad, and therefore fail to compensate for the initial investment outflow over an extended period of time.

The dividend record of foreign subsidiaries does not support this view. In tables II and III of my statement I have assembled some of the pertinent figures. For example, for the period 1957 through 1959, U.S. subsidiaries abroad distributed an average of 47 percent of the earnings to their U.S. parents. For U.S. subsidiaries in Western Europe, which have been repeatedly singled out for discussion in these hearings, the percentage was substantially higher—55 percent. The annual dividend distribution of these subsidiaries has increased by $145 million or 60 percent since 1957. By comparison, the annual rate at which earnings were reinvested in Western Europe has increased only by $37 million since 1958 and has actually fallen in relation to 1957. These figures clearly show that, contrary to the administration's view, U.S. shareholders, as a group, wish to receive a reasonable payout on their investment, even though the income received is subject to U.S. tax.

In summary, the evidence clearly shows that a policy designed to reduce our rate of foreign investment is singularly inappropriate as a remedy for our balance-of-payments problem. Even in the short run, such a policy, by reducing U.S. exports of investment goods, would not accomplish a great deal in reducing our deficit. In the long run, by retarding the growth of investment income, it would seriously weaken our balance of payments.

DEVELOPED VERSUS UNDERDEVELOPED COUNTRIES

A further objective of the administrative is to redirect private foreign investment from the industrially developed to the developing countries. In the administration view, U.S. investment in the advanced countries is no longer needed, whereas investment in the delevoping countries continues to serve the national interest.

There is no reason to believe that foreign investment, denied outlet in Europe, will seek outlet in the developing countries. The quantitative importance in foreign investment of so-called footloose industries, that is, industries willing to shift their base of operations in response to marginal investment advantages, has often been exaggerated. The location of the bulk of foreign investment is determined by basic consideration of markets, costs, and sources of supply and will not be affected by marginal incentives. These foreign investments will not be made at all if tax penalties make them economically unattractive.

Foreign investment is also closely tied into a network of world trade which cannot easily be sliced into segments of developing country trade and developed country trade. This interdependence is seen clearly from the experience of the oil industry. Investments in the industrially developed countries provide the market for most of the crude produced in the developing countries. Let me illustrate. Over the past decade U.S. oil companies have spent in excess of a billion dollars to develop additional crude oil producing and transportation capacity in the Middle East. Without the markets in Western Europe assured by these investments in refining and distribution facilities, the American oil companies could not have justified such large investments in the Middle East.

A great deal of emphasis has been given in these hearings to a regional comparison of income received and new funds invested over the past few years. It has been claimed that, over the period 1957–59, this comparison shows a deficit of $200 million for the industrially advanced countries and a surplus of $1.7 billion for the developing countries. Such a comparison ignores the complementary nature of much of foreign investment. It also overlooks the fact that a substantial portion, perhaps as much as 40 to 50 percent, of the income attributed to U.S. operations in the developing countries is actually earned in Europe, Canada, and Japan largely through sales to affiliated enterprises in these countries. The alleged regional imbalance of income received and new funds invested quite simply reflects a failure to take into account the interdependence of U.S. foreign investment and foreign operations in different parts of the world.

U.S. TRADE AND INVESTMENT

This committee will also hear the argument that U.S. foreign investment tends to reduce domestic employment by depressing exports and increasing imports. The available evidence does not support this view.

Concerning U.S. exports, Department of Commerce figures show that almost two-thirds of U.S. direct investment abroad over the past decade has gone into such industries as petroleum, mining, trade, and public utilities, the products of which, by and large, are not in competition with U.S. exports. Of U.S. investments in foreign manufacturing, almost one-half went to Canada, a country which has wage scales comparable to those in the United States and which has been running a very sizable deficit with the United States. On the import side, the major portion of shipments to the United States consists of raw materials and agricultural products. Except for U.S. subsidiaries in Canada, the output of U.S.-controlled foreign manufacturing concerns is overwhelmingly for sale abroad.

There is, however, a more important point. Shifts in the pattern of world production and trade brought on by basic economic forces or by the trade policies of foreign countries cannot be prevented by curtailing the rate of U.S. investment abroad. A good deal of U.S. investment in Western Europe during recent years has been defensive in character or has been attributable to the formation of the Common Market and the free trade area. It would be very unfortunate if our Government, at this particular juncture, should deter U.S. investment in the developed countries by generally increasing the tax burden on U.S. subsidiaries abroad.

The argument that U.S. capital is being invested abroad instead of in the United States is largely an academic one. I do not know many firms to which it would apply nor do I think there is any evidence that in the aggregate U.S. investment abroad has affected adversely the level of investment and employment in the United States. On the other hand, U.S. foreign investment helps protect our share of the world market and creates substantial employment opportunities in the United States by helping to maintain and increase foreign demand for U.S. goods.

CONSIDERATIONS OF TAX EQUITY AND POLICY

Next, I should like to say a few words on considerations of equity involved in taxing foreign and domestic investments which have received so much emphasis in these hearings.

Equity in this connection refers to equal tax treatment of persons similarly situated. I submit that foreign and domestic investors are not similarly situated. The foreign investor faces unusual risks in the pursuit of profitable business abroad. He confronts non-U.S. competitors whose income tax burden is exclusively determined by the rate of taxation of the foreign country in which the business is done. Here we find numerous cases where the effective rate is below the U.S. rate. A good case can be made out for the principle that foreign investment income be taxed only in the country where it is earned.

In support of this position one may also point out that the relative tax burdens carried by domestic and foreign investment cannot be determined from a comparison of income tax rates alone. Many foreign tax systems rely to a far greater extent than the U.S. system on trade, turnover, import, and general business taxes as sources of revenue. In the Common Market area, the portion of total Government revenues derived from indirect taxes ranges from 70 percent for Italy to 40 percent for the Netherlands. These indirect taxes inevitably affect profits and represent a heavy burden on business done in those countries.

Moreover, the U.S. tax treatment accorded foreign subsidiaries is less favorable than that permitted branches in a number of respects: losses are not deductible currently, capital gains are taxed at the same rate as ordinary income when distributed as dividends, the Western Hemisphere Trade Corporation deduction and other deductions allowed branches are not permitted.

Finally, there is the hardship involved in requiring an investor to pay U.S. taxes on earnings remaining abroad when it is not practicable for legal, business, or other reasons to remit such earnings as dividends. In some countries which the administration has defined as "developed," it is impossible to declare or to remit 100 percent of earnings as dividends. In others, especially if there are local or other shareholders, local business practice makes this virtually impossible. Finally, where foreign investment are financed in considerable measure by recourse to foreign capital markets, which is both conventional and advantageous to the U.S. balance of payments and general interest, it would usually be impossible to declare and remit anything like 100 percent of earnings as dividends. Under these circumstances, the proposal to tax earnings retained abroad is like asking shareholders of American corporations to pay individual income tax on earnings plowed back into expanding U.S. plant facilities.

As I have tried to show, foreign investment is essential if we are to maintain our position in the world economy and keep our balance of payments strong. I submit that these are overriding considerations of national interest which strongly argue for continuation of the present policy.

To go beyond considerations of equity and national interest, the proposal to levy a tax against the shareholders on undistributed earnings of bona fide foreign subsidiaries is contrary to U.S. income tax principles of long standing. It is without precedent in any of the industrialized countries of the world, many of which offer tax inducements to encourage foreign investments by their nationals.

Foreign operations are incorporated locally for many reasons. Governments or local creditors may insist on it. Licenses and permits required under the laws of the country may be withheld from nonlocal corporations. For reasons of public government, employee, local investor, and customer relations, local incorporation is often vital. Almost all of Jersey's operations in the industrialized countries are conducted by locally incorporated companies. Many of these companies were formed long before the United States had an income tax law.

TAX HAVENS

It is thus wrong to say that U.S. investors generally conduct their foreign business through foreign subsidiaries largely for tax reasons.

How real then is the problem of so-called tax havens? Some evidence indicates that some underpricing of U.S.-made goods to foreign affiliates has existed. This is a violation or abuse of existing U.S. tax law, and the remedy lies in enforcement, rather than penalizing legitimate operations in an effort to find an easy administrative out.

It has been suggested that other operations, although admittedly fully legal and moral under today's legislation and practice, contain elements which might desirably be limited in the national interest through the imposition of additional tax procedures. I have examined a number of such situations, and I must confess that all appear to involve aspects broadly desirable and in the national interest. I believe the committee will be rendering a valuable service in analyzing very carefully the real nature of the operations described loosely as involving tax havens and their impact on the national interest. If such analysis suggests some operations that from a policy point of view might well be curtailed or subjected to more immediate U.S. taxation, then careful consideration should be given to the broad impact of such proposed treatment on desirable foreign investment and on broad equities and policies affecting the whole tax structure.

CONCLUSION

In closing, I should like to remind this committee that Jersey Standard, almost from its beginning, has been in the international oil business and that we are the largest U.S. international investing and trading company. Over this extended period, it has been our experience that the free flow of investment capital contributes to the spread of technical knowledge, the equalization of economic opportunity and the strengthening of trade among nations. We at Jersey Standard, therefore, are convinced that the proposals before this committee would fail to stimulate domestic investment, impair the U.S. balance of payments, render more difficult the job of assisting in the economic progress of the developing nations and weaken, rather than strengthen, the economic unity of the free world.

TABLE I.—*Income from direct investments and direct investment capital outflow, 1956–60*

[In millions of dollars]

	1956	1957	1958	1959	1960
Remitted income	2,160	2,313	2,198	2,235	2,395
Less: Net capital outflow	1,839	2,072	1,094	1,310	1,541
Balance	321	241	1,104	925	854
Earnings retained by subsidiaries	1,000	1,363	945	1,081	(1)

1 Not available.

Source: Department of Commerce, Office of Business Economics.

TABLE II.—*Distribution of earnings by U.S. subsidiaries abroad, 1957–59*

[Dollars in millions]

	Total earnings	Dividends received [1]	Percentage of earnings distributed [2]
Canada	$1,906	$811	46
Western Europe	1,767	938	55
Other	2,684	1,064	42
All areas	6,357	2,813	47

1 Net of local dividend withholding taxes.
2 Gross of local dividend withholding taxes.

Source: Administration statement, exhibit II, table 3.

TABLE III.—*Earnings distributed by Western European subsidiaries, 1957–60*

[Dollars in millions]

Year	Total earnings	Dividends received [1]	Percentage of earnings distributed [2]
1957	$551	$245	47
1958	549	301	57
1959	667	392	61
1960 (preliminary)	665	390	59

1 Net of local dividend withholding taxes.
2 Gross of local dividend withholding taxes.

Source: Department of Commerce, Office of Business Economics.

Representative REUSS. We will now declare a 5-minute recess before calling Mr. Goodrich in order that the subcommittee staff may confer.

(Whereupon, a short recess was taken.)

Representative REUSS. The subcommittee will be in order.

The next witness will be Mr. Frederick Goodrich, of the United States Trust Co., New York.

We want to welcome you, Mr. Goodrich. We are very grateful to you for coming down and giving us the benefit of your wide experience on international financial matters. We particularly appreciate the practical approach which you bring to this problem.

You have prepared a statement which we have here, and in accordance with our usual procedures, we would like to admit this statement into the record so that it may be printed with the committee hearings, and then ask you, if you will, to proceed in your own way, either by reading it, or reading portions of it, or paraphrasing it, or summarizing it in any way you like.

STATEMENT OF FREDERICK N. GOODRICH, EXECUTIVE VICE PRESIDENT, UNITED STATES TRUST CO. OF NEW YORK

Mr. Goodrich. Thank you very much, Chairman Reuss and gentlemen. My name is Frederick N. Goodrich. I am an executive vice president of the United States Trust Co., of New York. My field is investments.

Is it going to be all right if I do read it basically?

Representative Reuss. Please.

Mr. Goodrich. Major objectives of the Joint Economic Committee are a well-balanced, growing economy at home and a strong exchange and trade situation abroad. Success in attaining one of these objectives helps to achieve the other.

Your Subcommittee on International Exchange and Payments is seeking both a strong dollar and a stable, liquid, convertible international financial situation. Here again success in reaching the one objective will help achieve the other.

My comments are not those of an expert who can add to the vast information you have gathered. I can give you simply the views of a trust company officer and student of investments who, like yourselves, has a deep interest in a growing economy, a strong dollar and a stable international environment.

My views are expressed below under five headings:

(I) Balance of Payments, (II) The Dollar as a Reserve Currency, (III) The Role of Gold, (IV) Expansion of the International Monetary Fund, and (V) Confidence, a Stable Dollar and a Growing Economy.

Before we go on these topics, allow me to briefly express the climate of my opinions:

(*a*) Our economic objectives at home and our world political objectives are not in basic opposition. A strong, highly productive, economically competitive free world should strengthen, not weaken, our domestic economy.

(*b*) The objectives of a vigorously growing economy and of a stable, noninflationary dollar are not at all in opposition. A stable dollar will support, not inhibit, our economic growth and reduction of unemployment.

(*c*) The achievement of successful international financial arrangements and of that somewhat elusive condition termed "international liquidity" will, of course, strengthen free world economic confidence. However, it is equally true that achievement of confidence in the free world's affairs—and, above all, of confidence in the United States and the dollar—is vital to the success of whatever financial arrangements are made. While a condition of financial liquidity certainly contributes to confidence, it is only a slight exaggeration to say that the definition of liquidity is confidence.

I. THE FIRST TOPIC, BALANCE OF PAYMENTS

On this question, which you have studied so extensively, I will be brief. Four principles for action seem to me important:

(1) We must aim at a balance of cash payments. The dollar's role as the key reserve currency and as an avenue of long-term investments may make a small deficit desirable over the next 5 to 10 years, but, as

discussed below, any such deficit should be small and within our control. Strong International Monetary Fund arrangements should permit international liquidity without more than a modest increase in dollar reserves held by foreigners.

(2) We should embrace all direct measures of a nonrestrictive nature which will help balance our payments: vigorous promotion of exports, pressures to reduce foreign restrictions, encouragement to foreign visitors, the sharing of international burdens, repayments of our foreign loans where means are available, curtailment of any nonessential Government expenses abroad, and the closing of any true tax loopholes without affecting the free flow of international investment.

(3) We must avoid restrictive measures that weaken the free world, detract from our own export prospects, and lessen our economic and competitive vigor. High on the list of measures to avoid are increased tariffs and quotas. The adoption of such measures, except where essential for national defense or for coping with disorderly dumping, is to admit defeat before beginning the battle. Of equal importance is the maintenance of the free flow of investment and exchange. The free flow of both goods and money is not only a vital source of international prosperity and cooperation but also enhances our own economy by keeping it alert and competitive and by bringing to it the fruits and stimulation of foreign progress.

(4) We will do the most for solving the payments problem by achieving a soundly expanding economy on a noninflationary basis. An expanding economy will give us the great production we need to meet both domestic and international objectives and will encourage foreign investment here. A stable price level will maintain international confidence in the dollar, increase our ability to compete, and, above all, make a major contribution to economic and employment growth.

II. THE DOLLAR AS A RESERVE CURRENCY

The role of the dollar as the key reserve currency will be a central factor for many years to come even though you succeed in expanding the role of the IMF. Foreign dollar reserves are now more basic than sterling as both the supplement and support to gold reserves. Before going on to the question of gold and the Fund, I will touch on three points concerning the reserve currency problem:

(1) The expansion of the world's dollar holdings—the other side of our adverse balance of payments—must henceforth be modest and under control. If foreign dollar holdings are now $18 billion, I would be inclined to place the desirable average annual change at something between no growth and a 5-percent increase, or less than a billion dollars a year. If the purchasing power of the dollar were stable, that amount of expansion of balances could almost certainly take place without weakening confidence in the dollar and could make a useful contribution to international liquidity. Any modest deficit that we absorb should be under control in the sense that it is more than balanced by our private investment abroad and curable by our ability to attract international investment through a growing economy and adequate interest rates.

(2) Dollar reserves should play a diminishing role as the functions of the Fund are strengthened. However, the dollar role will be vital

for many years to come as (*a*) the long-term trend toward less reliance on gold continues, and (*b*) the increasing role of the Fund must be gradual.

(3) As the operations of the Fund expand, the strength of the dollar, a major resource of the Fund, will be essential to its strength and effectiveness. While the credit of the Fund can support the dollar, a strong dollar will also be needed to support the credit of the Fund.

III. THE ROLE OF GOLD

After making due allowance for gold's historic use as money, we must recognize the great change that has taken place in both the real and psychological economic background. Gold's value through the centuries was based on heavy private demands for artistic and other useful purposes relative to a scarce supply. The monetary need for it followed from the absence of a highly developed banking and monetary system. The modern international gold standard, so nostalgically remembered, followed an earlier bimetalism and lasted from the 1870's to 1914. Today, gold is a convenient measuring stick for the principal currencies. It could still prove to be a partial refuge if the world's reserve currencies, in particular the dollar, were to collapse in purchasing power. However, gold, as an anchor of value, is an illusion, and, because of confusion about its role, it has become an unnecessarily upsetting element to monetary confidence.

The following points seem to me valid:

(1) Gold is no longer the world's money in any real sense: (*a*) its nonmonetary use is less than 20 percent of newly mined production, a fact which totally unfits it for continuing its former role; and (*b*) the money used by the citizens of nearly every country of the world is not convertible into gold.

(2) Despite the steadily widening gap between our actual money and gold, the governments of the free world, led by the United States, have fostered the fiction that gold is the basis of our currencies because it is used by central banks at an artificially fixed price to settle international balances.

(3) Since gold is used to settle international balances and therefore as a measure of reserves behind central bank issue, its quantity has retained a psychological importance. In recent years total free world central bank and government holdings of gold (including those of the Fund), now aggregating some $41 billion, have increased at an average rate of under 2 percent. An annual increase of 2 percent or less is considerably under the rate of increase of the money and credit needs of the world's economies.

(4) Because the fiction is maintained that the basis of our money is gold, because the United States guarantees a bottom price of $35 an ounce, and because the quantity of gold is rising too slowly in relation to money and credit needs, an apparent scarcity has arisen. Out of this situation have come the arguments for and the speculation on a higher gold price, causing questions about the position of the dollar and other leading currencies separate and apart from the truly basic questions of purchasing power and balance of payments.

(5) An increased gold price would damage confidence, help the Communist bloc, and contribute nothing of any permanence to world monetary stability and liquidity.

Because our policies foster an artificially stimulated speculative demand for gold—and I think this will recur again—we are likely to be faced within the next few years with either an increase in the price of gold or the development of new policies. I believe that the weight of the argument strongly favors new policies.

The principal ingredients of effective new policies include:

(1) Elimination of the 25-percent gold reserve requirement. We are the only country with such a requirement. And there is little real meaning in a reserve that neither is available to most holders of dollars nor bears any relationship except coincidental to our money and credit needs.

(2) Continued unrestricted paying out of gold to central banks on demand. An embargo on gold sales or any other new restrictions should be avoided at all costs. Restrictions are difficult to enforce, stimulate the demand one is trying to quiet, and lead to de facto devaluation in free markets.

Representative REUSS. May I interrupt you at that point, Mr. Goodrich?

Mr. GOODRICH. Certainly.

Representative REUSS. When you talk about restrictions being difficult to enforce, you mean restrictions on paying gold to the central banks or restrictions on paying gold to private persons?

Mr. GOODRICH. I am not thoroughly in sympathy with the policy of preventing private individuals from owning gold abroad. I did not make an issue of this, but, basically, I am thinking in terms of the gold embargo and restriction against shipping gold to foreign central banks in order to preserve our own gold holdings, with the view that, therefore, we somehow would maintain our gold holdings intact and, therefore, be in a stronger position.

Meanwhile, any such policy, if there were demand for gold, obviously would lead to a depression in the value of the dollar, the exchange value of the dollar, in relation to other currencies. So the practical restriction we are talking about is it would be an embargo and refusal to ship gold to central banks.

Representative REUSS. Thank you.

Mr. GOODRICH (continuing). (3) The United States should put the IMF in a position to accept from member countries, when mutually approved by the Fund and the U.S. Treasury, dollar deposits carrying a gold price guarantee and bearing a flexible rate of interest suited to the prevailing circumstances. If we will properly understand two essential points, (*a*) the position of gold as an artificially overvalued metal and (*b*) the necessity to our total national success and survival of achieving a dollar sound in the true sense of purchasing power stability. If we will properly understand these points, we will not hesitate to provide the Fund with gold price guarantees as needed to stabilize officially held dollar balances. The discussion on the Fund to follow will further outline this proposal.

(4) The introduction of a new national position on gold:

(*a*) We should recognize that in today's economic and monetary world the dollar lends more value to gold than does gold to the dollar. The holding of gold from the late 1930's to date has protected no one from the loss by the dollar of over 50 percent of its purchasing power. Gold at $1 per one-thirty-fifth ounce lost its value in equal steps with the dollar because its nominal value was a great overstatement of any real value. Gold today, exclusive of monetary demands by Government and private hoarding encouraged by the bottom price guaranteed by Government, is surely still substantially inflated in price relative to its nonmonetary value.

(*b*) We should assure the world in unequivocal terms that we are quite willing to sell all the gold we possess at $35 an ounce and consider it an excellent bargain.

(*c*) We should further take the position that, while we are willing to go along for a time with a $35 an ounce buying price for gold in the interests of world currency stability and liquidity, we will never raise the price and, if any serious pressure were to develop in the future to increase the price, we would feel free and be inclined to withdraw our future buying. Since the nonmonetary or nonhoarding uses of gold are small in relation to new supplies—to say nothing of hoarded old supplies—this policy would strike a major blow at the speculative urge, both governmental, and private, to buy gold. We should expect the price of demonetized gold—if we were forced to this—to act no better than did demonetized silver after the 1870's with a drop in price to under half of previously supported levels. While I do not suggest that we now liquidate gold as a basic foreign exchange reserve, we should hold that eventuality over the heads of governmental and private speculators who might be brash enough to threaten to corner this market which we have been guaranteeing for the monetary convenience of the world.

Such new policies would permit the United States and the free world gradually to reduce their reliance on gold as a basic exchange reserve. Under these policies, international monetary stability would not be subject to the amounts of newly mined gold or Russian sales or private hoardings. Since we can in any case be quite sure that restricted supplies of gold will not prevent our Government from taking steps to maintain full employment and to forestall deflation, it will be well to reduce the unsettling influences of the gold price question. Since gold is in inadequate supply to serve as the world's money but in large surplus relative to nonmonetary demands, sensible future policy will favor lessening our dependence on it rather than considering a new increase in its price to artificially increase its supply. The policy of price increase, official or de facto, would damage confidence, help the Communists and contribute nothing of any permanence to world monetary stability and liquidity.

It may be objected that lessening our reliance on gold will remove an important monetary discipline. This view rests on a misunderstanding of our situation and policies as they have developed during the past 30 years. The only true discipline today to our currency lies in (*a*) our external balance of payments, which is a basic discipline with or without gold as long as we desire convertibility and the maintenance of the value of the dollar in terms of other currencies, and (*b*) the desire of the citizenry for a stable purchasing power of the dollar. These are now our only basic monetary disciplines—they have not actually worked—and they will remain with the considerable force they exert regardless of our policy on gold.

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IV. INTERNATIONAL MONETARY FUND

Before commenting on proposals to widen the role of the IMF, I will touch briefly on the background:

(1) The Fund's resources and methods are adequate to meet limited objectives: the support of a majority of member currencies through serious but temporary emergencies; and the providing of helpful but limited assistance to the principal reserve currencies, the dollar and sterling. However, the Fund as it now functions could not deal with major withdrawals from the dollar or sterling.

(2) We are particularly concerned, as we look ahead, with the indications that the Fund's assistance in a dollar crisis would be, despite the U.S. quota and presumed drawing rights of over $4 billion, inadequate to the potential scale of the problem. During the past 25 years the dollar has become the world's major reserve currency. As such it has also become the key currency in terms of which other values are measured. Since World War II the free world's major financial problems have been met in large part by the channeling of U.S. resources through the dollar, while the Fund has provided the machinery for more temporary rough spots. While sterling also has a major role and while other reserve currencies such as the D-mark are appearing, the dollar's role will remain the central one just as the U.S. economic, political and military roles remain central to the free world's problems. A major gain would therefore be achieved for international monetary stability if the Fund were able to provide material additional strength to the dollar.

(3) The present institutional problem of the Fund appears to be basically as follows: can the Fund's ability to extend credit be enlarged substantially without giving it central banking powers which sovereign governments will not yet permit.

(4) A free world central bank—conceivably a world central bank at some future time—is a desirable long-term goal. However, it assumes a world of joined economies and convertibility at permanently fixed exchange rates for at least the major countries. A central bank's full functions would give the Fund great power over individual economies and currencies including wide power to determine how far the strong should subsidize the weak. This amount of power is considerably beyond that which major governments are yet willing to give to a central organization controlling a vital area of government. The Fund should have a wider scope and influence, but not in that degree.

With these points in mind, I will comment briefly on the Triffin plan, the Bernstein plan and a sketch of my own thoughts.

(1) I do not favor the comprehensive plan proposed by Professor Triffin. My basic disagreement is this: I favor strengthening the prevailing reserve currency system; Professor Triffin would liquidate the reserve currency system and substitute a free world central banking system. In my opinion, the major points against Professor Triffin's plan are as follows: (*a*) It would jeopardize the international liquidity now provided by the reserve currencies. (*b*) It would give the Fund powers that will be more consistent for a world of common governments, common economies, and common currencies. (*c*) In Professor Triffin's efforts to deal with the objections to excessive powers for the Fund, his plan would impose restrictions which are

complicated and would further weaken its chances of success. (*d*) The international liquidity provided by the reserve currencies and by the Fund's present functions can much more simply and surely be strengthened by a limited but significant expansion of the Fund's ability to lend strong currencies to the weak (as in the Bernstein plan) and by utilizing the Fund to assure major support to the dollar as the key reserve currency (as in Professor Triffin's own first-step proposal for the acceptance by the Fund of voluntary reserve deposits from members).

(2) I favor Mr. Bernstein's proposals which maintain the reserve currency system and provide additional access to available reserves by countries needing them. The provision for 100 percent automatic access to quotas would have the effect of adding each member's Fund quota to its monetary reserves. The issue of Fund obligations on standby arrangements with the great trading countries would effectively add to the free world's liquid resources: there is no essential difference between adding to aggregate reserves held by all countries and the ability to borrow the reserves from the accumulating countries to lend to the deficit countries. (Liquidity lies not in the aggregate of balances held. It lies in confidence in the purchasing power of these balances and in their availability to worthy borrowers. When depositors have confidence in the banker and the banker has confidence in worthy borrowers, the community has liquidity.) Furthermore, in a very real sense the Bernstein plan would add to aggregate reserves since Fund obligations would become part of the reserves of the lending countries.

(3) While Mr. Bernstein's plan is sound, it does not provide sufficient support for the reserve currencies. I therefore propose a program incorporating the Bernstein proposals and also the provision stated above in the discussion on gold as follows: the United States should put the IMF in a position to accept from member countries—when mutually approved by the Fund and our Treasury—dollar deposits carrying a gold price guarantee and bearing a flexible rate of interest suited to the prevailing circumstances. (If the United Kingdom should determine to offer a similar gold price guarantee to the Fund, sterling deposits also would be accepted.)

The great advantage to the dollar and to international financial liquidity of such a provision for guaranteed deposits lies in the following points: (*a*) Interest bearing dollar deposits carrying a Fund gold price guarantee would be more attractive than gold metal and would divert future dollar withdrawals. (*b*) By providing for approval by the Fund and U.S. Treasury of the acceptance of such deposits, the amount of interest paid and the amount of dollars carrying a gold price guarantee could be controlled. (*c*) By providing for these approvals, the rate of interest required at any given time on Fund dollar deposits could be determined by consultation, approaching the vanishing point if member countries were to swamp our Treasury with gold and the Fund with deposits and moving to high rates if needed to forestall excessive conversion of dollars to gold.

The proposed expansion of the Fund's functions would both provide for additional international liquidity and lend vital strength to the reserve currency system. If supplemented by policies curtailing future reliance on gold and by internal policies resulting in a dollar of stable purchasing power, you would assure as far as it is now possible the future position of the dollar and the maintenance of successful international financial arrangements.

V. CONFIDENCE, A STABLE DOLLAR, AND A STRONG ECONOMY

The achievement of successful international financial arrangements will depend most of all on confidence in a strong dollar of stable purchasing power. The importance of a stable dollar is equally great whether judged by our need for stable exchange in dealing with the world or by the need of the free world for an anchor to provide strength and liquidity to foreign exchange holdings.

A strong dollar will be supported by well-considered international financial arrangements. However, most of all a strong dollar depends on our own internal economic policies. Therefore, my comments would be incomplete without touching on the major requirements for a strong dollar and a strong economy, for the one has become dependent on the other.

(1) Rising costs and prices reduce the competitive ability of our goods and services, reduce employment, and prevent us—even with our fairly good level of exports—from earning sufficient exchange for doing all we need to do internationally for survival and progress.

(2) Rising costs and prices force many of our citizens out of the market as buyers of other people's goods and services and thus hold back effective demand and reduce employment.

(3) Rising costs and prices have magnified the total amount of borrowing—increasing the disparity of financial strength between borrowers and lenders—and will thus restrain the future ability of the borrowing groups to maintain purchasing power.

(4) Federal budget policies—including the acceptance of moderate deficit when the economy has been in a phase of depressed activity—have been exaggerated by conservatives and liberals alike as an inflationary factor of the past 10 years. Federal surpluses and deficits have been modest during this period relative to private debt increases averaging close to $40 billion annually. Government borrowing when the private economy and private borrowing are in a slump is an inevitable and necessary antideflation force in any economy in which governmental use of goods and services has become significant. Failure to recognize this has kept our Government—whether conservative or liberal—from adopting desirable tax reduction needed to foster economic and employment growth.

(5) While large Government spending for national defenses and other vital national objectives is necessary, decisions on nonessential Government spending should recognize the following principle: reduction of today's excessive income taxes will be, dollar for dollar, a far more effective economic stimulus than additional Government spending. Tax reduction should be a major national goal as long as productive and human resources are not being used at capacity.

(6) The principal cause of the inflationary trend, of the price increases of the last 10 years, has not been fiscal looseness. It has been monopoly. Although some business price fixing has taken place—but within an overall contraction of profit margins—the great monopoly of our times is that of the labor unions, fostered by laws which give the unions unprecedented monopoly power. Gentlemen,

if you do not curb this monopoly, you will not achieve a sound dollar; you will ultimately fail in your international financial arrangements no matter how well conceived; you will not find full employment within a free economy; and you will not develop the full economic strength we need to deal with our world problems.

(7) While there has generally been a conservative element in the Government's dealing with budget policies, particularly in the matter of tax reduction, both the executive and legislative branches have largely failed to understand the need for a strong central banking policy. Full use of our resources is an essential of our times. But the belief that easy money under almost all conditions fosters such a full use is a misconception. It is essential for the operation of a free economy with a stable dollar that interest rates be permitted to rise and fall as the central part of the stabilizing mechanism between the demand for investment funds and the supply of savings. A free economy—in fact, any economy short of a completely planned, repressive dictatorship—can no more control interest rates than a householder desiring to keep his home at a level temperature during winter can control the amount of fuel consumed. Interest rates, like the fuel for the house, are the stabilizing mechanism that must rise and fall with the climate—with supply and demand—if our economic objectives are to be attained.

(8) If monetary ease and lower interest rates are desired as accompaniments of liquidity, use the indirect and effective methods rather than the direct and ineffective. Achieve substantial confidence in the dollar, reduce annual wage increases to no more than productivity gains by reducing labor's monopoly power, and encourage maximum production by all available means. Such policies would result in stable prices, a sound dollar, a growing economy—and lower interest rates.

(9) The President's call for sacrifice is a clear recognition that demands on our resources will exceed their availability. Let us then not expect to solve the problem of the 1960's by embellishing the economic improvisations of the 1930's. The problem then was to find ways to use human resources. The problem today is to find the technical and human resources to meet our international and domestic objectives.

(10) We conclude: Encourage full use of our economic potential; let the Government spend what is needed for vital national goals but not for the purpose of stimulating the economy; reduce taxes as the solution to lagging personal and business demands; restrain all monopoly, and in particular the monopoly of union labor; permit the interest rate mechanism to operate effectively; and strengthen our international financial arrangements. Do these things to encourage the full development and use of our human resources and thus to achieve a sound dollar and growing economy.

CONCLUSION

To strengthen international financial arrangements, these points seem to me the most important:

(1) Strengthen the dollar at home.
(2) Avoid restrictive measures in international dealings.
(3) **Recognize fully the importance of the dollar as the key reserve currency.**

(4) Reduce the reliance on gold.

(5) Expand the functions of the IMF within the framework of the reserve currency system.

(6) Strengthen the U.S. economy by achieving a stable price level, by reducing incentive-destroying taxes, by supporting a strong monetary policy, and, above all, by encouraging creativity and hard work.

Representative REUSS. Thank you very much, Mr. Goodrich. This is a superb statement you have just made, and I am going to ask Senator Pell to open the questioning on it.

Senator Pell?

Senator PELL. Thank you, sir.

I am particularly pleased to welcome Mr. Goodrich here because I know him and the institution for which he works and I have great respect for the wisdom of both.

There are a couple of queries I want to ask you and one is where you discuss the Bernstein proposal, you mention there how you would beef it up.

The gold price guarantee, would that be a guarantee by one government, by the IMF as a whole, or by whom?

Mr. GOODRICH. It would be a guarantee by the International Monetary Fund to the depositing country, but it would have to be backed by a guarantee by our Government, by our Treasury, to the International Monetary Fund.

That is what I mean in part by saying we must put the Monetary Fund in a position to accept these deposits. It has been proposed from time to time, when our dollar has been under attack, that we offer a gold price guarantee to foreign central bank deposits, for example.

Rather than do this directly, do it through the Monetary Fund, to do it only as it is necessary to do it, I think is a proper procedure.

Senator PELL. Then you refer to a flexible rate of interest. Is your thought there that the rate should be set for the length of time the money is on deposit or that the Board of the IMF could change the rate of interest, as circumstances dictate?

Mr. GOODRICH. That it could change the rate of interest. I did not spell it out, but, possibly, on 30 days' notice, or something of that kind, but it would be a flexible rate of interest both for existing deposits and any new deposits, possibly approaching, as I say, the vanishing point, if such deposits are not wanted; and, of course, you can see the U.S. Treasury has a veto power, if we are talking about dollar deposits; the United Kingdom would have a veto, if we are talking about sterling deposits.

Senator PELL. You bring up the fact that private increases average close to $40 billion annually. What is that total private debt? I should know that, but I do not. What is it, roughly?

Mr. GOODRICH. The total figure today is approaching $600 billion.

Senator PELL. In other words, about twice the national debt, more than twice the national debt?

Mr. GOODRICH. It is more than twice the national debt.

Senator PELL. And has that relationship remained static or, if it has changed, how has it changed over the past 10 years?

Mr. GOODRICH. In the last 10 years the Federal debt has not risen a great deal. It has risen modestly. The private debt has increased, as you can see, very substantially. In the last 10 years, I do not know the exact figures, but it has certainly doubled, I think somewhat more than doubled, in the last 10 years.

Senator PELL. The private debt?

Mr. GOODRICH. The private debt.

And the Federal debt in that same period may be up 5 or 7 percent, something of that kind, but not very much. Of course, in the previous 10 years, World War II was the great period for Federal debt expansion. Post-World War II was the great period for private debt expansion.

Senator PELL. To my mind, it is a simple point, but it is a novel point that has not been brought out in the discussion, as yet.

In connection with your deemphasis on gold as the medium of exchange, is your thinking solely from the financial viewpoint or also from the political viewpoint in the sense that the present supply of gold is subject to pressures over which we have no control?

In other words, it is produced in the Soviet Union and the Union of South Africa. Hence, it could lead in the future to "dumping," over which you would have no supervision. I was wondering if your recommendations were based on that fact or on the inadvisability of gold as the sole medium from an economic point of view.

Mr. GOODRICH. My view is basically an economic and financial one. It is a controversial subject, I well recognize, but I personally do not believe that gold serves a very good purpose as money, and that it is on its way out in the 100-year sense of the term.

It so happens that the illogicalness of the use of gold, in my mind, is enhanced by the fact that it happens to help in a major way one country with whom we are not at all friendly, another one about which we do not happen to care very much one way or the other.

But those really are side issues.

Senator PELL. I agree with you 100 percent in your views on that, as you know. I was also struck by the fact that both you and Mr. Rockefeller yesterday, recommended the withdrawal of the 25-percent gold requirement on the part of the Federal Reserve Bank.

Do you think that these views are yours as individuals, or do they reflect the views, in your mind, of many of your colleagues on the street?

Mr. GOODRICH. I would not want to make too good a guess on that. I think I would guess that probably there would be more opposed than in favor, but there is a diversity of views on the subject.

Senator PELL. But there would be a respectable segment of the community——

Mr. GOODRICH. As far as the 25 percent, I think there would be a very respectable segment; as far as going further along the lines which I mention, obviously, a much smaller group; but, of course, it is a controversial subject.

There are a relative few who are taking a strong stand one way or the other. I think gold, the natural desire to use it as a crutch, as long as we do not have confidence in our money anyway, if we somehow lack confidence that we can arrange for a stable purchasing power of our money, if the world doubts whether it can rely on the dollar or in the International Monetary Fund based on the dollar, sterling, and one or two others, if they lack this confidence, gold, at least, has some value. So it is always there as a crutch.

But it is not in my view much more than a rather poor crutch, although, granted, it is better than worthless paper. But that is not saying a great deal.

I think we can expect in the future—and I certainly hope we can—much more than that for the U.S. dollar, properly managed.

Senator PELL. I congratulate you, sir, on your courageous, original, and provocative statement, and also, I find myself in general agreement with your ideas and hope that my colleagues may share those views.

Thank you very much.

Representative REUSS. I have a couple of points.

In your statement, Mr. Goodrich, you seem to be saying that monetary authorities have absolutely no effect upon interest rates. I am sure that you do not actually say that and mean that.

You would agree, for example, that the failure to create a domestic monetary supply sufficient for the needs of the Nation would cause interest rates to be higher than they otherwise would be.

Would you not agree with that statement?

Mr. GOODRICH. I think I perhaps express myself in too flat terms here without one or two modifying words I might have used.

However, I really do mean that I do not believe that over a period of time—and that period of time might be as long as 2 or 3 years—but I do not think any longer than that—that over a period of time, I do not believe that a central bank or the Government, unless it had powers of a dictator, can control the level of interest rates, particularly longer rates, but I think it is also true eventually of shorter rates.

I think in the example that you spoke of, of the failure to provide sufficient—you spoke of an example of failure to provide for enough additional money supply.

Representative REUSS. Yes; reserve bank credit.

Mr. GOODRICH. This is a complex subject. No. 1, money supply is not just the action of the central bank.

Representative REUSS. It depends on the willingness of borrowers to borrow.

Mr. GOODRICH. Of borrowers to borrow and also how eager banks are to extend their resources, granting that the central bank has an influence on it.

Representative REUSS. I do not want to overcomplicate this, since it is not a central point, or to spend too much time on it, but would you not agree that if the central bank fails over a period of years in which there are otherwise expansionary forces at work in the economy to make additions to the money supply, to create reserves to bring about a reserve situation where businessmen, if they wanted, can get a loan, that this will cause the interest rate to be higher than if the central monetary authority did create increases in the money supply?

Mr. GOODRICH. I believe that the central bank has an influence for a time, a relatively short period of time, particularly on short rates. There is no question that if they pursue a restrictive policy on bank reserves, and there is demand for borrowing, that your bank rate will tend to rise. However, I make a couple of points.

No. 1, a central bank has to pursue a pretty restrictive policy for the volume of savings of the community not to continue to flow into investments. There is at any given time a volume of savings seeking investments; there is a volume of investment seeking savings. One tends to flow into the other, and the central banking and banking mechanism—"marginal" may not be quite the right word, but it is only a fairly important marginal situation.

Second, if, through truly restrictive policies, there were to be both a short rise in the bank rate, the short rate, and an inadequate supply of funds, it would have an effect upon the economy, and I have an idea that in the long run it would have the reverse effect on interest rates.

Representative REUSS. It might bring about a depression. Nobody would want to borrow money.

Mr. GOODRICH. That is right.

Representative REUSS. And interest rates would be low?

Mr. GOODRICH. Exactly.

And in the same way, I think, an overly easy policy would tend to defeat itself again by having an inflationary impact for various reasons, by encouraging borrowing and by discouraging lending.

So I think both eventually, while it has a short-term effect in the direct line of intention, particularly on short rates as against long rates, I think eventually, if anything, it would have a reverse effect.

Representative REUSS. I am glad we had an opportunity to spend a little time on this, because I was sure you did not mean that nothing that the central banking authorities did had any effect, long or short, on interest rates.

Mr. GOODRICH. No; I did not mean that. I meant, basically, they could not control it, but with "control" underlined.

Representative REUSS. Let me turn to your very interesting point on the gold guarantee.

I take it you mean that this country, acting in conjunction with the International Monetary Fund, should guarantee to creditors of this country that if we should devalue the dollar, we would make up to them the difference between the old value and the new value in dollars?

Mr. GOODRICH. I think this would be a sound step. As I said before, it has been proposed that we do this when we were under pressure. I do not think it should be done just in a broad way. But if there were the outflow, and if the Monetary Fund could do this, with out backing, both our Treasury's approval and backing, in the form both of the gold guarantee and in the form of the interest rate that would be used to attract such funds, I think any outflow of central banking dollars, which, otherwise, would go to gold, would tend to go into these deposits.

Representative REUSS. There should really be no outflow whatever, if you have a workable gold guarantee.

Mr. GOODRICH. There would be no outflow of gold, but the dollars would be withdrawn, not to put into gold, but would be withdrawn to deposit with the Monetary Fund, and so there would be no outflow of gold.

Simply a transfer of, say, United Kingdom's holding of dollars would be transferred to the Monetary Fund, and the United Kingdom would hold the Monetary Fund obligation, in terms of dollars, while the Monetary Fund would hold the dollars that the United Kingdom previously had held.

Representative REUSS. Let me next address myself to the point you made, where you say:

> We should assure the world in unequivocal terms that we are quite willing to sell all the gold we possess at $35 an ounce and consider it an excellent bargain.

Let us suppose the world takes us up on that and says:

> Fine, we are glad to know that the United States does not consider the loss of its gold an unhappy thing. Therefore, we, the central banks of Belgium, Germany, Italy, France, and the United Kingdom feel perfectly free to call for gold in return for our $10 billion or so of short-term dollar deposits owned by foreign central banks.

And suppose they then did draw our gold. Let us also assume that we repeal the 25-percent gold cover, and that enough private holders of dollar accounts, both American and foreign, got their money out of the United States so that there was a total of about $18 billion worth of demand for gold.

So our $18 billion of gold would have a different tag on it in the Federal Reserve Bank in New York. It would say this gold now belongs to 20 other countries, and we in the United States have no gold left and can no longer redeem dollar obligations in gold.

I do not suggest this model to raise any horrors. Perhaps this could happen and the dollar would remain strong and the basic strength of our economy would depend upon the series of factors which you list.

But how about it?

Suppose our cheery willingness was accepted at its face value?

Mr. GOODRICH. The horrors, I am sure, would be psychological, newspaper headlines, political, all kinds of things. But, in pure economic terms, I do not think there would be so many horrors.

If this extreme were to occur, we would be relieved of $18 billion of claims that previously had existed upon us. Now, we would also have $18 billion less gold. As long as we agreed to buy the gold back at $35, of course, we simply would have exchanged paper claims on us for what we recognize to be gold claims on us.

If by some chance we should do the world a dirty trick and refuse to buy the gold back, we might even conceivably have saved ourselves $18 billion, less whatever gold is worth, and it is worth something.

As far as where we went on from there, the international exchange value of the dollar would depend upon the balance of payments and its purchasing power, and I do not think it would be in any worse case than it is now.

In fact, although I cannot imagine the situation actually developing, I think you could argue that we would be better off, because we would have relieved ourselves of many liabilities because of the foolish desire of everybody else to exchange them for gold.

Representative REUSS. You suggest that the world would not come to an end if we were to say that we are not going to forever buy gold at $35 an ounce. Your suggestion is one that certainly requires serious consideration. It would take some of the bloom off speculation, if speculators knew that they did not have a $35 floor under gold and that we might someday refrain from buying.

What steps could we take in the direction of a workable arrangement?

Mr. GOODRICH. This involves many complications, of course, but I think it would be somewhat along these lines: To begin with, it would be essential for the monetary stability of the world, the free world, that some arrangement be made, assuming that we had adopted these policies and the rest of the world recognized that we are all moving in a new direction, it would be essential to make arrangements for taking the gold officially held by the countries that we felt should be given consideration, that we take this gold off their hands. It would probably be done through the Monetary Fund, and then the burden of financing the Monetary Fund's purchase of gold could well devolve heavily upon this country, but it could be partly this country, partly the other major members of the Monetary Fund.

Having done this, how would the world measure its monetary unit in the future?

Supposing there were an International Monetary Fund monetary unit. Supposing it were equal to $1. How would it measure it in the future? Obviously, the countries of the world, the members of the Monetary Fund, want some assurance that however they think of their basic exchange reserves, they would be protected against a major loss of purchasing power, a devaluation of the major currency which is propping up this unit.

One possibility is using the dollar as the center, but assuring the Monetary Fund and its members against any substantial loss of purchasing power. I can imagine measures to work that out, not minor variations, but substantial variations.

There is the feeling today that if the dollar were to become worth, say, 30 percent of what it is today, that gold at least would afford some protection and it is a probably justifiable view.

It would not be justifiable as an important view if they could be sure of the purchasing power of the dollar even within reason.

Another approach is to make the Monetary Fund unit a function of the leading, say, the half dozen leading currencies that make it up. One would, therefore, be assured against any independent devaluation of, say, one leading currency like the dollar. One could draw up quite a few different proposals.

I think the world will actually work toward them gradually.

Representative REUSS. Mr. Despres, Mr. Tarshis, Mr. Salant?

Mr. DESPRES. I have a question about the gold guarantee. As I understand it, you do not favor the Triffin plan. You do favor the Bernstein plan substantially, with the addition of the gold-guaranteed-dollar-deposit arrangement through the Monetary Fund.

As you doubtless know, the proposal for a gold guarantee, which is one of the implied features of the Triffin plan, since the plan has its own unit of account defined in terms of gold, is one of the major sources of objection to the Triffin plan.

I would like to enumerate some of these objections in order to obtain your reaction. One is that to extend the gold guarantee, it has been said, would be a confession of defeat; the fact that we had to provide a gold guarantee in order to bolster confidence is, as it were, a confession of weakness.

Second, it has been suggested that the gold guarantee might not be effective. We used to have a gold guarantee in the gold clauses in Government and private bond obligations, and when the chips were down, this was declared to be unenforceable.

Therefore, a gold guarantee would not be credited.

The third objection that is made is that the gold guarantee would extend not merely to new funds, but that the existing official dollar balance, which foreign monetary authorities are now satisfied to hold here without gold guarantee, would be transferred to the gold-guarantee category, and, thus, the U.S. Government would be assuming obligations, extending guarantees, which were unnecessary in order to keep the funds here.

I cite these points simply to envoke your reaction to each of them.

Mr. GOODRICH. As you will see from my proposal, it is one that would be flexible and under the control of our Treasury, and, therefore, it would not be given except when it was deemed wise to give it, when there was a need to give it. I would think payment of interest on normal dollar deposits without a gold guarantee should be adequate under most circumstances to keep the dollars here.

My desire is to maintain the present system of holding dollar reserves here, but to afford a backstop in case what they can earn here is not a sufficient attraction to keep it from being transferred to gold.

If central banks then desire to go to gold, if they can, instead, at that point go to the Fund to deposit these dollars, and if the U.S. Treasury, along with the Fund, recognizing that it has now lost, we will assume, quite a lot of gold—in all probability the Treasury will not be disposed to give the gold guarantee except in an emergency—but if in an emergency it is in a position to give this guarantee through the Fund, and, also, at a rate of interest which is deemed to be necessary to attract to the Fund, it would then be in a position to surmount what I would expect would only be a temporary emergency.

One more thing. If any scheme, including this one, is not dealing with a dollar of fairly stable purchasing power, it will fail.

Mr. DESPRES. The other question I wanted to ask you is this:

The existing system of gold parities for national currencies can be described as a system of quasi-fixed parity; that is, under the Bretton Woods Agreement the possibility of occasional devaluation and upward valuation is always present, and the movements of hot money, the speculative movements of hot money, in recent years have been largely a result of the anticipation of devaluation and upward revaluation of one currency or another. Do you think that it is an essential feature of a workable world monetary system that this scope for devaluation, upward revaluation, should be allowed, or do you think we ought to move toward a system of truly fixed gold values?

Mr. GOODRICH. I do not believe it is practical at this stage to move toward completely fixed parities. Then I think we would be closer to adopting a central banking system. We would be closer to assuming almost joint economies, because each country today insists, and will insist, on operating, managing, to a degree, its internal economies.

If other countries are pulling in the direction that it does not approve of, this eventually will lead one or the other to a change in exchange rates.

This is what makes our problem a difficult one. If we could have fixed exchange rates, and knew that each country would abide by the internal economic rules that would make this possible, we would be a lot further toward joint economies and toward international monetary—toward an international monetary system.

Mr. DESPRES. If the existing liquidity arrangements were enlarged so that temporary surpluses and deficits in the basic balance of payments of somewhat larger magnitude than are now possible could be financed, do you think it would be too much to hope that through coordination of national fiscal and monetary policies that long-run equilibrium in balances of payments could be maintained at fixed exchange rates?

Mr. GOODRICH. You are assuming a coordination of monetary and fiscal policy, and I do not think we can yet assume that. I look forward to the time when we can do that, but I do not think we can assume that governments are going to pursue common fiscal and monetary policies; policies that have roughly the same effect upon their costs and their price level over a period of, say, 5, 10, or 15 years.

Therefore, I think we have to achieve international liquidity and provide for these temporary movements, but without hoping that we have yet achieved fixed exchange rates.

Mr. TARSHIS. May I ask a question about the use of the dollar as the reserve currency.

I gather from your remarks that you think we might be the gainer, were we to make our gold available in return for the dollar balances that are now outstanding; that the use of the dollar as a reserve currency does not contribute to the functioning of New York as a financial market and as a world trade center.

Would that be a proper inference?

Mr. GOODRICH. No, I think that is going too far. I think having the dollar used as a reserve currency is a necessary thing for the free world today, and I think it is beneficial to this country.

My comment was in reference to the rather extreme possibility that they would want to convert all those dollars to gold and my comment, which was only part of the picture, was, well, we would have lost all of those liabilities anyway; obviously that was only part of it.

I cannot imagine why all the gold would be withdrawn, unless it were—and I think this is the basic reason people do it, central banks or others do withdraw it—on the idea that next year or the year after we will sell it all back to them at $50 an ounce, or whatever the price. A much simpler thing would be to ask for a handout to begin with.

But I cannot imagine that it would work out that these reserve dollars disappear. I do not think it would be desirable, and I do not propose the gold guarantee either with the desire of having the dollars flow rapidly to the central bank and the dollar reserve system, therefore, be nullified.

But I do think that the International Monetary Fund should be strengthened and gradually take over additional functions, supporting and strengthening the reserve currency system, and I think we will evolve—I think we could evolve, put it this way—over a 25- or 30-year period—maybe that is not the right period—toward a true central bank, but I think it should be done step by step.

It was pointed out, this one additional proposal to the Bernstein plan of gold-guarantee deposits by the Monetary Fund is a step proposed by Professor Triffin, but it is the only basic step of his that I would take.

I would consider it as a first step, something we would consider as a practical one today; in a practical political sense, I do not know; but it would not involve any great, basic change in the Monetary Fund rules.

It would require legislation, as I understand it, of the United States.

Mr. TARSHIS. Do you think we would be very much the loser in terms of our international credit role, for example, and trade role, were these liabilities internationalized, were the dollar no longer to serve as the chief reserve currency?

Mr. GOODRICH. I think we would be the loser on any drastic quick change.

Mr. TARSHIS. It is the quickness then, the difficulty in developing a substitute quickly, that would create the problem, is it?

Mr. GOODRICH. I think that would be a great deal of it. I would assume that in a world of the future there would be many more of the dollars or funds held through the Monetary Fund.

Of course, the Monetary Fund would, in turn, hold dollars very importantly along with other currencies. I assume, also, that there would still be a large volume of dollars directly held because they were dollars held privately in large part and dollars which are about to be used or might be used in subsequent months to come for trade or other financial purposes.

So I do not think the dollar reserves would disappear at all, but I can see the increase being more via the Monetary Fund than by the directly held dollars.

I doubt there would be any diminishing under the kind of ideas that I have in mind, but it would not be the sole prop over and above gold that it has been in recent years.

Mr. SALANT. To clarify the last point, do I understand correctly that it is your thought that in the normal course of events foreign central banks and governments would hold dollar reserves as they do now and the proposed gold-guarantee deposits with the Fund would provide a resort, alternative to withdrawal and conversion into gold, at such times as central banks might otherwise feel disposed to convert to gold? Then when confidence returned (assuming it was loss of confidence that caused the withdrawal) these deposits would be reconverted into direct dollar holdings? Is that the kind of thing you had in mind?

Mr. GOODRICH. Something like that. My view is that in all probability the growth within a few years after such a plan was adopted of the Fund-held dollars, as opposed to the directly held dollars, would probably not be rapid.

This depends on how we were managing our internal affairs, in large part.

It probably would not be rapid, but there would be a beginning, and that over the years many things would determine how rapidly this grew.

For example, if we began to trend toward the kind of world where the economies were much more in common, where one could have, for example, fixed exchange rates such as other gentlemen have suggested, then I think you would be in a world where the indirectly held reserves with the Monetary Fund would become much more important.

At the present time I think it would only be a backstop, a guarantee, and I would not think, again, assuming that we have a fairly stable purchasing power of the dollar, I doubt if it would grow a great deal in the course of, say, 4 or 5 years.

Yet, I can see it as the opening wedge for a central banking system.

Mr. DESPRES. In line with your attitudes about gold, I wonder what you would think about the following proposal which has been made occasionally in the past: namely, that central banks or governments of the free world agree to buy gold only from each other out of the monetary reserves that exist at the time that the scheme goes into effect?

This would leave gold as a unit of account for international settlements, but it would leave the newly mined gold to find its own level in the free market, without the support of official buying by any central bank, insulating the monetary reserves from the new additions to the supply of gold.

Mr. GOODRICH. I had not thought much about that proposal. I can imagine it, I think, as a transitional step. Of course, by the very taking of it one would be admitting that the gold that one was using, say, at $35 an ounce as the central banking reserve, with other gold not supported and dropping below that price, one would be admitting you were simply dealing at an artificial price, and you ought to be able to take the further intellectual step to cut that tie, but I can imagine it as a transitional step, but not as having achieved a logical system.

Representative REUSS. Do you have any further questions, Senator Pell?

Senator PELL. No, no further questions.

Representative REUSS. Thank you very much, Mr. Goodrich.

Mr. GOODRICH. Thank you, Mr. Reuss.

Representative REUSS. Thank you for a real contribution.

Without objection, there will be inserted in the record at this point the replies from invitations addressed by the subcommittee to certain economists in this country and abroad to submit their comments on the problem of international payments imbalances and the need for strengthening international financial arrangements. These experts could not be present at any of the committee's hearings but have kindly consented to give us their views in writing.

The hearings of the subcommittee are now completed, and we will stand adjourned, subject to the call of the Chair.

THE PROBLEM OF WORLD LIQUIDITY AND PAYMENTS

(A statement by Charles P. Kindleberger, professor of economics, Massachusetts Institute of Technology, on leave; Ford faculty research fellow, 1960–61; written for the Subcommittee on International Exchange and Payments, Joint Economic Committee, Congress of the United States)

Current analysis of the so-called problem of international world liquidity frequently confuses a number of separable issues: persistent balance-of-payments deficits; the effects of world depression on countries producing primary products; the hot-money problem which affects key currencies when foreign holders lose confidence in them; and the reserve positions of individual countries after they have reestablished balance-of-payments equilibrium. These problems are related, but they are far from identical. It is important, moreover, to insure that measures taken to meet one not exacerbate another.

Persistent balance-of-payments disequilibria are the most important problem, both deficits, such as those which have recently afflicted the United States and the United Kingdom, along with most underdeveloped countries, and surpluses. No system of international payments, past, present, or devised, is proof against large-scale persistent disequilibria. These disequilibria call for a wide variety of national measures. They will not be helped by the creation of an international money, or even by extended facilities for financing them. Both of these types of proposals, in fact, appear to subvert the national discipline needed to correct persistent balance-of-payments deficits and surpluses. It is, moreover, untrue that surpluses and deficits are needed in the world payments system to expand the liquidity base: stabilization loans are an entirely suitable method of enlarging the reserves of an individual country, and swaps of liabilities can create reserves of two or more countries simultaneously.

World depression in all industrial countries at the same time is a potential source of great stress for the world payments system, but happily not an actual one. In the postwar period, in fact, phases of prosperity and recession have been more or less unrelated in Europe and the United States. It would be improvident to take far-reaching steps now to meet a problem which remains hypothetical. It is more than likely, in any event, that the economic machinery of the free world, including national antidepression measures, coordinated internationally in the OECD in Paris, would be proof against a collapse of the 1929–32 extent if it threatened.

Hot money is the most serious current aspect of the liquidity problem. When the dollar was the only key currency which commanded respect, except for the reserve holdings of politically related areas, destabilizing speculation was relatively unimportant. International reserves in foreign exchange could be held only in dollars. As the dollar declined, and other currencies rose in strength, however, holders of reserves have an incentive to shift them from one currency to another, and by moving from the weak to the strong, to infuse instability into the system. The Triffin plan would counter this possibility by internationalizing foreign-exchange reserves, converting the International Monetary Fund from a source of national help in crisis to a repository of world reserves. This change would greatly enlarge the foreign exchange reserves in the world subject to a gold guarantee, which the International Monetary Fund gives to its creditors and claims from its debtors. The plan is ingenious and addressed to a real issue. It suffers, in my judgment, from (1) mixing the affairs of other countries with those of the key currencies: as a world institution, the International Monetary Fund cannot take steps to expand its support for the dollar, sterling, mark, and so forth without enlarging its financing for underdeveloped countries; and (2) requiring a worldwide legislative effort of great complexity and long duration, which would in itself upset confidence in the key currencies and might lead to runs. The Bernstein plan has the advantage of limiting the remedy to key currencies, and not undermining balance-of-payments discipline; it does, however, require new and formal obligations from a number of countries to meet problems of unknown scope.

My predilection is for continuing and extending the methods of key currency cooperation worked out in recent years, under which central banks of the key currencies have stabilized one another in the face of runs, by buying the currencies under attack as private speculators have sold them. One important step in this extension would be to involve the treasuries in the OECD in Paris, along with the central banks in Basle. Another would be for the Federal Reserve System to hold foreign exchange among its reserves, along with gold, so that any future hot money shift into dollars from a European currency would build up its assets, and foreign central bank liabilities, rather than run down foreign central bank assets and reduce liquidity. (Since the dollar has changed from being the only strong currency to one of a number such, it is entirely appropriate that the U.S. central bank function like other central banks, in holding foreign exchange as well as gold among its reserves.) European central banks did an effective job during the attack on sterling in March. It is reported in the press that they are uncomfortable holding unaccustomed currencies. Discomfort is preferable to spreading currency crises, and would be relieved if the responsibility was shared with political agencies such as national treasuries.

The further development of central bank and treasury cooperation among key currencies constitutes a pragamatic approach to the liquidity problem. I have a strong preference for building international institutions slowly and empirically as requirements emerge, rather than to create new organizations, or radically modify old, through constitution writing on a grand scale.

The level of reserves of individual countries is a problem which can be tackled separately for separate countries after progress has been made with persistent balance-of-payments problems, and in the case of key currencies, hot money. It would be futile, for example, to make more reserves available to underdeveloped countries today, while they have a strong tendency to convert any gross asset into fixed capital. As already mentioned, convenient and inexpensive means exist for adding to the reserves of individual countries, when the time is ripe.

Beyond these separate problems—one persistent, one hypothetical, one current, and one dependent on preliminary steps—I deny that there is a world liquidity problem. In particular, it sems to me misgiuded and dangerous to atempt to establish quantitative limits to an alleged lack of liquidity, or quantitative remedies, such as requiring an internation institution to pump in reserves at 3 or 5 percent a year. The quantity theory of money has no greater relevance to international than to national transactions. Means of economizing payments in transactions have taken place in both areas, and may be expected to continue. The need for reserves to counter speculative pressures varies inversely with confidence. With central bank cooperation, moreover, it is possible to create new international reserves as confidence declines, and to reduce them when it improves.

PARIS, FRANCE, June 10, 1961.

INTERNATIONAL MONETARY RESERVES

(By Brian Tew, University of Nottingham, University Park, Nottingham, England)

THE NEED FOR RESERVES

The role played in international trade and payments by official reserves of gold and key currencies is prima facie very similar to that played in a country's internal economy by bank notes and bank deposits. In both cases the need for a stock of the appropriate kinds of monetary assets derives basically from the imperfect synchronization between receipts and payments: Anyone with no "kitty" to fall back on runs the risk of insolvency at times when his payments are unusually large or receipts unusually small. Such a risk has to be faced even by a transactor whose receipts and payments are in long-run balance, since his creditors have no means of establishing ex ante that this balance will in due course be achieved ex post: moreover, they may not in any case be prepared to wait.

To this basic need for monetary assets has to be added, both in the internal and in the international contexts, a further demand for such assets for purposes of hoarding: some transactors value monetary assets as the best medium for holding a portion of their more or less permanent savings.

But though the demand for monetary assets arises for much the same reasons in the internal and the international economy, the devices by which this demand is satisfied display a very marked contrast. For if our present United Kingdom internal arrangements were to be assimilated to present-day international arrangements, our present banks would have to disappear from the scene, and our present money (whether notes or deposits) would have to be replaced in part by gold and in part by I O U's issued at will by several of our large industrial companies, say I.C.I. and Unilever. Moreover, not only would the quantity of such I O U's depend solely on the vagaries of the financial requirements of the companies in question, but the relative value (or exchange rate) between gold and the different companies' I O U's might well need to be varied from time to time.

PRESENT-DAY ARRANGEMENTS

A brief outline of present-day arrangements for international monetary reserves will, I believe, confirm the validity of the foregoing analogy. Under these arrangements, reserves are held almost exclusively in the form of gold and of the short-term I O U's of Britain and the United States. These two countries, the so-called key-currency countries, hold their own reserves almost exclusively in the form of gold, of which they currently hold about $21 billion: the rest of the non-Communist countries hold their reserves also partly in gold (about $17 billion) but partly also in sterling (about $7 billion) and in U.S. dollars (about $10 billion).

It is no part of my argument that these reserves are at the present time inadequate in total amount:[1] In the past the arrangements un-

[1] The International Monetary Fund study, "International Reserves and Liquidity," published August 1958, concluded that the total amount of reserves was at that time adequate.

der which reserves are created have in fact, shown great potentialities for expansion. However, at any rate since the First World War, this expansion has been achieved to only a small extent by virtue of the increase in the world's stock of monetary gold. Rather it has been due to—

(a) the withdrawal of gold previously in internal circulation.

(b) the appreciation of gold, resulting from the worldwide devaluations of the 1930's.

(c) the United Kingdom policy of financing her war effort in the Second World War by flooding the world with sterling.

(d) the emergence of the large deficit in the U.S. balance of payments in the latter half of the 1950's.

But can the present system be expected to display the same potentialities for expansion in the future as in the past? With the present and expected future production of gold in the non-Communist world, plus Russian gold sales, the maximum rate of expansion, given the present price of gold and given also the present gearing ratio (i.e., ratio of total reserves to the stock of monetary gold), can be no more than about 2 percent a year. Though any nice calculation is impossible, this must surely, in the long run, prove much too slow. If this were to be the future rate of expansion of reserves, the world would in due course, sooner or later, run into a liquidity crisis.

What we, therefore, now need to ask is whether the present gearing could be further increased. My answer to this question is "No"; the present system is already so unstable that in its present form it could not stand any further increase in gearing.

That the present system is highly unstable is hardly open to doubt. In the case of one of the two key currencies, the pound, we have had three major crises since the introduction of de facto convertibility in February 1955; namely, the crises of 1955, 1956, and 1957. A further crisis may be impending in 1961. The other key currency, the dollar, has hitherto been much more secure, but its position is deteriorating and it had its first crisis in 1960.

Thus far, however, the crises have been attributable mainly (or even wholly) to switches of unofficial, rather than of official, holdings of the key currencies. This introduces us to another important feature of the present system, namely, that the calculation of a gearing ratio based mainly on the composition of official reserves (above) greatly underestimates the size of the superstructure of paper money which rests on the gold foundation of $38 billion. For, in the first place, an important factor contributing to the instabiliy of the present system is the huge volume of national currencies held externally by nonofficial holders. These holdings comprise the working balances of bona fide traders, commercial banks, and other financial institutions, plus balances which must be regarded as constituting (at any rate potentially) hot money. A great deal of these nonresident balances (of both types) are held in the two key currencies—about $7 billion in dollars and nearly $4 billion in sterling.

But this is not the end of the story, since even resident balances may be a source of instability, as was shown by the shift of resident dollars into gold in 1960. Such shifts out of the home currency may be checked by exchange control, but exchange controls are liable to leak, and anyway, citizens of most countries are at present legally entitled to switch into gold and/or into one or more oversea currency.

U.S. residents, who have not since June 1, 1961, been permitted to switch into gold, can nevertheless still switch into any oversea currency. Even United Kingdom residents are legally free to switch into other sterling area currencies.

POSSIBLE FUTURE DEVELOPMENTS

Moreover, in addition to the present size of the paper superstructure which now rests on the $38 billion of monetary gold, there are two further grounds for anxiety about the future. The first of these is the possible further proliferation of competing reserve media; the second is the possible decline in the internal cohesion of the sterling area and other traditional monetary areas.

Before the First World War the operation of the gold standard was on the basis of two reserve media, gold and sterling, and there was at that time only one important international financial center, London. The interwar period, however, saw the rise of another reserve medium, the U.S. dollar, and another international financial center, New York. Thus we already have three international reserve media: gold, sterling, and dollars, and it is clearly a possibility that they will soon be joined by one or more of the currencies of the European Economic Community.

Such a proliferation of international reserve media would be bad enough even supposing that each of the different media had its own loyal clientele, comprising a clearly defined currency area. Unfortunately, however, we can have little confidence that such will be the case. In the case of the sterling area, some of its present members may well leave the area altogether, as Iraq did in June 1959, and though, like Iraq, they may well continue to hold a high proportion of their reserves in sterling, they will feel themselves, as Iraq now does, much freer to vary the composition of their reserves from time to time as they think fit. Moreover, many oversea holders of sterling are even today not members of the sterling area, and it may very well happen that countries outside the area will from time to time in the future choose to hold a substantial part of their reserves in the form of sterling. But if they do, clearly they will be under no obligation to remain loyal to sterling if ever they decide that their immediate interest could be better served by replacing their sterling by some other reserve currency or by gold.

If I may now turn from the sterling area to the dollar area, the cohesion of the latter has never been an objective of U.S. policy: the dollar area has never been more than a group of countries which have for the time being chosen to hold most or all of their reserves in the form of dollars. They have always felt free to replace their dollars by gold or by other reserve currencies, and this will presumably remain so in the future.

As regards the other currencies which may develop into major reserve currencies in the future, I cannot see that it is at all likely that their use will be confined to a loyal clientele. Thus, in the future, official holdings of the key currencies may become as volatile as private holdings have been in the past.

Against such a pessimistic assessment of the future possibilities may be set the argument that a proliferation of national currencies in international use would serve to make the present system more, rather than less, viable, in that though switches or flights might well occur, they would only rarely be into gold, since among the range of eligible national currencies there would be always at least one whose convertibility would be beyond suspicion. But surely the history of the internal banking systems of most countries gives us little ground for such optimism. Once a run starts it tends to spread, to spread quite indiscriminately.

It could also be argued that though a proliferation of reserve media would add to the instability of the present system, it would at least have the advantage of resulting in an increase in the total volume of international reserves. But would it? Surely the unhappy experience of the United Kingdom and the United States would lead any other key-currency country to insist on something like 100 percent cover against their short-term liabilities. My suggestion is that Germany and other countries whose currencies might well become key currencies would be reluctant to allow their balance of payments to deteriorate to the extent necessary to produce a significant increase in the total amount of reserves held by non-key-currency countries.

THE PRESENT POSITION SUMMARIZED

(*a*) With no increase in gearing and with no increase in the price of gold, the rate of expansion of official reserves, thanks to the output of new gold plus Russian sales, would be about 2 percent a year, a rate which in the long run is almost certain to be inadequate.

(*b*) A further increase in gearing, simply by the expansion of nonresident sterling and dollars (plus any new key currency) would aggravate the present intolerable instability of the system.

(*c*) A further increase in the instability of the present system is in any case to be feared, if, as well may happen, there occurs a weakening of the loyalties which are the basis of the traditional currency areas.

(*d*) The possible proliferation of new key currencies is a development which is on balance to be feared rather than welcomed.

PLANS FOR REFORM

There is a considerable measure of agreement among economists as to the defects of the present system, and many proposals have been adumbrated for more or less radical reform.

One such proposal, whose most eminent British supporter is Sir Roy Harrod, advocates an upward revaluation of the price of gold. This proposal would certainly have the advantage of increasing the money value of total reserves and of increasing the share of gold in the total. It would, however, have the disadvantage of discrediting the use of national currencies as international reserves, and thus of increasing the future danger of flights from these currencies into gold. It would also encourage the production of gold (an intrinsically useless commodity), present a windfall gain to South Africa and Russia, and reward any countries which had previously been "rocking the boat" by switching out of dollars and pounds into gold.

Another proposal, which enjoyed a considerable following in the United Kingdom in the midfifties, favors the introduction of fluctuating exchange rates. This proposal was investigated by the Radcliffe

Committee and firmly rejected—in my view correctly. The Committee did not take a stand against any change of exchange rate in any circumstances, for—

experience has revealed no other instrument as powerful as devaluation that can be used to restore competitive power,

so that

in conditions in which the failure of exports to make headway is plainly restricting the level of domestic activity—and other countries are not experiencing similar difficulties, it offers a way of escape than cannot be excluded.[2]

But to allow the exchange rate to vary except in the face of such a compelling justification would be a very retrograde step.

The preservation of a fixed rate of exchange undoubtedly offers the best prospect of avoiding strains and stresses within the sterling area, except perhaps in highly abnormal conditions * * *.[3]

My brief remarks make no claim to do full justice either to the case for an appreciation of gold or to that for fluctuating exchange rates: they are intended solely to make my own position clear before I move on to consider a further series of proposals, in all of which I see considerable merit; namely, those advanced by Mr. Edward Bernstein, by Prof. Xenophan Zolotas (the governor of the Bank of Greece), by Mr. Max Stamp, and, finally, by Prof. Robert Triffin. These proposals, as I shall shortly argue, have in many cases elements in common, but to begin with I propose to give a brief résumé of each.

THE BERNSTEIN PLAN

This plan comprises two separate, though complementary proposals, which I shall for convenience label parts I and II.

Part I is a proposal for greater automaticity in the access enjoyed by members of the International Monetary Fund to the pool of national currencies held by the Fund.

Members should be free to draw 25 percent of their quotas in successive 12-month periods without requiring the prior approval of the International Monetary Fund. The position of a member would have to be restored after a reasonable period, say 3 to 5 years, as already established by Fund policy. Drawings in excess of the annual quota of 25 percent and drawings that would increase the Fund's holdings of a member's currency above 200 percent of its quota would continue to be made only with express approval and on terms and conditions agreed with the International Monetary Fund.

Part II of the Bernstein plan is for the establishment under the auspices of the International Monetary Fund of a subsidiary institution, to be called, say, a Reserve Settlement Account. The Reserve Settlement Account would operate under a new agreement which would be supplementary to the present International Monetary Fund agreement (which would not need to be changed) and might include the following provisions:

1. All members of the IMF are to become members of the Reserve Settlement Account by indicating their acceptance of the supplementary agreement.
2. The Reserve Settlement Account is to be established when countries with 70 percent of the quotas in the IMF accept membership.

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[2] Report of the Committee on the Working of the Monetary System, 1959, cmnd. 827, par. 716.

[3] Ibid., par. 710.

3. The Reserve Settlement Account is authorized to lend currencies or gold to any member for capital or current transactions on terms and conditions to be agreed with the borrowers.

4. The Reserve Settlement Account is authorized to borrow from its members, and to enter into prior undertakings for this purpose, on terms and conditions to be agreed with the lenders.

The resources of the RSA would come primarily from credits provided by its larger members. When the large holders of reserves secure approval of membership, their Parliaments would be asked to authorize their central banks or treasuries to purchase notes or debentures of the RSA up to a stated amount. If the United States would undertake to subscribe to $3 billion of such notes, the United Kingdom $1.5 billion, and France, Germany, Italy, Netherlands, Belgium, Canada, and Japan about $3.5 billion together, the RSA would have sufficient resources to meet any contingencies that could arise.

When the Reserve Settlement Account borrows from a member, it would do so through interest-bearing notes of specified maturity, denominated in the currency of the lending country, with the same gold guarantee that now applies to the transactions of the IMF. The RSA would call on a central bank to take up all or part of its agreed subscription only when it is increasing its reserves and another member needs that currency to meet a major outflow of funds or is presented with a demand for conversion of large balances by that country. Furthermore, subscribers would be able to use the notes prior to maturity to purchase any currencies they need to meet balance of payments deficits. Thus, subscribers would be assured that their own payments and reserve position could not be impaired by providing resources to the RSA.

THE ZOLOTAS PLAN

This proposal has much in common with part II of the Bernstein plan, in that it envisages an extension of the IMP's field of operations, by virtue of new credits to be obtained from certain members and used for the benefit of others. Professor Zolotas has suggested the following detailed provisions as a basis for discussion:

1. The Fund shall be empowered to contract standby arrangements with surplus member countries. Under these arrangements, surplus countries shall make available to the Fund, in terms of their own currencies, a substantial part of the annual increase in their monetary reserves (as defined in article XIX of the articles of agreement), or a higher percentage of the annual increase in the gold component of their monetary reserves, whichever is larger, provided that their total reserves do not decline during the year.
2. [This provision gives a proposed definition of a "surplus country."]
3. It is advisable to make the contracting of standby arrangements mandatory for surplus countries.
4. The Fund shall be empowered to contract corresponding standby arrangements with deficit member countries outside their quotas. Under these standby arrangements the Fund shall make available to the deficit countries, under adequate safeguarding provisions, an amount of reserves that would relieve the strain on their external position. In the case of a deficit country whose currency is widely used as international reserves (key currency), the Fund may grant loans amounting to a high percentage of the annual decrease in the gold component of their reserves. The Fund in making the loans in question shall try to make a balanced use of the currencies of all surplus countries available to it.
5. [This provision gives a proposed definition of a "deficit country."]
6. Standby arrangements shall be contracted for a period of up to 3 years and shall be subject to renewal.
7. The Fund shall make provisions for the multilateral clearing of credit and debit balances effected under standby arrangements.
8. [This provision refers to interest and other charges.]
9. All transactions under standby arrangements will have benefit of a gold guarantee.

THE STAMP PLANS

Mr. Max Stamp puts forward two alternative proposals, labeled respectively plan A and plan B.[4] The latter has a close family resemblance with part II of the Bernstein plan and also with the Zolotas plan: under it—

the Fund would negotiate "reverse standby agreements" with countries whose currencies would be needed to support the dollar in time of need: under these agreements the Fund would have predetermined (and of necessity very large) lines of credit with each country, under which it could borrow that country's currency if it needed to do so. If the reserve currencies came under pressure from the withdrawal of foreign balances, the Fund would draw on these lines of credit and re-lend to the United States or Britain. The net United States or British position would be unchanged; but there would be one important difference: because each member of the Fund guarantees to maintain the value of the Fund's holdings of its currency, the United States or Britain would have given an exchange guarantee in respect of that portion of its foreign debt which had been taken over by the Fund. The foreign government would, on its side, have exchanged a dollar or sterling claim, which can at present be converted into gold at approximately $35 to the ounce, but which it fears might not be so convertible in future, into a claim against the Fund, which carries an exchange guarantee which is permanently valid.[5]

The Stamp plan A is an altogether different and much more radical proposal, its closest antecedent being a proposal which Sir Hubert Henderson[6] put forward on the eve of the Lausanne Conference in 1932. Under plan B—

The Board of Governors of the Fund would authorize the issue of Fund certificates to a value of, say $3 billion over the next 12 months. The value of these certificates would be expresesd in terms of gold, but they would not be automatically convertible into gold. Each member would agree to accept them when tendered by the Fund or a central bank and to provide its own national currency in exchange. Countries such as the United States which at present undertake to sell gold at a fixed price when their currency is tendered by a central bank could modify that obligation: henceforward, they would have the option of selling gold or tendering any Fund certificates in their possession. The holder of a Fund certificate would be able to exchange it at known rates into the currency of any country which is a member of the Fund.

The Fund would then give the certificates to an aid-coordinating agency which would allocate them to the underdeveloped countries under an agreed program. The country receiving the certificates would use them to buy, say, machinery in Germany, the United States, and the United Kingdom, by tendering them to the central bank and acquiring deutsche marks, dollars, or sterling. If Germany were in overall surplus she would add the certificates to her reserves; if the United States were in overall deficit she could, if she desired, use them to meet that deficit instead of losing gold. The certificates would end up with the countries which are in overall surplus, which, therefore, would have automatically lent part of that surplus to the rest of the world.[7]

THE TRIFFIN PLAN

Though Professor Triffin has presented his plan in full detail only in the context of a proposal for a new charter for the IMF[8] the essentials of the plan could be equally well applied (as he himself has always emphasized) in the context of other international insti-

[4] See his "Changes in the World's Payments System," in the spring 1961 issue of the review Moorgate and Wall Street.
[5] Ibid., pp. 16 and 17.
[6] "Monetary Proposals for Lausanne," subsequently republished in his collected works, "The Inter-War Years."
[7] Ibid., pp. 10 and 11.
[8] See his "Gold and the Dollar Crisis, pt. 2, ch. 4.

tutions with a different membership from the Fund's. Thus he has from the start envisaged the possibility of his plan being operated by the EEC or the OEEC; and more recently, with the formation of the OECD, he has come to be impressed (and, rightly, in my opinion) with the case for operating plan by an agency, to be called (say) the Atlantic Monetary Organization, with the same membership as the OECD (i.e., Western Europe plus North America).

But since the only detailed statement of the Triffin plan relates to its application by the IMF, it is on this basis that I drafted the résumé which follows:[9]

(1) Each member country's official reserves would include a deposit at the Fund denominated in terms of a new unit of account which I shall for convenience refer to by the Keynesian label of "bancor,"[10] through in practice it might be better to have a completely new label.

(2) A minimum demand for bancor would be created by getting all members to agree to hold at least 20 percent of their official reserves in this form.

(3) The initial supply of bancor would be created by the IMF accepting from all members (*a*) a deposit payable out of existing reserves (and therefore comprising mainly gold, U.S. dollars and sterling) equal to 20 percent of each members' present reserves and (*b*) a further deposit of all sterling and U.S. dollar balances then remaining in official reserves.

(4) Following these initial operations, the IMF's balance sheet would be roughly as follows, all amounts being expressed as their equivalent in U.S. dollars:[11]

	Billions
Assets:	
(1) Gold: IMF's present holding	$1.5
To be deposited under (3) above	3.4
(2) National currencies: IMF's present holding	1.1
To be deposited under (3) above:	
As per 3a	5.1
As per 3b	10.0
Total	21.1
Liabilities:	
Bancor:	
Minimum balances, as under (2) above	11.1
Other balances	10.0
Total	21.1

(5) A member would normally use his bancor balance to make payments to other members, but he could also withdraw his balance—either in gold or (at the Fund's option) in his own national currency (to the extent of the Fund's holding of that currency).

(6) Since, according to the table above, the Fund would initially hold only $4.9 billions of gold against $21.1 billions of bancor liabilities, could the Fund ever get into the position of not being able to meet its obligation to repay in gold? Such a contingency is most

[9] This résumé is largely taken from "International Monetary Cooperation, 1945–60," p. 182.
[10] See "Proposals for an International Clearing Union," published in a British white paper in 1943.
[11] These figures are taken from Triffin, op. cit., pp. 110 and 111: they refer to this position as it would have been at the end of 1958.

unlikely, partly because $11.1 billions of the $21.1 billions of bancor would comprise minimum holdings which could not be presented for repayment, and partly because of the Fund's option, under (5) above, to repay in the withdrawing member's own currency. But even a remote contingency has to be provided for, and Triffin proposes that this could best be done by providing for the possibility of increasing to more than 20 percent the minimum reserve requirement. Any member could then refuse to agree to such an increase in his deposit obligation, but such a refusal would then bring automatically into operation a technical scarcity of the member's currency, with the consequences spelled out in article VII of the present IMF Charter.

(7) After the initial creation of bancor, further amounts would be created by the IMF buying gold or by acquiring (through open market purchases or by granting advances) [12] further amounts of member countries' currencies. The aim would be to increase the total amount of bancor in existence at a rate sufficient to insure that the total amount of bancor and gold held in official reserves should grow pari passu with legitimate requirements for international liquidity in an expanding world economy. In order to guard against any possibility of an inflationary bias, Triffin suggests very simply that a presumptive ceiling on the yearly increase of the Fund's loans and investments be agreed to in advance, and that qualified majority votes (two-thirds, three-fourths, or even four-fifths of the total voting power) be required to exceed this ceiling over any 12 months' period of operations.

(8) The $16.2 billion of national currencies appearing in the balance sheet on page 15 together with further amounts subsequently acquired, could be held by the Fund in their original form or could alternatively be switched into other currencies, though only in a smooth and progressive manner. One possibility would be to give the Fund an option to liquidate such investments at a maximum pace of, let us say, 5 percent a year,[13] but other (and maybe more satisfactory) arrangements might be considered.

(9) All national currencies held by the Fund would enjoy a gold guarantee, in the same way as the Fund's present holdings of national currencies.

THE ESSENTIAL ELEMENTS OF THE PLANS

As I have already indicated, the plans put forward by Bernstein, Zolotas, Stamp, and Triffin have in many cases features in common. That this is so can best be seen by sorting out the essential elements from which the rival plans are constructed. It seems to me that most of these elements can be considered under four headings: (a) exchange guarantees, (b) rescue facilities, (c) automaticity of drawing rights, and (d) bancor.

(a) *Exchange guarantees*

This heading covers provisions for indemnifying nonresident official holders of a currency against a fall in the exchange value of the currency concerned—such a fall being usually defined as a fall in relation to gold.

[12] Advances would however be at the Fund's discretion. Members would not have automatic drawing rights.

[13] In my own personal view, 5 percent per annum is too high a rate.

There is nothing new in the idea of an exchange guarantee. The United Kingdom gave gold guarantees under some of the postwar bilateral monetary and currency agreements. All IMF holdings of national currencies have always been covered by a gold guarantee.[14] The present European Monetary Agreement gives a dollar guarantee for all official holdings by one member of another's currency (and, in the case of holdings under the Interim Finance provisions, a gold guarantee too). The Basle arrangements of March 1961 are understood to take the form in part of gold swaps, which are one way of giving a gold guarantee.

But so far neither of the two major key currency countries has been prepared to give a gold guarantee across the board on all nonresident official holdings of its currency. It is therefore an essential assumption in part II of the Bernstein plan, in the Zolotas plan, in the Stamp plan B and in the Triffin plan, that the United Kingdom and the United States would be prepared to accord to an international agency such as the IMF a privilege which they seem very reluctant to accord directly to purely national agencies.

(*b*) *Rescue facilities*

This heading covers all types of international cooperation whose aim is to support a key currency subject to speculative pressure. Good examples in the past were the help afforded to Britain by the IMF and Export-Import Bank after the Suez crisis in 1956. Another example would be the Basle agreements of March 1961. The Bernstein scheme for a Reserve Settlement Account to be operated by the IMF might reasonably be described as a device to enable the Fund to undertake bigger and better rescue operations in the future than in the past. The Zolotas plan and the Stamp plan B would also operate to the same end.

Rescue facilities under the Triffin plan would usually take the form of open market operations undertaken at the discretion of the IMF or other bancor-issuing agency. Such open market operations would usually need to be compensatory switches (for example, out of marks into pounds, when hot money was leaving London for Frankfurt), though to a smaller extent they could comprise the net annual addition to the stock of bancor.

Rescue facilities do not in themselves serve to replace or supplement the reserves of key currencies now held in official reserves: instead they serve to mitigate the instability of the present system and thereby to render less risky an increase in its gearing in the future.

(*c*) *Automaticity of drawing rights*

The essential feature of part I of the Bernstein plan is that the purchase rights enjoyed by members of the IMF should be made much more unconditional or automatic than at present.

The aim of this reform may be regarded as coming under my heading "Rescue facilities," since greater automaticity would render rescue operations by the IMF in some degree automatic. But the implication of greater automaticity goes much further than this, in that automatic drawing rights might well come to be regarded as such a good substitute for reserves that countries would count such rights (if still unused) as part of their reserves. Thus greater automaticity would

[14] Under art. IV, sec. 8 of the Fund agreement.

not merely protect existing reserves (of gold and key currencies) from the instability caused by switching, but would also in effect add to the volume of reserves.

A possible disadvantage of greater automaticity is that it is so indiscriminate. The most pressing need for reform is to achieve greater stability, rather than a greater volume of reserves, but greater automaticity in the IMF has to provide both simultaneously: moreover the increase in reserves would inevitably go to all members pari passu with their quotas.

Another possible weakness of part I of the Bernstein plan is that with such generous automatic drawing rights, the Fund's kitty of gold and convertible currencies might soon become exhausted, or might at any rate come under the suspicion of exhaustion. And mere suspicion might be sufficient to undermine the advantages of automaticity, since what is the use of unconditional rights if you cannot be sure that the rights will always be honored?

The standby arrangements provided for in the Zolotas plan have much in common with part I of the Bernstein plan, in that these are not intended solely for facilitating a possible rescue operation in favor of any of the key currencies. They would indeed be available to all participants who at any time qualified as deficit countries, and being automatic could (like automatic purchase rights in the Fund) reasonably be regarded as the equivalent of additional reserves.

(*d*) *Bancor*

I shall use this Keynesian label to describe any kind of international money which is neither a metal nor a national currency. The nearest, and indeed the only, approach to the use of any form of bancor in the real world was in the European payments union, where the union's indebtedness, denominated in units of account (which were promises to pay neither a specified amount of gold nor a specified amount of any national currency) might reasonably be regarded as a species of Bancor.

But proposals for introducing other bancor arrangements have been very common. Apart from Keynes' clearing union, there were Sir Hubert Henderson's monetary proposals for Lausanne, and more recently the proposals of Messrs Stamp, Day,[15] and Triffin, not to mention the less detailed proposals of Sir Oliver Franks,[16] and of the Radcliffe committee.[17] Among the plans I have considered above, the Stamp plan A and the Triffin plan both involve the use of bancor.

The following issues have to be faced in any scheme involving the use of bancor:

(i) *Is the bancor to be convertible?*—The bancor of the EPU was not immediately convertible, but the provisions governing the withdrawal of members and the eventual dissolution of the union insured that the union's debts would eventually turn into a mixture of gold or dollars plus a selection of European currencies necessarily including a goodly proportion of the soundest ones.

In contrast, Sir Hubert Henderson's bancor was to be completely inconvertible, and Mr. Max Stamp follows suit. I think that one may legitimately doubt whether such proposals will be practical politics in the 1960's.

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[15] Radcliffe Evidence, 3d vol. of memoranda, p. 75.
[16] See his report, as chairman of Lloyds Bank, for 1958.
[17] Cmnd. 827, par. 678.

The essence of the Triffin plan is that bancor should be fully convertible into gold at a fixed price, subject only to the constraint that each country subscribing to the plan would always accept a minimum holding of bancor equal (in the version of the plan which I outlined above) to 20 percent of the country's total reserves. How would Triffin assure the convertibility of his bancor? Three provisions of his plan are relevant to this question:

(*a*) The subscription provisions, which insures that the bancor-issuing agency starts life with a reasonably large kitty of gold;

(*b*) The minimum-holding provision, under which each member undertakes to keep not less than a certain specified percentage of his reserves in the form of bancor. (This provision means that each member's bancor would comprise two parts: that which could be converted unconditionally and that which could be converted only pari passu with a depletion of his total reserves.)

(*c*) The exchange-guarantee provision, which would insure that the bancor-issuing agency's balance sheet would always show enough gold plus national currencies to balance, at current exchange rates and with an unchanged gold value of bancor, the total bancor liabilities of the agency. Thus the agency would always have a sound balance sheet. Moreover, in the early days of the application of the plan, while (let us suppose) many countries had reserves in gold as well as in bancor, the value of the gold-guarantee clause on the bancor-issuing agency's holding of national currencies might be more than just a concession to bookkeeping prejudices, since the agency's holdings of some countries' national currencies might be permitted to give it access (albeit presumably limited) to these countries' gold. But insofar as the Triffin plan was successful, less and less gold would be held by countries, so national currencies would become simply claims to bancor, and claims to bancor cannot well be safer and more substantial than bancor itself.

(ii) *Is bancor to be in replacement or existing reserve media?*—The bancor of Sir Hubert Henderson, of Lord Keynes, and Mr. Stamp (in his plan A) are intended solely as an addition to existing reserves: thus reserves would come to be held in gold, dollars, sterling, and bancor—a multiplicity of reserve media which would hardly be conducive to greater stability.

By contrast, the Triffin plan is based on the assumption that the key currencies would be displaced almost entirely by bancor in official holdings, and that even gold would, in due course, likewise get into the almost exclusive ownership of the bancor-issuing institution. Nor do I think that Triffin is utopian in expecting his plan (if adopted) to work out in this way, since his bancor (being convertible at a fixed rate into gold and nevertheless yielding interest to its holders) would be a more attractive reserve asset than gold. Hence the Triffin plan would provide a much more stable arrangement than the present one, with its multiplicity of rival reserve media.

(iii) *Is bancor to be only a reserve media, or could it be held by nonofficial holders?*—No proposal has so far envisaged the latter, though the idea should not be rejected out of hand. If, however, bancor is solely for official holders, the switching which the bancor arrangement a la Triffin would eliminate would be solely official switching. Unofficial switching between national currencies could continue as at present. Hence the Triffin plan can help to cope with unofficial switching only by virtue of the rescue facilities which are envisaged.

(iv) *How can bancor provide for the expansion of reserves?*—It (as under the Triffin plan) bancor needs to be convertible into gold, how could world reserves be increased without giving rise to just that increase in gearing which (I have argued) would be intolerable under the present gold exchange standard? My answer is that a higher gearing is tolerable under the Triffin plan than under present arrangements, and for the following reasons:

(*a*) Members of the Triffin institution would agree in advance to be loyal to bancor as to at least 20 percent of their reserves, and this percentage could probably be stepped up as, with the passage of time, it became necessary to create more and more bancor. In contrast, loyalty to key currencies may become increasingly precarious.[18]

(*b*) The plan calls for a certain minimum pooling of gold reserves in any case and, once these arrangements were seen to work satisfactorily, the pooling might well embrace nearly 100 percent of the world's monetary gold. A central pool of gold would clearly be a more efficient way of achieving convertibility than is the considerable dispersal of gold holdings which obtain under the present regime.

To what extent, however, could these desirable features of the Triffin plan be enjoyed without replacing the present key currencies as reserve media? In principle they could be, but in practice the difficulty of getting the necessary reforms accepted might well be at least as great as getting agreement to the Triffin plan. For what reforms would be necessary?

(*a*) Some kind of loyalty oath by members of the sterling area and of other currency areas.

(*b*) Some kind of drawing rights arranged between the central banks of the main financial centers, for example on the lines of Bernstein's Reserve Settlement Account, though on a more ambitious scale. In this way, the world's stock of gold could be effectively pooled, for use in converting whichever key currency happened to be under pressure. Likewise some amount of switching between one key currency and another could, by this means, be accommodated.

(*c*) A gold guarantee clause covering all official holdings of key currencies, such as now operates in respect of national currencies held by the IMF.

In the absence of far-reaching reforms on these lines, I do not see how the gold exchange standard could safely be allowed to operate with as high a gearing as would be practicable under the Triffin plan.

I have still to make the really important point that arises under my heading (iv), namely that under a bancor arrangement, such as envisaged in the Triffin plan, it is possible to provide for a steady and regulated rise in the supply of international reserves by open market operations undertaken by the bancor-issuing agency. Who, under the present key-currency regime, is in a position to force the

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[18] Above, p. 4 et. seq.

United Kingdom, the United States, or indeed any other key currency country, to increase the availability of key currencies to the rest of the world, and at a steady and regulated rate? I do not see any satisfactory answer to this question.

(v) *What would be the best bancor-issuing institution?*—The IMF or an associated institution with a similarly worldwide membership would be the ideal choice. But the IMF is a cumbersome piece of machinery and many countries whose support is vital to the success of a reform on the lines of the Triffin plan would probably object to the participation of large numbers of underdeveloped countries. The next best would probably be an Atlantic Monetary Organization under the aegis of the OECD, whose members hold about three-quarters of world reserves and about the same proportion of officially held nonresident dollars.

Unfortunately, however, the OECD members hold only a small proportion of all officially held nonresident sterling. It would, however, surely be possible to allow the countries of the outer sterling area to become associate (nonvoting) members of the AMO club. The associate member would be allowed to buy bancor (a) with his holding of sterling as at mid-1961, or (b) with gold at any time, and (c) to acquire bancor at any time from other members. In these respects associate membership would be no different from full membership. But an associate member would have no voting rights, and would have no expectation that the club would buy his currency in the course of its open market operations. Thus in these respects the associate member would enjoy fewer privileges than the full members. In return, he must be allowed to escape some of the duties of full membership: my suggestion is that he should escape the minimum reserve requirement (probably 20 percent in the first instance) imposed on full members. Thus the associate members would hold bancor wholly on a voluntary basis, and still enjoy 100 percent convertibility into gold.

CONCLUSION

My conclusions are:

(*i*) That present arrangements are in urgent need of reform.

(*ii*) That a revaluation of gold would be a very doubtful and risky expedient.

(*iii*) That the Radcliffe committee was right in rejecting the case for fluctuating exchange rates.

(*iv*) That the various plans for reform advanced by Bernstein, Zolotas, Stamp, and Triffin would all represent a substantial improvement on present arrangements.

(*v*) That there is nevertheless a distinct advantage in a scheme for reform which (like the Triffin plan) aims at replacing the national currencies now held as reserve media by some kind of "bancor" arrangement.

(*vi*) That a suitably contrived bancor arrangement (probably involving the application of the Triffin plan within the framework of the OECD) would probably not require any more drastic institutional changes than would in any case be needed for any reform capable of achieving a viable regime of international liquidity.

UNIVERSITY OF NOTTINGHAM, *June 20, 1961.*

THE INTERNATIONAL MONETARY CRISIS: DIAGNOSIS, PALLIATIVES, AND SOLUTIONS [1]

(Submitted by Robert Triffin, Pelatiah Perit, professor of political and social science, Yale University, New Haven, Conn.)

The February 6 message of President Kennedy to the Congress contrasts sharply—and refreshingly—with previous official pronouncements about the "dollar" crisis. Without denying in the least the difficulties that we still face in putting our own balance of payments in order, the President's message puts them in their proper perspective and stresses, in particular, their relationship to some major defects in the international monetary mechanism itself. The recent dollar crisis, indeed, cannot be understood in isolation from the international monetary framework which allowed it to develop, just as it contributed over the last 30 years to far deeper and recurrent sterling crises. Even less can it be cured by unilateral U.S. measures without jeopardizing gravely in the future the prospects for financial stability and economic progress in the world at large, as well as in the United States.

The message notes the paradoxical, but illuminating, fact that a record rate of overall deficit in the latter part of 1960 coincided with a nearly alltime peak in our curent account surplus, and a spectacular recovery in our basic transactions balance including foreign aid and other official capital exports and military expenditures abroad.

Two lessons emerge from this observation:

1. We may—and have in the past—run enormous deficits in our basic transactions without being penalized and stopped by gold losses, as long as foreigners are temporarily willing to accumulate sight or short-term I O U's (or "dollar balances") in settlement of their surpluses. Thus, very few people in this country or abroad noticed—or worried about—the $10 billion deficits incurred by us over the years 1950–57. These were overwhelmingly settled in the form of dollar I O U's rather than gold payments.

2. We and others, however, developed a near panicky attitude toward the problem when, in 1958, and particularly in 1960, large outflows and repatriation of private capital—stimulated by financial recovery, booming economic prospects, and higher interest rates in Europe—slowed down the continuous growth of short-term dollar investments here by foreigners, and led to substantial gold losses by our Treasury. Further improvements and consolidation in our basic transactions may not guarantee us against large gold losses arising from future conversions into gold, for similar or other reasons, of the enormous short-term claims accumulated against us as a result of past transactions.

In brief, the use of sterling and dollars as international reserves under the so-called gold-exchange or key-currencies standard has long played havoc with the much-vaunted balance-of-payments discipline supposedly forced upon all countries by the older gold-coin or gold-bullion versions of the traditional gold standard. The key currency countries—Britain yesterday, and the United States today—may enjoy for years the ease with which I O U settlement of their deficits

[1] Reprinted from Quarterly Review and Investment Survey, Model, Roland & Stone, New York, N.Y., 1st quarter 1961.

give them more and more rope to hang themselves. The day of reckoning inevitably comes, however, when the rope suddenly tightens at the most inconvenient moment. Continuous discipline is replaced by temporary overindulgence, to be paid for later by a sudden and violent crisis in the international position of the key currencies. This is the consequence of the abuse of an international monetary system whose smooth functioning has become inextricably tied with unquestioned reliance on such key currencies as monetary reserves for other countries' central banks.

For the key currency countries themselves, the resulting threat takes the form of large and sudden gold outflows which may lead to an exchange-rate devaluation—as in 1931 and 1949 in Britain—or to various techniques of inconvertibility and exchange control—as in Britain again during most of the postwar years—or, at the very least, to restrictive fiscal, credit, and interest-rate policies which may be in direct conflict with internal employment and growth policies—as in Britain once more in the late 1920's and in both Britain and the United States in the very recent past.

For the world at large, the consequence of the system may become manifest in the international spread of deflation, trade and exchange restrictions, and/or chaotic exchange-rate fluctuations and competitive devaluations. There is little doubt that these typical post-1914 ills can be ascribed to a considerable extent—even though not exclusively, of course—to our obduracy in confusing international monetary order with the mere digging up and dusting off of the 19th-century gold standard, supplemented by the haphazard, precarious, and foredoomed use of one or a few national currencies as international reserves.

There is pretty unanimous agreement today on the need to restore overall equilibrium in our balance of payments, and to put a stop to the indefinite piling up of more short-term indebtedness abroad characteristic of the last 10 years, as well as to the more recent gold drain which was its ultimate and perfectly predictable—and predicted, may I add—consequence.

What is not so fully understood is the impact of such a readjustment upon the future growth of world liquidity.

The gold and dollar holdings of foreign countries and international institutions have grown more than satisfactorily indeed—perhaps even at an inflationary pace—over the last 11 years, from about $18 billion in December 1949 to more than $45 billion in September 1960. Of this increase of $27 billion, however, 78 percent ($21 billion) was derived from U.S. net reserves losses, about 4 percent (more than $1 billion) from U.S.S.R. gold sales in Western markets, and no more than 18 percent (less than $5 billion) from current gold production in the West.

The broad picture is the same if we look at the increase of monetary reserves as such—excluding privately held dollar balances, but including officially held sterling and other foreign exchange, together with gold and official dollar holdings. Nearly two-thirds of the increase of world monetary reserves over the decade of the 1950's—and as much as 92 percent over the 2 years 1958 and 1959—was derived from the deterioration in the U.S. net reserve position, 5 percent from the growth of other foreign exchange reserves, 6 percent from U.S.S.R. gold sales, and less than one-fourth (24 percent) from current gold production in the West.

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Finally, and taking the world as a whole, including the United States, we find (see table) that gold production has long ceased to provide more than a fraction of reserve requirements in an expanding world economy: 43 percent over the whole period 1914–59, and only 33 percent over the decade of the 1950's. The bulk of reserve increases has been fed, for nearly half a century, from a variety of expedients, makeshifts, or accidental sources, such as:

(1) The growth of foreign exchange holdings—i.e., primarily dollar and sterling I O U's—as supplementary means of reserve accumulation, alongside insufficient gold supplies (34 percent for the period as a whole, with a peak of 59 percent in 1950–59 and a dramatic decrease of 31 percent in 1929–33).

(2) The withdrawal of gold coin from circulation and its addition to central banks' gold reserves (only 6 percent of the overall reserve increase for the period as a whole, but 30 percent over the years 1914 through 1928); this, of course, came to an end in 1933.

(3) The dollar devaluation of 1933–34, which accounted for more than the total reserve increases of the years 1929–33, its impact being partly offset by the simultaneous—and closely related—wholesale liquidation of foreign exchange reserves, through their conversion into gold (see point 1, above).

(4) In more recent years, the growing sales of U.S.S.R. gold in Western markets. Insignificant in earlier years, such sales contributed as much as 9 percent of the world's reserve increases over the years 1950–59, and well over a third of the total increase in gold reserves over the 4 years 1956–59. Their abrupt cessation in the fourth quarter of last year undoubtedly played a role in the disruption of the London gold market in October.

Sources of increases in world reserves, 1914–59

	Total increase [1]	From Western gold sources [2]	From other sources: Total	Coin withdrawal	Dollar devaluation	U.S.S.R. gold sales	Foreign exchange
A. In billions of dollars:							
1914–28	8.5	3.2	5.3	2.5		(4)	2.8
1929–33	7.2	.9	6.4	.8	[3] 7.9	(4)	−2.3
1934–38	7.5	6.8	.7			−.1	.8
1939–49	19.1	8.7	10.4			.3	10.1
1950–59	12.8	4.1	8.2			1.1	7.5
Total, 1914–59	55.1	23.7	31.4	3.3	7.9	1.3	18.9
B. In percent of total:							
1914–28	100	38	62	30		(4)	32
1929–33	100	12	88	10	[3] 109	(4)	−31
1934–38	100	90	10			−1	11
1939–49	100	46	54			1	53
1950–59	100	33	67			9	59
Total, 1914–59	100	43	57	6	14	2	34

[1] Excluding Soviet-bloc countries throughout, as well as IMF currency holdings.
[2] Current gold production in the West, minus net sales to, or plus net purchases from, private channels. Large net repurchases from private channels (estimated at $1.7 billion in 1934–7) followed the sterling and dollar devaluations, in sharp contrast to the usual net absorption of gold into hoarding and private uses.
[3] Calculated on the basis of the official parity change of February 1934, following the suspension of gold payments and the de facto dollar depreciation in 1933.
[4] Included, until the end of 1933, with Western gold sources.

Sources: These must be regarded as only rough estimates—particularly in the early years of the table—put together from various IMF and Federal Reserve publications.

Can anyone seriously argue that such a system can safely be relied upon tomorrow—any more than in yesteryears—to adjust world reserves to actual requirements in an expanding world economy and to serve as a basis for a stable and viable system of international settlements? The point to be kept in mind is not that these various sources of reserve supply taken together have failed to provide enough liquidity. They may well, on the contrary, have provided too much; particularly in recent years owing to the enormous growth of dollar balances associated with the $10 billion deficits incurred by us since the end of 1957.

The indictment of the present, unorganized gold exchange standard is that it can only operate—and has indeed operated for nearly half a century—in haphazard fashion, creating too much liquidity at times, but only through generalized currency devaluations or through a persistent piling up of sterling or dollar I O U's, bound to undermine in the end the acceptability of these so-called key currencies as safe reserve media for the other countries' central banks. There is now general agreement in this country that overall payments deficits must be brought to an end, but until President Kennedy's recent message on gold and the balance of payments little thought had been given to the ultimate results upon the world at large of the consequent drying up of the source of two-thirds of the liquidity increases of the last decade.

Measures to improve international monetary institutions are indeed the very first item of the new administration's balance-of-payments program. "Increasing international monetary reserves will be required to support the ever-growing volume of trade, services, and capital movements among the countries of the free world. Until now, the free nations have relied upon increased gold production and continued growth in holdings of dollars and pound sterling. In the future, it may not always be advisable or appropriate to rely entirely on these sources. We must now, in cooperation with other lending countries, begin to consider ways in which international monetary institutions—especially the International Monetary Fund—can be strengthened and more effectively utilized, both in furnishing needed increases in reserves, and in providing the flexibility required to support a healthy and growing world economy.

The President's message has finally whipped up active interest—here and abroad—in a number of proposals for International Monetary Fund reform which had, up to then, been cavalierly brushed off by responsible officials and bureaucrats.

The more modest of these—at least in appearance—are those of the former Director of Research and Statistics of the International Monetary Fund, Mr. E. M. Bernstein. Mr. Bernstein's diagnosis of the problem is strikingly similar to mine, but his plan makes no pretense of meeting the long-run liquidity requirements of an expanding world economy. This would continue to depend on future and recurrent increases in the Fund's capital, requiring each time cumbersome negotiations with several scores of countries, new international agreements among their governments, and—in most cases—legislative approval by their Congress or Parliament. Under the mechanism of the Fund, three-fourths of their additional capital subscription would be in the national currency of member countries and would—in the case of most of them—merely result in flooding the Fund with currencies with which it is already overflowing and for which it will have no earthly use in any foreseeable future. What point is there in complicating to that extent the process of international negotiations for the pleasure of increasing even further the already inflated Fund holdings of cruzeiros, bolivianos, rupees, rupiahs, bahts, kyats, etc.? One is forcibly reminded of the old saying: "The mountain labors, and gives birth to * * * a mouse!"

The Bernstein proposals do not address themselves to this problem, and concentrate on a more limited, but extremely important, one: that of meeting temporary disequilibriums among the major trading countries themselves, and particularly of offsetting major outflows of short-term funds from one currency into another. The importance of this problem, under convertibility conditions, has been highlighted recently by our own huge gold losses of the last quarter of 1960, due nearly entirely to such movements of short-term funds from New York to other financial centers and into gold. A similar, and even more serious, crisis might threaten sterling tomorrow in the case of a reflux toward New York of the large dollar outflows which have veiled during the last year the deterioration of the United Kingdom's balance of payments on current account, just as a previous inflow of funds toward New York had partially veiled the deterioration of our own current account transactions in 1959.

Mr. Bernstein would leave untouched the basic mechanism of the Fund, but supplement it with additional machinery in the form of a subsidiary Reserve Settlement Account, requiring negotiation and agreement with a handful of countries only: the United States, the United Kingdom, Canada, Germany, France, etc. Each of these countries would subscribe special interest-bearing and gold-guaranteed debentures in its own currency, but the Fund would not call upon any subscribing member to take up all or part of its agreed subscription except to the extent necessary to meet large demands of such currencies by another member of the system. It might not be particularly easy to get our own Congress to approve $2.5 billion of such debentures—as suggested by Mr. Bernstein—less than 2 years after having extracted from it a $1.4 billion increase in our subscription to the International Monetary Fund's capital on the ground that this would solve all such problems for a long time to come. It could, of course, be agreed that we are very unlikely to accumulate in the near future any surplus that will justify a Fund's call on our debentures. The United Kingdom will be able to present the same argument in relation to the $1 billion debentures foreseen for it in the Bernstein plan. By the same token, however, this would mean that the total of $6 billion debentures to be negotiated would yield at most an increase of only $2.5 billion in actual resources for the Fund. In fact, the most likely outcome would be substantially less than that, since some of the participants other than the United States and the United Kingdom may also run surpluses far short of their subscriptions—or even be in deficit—while the subscription of one or a few others may fall far short of their own surpluses. Once again, the "mountain" to be negotiated may turn out in the end to yield a mere "molehill."

I certainly agree that Mr. Bernstein's plan would be better than nothing. I am afraid, however, that it may detract attention from the basic defects in our international monetary system which I have stressed above, and that by leaving untouched the Fund's machinery itself, it would perpetuate the obvious flaws in that machinery which experience has brought to light.

The amounts of each currency at the disposal of the Fund would remain dependent on advance, and necessarily haphazard guesses about the future evolution of each country's balance of payments, and on recurrent ad hoc negotiations with prospective creditors. Specific action by the Fund would also remain necessary in each case to thwart—or offset—the normal tendency of members to concentrate their borrowings on the so-called reserve currencies or key currencies, rather than on the currencies of the countries with overall balance-of-payments surpluses.[2] If and when sufficient support can be gathered for amending the Fund's statutes, it would seem to me far prefable to seize upon this opportunity to simplify, streamline, and rationalize the whole agreement in such a way as to minimize the need for future revisions or makeshifts and for periodic renegotiation of the capital subscriptions of members.

An exceedingly simple way of fulfilling these objectives is described at length in Gold and Dollar Crisis (Yale University Press, New Haven, May 1960), amply discussed in the hearings of the Joint Economic Committee of Congress (sessions of Oct. 28, 1959, and Dec. 8, 1960), and briefly summarized in simpler language in the February 1961 issue of the Atlantic Monthly. My proposals are still regarded in some circles—although far less generally than was the case 2 years ago—as dangerously radical and visionary. Yet, they conform exactly to the historical line of development of monetary and banking institutions which experience has revealed indispensable to their sound operation in every country of the world, and whose first stage has already been imitated by the international monetary system itself. Credit reserves—in the form of foreign exchange holdings—have gradually and increasingly supplemented commodity reserves—in the form of gold—over the last 50 years, just as credit money—in the form of currency and bank deposits—had previously and increasingly supplemented and finally replaced commodity money—in the form of gold and silver coinage—within each country's monetary system.

The obvious danger and vulnerability arising from the unorganized creation of credit money imposed within each country, many years ago, the gradual development of central banking techniques of monetary regulation. In the international field, however, shifts between one key currency and another, or between key currencies and gold, preserve unto this day the same sources of vulnerability which marked the monetary system of the United States, for instance, before the creation of the Federal Reserve System. Something akin to a World Reserve System is still missing, and is at the source of many of the troubles that have plagued the international monetary system for nearly half a century.

This is not to say that the several scores of sovereign nations that make up our world are ready to yield their precious sovereignty to a worldwide monetary institution, endowed with powers of regulation comparable to those wielded by the present Federal Reserve System or other central banks, after many years of slow, gradual development. Neither is this necessary to restore the minimum of order in-

[2] Mr. Bernstein suggests that the reserve currency countries whose currency has been regrettably requested from, and sold by, the Fund can always offset this destabilizing action of the Fund by subsequent drawings of the surplus countries' currencies. This is true, but remains nevertheless an unnecessarily complex and ludicrous procedure of achieving the Fund's stabilization objectives.

dispensable to the smooth functioning of the international monetary system itself.

All that is needed is to endow the International Monetary Fund with the far more modest, but historically crucial, functions entrusted to central banks at the origin of their development. Foremost among these would be the assignment to the IMF of the role of single depository for the credit reserves of member central banks. Ideally, individual countries should cease to use national currencies as international reserves, even though this may not be achieved at a single stroke. They should be encouraged to convert their present foreign exchange holdings into international deposits with the IMF, and the volume of these should be allowed to grow over the years to the extent necessary to supply—together with available supplies of monetary gold—the reserve requirements of an expanding world economy.

This purpose could be served through a surprisingly simple reform and long overdue rationalization and streamlining of the charter of the International Monetary Fund. Stripped down to essentials, my proposals are that present capital subscriptions to the IMF be abolished—and refunded to members—and replaced by a mere obligation for each member to hold an agreed proportion of its overall gold and foreign exchange reserves in the form of reserve deposits with the IMF. These deposits would be fully usable for settlements among central banks throughout the world and would carry—like all other Fund's assets and liabilities—a specific guarantee against exchange risks. They would, in this way, be "as good as gold" and better than the large amounts of reserves now freely retained by central banks in the form of sterling or dollar balances. They would indeed be more attractive than gold itself since they would devolve interest earnings to their holders or a participation—pro rata of their amount—in the earnings of the Fund.

Such a system of minimum deposits with the Fund would have two major advantages over the present system of capital subscriptions.

First and foremost, these deposits would automatically adjust to the fluctuations in the overall reserve position of each country. The Fund's overall resources would thus increase over the years, as the overall level of the world's reserves increases as a result of future accretions to monetary gold stocks and of the Fund's own lending and investment operations. Most of all, the increase in deposits would concentrate on the countries which currently develop net surpluses with the world at large and whose currency is therefore most needed for international settlements.

Second, and in contrast to present capital subscriptions, these deposits would not impair in any way the liquidity and reserve postion of the contributing countries. They could be used at any time, together with the other reserves held by members, to make payments anywhere in the world. They could indeed—to take an extreme case—be freely drawn down to the last cent if a country were unwise enough to sacrifice the totality of its monetary reserves to settle persistent deficits instead of correcting them in time. Yet, even in such a case, this would not affect in any way the sum total of Fund deposits—nor the corresponding assets and lending capacity of the Fund—since the decline in the overall reserves and deposit requirements of the members in deficit would be matched and offset by corresponding increases in the reserves and deposit requirements of the surplus countries to which payment is made.

The attractiveness to central banks of interest-earning, gold-guaranteed deposits with the Fund is so evident indeed that the reform might well be initiated, if needed, without any compulsory feature whatsoever, and without requiring any renegotiation of the Fund's statutes. A mere declaration of the Fund—by way of interpretation of its charter—that it is ready to accept such reserve deposits from member central banks would, in all likelihood, induce most countries to convert into such Fund deposits a growing portion of the reserves now freely held by them in the form of foreign exchange—subject to devaluation risks—and even in the form of gold—on which they earn no interest.[3]

This would, of course, entail corresponding shifts in the ownership of the outstanding dollar and sterling balances converted by their holders into deposits with the Fund. Title to such balances would pass from several scores of foreign countries to the Fund itself. There is no reason why the Fund should wish to liquidate these balances, or modify their present pattern of investment in the New York and London money markets. It should, however, be empowered to do so in the future, but only in a smooth and progressive manner, insofar as useful for the most efficient performance of its worldwide monetary stabilization functions, and in close consultation with the monetary authorities of the countries concerned. I have suggested that this purpose could be served by giving the Fund an option—which it would rarely wish to use in full—to liquidate these investments at a maximum pace of, let us say, 5 percent a year. This, however, would obviously be a matter for negotiation with the United States and the United Kingdom rather than for arbitrary determination by a lonely professor at Yale.

Whatever the concrete decision arrived at on this point, it is more than evident that it would entail far less risks for the United States and the United Kingdom—and indirectly for the world's monetary system itself—than the present right—alas, increasingly theoretical—of sterling holders to require at any time the conversion into dollars of about $10.5 billion of sterling balances, and of official dollar holders to demand the conversion into gold at our Treasury of more than $10 billion of dollar balances now held by them, to say nothing of the further $7.5 billion which they might acquire from present private dollar holders abroad, in the course of their stabilization interventions on the foreign exchange markets of the world.

The recurrent sterling crises of the postwar period and the present international dollar crisis are clear evidence of the overwhelming advantages of such a long overdue reform of the gold exchange standard for the United Kingdom and the United States. Far from implying an effective surrender of sovereignty to an international body, it would restore to both countries a freedom of monetary management—particularly in relation to interest-rate policy—which they have long lost through the gradual accumulation of an excessive level of short-term foreign indebtedness inseparable from the gold exchange

[3] One should note, in passing, that such a proposal was unanimously endorsed, more than a year ago, by the Radcliffe Committee on the working of the monetary system and received enthusiastic support from the Latin American participants at the Sixth Meeting of Technicians of Central Banks of the American Continent, held last November in Guatemala City.

standard's reliance on national currencies as a supplementary source of international liquidity.

Yet, the enormous powers which such a reform would vest in the Fund remain the major hurdle to be overcome by an effective negotiation of the reforms proposed above. The present pattern of voting power in the IMF corresponds roughly to the capital contributions of members. It gives about 26 percent of the total votes to the United States, 24 percent to all the nations of continental Europe put together, 12 percent to the United Kingdom, and 37 percent to the rest of the world.

The pattern of minimum deposits that would, in the end, replace capital subscriptions, if my plan were adopted in full, would increase sharply the relative contributions of continental Europe and the United States (to about 33 percent each), and reduce correspondingly those of the United Kingdom (to about 5 percent) and of the rest of the world (to about 30 percent). A parallel change in voting power would be difficult to negotiate, and might still fail to reassure some countries about the effectiveness of their own influence on the Fund's management of the sums put by them at its disposal. It is, moreover, doubtful whether the worldwide administrative structure of the Fund could handle quickly and efficiently the numerous and delicate decisions inevitably entailed by the handling of such large sums and responsibilities.

A decentralization of the Fund's machinery is, in any case, highly desirable for a host of other reasons. Such decentralization is universally accepted as necessary for the effective organization of policy-making decisions in a national community. In our own country, all power is not vested in Washington. Some of it is left to each of our 50 States, and even to smaller administrative units such as counties, cities, townships, etc. If this be necessary within an historically integrated community, how much more necessary must it be in the initial building stages of an international monetary administration encompassing widely heterogeneous areas, with vastly different problems arising from a variegated history, and at greatly uneven stages of political, economic, and financial development.

My own feeling, therefore, is that the reforms proposed above should be implemented not only through a reform of the IMF itself, but should be inserted in part within the framework of existing, or future, regional organizations such as EEC, OECD (Organization for Economic Cooperation and Development), the Latin American Free Trade Area, etc.

The most important and immediately feasible step in this direction could be taken at the occasion of the creation of OECD. When joining that organization, the United States and Canada should also join the European Monetary Agreement and enlarge its functions along the lines described above. The members of OECD could distribute their international deposits between the IMF and an OECD monetary organization in rough proportion to their pattern of international trade and payments outside and within OECD. This would help solve, or bypass, the voting-power hurdle mentioned above, by keeping a substantial portion of the deposits under the more closely knit and more workable management of OECD. That would also give vital and powerful support to the development of the closer harmonization of "the financial and economic policies for growth and stability of these industrialized nations of the world whose economic behavior significantly influences the course of the world economy and the trend of international payments," called for in President Kennedy's message of February 6 on the balance of payments and gold.

A final word might be added about the timing of the various steps which the full implementation of the above suggestions would involve.

(1) The acceptance by the Fund itself of voluntary reserve deposits from members would require no more than a mere interpretation of its statutes, without any necessity for any formal amendments subject to legislative ratification by member countries.

In view of the benefits which the conversion of outstanding dollar and sterling balances into gold-guaranteed deposits at the Fund would entail for large dollar and sterling holders, however, such conversions should be initially subordinated to transitional, ad hoc, agreements with the major countries involved (Germany, Japan, Italy, France, etc.) regarding the cashing into gold metal of the balances which they would transfer to the Fund or continue to hold directly in dollars or sterling. These transitional arrangements would eventually be substituted by the uniform minimum deposit requirements envisaged under (2) and (3) below.

(2) The setting up of similar gold-guaranteed deposits within an OECD framework could be inserted into the revision of the European Monetary Agreement which is, in any case, to be undertaken before October 1 of this year, under the terms of the agreement itself. Participation of the United States in the system would presumably require an act of Congress, even though similar exchange guarantees were granted to some European countries by mere Executive agreement under the Tri-Partite Agreement of 1936.

The OECD deposit system should contemplate minimum reserve requirements for members, similar to those suggested under (3) in order to ward off excessive conversions into gold, and to provide the keystone of the common reserve policy advocated in the U.S. Aide Mémoire of February 20, 1961, and broadly supported in recent official and unofficial discussions of these issues in Europe.

(3) The above measures should give the IMF the breathing space necessary to negotiate the substitution of present capital subscriptions by minimum deposit requirements as suggested above (p. 6). My own feeling is that fairly modest requirements (20 percent of overall reserves?) would be amply sufficient to secure the Fund against excessive gold withdrawals, since the gold guarantee and interest earnings attached to Fund deposits should normally attract large voluntary deposits to the Fund. The Fund should, neverethless, be empowered to vary such requirements, within preagreed limits, in case of need, and particularly to apply a higher deposit ratio to future reserve increases or to that portion of each member's reserves which exceeds the average ratio of world monetary gold to world imports.

The exploration and negotiations now underway will undoubtedly uncover other, and probably better, ways of dealing with the problems raised in this paper. Anybody who has ever participated in negotiations of this sort cannot but be keenly aware of the need to prune, amplify, and readjust initial proposals in the light of the unforeseen difficulties, as well as of the unsuspected opportunities, which only the negotiation itself can bring to light. This applies to the so-called Triffin plan as well as to the Bernstein plan. The greatest obstacle to the maximum achievements that should be hoped for and strived for, would be to freeze prematurely the path of discussion into any predetermined channel, and to close the door to a full exploration of any feasible technique to strengthen the international monetary structure of the West, and indeed of the world itself.

(Professor Triffin supplied the following additional statement to accompany the article from the *Quarterly Review and Investment Survey:*)

One of the keenest and most perceptive minds in the central banking world recently summarized very lucidly the major objections raised by him—and some of his colleagues—to my proposals for IMF reform. My answer to him may be of interest to others and is therefore reproduced below:

"I am forever puzzled and distressed at my apparent inability to put across clearly views on which I feel so close to your own methods of analysis and policy preoccupations. False, or unrelated, issues always seem to crop up to blur this basic agreement and leave us on opposite sides of the fence.

"In the present case, for instance, I very much agree with your breakdown of the problem into three different issues: (1) the volume of international liquidity, (2) its structural composition and characteristics and, (3) the U.S. balance of payments.

"You wish, however, to isolate these three problems from one another and conclude that

"(1) there is now an ample volume of liquidity;

"(3) the U.S. balance of payments problem is certainly not due to a lack of liquidity; and

"(2) the structure of liquidity may be helpful as well as destabilizing: you recognize the need for study here, but feel that the problem can be handled without fundamental reforms in the IMF framework.

"Let me state unambiguously that I fully agree with you on the first two points (1 and 3).

"I, too, feel that the volume of international liquidity, calculated on a gross basis, i.e., including dollar holdings as reserves for their owners, without deducting them as liabilities for the United States, may have increased too rapidly, rather than too slowly, in recent years, that we do not face today any overall shortage of liquidity, and are unlikely to do so as long as gold is supplemented by adequate—or more than adequate, as is now the case—holdings of foreign currencies. This excessive increase, however, is precisely due to the impact of U.S. deficits on the volume of reserves, owing to the role of key currencies in the structure of reserves.

"All I have said in this respect is that gold alone would not provide adequate liquidity, that it has long ceased to do so (see table above), and that it is fundamentally absurd to leave the regulation of international liquidity supplies to be determined to a major extent by:

"(1) Russian decisions regarding gold sales in western markets (30 to 40 percent of monetary gold increases in recent years), and

"(2) The size of U.S. external deficits, and the willingness of central banks to accept settlement for these in the form of dollar I O U's (two-thirds of total liquidity increases over the last decade).

"I find it hard to understand how anybody could disagree with these strictures on the present system.

"On point (3), there is not the slightest difference between us. I have repeatedly stated that the United States must cure its deficits, and that my IMF proposals do not in any way solve this problem, nor obviate the need for its solution. What I have claimed is that:

"(1) Its solution, when it comes, will eliminate a source of liquidity from which two-thirds of liquidity additions have come over the last decade. This has indeed, as you point out in your last sentence, resulted in an abundance of international liquidity which appears excessive, but do you believe that one-third of these past liquidity increases would have been enough to meet reasonable requirements for reserve growth in the past, or will do so in the future?

"The ease with which we could settle our deficits with dollar I O U's is partly responsible, as you say yourself, for our own laxity because it 'caused us to take years to find out that there was a problem at all.' I do not like a system that gives the key currency countries that much rope to hang themselves, and then suddenly pulls on that rope and forces discipline on us with unwarrantable delays, but also in such violent fashion as to threaten a collapse of the key currencies on which the other currencies have by than become so dependents that the crisis can hardly fail to assume worldwide proportions, as in 1931. Note also, once more, that the overabundance of international liquidity is itself the result of these techniques of reserve creation.

"This is the reason why my analysis of point (2), while similar to yours, is probably more pessimistic.

"Most of all, while recognizing three separate problems, I would stress their interdependence. I cannot disregard the fact that the key currency solution to the volume of liquidity (your problem 1) is one that depends on the creation of supplementary reserve media—without proper controls—through continuous deficits in the balance of payments of the key currency countries and a consequent deterioration in their net reserve position (problem 3), resulting in a dangerous weakening in the structure of international liquidity itself (problem 2). I don't think you can realistically isolate these three problems from one another.

"Two final observations as to the nature of my own solution.

"(1) I do not suggest that the IMF underwrite automatically future U.S. deficits by absorbing indefinite amounts of dollar balances. Any dollars transferred to the Fund by other countries would be debited from the U.S. deposit account and force the United States to replenish it through gold payments unless the Fund specifically decides to purchase larger dollar investments or grant advances to the United States.

"(2) I am keenly conscious of the political aspects—including voting power—of the proposed enlargement of the Fund's role and means of action. I know also of the doubts entertained in this respect by many people, particularly as to the ability of the IMF to resist undue pressure for excessive borrowings by some countries. This is why I would favor a decentralization of these functions, possibly through the simultaneous strengthening of EMA. The United States should join EMA when it joins OECD, shifting—nearly automatically—the EMA exchange guarantees from a dollar clause to a gold clause (since the United States could hardly notify its dollar repurchase price in terms of dollars), and EMA members should be allowed to hold reserve deposits with EMA itself, as well as with the IMF. In this way, the bulk of the financial strength and decisions would concentrate in EMA, rather than devolve fully and exclusively on the IMF. I have discussed all this in my book, and need not revert to it."

Sterling and International Liquidity Arrangements [1]

(By A. M. Stamp, Maxwell Stamp Associates Ltd., London, England)

I have been asked to consider the effect on sterling of the various proposals which are being put forward for changes in the world's payments system. As I write, in June 1961, it appears likely that late this year the Fund will produce its own plan, which will probably bear some resemblance to the proposals of Mr. Bernstein and Professor Zolotas. But as yet we do not know exactly what the Fund proposals will be; nor how they will have to be modified to meet the wishes of the member governments. We do not know whether they will be the final answer or merely a first installment to be modified later as the inadequacy of the first stage of reform becomes apparent; just as the present "movement" derives from the realization that the Fund's last change—the increase in its quotas—was not an adequate answer to the world's problems. This article then, cannot be an appreciation of the effect on sterling—or on other currencies—of a scheme about which the details are as yet unknown; it can only be an attempt to add a little to the analysis of the problem in the light of which the adequacy and appropriateness of the Fund's proposals and other alternatives can be judged. It is written by an Englishman, with special emphasis on the position and problems of sterling, but the analysis is, I hope, of general validity.

In judging the Fund's proposals or other alternative schemes, it will be important to distinguish between two possible types of change in present arrangements; the distinction between changes which are designed to increase international liquidity and those which are designed to remove disequilibriums more speedily or with less disruption to trade and production. The two are interconnected, but distinct; the less efficient the mechanism for correcting disequilibriums, the greater will be the need for reserves; and the greater the reserves the less urgent it is to have a speedy and efficient method of correcting disequilibriums. If one accepts the premise that reserves in total are in present conditions inadequate or are likely to become inadequate, this situation can be remedied either by increasing reserves or access to credit, or by improving the mechanism by which unbalances are corrected. For reasons which will appear later, I believe that any solution which concentrates on the first to the exclusion of the second is likely to be at best a palliative rather than a fundamental improvement.

[1] This article by Mr. Stamp is to be published in September by the Creditanstalt Bankverein.

The United Kingdom, of course, is vitally concerned that the world should have adequate liquidity and that its payments system should be as good as can be devised; but the British concern should be shared by other countries, for despite the fact that sterling is a reserve currency, the problems of many other countries are different in degree rather than in nature. All countries in which foreign moneys have been deposited at short term and can be easily withdrawn or which impose no effective exchange controls on their own residents, so that they may be faced with a flight of capital, are vitally concerned with the means at their disposal for dealing with such a capital flight. Moreover, since it is usually if not inevitably a deterioration or anticipated deterioration in the current account balance which sparks off a capital outflow, the efficiency of the mechanism by which a current account imbalance can be redressed is a matter of vital concern to every country. The difference between the reserve currencies and the rest is largely one of scale. Both reserve and nonreserve countries have short-term liabilities to foreigners, but the reserve countries, besides attracting private credit, also attract large "official" deposits by other governments who find it convenient or profitable or politic to keep a proportion of their reserves in the form of British or American Treasury bills or bank deposits.

Movements in these "official" holdings are guided by rules which differ from those which determine the ebb and flow of private balances. Private money may, for instance, move from New York to a Latin American country if, in the view of its proprietors, the higher rate of interest more than offsets the extra risks involved. Official reserve balances are more unlikely so to move, though they may move between one reserve currency and another. The distribution of reserves between dollars, sterling and gold is determined more by national tradition or legal provisions, which vary from country to country. But as some countries either desire or are compelled by law to keep a proportion of their reserves in gold, then, if their reserves increase, only part of the increase will be lent to the reserve countries; the remainder will be converted into gold.

Of course, the United Kingdom and United States being reserve countries, with very highly developed financial systems, are attractive places for private capital as well as official reserves. This has advantages and disadvantages: on the one hand they get control over foreign resources on relatively inexpensive terms—they attract deposits like a banker. On the other hand, there is a tendency for at least part of these deposits to be reinvested either at home or abroad in relatively illiquid forms. There is a natural tendency for these countries to borrow short and lend long, or even for the inflow of liquid funds to be used to finance a current account deficit, or aid in the form of grants, so that the increased liabilities to foreigners are not even balanced by a corresponding increase in long-term assets.

This is a problem which is faced by some nonreserve countries, which because of the stability of their economies or the excellence of their banking systems attract short-term liquid funds. For reserve and many other countries, as long as things are going well the short-term funds flow in, but almost inevitably the net liquidity of the country tends ultimately to decrease. The banks which receive the extra deposits from abroad tend to increase their investments: part of the funds seep through into the long-term capital market, and the country becomes an attractive place for foreign borrowers to borrow in. As long as the country concerned is in current surplus or even balance, or as long as the foreign depositors do not need the money to cover their own balance-of-payments deficits with other countries, or to finance their own development programs, all can be well, but to maintain confidence, reserves must be adequate or the government must be demonstrably able to offset repayment of debt to one set of debtors by a corresponding borrowing from another source (e.g., the IMF or central banks); and if, as is often the case, the withdrawal of liquid funds has been "triggered off" by the emergence of a deficit on current account, the government must have the means and the will to correct that deficit quickly. No one likes to have their money in a bank which is losing money, even if its liquid position appears relatively strong. Recent events have shown that a country with a low ratio of reserves to liabilities can be in a much stronger position if its current account is in balance and it is gaining reserves, than a country which has large reserves and a much more favorable ratio of reserves to liabilities but is losing reserves. A level of reserves which appears adequate when things are going well will quickly look very inadequate if things begin to go badly—unless it becomes clear that the current account deterioration can and will quickly be put right.

It is, in fact, impossible to define a level of reserve which is adequate or just right either for a single country or for the world as a whole. It is a matter of judgment, and the judgment will vary as circumstances change. The judgment has to be made; and though it is impossible to define "gray" one can at least say that something that is black is not gray. But a shade of gray that looks quite pale in one light will look quite dark in another; and so it is with reserves. To compare changes in world reserves with changes in the volume of world trade, or to express a country's reserves in terms of a number of weeks imports which those reserves could finance is not very enlightening; this seems to be a field in which quantitive conclusions are either impossible or misleading. But judgments about the adequacy of reserves have to be made; they are always being made both by the governmental authorities and by the proprietors of liquid funds. It is changes in this general view about whether a particular country's reserves are or are not adequate which is one of the main factors which cause "hot money" to move from one country to another. I cannot, therefore, (and nor I think can anyone else) produce neat arithmetical sums to show by how much world reserves in total or the reserves of individual countries fall short of some hard and fast standard of adequacy. This difficulty of proof does not dispose of the problem, any more than the difficulty of defining "happiness" disposes of the problem that some people are unhappy and need help; but it does make it more difficult to obtain agreement on the seriousness of the problem and on measures appropriate to its solution. Despite the fact that many governments and even the Fund itself have now come to believe that there is a problem, there is much hard thinking and analysis to be done and much convincing of the doubters before the necessary reforms can be agreed.

We are, then, still in the stage of analysis and argument. In this article I cannot do more than indicate some of the facts and factors which the analysis must include, and some of the directions along which our thinking should, in my view, develop.

First, to count as the total of world reserves foreign countries' holdings of dollars and sterling, without making corresponding allowance for the fact that these dollar and sterling holdings represent liabilities of the United States and the United Kingdom against which reserves must be held is double counting of an obvious kind. It is not enough to dismiss this as a problem of maldistribution—to say that other countries' reserves are adequate, but not, e.g., those of the United Kingdom or the United States. For the only way in which the United States and the United Kingdom can improve their net positions is to run surpluses, which will have the effect of reducing correspondingly the reserves of other countries. For apart from new gold supplies, or supplies which come out of hoards, if one country gains reserves another must lose them or get more illiquid.

Nevertheless, because of this system of double counting, and because the reserve countries have been prepared to get themselves into dangerously illiquid positions, we have had a considerable increase in gross world reserves in recent years. The gold exchange standard, erecting an ever-growing mountain of foreign obligations on an inadequate gold base, has worked up till now. But it has only worked because the United Kingdom was forced to go into debt to finance her war effort and because the United States was willing to go into debt to finance aid and long-term investment. Now we have come either to the end of this road or very near to it; and this at a time when the need for reserves is likely to increase rapidly.

This last judgment, I realize, requires justification and I must now give the reasons for my belief.

We have seen that adequacy of reserves either of a country or of the world as a whole is a matter of judgment and that the view of the responsible authorities within a country and of those who have more liquid funds about the world, will change as circumstances change. A level of reserves which appears adequate when world trade is expanding and exporters are winning new markets may seem sadly inadequate if trade falls off. Even those countries whose trade position initially benefits from a recession (e.g., because of a fall in the prices of their raw materials) see the impoverishment of their customers with alarm. For them presently rising reserves are but slight consolation for the perils which they see ahead. Now the world has not had to face a serious recession since the war; the minor ones we have suffered have been cushioned by the continued outpouring of dollars from the United States of America. The cessation of this outflow, plus the end of the current U.S. recovery when it comes is likely to face the world with a new and unprecedented situation. It will certainly make it more difficult to counter a recession, even if it does not itself provoke one.

There is nothing like a healthy current account for making reserves look adequate. So a vital element in whether reserves are adequate or not is the ability and will of governments to correct a disequilibrium speedily. There is some reason to believe that the ability of governments to do what is necessary to put their house in order, i.e., to correct an adverse balance of trade by restricting domestic demand, is growing less than it was. To illustrate this let us take a two-country system with countries A and B and suppose that A's exports to B fall because of a change in taste or a crop failure or for some other reason. A's deficit with B is B's surplus from A, and theoretically the disequilibrium could be cured by A cutting down imports from B or B increasing its imports from A. If B reduces her tariffs against A's goods, A's task if obviously much easier than if B does nothing; similarly, if B increases domestic demand by expanding her money supply or reducing taxation. But if both A's and B's reserves are on the low side, B will not be worried by—indeed will welcome—an increase in reserves at A's expense. The B government may be reluctant to expand domestic purchasing power for fear of inflation; her manufacturers will probably vigorously resist a lowering of tariffs. The burden of adjustment then falls on A.

In the real world the burden of adjustment tends to fall very largely on the deficit country. What are the means at its disposal for redressing its situation? The classic remedy is deflation, cutting down incomes and purchasing power so that her citizens cannot afford to buy so much from abroad, and prices fall so that it becomes a good place to buy from and a bad place to sell to. If money wages fall easily this may be painful, but the remedy will work and work fairly quickly. But nowadays with the increase in the power of trade unions and collective bargaining, money wages do not fall, so that the whole effect has to be obtained by the creation of unemployment or unused capacity, and the process takes much longer than would be the case if money wages fell in response to a small increase in unemployment. For good or ill the world now lives in what has been called a ratchet economy. The deflating process still works, but less efficiently and more slowly than before. This phenomenon has been masked hitherto by the postwar inflation. If prices in B are rising, then all A has to do is to keep prices stable for a while to be "floated off" her deficit situation. But if prices in B (the rest of the world) are stable, A is faced with a much more difficult problem. The adjustment process will take longer and A needs much higher reserves to ride out the storm. If, as the Managing Director of the Fund has claimed, the problem of world inflation has been largely conquered, the corollary of his view should be that much higher reserves are necessary to compensate for the greater difficulty which deficit countries will have in reestablishing their position if prices in the outside world are stationary or falling.

The position of the United Kingdom in the summer of 1961 illustrates the difficulty. The United Kingdom needs an improvement in her current account position of £200 to £300 million. If the Chancellor cuts down internal demand by this amount, it will have some effect on imports, but only a proportion of the reduction in demand will be import saving. Except to the extent that exports are at present prevented by home orders, it will have no immediate effect on exports. Only if we make the British economy depressed, so that manufacturers cannot sell at home and are forced to look abroad for markets will exports ultimately increase. But this is a long process and in the meantime their profits fall and they undertake less new investment. So the effect on the balance of payments is slow; and it is a very painful and depressing process, in which the cure has a dampening effect on the enthusiasm of manufacturers to undertake the investment on which future growth and competitive ability depends.

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If, however, the Chancellor knew that any reduction in United Kingdom domestic demand would mean that the goods not bought at home would immediately be exported, his problem, though still requiring decisive action, would be relatively simple. It would be obvious that Britain could easily cure an adverse balance and British reserves would seem much more adequate than they do at the moment.

It must be noted, however, that if the United Kingdom is successful, the resultant improvement in the British position means a worsening of some other countries' positions. If it is the surplus countries which sell less to us, then though the total of world trade may fall, at least the position gets righted fairly quickly. But if the shock falls on those countries which are now just in balance, they will go into deficit and will be forced in their turn to restrict demand; and this makes the British position in turn more difficult. There is a very real danger of a vicious circle in these circumstances, which will only be righted when the pressure finally seeps through to the surplus countries and their exports are reduced.

The same argument on a more important scale applies to the United States. If the United States improves her overall balance by $3 billion and thereby eliminates, more or less, her overall deficit, the balances of the rest of the world must deteriorate by a corresponding amount. There is no assurance at all under our present mechanism that it will be the countries which are now running surpluses who will export less or import more; rather it is more likely that the difficulties of those countries now in precarious balance that will be increased. The fact that among the means used by the United States to strengthen the dollar is a reduction of military expenditure in Britain—which can ill afford the loss of these invisible exports—is an obvious example.

The true interest of sterling, and indeed of other countries, will be served by those reforms which best enable a country in current account deficit to remedy that situation easily, and without provoking a vicious circle of currency difficulties for others. Ability to borrow enables a country to take longer over correcting a disequilibrium—it gives it breathing space—but far better is anything which will enable it more easily to balance its accounts without incurring debts which will soon have to be repaid. Any scheme which gives the reserve countries—and other countries with heavy short-term liabilities—the ability to borrow from an international institution to offset withdrawals of private or official capital is, of course, to be welcomed. And if this, for political reasons, is the best that can be arranged, we must be thankful for what has been achieved. But fundamentally it is only tinkering with the problem.

What is required is not only an absolute increase in world reserves, or the provision of new or enlarged sources of international short-term credit, but some means of counteracting the increasing difficulties which deficit countries are likely to find in removing disequilibria on current account, and a mechanism for allowing them to do so without correspondingly weakening the positions of other countries. Merely to allow them to borrow reserves from the surplus countries, either directly, or indirectly through the Fund, postpones the need for action, but does not make it easier, when taken, or less damaging to other countries. If the United States can draw large amounts from the Fund it may enable her to postpone the day when she shuts her bases in Britain or cuts aid, or discourages the export of capital; but some day she must earn the necessary surplus to repay the Fund—and then we are back to our original problem.

It was for this reason that I have felt for some time that a substitute for gold, to be used alongside gold as the base on which the international liquidity structure can be erected, is urgently needed. This substitute could be either Fund credit, or it could be paper money, printed for the purpose and issued by the Fund or by some other authority. But several questions arise: shall the certificates or credit be backed by the Fund's promise to pay and if so shall they be redeemable in gold? Shall the extra credit creating powers of the Fund be used primarily as a support for the reserve currencies in the time of need (in which case they may never be used, for the Fund has quite considerable lending powers and resources as it is)? What are the repayment conditions on which this credit shall be extended? How, indeed, is this extra credit-creating power to be used, given the fact that the Fund's existing resources are far from fully employed?

There is, in my view, considerable advantage in not making the Fund credit or certificates convertible into gold as a matter of right, though their value must be expressed in terms of gold. I realize that this makes the scheme much more difficult to "sell" to those who believe in the mystique of gold, and believe that paper money ultimately derives its value from the ability of the holder to convert it into gold. Nevertheless, if the Fund must redeem in gold on demand it must always be worried about its own liquidity position, and we should really only be erecting another layer of credit on the already overburdened and inadequate gold base. It would be far better if the Fund credit or certificates derive their value from the fact that all members have agreed that they shall be legal tender so that the base itself is broadened by the addition of a gold substitute. There need then be a minimum of interference with established habits; in particular, members would not need to surrender part of their reserves to the Fund to give the Fund adequate backing for its credits or notes, as would be necessary under Professor Triffin's plans. Convertibility into gold may reassure those who fear abuse of the Fund's credit-creating power; and, indeed, it does impose severe limits on that power—limits which may be completely inconsistent with the real needs of the world in future years. New gold supplies coming into the hands of the Fund and central banks are very likely to be inadequate as a basis for the creation of adequate new international reserves; and the credits which can be safely extended if they are to be redeemable in gold are also likely to be inadequate.

If, however, the Fund credit or certificates derives its value from its universal acceptability the world can be liberated from the dilemma that either credit will be dangerously extended on an inadequate gold base or inadequate credit for the world's needs will be created.

To achieve this universal acceptability all that is required is that a sufficient number of important trading countries shall undertake to provide their own currencies when these certificates are tendered by another central bank. The scheme could, in my view, still work if one or two countries decided to stay outside it and elect to be paid completely in gold. If, for instance, France declines to join the scheme and she runs a surplus with the rest of the world she could, as now, either lend that surplus to the United States by holding dollar balances or take it in gold. The United States would be much less worried by the loss of gold if this were more than balanced by an increase in her holdings of Fund certificates, for she could use the latter instead of gold to settle her accounts with any country except France. So if the French insist on being paid in gold there would be plenty of gold to settle any surpluses which they might run.

The next problem is how the credit-creating power shall be used. The power to create credit is not the same thing as actually creating it, for borrowers may find the conditions too onerous. The ability to borrow is not the same thing as having one's own reserves, for loans must be repaid. Bolstering the reserves by fresh borrowing is perhaps one of the most dangerous ways in which the financial authorities of the world give themselves illusions. The problems of the world will be eased if the United States or United Kingdom can borrow enough from the Fund to counter a run on the dollar or sterling; but there is no real substitute for these countries ceasing to run the deficits which are the primary cause of the concern about their currency. Yet if they do this, the balances of other countries must deteriorate and the United States and Britain may well have to deflate to a very uncomfortable extent or reduce aid, or put restrictions on capital exports to achieve this new balance. It is no solution for the Fund to lend on short term, for this means a corresponding short-term liability to repay on the part of the borrower. Hence my suggestion of 3 years ago that the Fund should lend to the World Bank (or IDA), which would relend on long term; or my more recent suggestion that the Fund certificates should be simply given away to the most needy recipients—the underdeveloped countries. Either of these alternatives would mean that the deficit countries could improve their positions without a corresponding worsening of the positions of other countries, and that the assymetry which we have noted—that all countries like to see their reserves increasing and will do little to stop a modest increase, thereby placing the burden of adjustment on the deficit countries—would be eliminated in a natural way.

To see how the system might work in practice let us take a world with only four countries, but which bears some relation to present conditions—Britain, the United States, Germany, and India. Britain has a somewhat overstretched economy and an adverse balance; the United States has plenty of spare capacity and an adverse balance; Germany has a fully employed economy and a surplus; and India just needs more money for development. India receives $1,500 million of certificates as a gift or a very long term loan. Part she spends in Britain; as the British economy is fully stretched British home demand must be cut down to make room for the exports—but less than it would have to be reduced to right the British situation if this had to be done merely by cutting down imports through a reduction in demand. The British task of improving her balance would be much eased. Part India spends in the United States, which would simply use spare capacity to fill it, getting a welcome increase in reserves in the process and getting out of her recession in a healthy manner. Part India spends in Germany. This, it must be admitted, would add to that country's problems. Germany's order books would lengthen and she would be less aggresive in getting more exports, but there would be greater pressure on her resources, higher incomes in Germany and more tendency for prices to rise. However, to the extent that German goods become scarcer in Germany more imports would be brought in. To the extent that her reserves rose because of the additional orders she would be lending to the world community in a risk-free and painless manner. At present if Germany runs a surplus she has either to take gold, thereby putting pressure on the gold reserves of other countries, or she must lend it to other countries, such as the United States by holding balances of their currencies. The accumulation of Fund certificates as reserves would provide a way in which Germany could lend her surplus to the rest of the world with no risk of exchange loss. Germany could, indeed, minimize the pressure on her overexpanded economy and yet cooperate to the full by agreeing that the new Fund certificates should not be eligible for purchases in Germany, but that she would accept them from the United States, United Kingdom and other governments which had received them against delivery of goods to India. No extra strain would then be put on her economy initially, but she would have a devaluation-proof form of reserves in which to "store" her surplus. It must be admitted that the injection of fresh purchasing power into the world will tend to increase the strains on those countries which are fully employed and are enjoying a balance-of-payments surplus. Nevertheless, the strains would not be greater than if, say, the World Bank made an extra loan to India of an equivalent amount; and it would hardly be right to hold up aid to India on the grounds that some of it might be spent in countries which are already fully employed. Moreover, participation in the scheme would render it less likely that other countries would be forced to devalue or that Germany would be forced to make further upward adjustments in the value of her own currency.

This easing of the world's currency tensions would therefore be of considerable benefit even to those countries, such as Germany, which would seem, at first sight, to be disadvantaged by it.

My suggestion has been attacked as inflationary; and I think it must be admitted that it could be inflationary in the same sense that an expansion of the fiduciary issue within a single country could be inflationary. But sometimes such an expansion is necessary to prevent deflation and to take care of the growing needs of trade and industry. Expansion is appropriate where there are spare resources waiting to be brought into use; it is bad when there is no unused capacity. The issue of Fund certificates, therefore, ought ideally to be confined to times of recession and spare capacity. In times of world boom the corresponding aid to underdeveloped countries must be found by increasing taxation. The scheme implies a transfer of resources to the underdeveloped countries from the rest of the world; if the resources would not have been used anyway then it is pure gain. But if they would have been used they must be taken from those who would have used them by persuading them to increase their rate of savings or by taxation. This is, of course, only what would happen anyway; but it is as well to be clear on the process. The advantage of this scheme is that it also increases world liquidity and bolsters the shaky gold exchange standard.

It is, I think, very easy to exaggerate the inflationary effects of my proposal, by overlooking the fact that it is the monetary and fiscal policies of individual countries which determine price levels within those countries, and that this would continue to be true if the Fund issued certificates. Naturally, any country whose reserves are increasing has a need to control the resultant pressures; but most countries would be only too glad to be faced with that particular problem. If a country's exports increase its manufacturers and exporters will earn higher incomes; if it has unused resources they will be brought into use and the extra incomes will be spent on them. If it is fully employed savings or taxation must be increased to prevent inflationary pressures. But this is what monetary policy is for, and it is no different from what happens when, for example, the end of a recession in the United States causes American imports from Germany or France to increase at a time when these countries are fully employed. In any case many countries have unused resources which could be diverted to exports—if only they could sell the exports. To believe that in most years the world cannot produce $2 or $3 billion worth of extra goods without suffering from inflation seems, on the face of it, needlessly alarmist. It appears to imply that countries are not prepared to devote resources to building up their reserves, and that there is something immutable, exactly right, and ordained by Providence in the amount of new gold which gets into the system each year, or in the extent to which the total fiduciary issues of the world are increased each year by the combined efforts of national governments. An additional $2 or $3 billion a year in those years in which the world's economy is not fully employed is a tiny fraction of the total value of world production, or of the total world money supplies. I cannot believe that it would add significantly to the problems of national governments in controlling their economies and price levels; but it would ease significantly the problems of those countries which are in balance-of-payments deficit, without adding correspondingly to the difficulties (if any) of those in balance-of-payments surplus.

From the above it will be seen that I regard any scheme which is merely designed to strengthen the reserve currencies by increasing the borrowing powers as decidedly inferior to one which removes the need for their borrowing by enabling them to strengthen their current account balances more easily. The Fund or Bernstein schemes are liable, like the recent increases in quotas, to be a gesture of which no advantage will in practice be taken. World trade may languish, but no one will quite know why.

Professor Triffin's schemes get more nearly to the root of the matter; but he has been, I think, unduly impressed with the disadvantages of the reserve position of the world depending on the short-term indebtedness of the United States and United Kingdom and would like to substitute the credit of the Fund. The gold exchange standard, however, can work quite well if it is supplemented by another source of liquidity and if the United Kingdom and United States can correct their balance of payments more easily and with less damage to others than is at present the case.

If the fund uses the credit-creating powers given it under the Triffin plan, not for taking over the United States or British liabilities, but to make long-term loans, possibly via the World Bank or IDA, there is not all that much difference in principle between his proposals and mine. But the essence of the matter is the creation of new reserves without creating corresponding short-term liabilities, finding a substitute as a source of reserves to the American deficit of recent years and the finding of a means of easing the increased difficulties which, in a noninflationary world, deficit countries will find in eliminating their deficits. It would be a pity if the forces of reaction prevent any real progress toward this goal; for the result may well be a slowing of the growth of world trade and a world recession when the current upswing is over. We might even be forced to raise the price of gold, which would, indeed, be a sad reflection on the ability of the Western World to order its affairs in a sensible manner.

THE WORLD'S PAYMENTS SYSTEM

(By A. C. L. Day, reader in economics, London School of Economics, London, England)

It is not at all difficult to diagnose what is wrong with our present international monetary system and on much of the diagnosis the experts are in broad agreement. Our system is fundamentally a restored gold exchange standard, very like the restored gold standard of the late twenties, which collapsed so completely in the great depression of the early thirties. Our present system was formally established at the end of 1958 when the convertibility of the major European currencies was restored. It is based, like its predecessor, on gold as the ultimate means of payment between (but not, of course, within) nations, reinforced by extensive international use of two major national currencies—the key currencies, sterling and the dollar. The basic rules of the game today are very like those of the old gold standard—countries should interfere as little as possible with freedom of international payments (hence the significance of convertibility as the initiation of the new regime); countries forswear the use of exchange rate changes as an instrument of policy save in exceptional circumstances, but keep their exchange rates pegged within narrow limits; and a country which finds itself in external economic difficulties with a balance-of-payments deficit is normally expected to deal with its troubles by internal action taken to reduce domestic spending and incomes. Moreover, the rule for a country with payments difficulties is to attract foreign lending by high interest rates. It is this system which is already running into severe difficulties, as shown by last year's pressure on the dollar and this year's on sterling.

The weakness of the system which is most commonly discussed is that there is not a sufficiency of money which is internationally acceptable. Just as in the late twenties, there was repeated discussion of the gold shortage, so in recent years, there has been steadily increasing discussion of the shortage of international liquidity—of liquid funds which are widely acceptable for making international settlements. There are good grounds for considering that there is a shortage today, and there are even better reasons for thinking that the shortage will become more serious.

Many of the arguments for believing that there is or will be a shortage are, to my mind, not conclusive. Others are very important—for example, the argument to the effect that since the war newly mined gold has provided only a fraction of the world's needs, while the rest have been satisfied by increased sterling and dollar debts—debts which are now so large that the British and American Governments fear that any further increases would be unmanageable. But in addition, there is an argument which really does clinch the matter. Countries hold reserves of international currency for the same reasons as indi-

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viduals hold ordinary money; they hold some of their total wealth in a form which can easily be used to buy almost anything anywhere. Just as some individuals hold small reserves of cash and others big, so with countries; a country whose total wealth is very great, or one which does a great deal of foreign trade, or one which cannot bring itself to use the money in other ways (such as allowing more imports or encouraging long-term oversea investment) countries such as these will tend to want to hold a good deal of their wealth in international currency. But if the total amount of internationally acceptable currency in the world is less than the total amount which all countries, taken together, would like to hold, then inevitably some country is frustrated. And this is, in fact, the present situation. Judging by their actions and the policy statements of their governments, no country seems to have much more international money than it would like, while a good many (including the United Kingdom) have less.

This is an absurd situation which cannot be solved by an attempt on the part of the countries with too little to earn more because if they do, they simply deprive someone else. So we find most of the developed countries which, it would seem, would like to put more of their savings into international money, but are often frustrated because insufficient is available. And at the same time, we find many underdeveloped countries which are desperately short of funds to finance their investment programs. The failure of our international monetary system to bring these two groups of countries together—the countries which want to put savings into international currency and those which need to borrow savings to invest—is monstrous and unnecessary; unnecessary because it can be solved by printing some internationally acceptable money and monstrous because it means that the poor countries are poorer than they need be.

The other great weakness of our present system is that it is not flexible enough for a world where countries are trying to maintain full employment. In particular, it is extremely difficult for the monetary authorities to envisage any change in the exchange rates of the key currencies, because the suggestion provokes violent speculation, and because a devaluation by a key currency might lead to a permanent loss of confidence in using it as a monetary reserve. Yet exchange rate changes there must be; it is unrealistic to suppose that, even if their present parties are reasonable, the current pattern of rates can survive for all time into the future. The full gold standard rules are nonsense today; no country can reasonably be expected to rely solely on massive internal deflation to deal with all and every external payments difficulty. On some occasion deflation is the right remedy; generally deflation may be needed to support a devaluation; but it is absurd for a country to be forced to reduce domestic spending right up to the point where its imports are reduced to the level of its exports, if the real trouble is that its prices are uncompetitive and it is in fundamental disequilibrium. Yet it is this policy which is demanded, particularly from the key currencies, in the new gold standard system.

There are two main kinds of remedy under discussion, to deal with these problems of the inadequacy of our supplies of international money and the particular demands thrown on the key currencies. The more conservative line of policy wants to buttress the present system by supporting the key currencies and by increasing the use of the International Monetary Fund. The more radical line of policy would like to transform the present system, by abandoning the use of key currencies and by creating an international central bank which would act as a bank where countries would make settlements with one another (the clearing function) and as a body which could create new international paper currency (the credit-creating function).

There have been many variants of both these schemes and indeed most of the elements in the debate between them can be found in the debate between the radical British position at Bretton Woods in 1944 and the more conservative American position. The most widely publicized contemporary versions are those of Edward Bernstein on the conservative side and Robert Triffin on the radical side. In official circles, it appears that the conservative view is in the ascendant.

But while the official view is generally conservative, the position taken by most economists and financial commentators seems to lean fairly uniformly on the radical side of center. Most writings on the subject (leaving aside these people who regard inflation as the only evil and those who see an easy remedy in raising the price of gold) regard a Triffin-type plan as the right aim, and a Bernstein-type plan as no more than a pis aller.

I consider that a radical solution is certainly necessary. It is not enough to shore up the present system, by supporting the key currencies. To do that would mean that the system would remain inflexible, because exchange rate patterns would have to remain too rigid; it would mean that a basic instability would be built into the system, because we should be using three international currencies which can never be perfect substitutes for one another, so that their holders will always be tempted to change their loyalties. Moreover, it would be morally wrong to shore up the present system, if it were to mean that Britain and the United States could pile up still more short-term debt (and if the key currencies are to provide a net contribution to world liquidity, then Britain and the United States of America would have to increase their net short-term liabilities) because such a policy would mean that these rich countries could continue to run payments deficits—in effect to live on the rest of the world. This is hardly defensible, when there are plenty of poor countries which have more need to borrow.

Nevertheless, it is quite wrong to see the conservative-radical conflict on these issues in the black and white terms in which it is usually presented. For one thing, there is good reason to be alarmed about the political implications of an international central bank in the absence of an international government; to have international bureaucracy with the power to initiate open market operations in member countries (as Triffin proposes[1]) or to determine the pattern of world exchange rates (as suggested by Meade[2]) would give an immense degree of power to a small group of men with no direct responsibility to any electorate. If we create a world central bank before we have some sort of effective world government, we are in danger of giving a degree of power to the bankers which is unprecedented—even in the days when it was considered that national control banks must be quite independent of the government.

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1 "Gold and the Dollar Crisis," New Haven, 1960.
2 "Three Banks Review," Summer 1961.

The other doubt about the radical position is that it fails to take sufficient account of the danger that idealist schemes will simply be politely ignored.

Looked at in this way, I see the Bernstein type of plan as being much more than a pis aller; it can very easily be the right step in the right direction. This is in fact true, even of the weaker schemes than Bernstein's which can be expected in the near future—the schemes which amount to a formalization and consolidation of the Basle Agreement, by which the continental central banks have been supporting sterling by holding unusually large amounts of it—holdings which apparently enjoy an exchange value guarantee.

In total, and ultimately, three things are necessary to make a satisfactory world currency system. The first is a rescue operation for the key currencies; the second is a single unified international currency; the third is to be able to create as much international currency as is necessary. In order of priority, the first of these (the rescue operation) is the most urgent; the second (the unified currency) is almost equally urgent; the third (the creation of more liquidity) can wait a little time. When nations have come to accept the existence of a new international currency which is just as good as gold—and in some respects better—then it will be possible to go ahead creating as much of it as is necessary. The right order of events is not to agree on a commitment on the part of all countries to use and hold a new currency, but to establish the new currency and demonstrate that it is an attractive thing to use and hold. The method of prior agreement means that one is always held back by the laggards; the better method is the one by which banknotes and other bank-created money became accepted within nations, and ultimately replaced the use of precious metal.

The encouraging feature of the present situation is that events are moving in the right direction, and that it would not demand a great deal in the way of modification to the course of present policy to achieve the first two of the three stages in the very near future. We are in the middle of a resuce operation for sterling of far greater magnitude than is generally realized; the steps being taken and likely to be taken for that purpose could, by quite a small diversion of their direction, lead to the creation of a new world currency which would safely supplement the use of gold. Then, once such a currency is firmly established, it will be possible to go on to the third stage of creating more of this currency, in accordance with the world's needs.

So far, the rescue operation for sterling has taken the form of inter-central bank support. The scale of this support is unknown outside official circles, but the indications are that it may already have been on a scale not so very much smaller than that of the abnormal capital inflow into London last year—a flow of roughly £700 to £900 million. Perhaps the best working hypothesis that can be made is that the reserves at the end of June 1961 would have been down to the unprecedented figure (for the postwar years) of £500 to £600 million, instead of £1,000 million. This means that, in the absence of this central bank support, a major exchange crisis would have been on the British Government's hands by now.

It appears that the next stage in this rescue operation is now being prepared. It would mean that holders of these abnormal sterling balances will probably convert them into a claim against IMF—offset by a corresponding liability by Britain to the same organization. Such an operation would broadly follow the lines of Bernstein's reserve stabilization account, although probably within the powers available within the Fund's Articles of agreement. In the following argument Bernstein's plan can conveniently provide the basis of discussion because it has been publicly spelled out; but it would be perfectly possible to do much the same thing without new formal agreement, by stretching a point or two of interpretation in the articles of agreement.

In Bernstein's scheme, a Reserve Settlement Account—a new agency of the IMF—would be able to borrow from members by issuing to them interest-bearing notes with a gold value guarantee. These notes would have a specified maturity—but their holders would be able to use them prior to maturity in order to meet balance-of-payments deficits. The funds so acquired could be used to make loans to other members, for the purpose of a rescue operation.

The significant fact is that one is here very near indeed to establishing a new international currency—on the lines of Keynes plan for a "bancor." To get all the way, one has to make one simple, though important, modification. That is to provide that the new notes should be repayable on demand instead of simply when a holder has a payments deficit. In practice, holders of notes with a reasonable interest rate would only demand repayment if they had a payments deficit—but the additional freedom I am suggesting would mean that their holders would have no doubt about regarding the notes as being as good as gold as a way of holding reserves.

In fact, they would be better than gold, because they would earn interest. And they would be better than sterling or dollars, because they would avoid the exchange risk involved in holding those currencies. So the next step in the operation, after the rescue work envisaged by Bernstein, could follow very quickly. This would be for the IMF (or its Reserve Stabilization Account) to accept further deposits by members of gold, dollars or sterling in exchange for these new notes. Gold deposits would swell its reserves against withdrawals by the mystics and the obsessionals who decided to prefer gold; sterling and dollar deposits would be offset, as in the Triffin-type plan, by a funded claim against Britain or the United States.

The last stage in the development would be to move ahead from these stages of merely swapping one sort of liquid claim for another to the stage of creating a net addition to international liquidity. Here it is useful to go back to the fundamental points made earlier—that we want a mechanism which allows for the fact that countries such as Germany and the United Kingdom want to add to their liquid savings, while countries such as India want to invest—and that we cannot safely create a simple international analog of an international central bank while we have no international government.

This suggests that the new system should follow two main principles. One is that the new money created artificially should be used to help the poorer countries; the best method would be for the IMF to take up long-term bonds of the International Bank for Reconstruction and Development and of similar agencies which are able to see that loans are used to good purpose; these bonds would be paid for with newly issued notes.

The other principle involves the question of the control of the issue of new notes. Here it is very doubtful whether it is right to give the power of initiative to the IMF or to any similar agency. The determinant should be the voluntary desire of countries to hold additional savings in a liquid form. One method by which this might be done would be for the IMF at the end of each year, to ask each country whether it regarded any net change in its reserves over the year as permanent, or as merely temporary and therefore to be corrected subsequently. As things stand today, most surplus countries would probably regard most of their net additions to reserves as permanent, while most deficit countries would regard losses of reserves as temporary and something to be put right in the future. The IMF would then calculate the sum (algebraically, minuses being subtracted) of the changes in individual reserves regarded as permanent. This sum (minus the year's gold production) would be the amount of the net new international creation of money which would be regarded as justifiable in the following year. Such a rule would mean that once most countries regarded their individual reserves as broadly adequate, then no further artificial creation of international money would take place. In practice, most countries would probably choose to have a slow indefinite expansion of their reserves along with the rise in the level of their trade and total wealth. If so, the rule would provide for an indefinite increase over time in the supply of international money. In either case the supply of international money would be determined by the amount which countries wished voluntarily to hold; and any newly created money would go to the benefit of needy countries.

Monetary Reform in an Atlantic Setting

(By Michael A. Heilperin [1])

THE MONETARY COMPONENT OF AN "ATLANTIC GRAND DESIGN"

The Atlantic concept is basic to the policies of the United States and of Western Europe in the cold war. NATO in the military field (and, virtually, in the broader field defined by article 2 of the North Atlantic Treaty) and the OECD in the economic field are the two principal institutional organs of Atlantic cooperation. The membership of the latter, as is well known, is more inclusive than that of the former, due to the existence of the European neutrals. The fact that these countries have been members of the OEEC and will be members of the OECD, the successor organization, is of great importance for the grand design because they include economically very important units, such as Switzerland and Sweden.

The grand design is nothing else than a substantial degree of economic integration—and consequently of political understanding—within the entire North-Atlantic group of countries whose combined strength is the best guarantee of peace. The European Economic Community (Common Market) and the European Free Trade Association (EFTA)—nicknamed the "Six" and the "Seven"—are steps in the direction of wider economic unity in Europe. Should Britain join the Common Market, which, while not easy, seems now inevitable, the other members of EFTA, except presumably Austria, will follow suit by and by and the ensuing European Customs Union will be a challenge to the two North-American members of the OECD, the United States and Canada. They can meet the challenge only by entering into tariff negotiations with Europe, for the sake of opening the European market to North American goods, against a corresponding opening of the North American Markets to European goods.

For the United States this would involve the need for a new trade legislation to take the place of the obsolescent Reciprocal Trade Agreements Act, due to expire on June 30, 1962. I have set out the basic principles of such a legislation in my article: "U.S. Foreign Economic Policy," Fortune, June 1958.[2] The new legislation ought to enable the United States to cut its tariffs down to a small fraction of their present level, without peril-point or escape-clause provisions, preferably "across the board"—against a correspondingly sweeping reduction of the European tariff. Thus we should obtain a good approximation to Atlantic free trade, without Congress surrendering its control over the American tariff. Alternatively, the United States could form

[1] Professor at the Graduate Institute of International Studies, Geneva, Switzerland, and associate editor and economic correspondent for Western Europe, Fortune magazine (Time, Inc., New York). The views expressed are purely personal.

[2] Reprinted as app. 7 to my book, "Studies in Economic Nationalism," Geneva, Publications of the Graduate Institute of International Studies, 1960.

a free trade area with the European Customs Union. All this would be a gradual process and provision should be made in the American law for giving adequate compensation or other facilities to interests, whether on the labor side or on the investors' side, which would be adversely affected by the change.[3]

It would exceed the scope of this paper to discuss these trade proposals more fully. What needs stressing, however, is the basic role money plays in the unification (using this term in a deliberately vague sense) of the West. For there can be no stable expansion of international commerce and of international finance without the existence of a well-organized international monetary system or, as I prefer to put it, without "an established and stable international monetary order."

Actually, I have been convinced for many years that Atlantic unity must have, as one of its main components, full monetary convertibility. The following excerpts from a paper I wrote in summer 1958 for limited private circulation among leading statesmen, businessmen and intellectuals of the Atlantic group of nations, may be of interest in the present context:

> What are the monetary policies which might best foster the unity of the West? In a word, they are policies of convertibility. By this term I understand a complete absence of exchange control, i.e., freedom of international payments. It means, on the part of the various countries, policies aimed at the long-term equilibrium in their foreign payments. It further involves liberal commercial policies (because the ultimate reason for convertibility lies in the freedom of trade and capital movements, which are thereby fostered). And, finally, to my way of looking at things, convertibility means freedom of exchanging one currency for another at will, at fixed parities.

I went on to take a stand critical of the adequacy of various forms of limited or near convertibility which so many economists and Government officials regard as an entirely satisfactory degree of progress, the various forms of near convertibility—

> have—even at their most liberal interpretation—one major drawback in common, to wit, the continuing existence of exchange control machinery, of its legal and administrative framework. But as long as this machinery remains in being, backsliding into more drastic controls remains an ever-present alternative to the adoption of sometimes politically difficult and unpopular measures of domestic monetary discipline.
>
> In the interest of long-term economic cohesion among the Atlantic countries, we must aim at the complete elimination of exchange controls at least within this inclusive group of countries, if possible, beyond it.

Convertibility, however, requires the availability of adequate international monetary reserves. Now, I noted in the same paper:

> The non-Soviet world finds itself on a kind of gold-plus-dollar standard, with gold production providing about one-third of additional reserves and the growth of U.S. foreign liabilities—about two-thirds. This is an inherently very unstable situation.

This was written, may I repeat, in the summer or 1958, well before the first of the three successive very large U.S. balance-of-payments deficits became fully apparent. Nonetheless, I warned that—

> the United States cannot be safely counted on to continue adding a billion dollars annually to its liabilities in order to buttress the monetary reserves of the outside world—

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[3] See "The United States and World Trade: Challenges and Opportunities," final report to the Committee on Interstate and Foreign Commerce, U.S. Senate, by special staff on the study of U.S. foreign commerce, U.S. Government Printing Office, Washington, D.C., Mar. 14, 1961, especially ch. 7 and app. I.

and concluded that—

the problem of international liquidity is entering into a serious phase—and may become acute later on.

Nearly 3 years have elapsed since that paper was written. U.S. deficits totaled over $10 billion in 1958–60. No major monetary reforms were undertaken, but the existence of a liquidity problem has been more widely recognized and a number of plans have been proposed by distinguished economists to cope with it. They mostly relate to reforming the International Monetary Fund and they mostly pay scant attention, if any, to international monetary order. They are therefore geographically too ambitious and economically not ambitious enough. Allow me to explain.

They are not ambitious enough in that they settle for some form of near convertibility combined with a substantial dose of (at least implicit) monetary nationalism. My own, more ambitious, position, already indicated in the quotations from my 1958 paper, calls for full convertibility and for domestic monetary discipline. The latter means that a country having either a deficit or a surplus in its external payments would adopt prompt and efficient domestic measures to redress this unbalance. And this is precisely what I mean by international monetary order: a regime of free international payments with fixed parities among currencies and an efficient mechanism of reequilibrium in international payments.[4] But the authors of the recent crop of monetary plans are too ambitious when they envisage a reform on the scale of the IMF. For only relatively few countries are ready for the adoption of monetary order as defined above. Practically all of them are in the Atlantic group of nations (though not absolutely all of the OECD countries are ready for the more ambitious monetary reforms). It is worth noting, too, that the Monetary Committee of the OEEC (as it still is called), established last April, includes all of the Western countries which are capable and might be willing to establish among themselves an international monetary order.

ORDER AND LIQUIDITY IN THE INTERNATIONAL MONETARY SYSTEM

Order is defined here as full convertibility at fixed parities coupled with a well-functioning mechanism of international monetary reequilibrium. By international liquidity is meant the capacity of the various countries to meet balance-of-payments deficits without suspending free convertibility or altering the parity of the national currency. International liquidity consists, since World War II, of gold, sterling, and dollar balances, and drawing rights upon the IMF (as an important subsidiary source of liquidity—which must be, however, repaid after a relatively short time). As long as both the United Kingdom and the United States keep their balances of payments in medium- and long-term equilibrium, the only source of new liquidity (or new reserves) is gold, i.e., the production of new gold outside the Soviet bloc minus industrial uses of the metal and hoarding plus sales of Soviet gold in the West. The question hotly debated in the recent years is, how adequate—or inadequate—the annual increase of gold reserves alone, without increases in holdings of the reserve currencies,

[4] See my book, "International Monetary Economics," London and New York, 1939, ch. VIII.

to meet liquidity requirements of national monetary authorities? And, if new gold supply is insufficient, what best should be done about the liquidity problem? On all this "doctors disagree."

Before offering my own point of view, there are several points to be cleared up. Most important of these is the relationship between "order" and "liquidity." It stands to reason that in an orderly international monetary system in which balance-of-payments disequilibria are promptly corrected by the countries concerned through the adoption of appropriate domestic correctives, there will be less need for sizable international settlements than in a system in which disequilibria are allowed to become chronic and large. Now the IMF has only limited powers to impose monetary discipline—or to induce it by persuasion. A surplus country, e.g., the Federal Republic of Germany, can have a chronic and large annual surplus and remain a Fund member in good standing (unless its currency were to be declared "scarce" which has never happened in practice so far). A deficit country which does not appeal to the IMF for help, e.g., the United States, can run up as great a deficit and as chronic one as it wishes without the Fund having anything to say about it. Only when a member of the IMF applies for credits exceeding 25 percent of its quota, can the management of the Fund set conditions or formulate requirements in terms of that country's domestic policies. This is far from being a satisfactory international monetary "order"; and it is even less satisfactory if one considers that convertibility under the Bretton Woods Agreements falls rather short of the definition of full convertibility provided earlier in this essay. The regime of exchange control remains intact, with only the wide exception for current transactions as regards countries which are under the scope of article VIII (but not the many more numerous countries remaining under the rule of the transitional art. XIV). Thus the Bretton Woods Agreements have failed to establish an international monetary order as here defined. But, as has been already stressed, such an order is indispensable for the smooth and steady working of the international economy. And it has been noted, too, that it is too ambitious to seek such an order in a group much wider than the Atlantic community.

This takes me to the second important point that needs to be stressed at this stage of the argument. The many underdeveloped countries of the world care very little for international monetary order, absorbed as they are in the national planning of their economic growth. Their domestic policies involve different degrees of inflation and their monetary parities are protected by exchange control (and, therefore, mostly unrealistic), while their external trade is subject to a wide use of import quotas (which are a twin of exchange control). Their balance-of-payments difficulties are usually met through IMF credits or foreign aid. In fact, these countries are not really interested in accumulating adequate central banking reserves: they are interested in spending as much as possible on imports. In the final analysis what they need is not liquidity but capital. And this requirement cannot be met through a reform of the IMF but through a number of measures, both domestic and international, in the area of capital supply. A plan proposed last winter by the British economist and banker, Mr. Maxwell Stamp, aimed at solving simultaneously the liquidity problem of the West and the capital problem of the underdeveloped countries. He proposed that the IMF issue $3 billion of certificates, labeled in gold but not convertible into gold; that these certificates be handed over to foreign aid dispensing agencies; and that the Western countries, toward which these certificates would eventually move in payment for supplementary exports to underdeveloped countries, should undertake to hold and use them ex aequo with gold, dollars, and sterling. Appropriate exchanges would be made in the statute of the IMF.[5] Without going into technical problems raised by this imaginative and intriguing proposal, let us just note one basic criticism of it. Mr. Stamp wants, in effect, to finance part of the capital requirements of the underdeveloped countries by means of creating a new international currency. Whether it is at all wise to contemplate in 1961 the creation of an international currency is a question to which I shall yet have to revert in connection with the Triffin plan. But there is a long—a very long—experience of national monetary authorities creating more money to satisfy demands for more capital and the result has always been the same—inflation. Capital is created by savings not by printing presses or (to be up to date) through credit creation by banks, commercial or central.

To conclude on this point: underdeveloped countries cannot be helped by a reform of the IMF but only by measures reaching far more deeply into the structure of the economic process. Nor are these countries must interested in monetary liquidity as such. And even less so as was noted above in what is here defined as "international monetary order." It follows that the liquidity problem must be dealt with, and monetary order sought, in a smaller geographic framework than the IMF. The proper framework for dealing with these vital matters is the Monetary Committee of the OEEC (OECD).

Within this smaller group of economically most advanced countries, both international monetary order and adequate international liquidity are needed. With respect to liquidity, what is needed is not only an adequate present position but, in an expanding world economy, an annual rate of growth of reserves which monetary authorities consider sufficient for the handling of always possible imbalances in international payments. Of these two objectives, that of order strikes me as objective No. 1, that of adequate liquidity—as objective No. 2. Having, in various writings, advocated solutions to the liquidity problem ever since the early fifties—and long before the present "grand debate" about it started—I now feel convinced that it would be unwise to deal with the liquidity problem without having settled (either first or simultaneously) the problem of order. For, clearly, less liquidity is needed when countries correct promptly and efficiently their balance-of-payments disequilibrium than when they fail to do so. Indeed, there is one school of thought—of which the most prominent exponent is Dr. Per Jacobson, Managing Director of the IMF—who nedy the existence of a liquidity problem altogether. They claim that there is enough liquidity in the world today to take care of requirements for years to come, provided countries follow sound internal policies; i.e., keep their balances of payments in equilibrium. The experts of that school see—or appear to see—nothing wrong with the international monetary system now in existence, based on gold and on dollar and

[5] See two articles by Mr. Stamp in the Guardian, Manchester, Feb. 10 and 13, 1961.

sterling balances, plus the recourse to the IMF at times of exceptional difficulties.

Another group of experts regards the liquidity position as inadequate now (e.g., Sir Roy Harrod, of Oxford) or in the future (e.g., Professor Triffin, of Yale, Dr. E. M. Bernstein, of Washington, D.C., and many others). They seek in increase of liquidity either through a large upward change in the world price of gold (Harrod) or through the transformation of the IMF into a world central bank (Triffin, Stamp, to a lesser degree Bernstein, others). Some of these experts—primarily Professor Triffin—would modify profoundly the structure of the international monetary system, by substituting for "reserve currencies" (dollar and sterling) deposits with the IMF, an idea which goes back to the wartime (1943) proposals put forward by the late Lord Keynes in favor of an International Clearing Union with an international unit of account, called bancor.

Another, most vital question, has been recently raised by M. Jacques Rueff, the principal author of the French financial and monetary reconstruction of 1958. In an article entitled: "The West is Risking a Credit Collapse" (Fortune, New York, July 1961), he urgently warns against the dangers of the gold exchange standard and points to the need of adopting a new monetary system, preferably the gold standard with its discipline.

> There is unfortunately,

he writes—

> only one way to rid ourselves of the risks that are the West's legacy from 15 years' operation of the gold exchange standard. This is to pay off in gold all the dollar assets held by central banks outside the United States. Only such a drastic step can banish the danger of sharp deflation or collapse that is inherent in the double-credit structure now based on the U.S. gold reserves.

Of all the experts, Rueff is the only one who lays great emphasis on the concept of international monetary order (though he uses a different terminology from mine). He refers to the "discipline of the gold standard" as being "unconditional and inevitable," contrary to "other multilateral arrangements" which, "being voluntary, would be precarious and uncertain." As of now, M. Rueff has offered no detailed blueprint for action based upon his diagnosis—but it is a relatively easy matter to work one out starting from his article. To my way of looking at things, this is the path the West should follow. I shall endeavor to show in the third and final section of this paper that this is the road to both international monetary order and adequate liquidity. There is a major hurdle on that road and to this I shall mainly direct my attention: the redefinition of the place of gold in the monetary system and the question of its world price.

POSITIVE PROPOSALS

Let us start with several brief propositions:

1. International monetary organization built in part on gold and in part on gold-convertible currencies—the gold exchange standard—has proven highly dangerous in the interwar years and has slipped back into existence since the end of World War II. It promotes inflation in its optimistic or expanding phase, and deflation (even collapse) in its pessimistic or contracting phase. It tends to encourage

balance-of-payments deficits—and to make them chronic—in countries whose currency is used as reserve currency abroad (because these countries don't pay off their deficits, which would result in the adoption of policy correctives, but merely build up a gold-convertible foreign indebtedness).[6] The longer the expanding phase of the gold exchange standard lasts, the greater foreign demand liabilities of the key currency countries become, and the greater the risk of an international confidence crisis, of demands for massive gold payments, and of an eventual international monetary breakdown.

2. If key-currency countries follow policies aimed at balanced external accounts, the supply of their currencies for reserve purposes diminishes. In fact, any gold exchange standard must come to an end either quietly, through sound policies of key-currency countries, or chaotically, through a crisis of confidence in the key currencies and large demands for gold repayments. In 1931 the gold exchange standard based on sterling came to an end under crisis conditions which greatly deepened the depression. At the end of 1960 there almost developed a crisis of confidence in the dollar and a breakdown of the currently prevalent form of the gold exchange standard. We now have a breathing spell for an orderly monetary reform—which should involve an orderly liquidation of the dollar standard. (Sterling, though intrinsically much weaker than the dollar, is consolidated within the sterling area by arrangements and customs of 30 years' standing.)

3. It may well be that the whole concept of reserve currency which is a byproduct of the gold exchange standard, should be rejected—in the interest of the countries whose currency is so used, because these countries are thereby exposed to great speculative hazards and uncertainties; and in the interest of the other countries that would be affected by any breakdown of a key currency. This is an acknowledgedly debatable proposition: my hope is that it will be coolly and fully debated.

4. Monetary reforms envisaged here apply only to the Atlantic group of nations. Their new monetary system should be integrated into the wider and looser IMF system.

5. From the point of view of international liquidity alone, we have a wide variety of proposed expedients including wider lending possibilities for the IMF; regional EPU-type arrangements; special bilateral arrangements among central banks (many of which are currently in operation), etc. Another type of expedient would consist in rising the world price of gold to a level at which enough new gold would be produced to dispense with reserve currencies (which will be largely unavailable once the U.S. balance of payments has been brought into equilibrium), but without readopting the gold standard.

6. Should as much attention be paid to international monetary order as to liquidity, we could contemplate real solutions instead of mere expedients. Solutions meeting all the requirements discussed earlier in this study fall into two groups: (*a*) the establishment, within the Atlantic framework, of a supranational Triffin-type central bank, with powers of credit (i.e., liquidity) creation; (*b*) the rehabilitation of gold as central element in the monetary order of the Atlantic world and the adoption of a new gold standard.

[6] This process is fully explained in M. Jacques Rueff's above-cited article from Fortune.

Intellectually, the idea of a supercentral bank is very tempting and the arguments mustered by Professor Triffin in his book "Gold and the Dollar Crisis" are very plausible. At closer scrutiny, not of details but of basic concepts, I, for one, feel like strongly resisting the temptation. A central bank is an element of organized society, integrated with many other elements of economic organization and policy and of national purpose. Its actions are subject to control—in democratic societies, ultimately, to parliamentary control. In the world of the 1960's, even if confined to the Atlantic countries, there is no organized society as yet in existence and much as one should wish to see one emerge soon, there is no reason for easy optimism in that respect. Accordingly, I find it very difficult to envisage the establishment and operation of an Atlantic Central Bank. And I find it even more difficult to visualize a purely voluntary discipline in the realm of national monetary and fiscal policies, such as is absolutely required by the existence of a viable international monetary order. And, short of demonetizing gold altogether, I find it perilous to build up a growing credit stricture (even if generated by and international institution) on the basis of an inadequate gold supply. And I cannot envision, in the next decades at least, the demonetization of gold. The yellow metal still enjoys over most of the planet more confidence than any currency.

Accordingly, in the search for the bases of an enduring monetary reform, I find myself on the side of some—if not all—of the advocates of the gold standard. Let me qualify my position right away by stressing that what I favor is:

1. An international gold standard, to begin with, in an Atlantic setting;

2. A semiautomatic, rather than an automatic system (the old gold standard was far more "managed" than is admitted by many of its defenders and most of its opponents);

3. A system incorporated into the wider and looser setting of the IMF;

4. An arrangement based on an explicit undertaking by all the participating countries:

(*a*) to follow the rules of domestic discipline with the aim of prompt reequilibrium of balances of payments, whenever a deficit or surplus becomes apparent;

(*b*) to eliminate all exchange restrictions and liquidate the exchange control machinery; and to eliminate import quotas as well;

(*c*) to settle international accounts (i.e., balance-of-payments deficits) in gold;

(*d*) not to accumulate any new official holdings of foreign exchange (to avoid a future relapse into the gold exchange standard).

Most balance-of-payments difficulties are due to national inflations or, more generally, to the pursuit of autonomous national monetary policies by the countries concerned. Monetary nationalism is the basic reason for balance-of-payments difficulties and all the restrictive trade and payments policies to which these lead. The opposite of monetary nationalism is international monetary order (as defined earlier); while monetary nationalism is a forerunner of all the other forms of economic nationalism and of international economic disintegration.[7] True, there may be also cases where a country experiences "flights" from its currency (hot money): this tends to be the result of one of two main reasons: either the country's domestic economic policies lead to a crisis of confidence; or the country's geographic position in an insecure world renders it vulnerable, and monetary transfers ensue. The first reason is best dealt with by the country concerned which can, through appropriate changes in its fiscal, monetary and general economic policies, restore confidence in its currency. As to movements of hot money due to political circumstances beyond any single country's control, the best answer lies in arrangements among friendly nations (such as the Atlantic group) to come to one another's support either by way of ad hoc arrangements or, preferably, by way of institutional arrangements of a durable character. I can well imagine such arrangements as part of either the NATO or the OECD setup.

Contrary to the 19th century, there is widespread concern today over upswings and downswings of employment and economic activity and practically all governments are committed, in one way or another, to policies of full employment. Some opponents of the gold standard argue that this commitment is in opposition to the discipline of the gold standard. I don't share their opinion; in the first place, the monetary discipline is a short-term policy while countercyclical policies inspired by the concern over full employment are medium-term policies—so that there is scope for a reconciliation of both objectives; in the second place, I am convinced that, gold standard or no gold standard, we need to achieve much more progress than has so far been the case in the direction of an international coordination of business-cycle policies. Accordingly, the new gold standard would involve as one of its distinctive features (which the old one did not posses) permanent and institutional machinery for consultation about and coordination of national economic policies. Here again, the OECD provides a most promising framework.

The real difficulty over rehabilitating gold lies elsewhere. It lies in the fact that the gold standard can only be restored (and the gold exchange standard fully liquidated) if there is enough gold. At the price of $35 an ounce of fine gold there just is not enough gold to rehabilitate it as monetary metal. So long as we have gold in the monetary system in an insufficient amount, we are exposed to all the hazards of the gold exchange standard (even should the GES be internationalized as proposed by Professor Triffin and others). All the expedients currently discussed in connection with a more or less far-reaching reform of the IMF fall far short of dealing with this basic weakness of the international monetary situation. As already indicated, I have no confidence in solutions of supercentral bank type, and I don't believe that demonetization of gold is at all in the cards. What remains is the full gold standard in a new setting. And this calls for a substantial increase in gold production as well as for a revaluation of the existing gold stock (in order to liquidate the gold exchange standard). This canot be done without a substantial upward change in the world price of gold.

[7] On all this see my books: "International Monetary Economics" (London and New York, 1939; "The Trade of Nations" (2d ed., New York, 1952); and "Studies in Economic Nationalism" (Geneva, 1960).

I fully realize how much opposition there is to such a measure, most of all in the United States. Yet the Bretton Woods Agreements provide for both such a contingency and for machinery to deal with it, under the heading of "simultaneous changes in par values of currencies." The price of gold is an arbitrary price under all circumstances; it is essential that it should be set at a level at which international monetary order can be indefinitely preserved. There were only two instances in the past 150 years when a change in the world price of gold was called for: the first was after World War I, the second after World War II. In the first case, we got the gold exchange standard instead and the great depression. Now we have again embarked upon a gold exchange standard and are faced with the possibility of another depression should something go wrong with our precarious monetary arrangements. If we set the world price of gold at an appropriate level and there is no new world war, I am confident that the price of gold can remain set for another hundred years. By which time the world may be ripe for the Triffin central bank.

No suggestion is offered here concerning the new level of the gold price. I believe that this is a task for experts in gold production. But, most of all, the extent of the rise needed will depend upon the rules of the new gold standard. If we can rely on its discipline, requirements of liquidity may be less than they have been in recent years. I submit that if the main issue, namely what kind of international monetary order we are going to have, is settled, the detailed working out of the problem of the gold price should be decided by central bankers with the help of mining experts. But let the taboo of the $35 price not stand in the way of swift progress toward a durable monetary reform for the Western World.

(Whereupon, at 4:20 p.m., the committee adjourned, subject to the call of the Chair.)

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