225

OUTLOOK FOR UNITED STATES BALANCE OF PAYMENTS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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OUTLOOK FOR U.S. BALANCE OF PAYMENTS

WEDNESDAY, DECEMBER 12, 1962

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

The subcommittee met, pursuant to notice, at 10 a.m., in room AE-1, U.S. Capitol, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss, Senator Bush.

Also present: Don Humphrey, consultant to the subcommittee, Wm. Summers Johnson, executive director, and John Stark, clerk.

Representative REUSS. The Joint Economic Subcommittee on International Exchange and Payments will be in order.

We are starting a series of hearings which will last today, tomorrow, and Friday on the overall subject of the need for reducing the deficit in the U.S. international balance of payments, means of reducing the deficit, as well as appraisal of the opportunities for cooperation in international trade.

The hearings this morning will center on how to improve our balance of payments, with particular reference to the U.S. competitive position and the challenge of the Common Market to U.S. exports.

Our first witness is the Under Secretary of Agriculture, Mr. Charles S. Murphy.

We are very pleased to have you with us today, Mr. Murphy. I notice that you have a written statement. You may proceed in your own way.

STATEMENT OF HON. CHARLES S. MURPHY, UNDER SECRETARY OF AGRICULTURE; ACCOMPANIED BY RAYMOND IOANES, ADMINISTRATOR, FOREIGN AGRICULTURAL SERVICE, AND RICHARD DE FELICE, DEPUTY ASSISTANT ADMINISTRATOR, INTERNATIONAL AFFAIRS, FOREIGN AGRICULTURAL SERVICE

Mr. MURPHY. Thank you very much, Mr. Chairman. I will have additional copies of this statement very shortly. There were some last minute changes which were made.

Representative REUSS. Will you identify your associates for the record?

Mr. MURPHY. Mr. Raymond Ioanes, Administrator, Foreign Agricultural Service, and Mr. Richard De Felice, Deputy Assistant Administrator, International Affairs, Foreign Agricultural Service.

And if I may, Mr. Chairman, I would like to read the prepared statement. And then among us we will be happy to answer as well as we can any questions that you might have.

I am pleased to meet with you today to discuss the role of agricultural exports in the U.S. balance-of-payments position and the outlook for such exports, especially as our trade may be affected by the European Common Market.

I will not dwell upon the overall difficulties with respect to U.S. balance-of-payments problems in recent years. That will no doubt be covered exhaustively by other witnesses. Suffice it to say that the enormous expenditures in the effort to strengthen the free world in recent years have resulted in a very large and continuing balance-of-payments deficit. Heroic measures have been required and have been taken to offset this deficit.

How all our efforts to cope with the balance-of-payments problems are seriously threatened from a new direction—the European Common Market and its retrogressive steps in agricultural trade. Our exports of agricultural commodities to Western Europe constitute an essential element in the U.S. balance of payments. This agricultural trade is approximately equal to the trade deficit that the United States will have this year in its overall international balance. This deficit was incurred primarily to meet our security and assistance commitments in Western Europe and other areas, and any sizable cutback in the volume of our agricultural trade would seriously impair our ability to maintain these commitments. In other words, the role of agricultural exports is considerably broader than that of helping to maintain a sound American agricultural economy.

The United States, as we all know, has a tremendously productive agricultural plant, and from that plant we are exporting about 15 percent of the production. This compares with about 8 percent of our nonfarm production sold in foreign markets. For the year ending June 1962, agricultural exports reached a record total of $5.1 billion. This total includes both exports for dollars and exports under Public Law 480. If Public Law 480 sales are deducted, then dollar agricultural exports account for about 20 percent of our total merchandise export earnings.

During the past 5 years, there has been a marked growth in the value of our farm products sold abroad for dollars as compared with imports of agricultural commodities that are directly competitive with our own production. The aggregate value of our exports of such commodities exceeded our imports of such commodities by $5.4 billion over these 5 years, which amount is shown on the credit side of our balance-of-payments ledger.

We have consistently exported more competitive agricultural products than we have imported. This fact eloquently attests to the efficiency of American farm production. There are some who suggest that this balance is maintained through the use of extensive import controls on these competitive products. Let me correct this erroneous notion.

We have been fairly generous in past trade negotiations in granting access to our markets for competing agricultural products. These concessions have been granted in exchange for concessions we have obtained from other countries on our exports, often industrial exports. The results add up to a liberal trade policy on our part with respect to agricultural imports.

Import controls limiting the quantity which foreign suppliers can sell in the U.S. market are applied today on only five agricultural commodities—cotton, wheat and wheat flour, peanuts, certain manufactured dairy products, and sugar. And the domestic production of all these commodities, except dairy products, is likewise controlled. All other agricultural imports of the United States, which include fresh and frozen beef and lamb, pork, a large variety of canned meat products, vegetable oils, fruits and vegetables, tobacco, and even feed grains, are permitted unrestricted entry and are subject to only moderate tariffs.

Representative REUSS. If I may interrupt at that point, what are our tariffs on the items you mentioned? I will accept rough figures, I don't expect precise tariff rates at the present.

Mr. MURPHY. The tariff on beef is 3 cents per pound or roughly 8 percent ad valorem, for example.

Representative REUSS. Lamb?

Mr. MURPHY. I will let Mr. Ioanes answer.

Mr. IOANES. 3.5 cents per pound or about 9 percent, and pork is 3½ cents per pound or about 3 percent ad valorem.

Representative REUSS. Canned meat products?

Mr. IOANES. The way I would answer that is that in general our tariff structure on canned meat imports is about 12 percent.

Representative REUSS. Vegetable oils?

Mr. IOANES. I can't give you that offhand.

Representative REUSS. Fruits and vegetables?

Mr. IOANES. In the neighborhood of about 15 percent for canned fruit and 10 percent for canned vegetables.

Representative REUSS. Tobacco?

Mr. IOANES. Tobacco is a fixed duty, it is around 12¾ cents a pound.

Representative REUSS. Feed grains?

Mr. IOANES. Feed grains duties would vary with different items. As I recall, the duties on feed grains run less than 10 percent.

Representative REUSS. Thank you.

Mr. MURPHY. Our farm productivity and efficiency have put American agriculture in the export business, and it is there to stay. From early history, we have relied on cotton and tobacco for our major agricultural export earnings. Now these historical exports must share the limelight with other American products. Today, we find these export earnings swelling rapidly through our increased sales of soybeans, feed grains, poultry, and fruit. We look to a further substantial expansion of the commercial exports of these and other products provided we get improved access to markets abroad. Not only is it necessary to obtain the relaxation or removal of nontariff barriers which presently impede our trade, but it is imperative that foreign governments refrain from applying protectionist measures which nullify our competitive advantage and deny U.S. farm products a reasonable opportunity to compete in their markets.

It is sometimes suggested that a more extensive use of export subsidies would substantially increase our agricultural exports and result in a significant contribution to meeting our balance of payments difficulties. We have used export subsidies primarily where needed to maintain our fair share of the world trade in certain commodities. We now make export payments on a limited number of products. We feel that if used indiscriminately, export subsidies could not only seriously disrupt orderly international trade, but could also endanger our balance of payments condition. Any undue disruption of trade patterns might bring about retaliatory measures not only agains the subsidized product, but against our industrial exports as well.

You will note that I refer particularly to an expansion of our dollar trade. There are really two types of markets for our agricultural exports—the markets in the developed industrialized countries where we sell for dollars and the markets in the developing countries where the bulk of our sales are on concessional terms. In the latter countries, we will continue to seek ways to share our abundance to relieve hunger and to encourage economic growth. By using the productivity of our farms to hasten economic development, we build the commercial markets of the future. This has already been demonstrated, for example, in the case of Spain, which used to be a large Public Law 480 customer for our soybean oil. It has now become a dollar buyer of this product. This year, Spain's dollar purchases of U.S. soybean oil will amount to over 400 million pounds, valued at about $45 million. It is now the largest single export outlet for our soybean oil.

Japan presents an even more dramatic example. Only a few years ago, a large part of our agricultural sales to Japan were made under Public Law 480 for local currencies. Now Japan has a booming economy, and last year was our largest dollar export market. It is a market we value very highly—one that has the potential of further substantial expansion, one where the Trade Expansion Act of 1962 will be of material assistance to us in further improving terms of access.

It is our dollar exports—trade with the so-called developed countries, and particularly with the Common Market—that I would now like to discuss. In fiscal year 1962, Canada, Japan, and the United Kingdom were grouped closely together as the leading individual exports markets for our farm products. Each bought about $500 million worth of agricultural products. Also in 1962, as a group the six members of the Common Market bought about $1.2 billion of U.S. agricultural commodities out of total U.S. dollar exports of $3.5 billion. Indicating this is a rapidly growing market, our agricultural sales to the Six in fiscal year 1962 were 35 per cent greater than in fiscal 1958. During the 1958–62 period, our feed grain and soybean shipments to the Common Market have more than doubled. From 10 million pounds in calendar year 1958, our shipments of poultry, mainly to West Germany and the Netherlands, rose to 160 million pounds in calendar year 1961.

The rapid rate of growth and the booming economy of the Common Market, attributable no doubt in large part to their developing economic unity, have afforded us increased potential outlets for our farm production. Prosperity in Western Europe has brought increased demand for meat, poultry, milk, and eggs—a demand that has expanded livestock and poultry numbers. U.S. grain has been imported to supply the additional feed required. We foresee that as the economy of this area becomes more prosperous, there will be an ever-increasing demand for food and fiber. However, there is a grave question as to who will be allowed to supply this increasing demand—and, indeed, as to whether the United States and other third countries will not have the doors of historic trade closed in their faces.

The prospects for a continued outlet for our agricultural exports will be determined in large part by the evolving common agricultural policy of the EEC. We are disturbed by the mounting evidence that this policy will be regressive and trade restrictive. We have been urging that the Common Market develop its common agricultural policy along lines consistent with the maintenance of international trade. By this we mean that it should formulate its agricultural policies so as to maintain a level of international trade consistent with principles of fair competition having due regard to its position as a major importer of agricultural commodities and a major exporter of industrial products. Such a policy is not only required in the interest of fairness to friendly agricultural exporting countries, such as the United States, but in the interest of the Common Market itself.

Industrialization in Western Europe has historically been aided by the importation of moderately priced agricultural and other raw materials from outside the area. Its industries as well as its consumers have greatly benefited from this practice. We want to see it continued. The formation of the Common Market has ushered in a new period of economic growth which can be continued and even accelerated if its consumers and its factories continue to have access to moderately priced agricultural imports.

Our hopes for liberal trade policies are being realized on some products. These are the products which the Common Market does not produce at all, or produces in small volume. These include cotton, soybeans and soybean meal, tallow, hides and skins, certain fruits and vegetables, and some other farm products. These commodities represent about $700 million worth of our farm products shipments to the area. For these products, the EEC proposes to apply a fixed common external tariff. The prospects are bright that our exports of these products as a group will expand as that trading area expands. However, even for these commodities, trade is not entirely free of problems. For some products, the duties are still high. To safeguard our trade, we will need to negotiate a reduction in the common external tariff of items such as tobacco, vegetable oils, and canned fruits and vegetables.

For the remainder of our current trade with the Common Market, amounting to nearly $500 million, we are concerned over our future prospects. This includes our trade in wheat and wheat flour, feed grains, certain meat products, poultry, eggs, and rice. The reason for this concern is the emphasis placed by the EEC's common agricultural policies on variable levies and minimum import prices rather than on fixed tariffs. This levy system is designed to make possible unlimited protection to domestic production and could readily be used for the deliberate purpose of promoting self-sufficiency.

The first Community-wide regulations for agricultural commodities went into effect on July 30, 1962, for wheat, wheat flour, feed grains, poultry and eggs, certain fruits and vegetables, wine, live hogs, and hog carcasses. Regulations for other livestock products and rice are expected to follow shortly.

The regulations for wheat, flour, feed grains, poultry, eggs, and pork—all items of important trade interest to the United States—establish variable levies to replace the previously existing tariffs and other trade regulating mechanisms. These levies will vary from time to time and to the extent necessary not only to equalize the price of the imported products with the EEC's internal domestic prices but also to afford a price preference for the marketing of domestic production.

Domestic prices, most of which are already high, will be fixed by government action. Under this system, a nonmember supplier—no matter how efficient he may be—can never get a price advantage over the domestic producer when the variable levy is applied. It is the purpose of this device to equalize the cost of imports with the predetermined level of internal prices. EEC producers will be guaranteed a market for all they can produce at the price levels fixed by the governmental body. The pressures for high internal prices will be great. The use of this system to maintain high internal target prices could provide a powerful stimulus to uneconomic production and a substantial decrease of imports.

Representative REUSS. May I interrupt at this point to get the sense of what you are saying.

This variable levy is in effect an infinite protective tariff, it could be 10 percent, 20 percent, 50 percent, 200 percent, or 300 percent ad valorem, almost any ad valorem figure necessary to keep out the competing commodity could it not?

Mr. MURPHY. It is designed to serve that kind of purpose, so that it can be raised to whatever level is necessary to keep out competing commodities or to protect a predetermined price level for internal producers.

Representative REUSS. You don't know the name of the man who thought of this word "variable levy," do you?

Mr. MURPHY. I do not, Mr. Chairman. It is a complicated mechanism, as necessarily it would have to be, to bring the external levies to a common level eventually. It varies from commodity to commodity. It is implemented by an extremely complex set of regulations. Many of us find that we experience a difficulty in understanding our own regulations. And I am inclined to suspect that the people who administer these variable levies have the same kind of problems with their regulations.

Mr. Ioanes, who is with me, is a relative expert on the specifics of these regulations, and if you care to explore them we will be glad to do so. But the purpose of the system is to provide whatever level of protection is necessary to give an advantage to encourage producers. The levy works against any import price. They decide what the target price is internally, and generally speaking they add an amount equal to the difference between the target price and the import or world price to the world price, or a little bit more, to protect the target price. And that is the way the system works.

Turning to my prepared statement, Mr. Chairman, wheat, flour, feed grains, and poultry products account for most of the value of the U.S. exports that will be affected by the variable import levy system. In the marketing year 1961–62, our exports to the EEC of wheat and flour were $121 million; feed grains, $271 million; and poultry and eggs, $67 million. Trade data now available do not enable an evaluation of the impact of this system on our trade in wheat and feed grains since its adoption on July 30. Due to the overprotection afforded by this system, our trade in flour has virtually disappeared. There has been a substantial slowing down of our sales of poultry and egg products since July 30. This is due primarily to the application of levies and minimum import prices which has resulted in an import charge of about 12.5 cents a pound on poultry by West Germany, our major market, in place of a duty of about 5 cents a pound charged before July 30.

The combined value of these exports approaches $500 million. The loss of any substantial part of these exports would have a serious effect upon our balance-of-payments position.

A comparison of import charges—where valid comparisons are available—clearly shows the extent of the increase in levels of protection for those commodities about which we are especially concerned. The following table illustrates selected examples of import levies in major markets for certain commodities before and after the common agricultural policy became effective.

In the case of the Netherlands, the levy on wheat prior to July 1 was $3.19 per ton.

Senator BUSH. What kind of ton?

Mr. MURPHY. Per metric ton.

After July 30 it was $33.24.

For wheat flour it went from $14.50 to $49.60.

For corn, from $16.67 to $18.63.

For barley, from $16.67 to $21.03.

Sorghums, $16.67 to $21.07.

In the case of Germany, the levy on wheat went from $42.50 to $61.25.

On corn, from $46.05 to $55.20.

Barley, from $35.69 to $49.40.

Sorghums, $45.84 to $55.15.

And on poultry, from about 4.5 to 5 cents to 12.5 cents a pound.

You can readily see how these radically increased burdens on U.S. imports will play havoc with existing trade patterns.

The amount of our trade threatened by the common agricultural policy would be increased if the United Kingdom should become a member of the EEC. In fiscal 1962, our agricultural exports to the United Kingdom were about $500 million. If the variable levy system of the Common Market were applied to the United Kingdom, it would affect $130 million worth of those exports to the United Kingdom of grains and certain livestock products. For most of our other trade with the United Kingdom, duties are substantially lower than in the Common Market. The extension of the Common Market to include the United Kingdom without any changes in the present features of its common agricultural policy would therefore substantially impair our terms of access to the United Kingdom market.

How can we meet this trade challenge posed by the Common Market? Today, the issue hangs in the balance. The way is open, and we hope the Community will not irrevocably cast the die in favor of retrogressive protectionism.

As we seek to meet this challenge, we find the status of specific commodities to be as follows:

In quality wheat, we have an interim agreement with the Common Market that if the common agricultural policy results in a decline in our historical trade, action will be taken to correct this decline. We are keeping this matter under continuing examination to determine the need for this corrective action.

Flour: We have a small but steady trade in flour with the Netherlands. This is fast disappearing because of the overprotection given flour through the variable import levy system. We have urged moderation of this protection. We have not yet gained our point.

Rice: We have stressed the trade-damaging effects that a proposed variably levy system could have. Our efforts have been supported by the interests of certain member countries and thus far, the variable levy system has not been put into effect.

Tobacco and vegetable oils: The Common Market officials are well aware of our dissatisfaction with the tariff levels negotiated at the last trade conference in 1961. We have their assurance that they will be prepared to consider reductions at our next tariff negotiations.

All wheat, corn, grain sorghum, and poultry: At our last tariff negotiations with the Common Market, we kept the door open for further negotiations on these items. With respect to poultry, strong representations have been made by President Kennedy to Chancellor Adenauer on the potential harmful effects of the sharp rise in the protection given poultry in West Germany. The German Government is now considering action which we expect to lead to a reduction in the levy. We are urging the Common Market officials either to eliminate the minimum import price feature of this system, or to reduce it substantially.

We have had numerous discussions with Common Market officials and pointed out that under their levy system, the key element is that of the level of prices set by the Community. We have urged that they demonstrate their declared intentions of following a liberal trade policy in agriculture by establishing moderate price levels for their grain products. This would retard expansion of uneconomic production and permit trade to continue with efficient producers.

There has been increasing emphasis by the Community officials in these discussions on the need for international commodity arrangements to deal with some of these troublesome agricultural trade problems. On our part, we believe that international commodity arrangements merit consideration, if they are designed to preserve legitimate trade patterns. We are willing at the proper time to seek to negotiate such arrangements. We have indicated our desire that a meeting be called early in 1963 under the auspices of the GATT in an attempt to negotiate a grain agreement. Our objectives as an exporting nation would be to obtain reasonable access to the Common Market. This might be accomplished by any one or a combination of several methods, including maximum limits on variable fees and assured import quotas.

We do not look upon commodity agreements as a substitute for normal rules governing world trade in farm products. Trade in the widest possible range of agricultural commodities and foodstuffs should continue to be regulated by conventional means of moderate fixed tariffs, tariff quotas, and limits on levies. We firmly believe that the international trade rules for agriculture should not be permitted to drift away from the rules which apply to international trade generally. In other words, countries should seek to carry out their trade policies in accordance with the provisions of the GATT, which apply to industry and agriculture alike.

In this connection, at the last GATT meeting, we sought the enforcement of these rules on certain countries who continue to restrict imports of our farm products. The GATT countries recognized our complaint against France and approved the withdrawal of compensatory benefits by the United States if France did not remove its restrictions within a reasonable time. A similar action against Italy was suspended when Italy removed some of its restrictions. This represents the first action by the United States to threaten withdrawal against other GATT partners if illegal restrictions were not removed.

We propose to insist upon fair treatment.

We have built into the fabric of highest U.S. policy a determination to preserve reasonable access to the Common Market for our agricultural products. For many months we have been expressing through diplomatic channels and publicly our apprehensions about the emerging EEC agricultural policies. Secretary Freeman, on November 19 before the Agricultural Ministers of the OECD in Paris, expressed these apprehensions most vigorously.

At that time, Secretary Freeman warned our European friends that they must be internationally minded in developing their agricultural policies. He pointed out that decisions of the EEC will be the most important single factor in determining whether the world continues to move forward toward more liberal international trade policies, not only for agriculture but for industry as well.

We cannot—

the Secretary said—

be internationally minded in industrial areas of our respective economies, but nationalistic and overly protective in the agricultural sector. Either the two great sectors must move forward together under liberal trade agreements, or both will in time succumb to protectionism.

Under Secretary Ball of the Department of State repeated this U.S. policy the following week in Paris at the Foreign Ministers' meeting of OECD.

It is only within such a framework that we will be able to use the Trade Expansion Act of 1962 to promote more liberal trade arrangements. We have a mandate by the Congress to use this act to gain access for our agricultural commodities. This is evident from the section 252 provision.

The Trade Expansion Act gives us bargaining power to offer broad and deep tariff cuts to the Common Market in exchange for concessions on agricultural exports from us. Equipped with this bargaining power, we may be able to obtain access to their agricultural markets, including those protected by the variable import levies, if we make it clear at the outset and throughout our negotiations that fair solutions for these agricultural trade problems are an indispensable part of the tariff and trade package we mean to negotiate.

The wrong agricultural policies in Europe could negate the opportunities to use the provisions of the new trade act. As Secretary Freeman said, we cannot negotiate reductions in our industrial tariffs while at the same time we are denied access to markets for our agricultural exports.

It will be a great pity if Common Market officials fail to recognize that the trading countries of the free world will not permit agricultural trade to retreat behind high tariffs and protective devices. The expanded EEC would be a dominant factor in world trade in agricultural products. Friendly countries should be able to look to it to assume a proper position of responsibility and set a trade example which their trading partners can follow. These countries, as equally concerned as the United States over their agricultural trade with the expanded community, are looking for U.S. leadership in the forthcoming tariff negotiations under the Trade Expansion Act. There is an increasing awareness that if this act turns out to be a meaningless instrument in the field of agricultural trade, and the Common Market persists in providing excessive added protection for its own agricultural programs at the expense of outside supplies, the economic and political unity of the Western World will be seriously affected.

Representative REUSS. Mr. Murphy, this is an astonishing and terrifying story which you tell here this morning.

I gather from your testimony that if the Common Market persists in the course upon which it seems to be embarked, that we stand to lose up to a half a billion dollars of annual exports just in the field of agricultural commodities alone.

Mr. MURPHY. The present volume of the exports to the present Common Market countries seriously affected is a half a billion dollars. If you add in the United Kingdom and the other countries that have applied for membership, the volume becomes larger. It is difficult to think of the total loss of all of this trade, but it will be drastically affected—it could be, let me say, drastically reduced. We hope that the signs—that the real purpose and intention is not as bad as the signs indicate it may be.

Representative REUSS. First, I want to get an estimate of the possible volume. I gather that even without the addition of other countries to the present six of the Common Market, our potential loss is in the order of a half a billion, and with the addition of those countries it can be more.

Mr. MURPHY. Up to a half billion will be affected. It is difficult to think of the loss of all those exports.

Representative REUSS. If you add the United Kingdom to all of these other countries, if worse comes to worse, the actual loss——

Mr. MURPHY. The actual loss could be great.

Representative REUSS. The actual loss could be in the order of a half billion dollars?

Mr. MURPHY. It is too early to say with certainty just how this trade would be affected. We do have some rather alarming examples, I think, in the early stages, as indicated in this statement.

The first of these variable levies was put into effect July 30 of this year. They have had a very sharp, drastic effect on exports of poultry to West Germany. This was running at the rate of something like 150 million pounds a year, as I recall, some 12 million pounds a month. And we have the reports, I think, on the first 2 months under the variable levy, and it has dropped to about 12 million pounds or an average of 6 million pounds a month. So this is down to about 50 percent of the level before the levy went into effect.

In the case of wheat flour, the Netherlands, I believe, was our principal market. And this was not a very large trade, but it has been established for years. And the variable levy on wheat flour is just extraordinarily high in comparison to the levy before this July 30 date. And this trade has been virtually eliminated for the time being.

Representative REUSS. The point I wanted to make—and you have answered it—is that the potential loss if this madness persists is of an enormously high order, on the order of possibly a half a billion dollars.

Mr. MURPHY. That is right.

Representative REUSS. And if we add a half a billion dollars a year to our existing balance-of-payments deficit, then we are in substantial trouble. You wouldn't deny that, would you?

Mr. MURPHY. That is certainly true.

Representative REUSS. Let me get my second point. I have just returned from Western Europe. And unless my ears deceive me, the leaders of the Common Market countries are laughing at the United States and its appeal for reasonableness on farm policy.

When I was in France, for instance, I found the French Minister of Agriculture saying that they had no intention of listening to the American plea for the application in France of the principle of comparative advantage, that France ought not to produce farm commodities which can be produced elsewhere in the free world more cheaply.

Did I hear wrong, or do you think you have been getting anywhere with Secretary Freeman's suggestions? Are you pleased with your progress?

Mr. MURPHY. No, we are not pleased with our progress, I can answer that. This is a very tough problem. We don't think the battle is lost by any means. All indications we get are that Secretary Freeman's recent statement had a salutary effect, and if the leaders in the European Common Market were laughing at the United States before, perhaps they are not laughing just the same way now.

Representative REUSS. After Secretary Freeman's Brussels speech, I heard them and it still sounded like a laugh to me. They weren't impressed. I heard no Common Market leaders say that Freeman has got a point there.

Mr. MURPHY. I haven't talked to any of those people over there, Mr. Chairman, since that time. However, I am certain that the United States is deadly serious about this. And if this is not the definite impression abroad, I think we ought to correct this in every way that we possibly can.

Representative REUSS. This brings me to my central point, that I would like to discuss with you. You say the United States is deadly serious.

Mr. MURPHY. I am convinced of that.

Representative REUSS. I grant you various U.S. statesmen have said the Common Market ought to get rid of these variable levies and ought not to go autarchic and protectionist all of a sudden. However, I want to get away from this.

The Common Market owes its existence to article 24 of the General Agreement on Tariffs and Trade. Article 24 of the General Agreement on Tariffs and Trade says that if a group of GATT nations are allowed to form a customs union or free trade area, by virtue of which they discriminate against other members of GATT, they have got to do it in such a way that the general incidence of their tariff levies leaves their trading partners in at least as good a position as they were before.

Now I find that we benignly welcome the Common Market. This is our baby, our creature. You tell me—and I think you are right—that the Common Market now proposes by a super tariff, a variable levy, which is worse than any tariff ever was, to exclude up to half a billion dollars of U.S. farm products alone, not to mention industrial goods, not to mention what they intend to do to the rest of the world.

And then I find you saying in your statement that the United States is going to try to bargain them down by giving them concessions on industrial goods. Well, this is a very odd way to pursue this loss, it seems to me. We are starting to give them concessions out of our American hide, when they haven't given us anything out of their own hide.

I therefore suggest that we aren't taking this seriously enough and that our docile, hat-in-hand attitude is likely in the future to give us what it has so far given us—nothing.

Mr. MURPHY. I would not like to leave you with that impression of what is on page 15 of this statement.

Representative REUSS. Isn't that what it says?

Mr. MURPHY. I don't think so. That was not what I intended to say, either.

Senator BUSH (reading):

> Offer broad and deep tariff cuts to the Common Market in terms of concessions.

Representative REUSS (reading):

> With this bargaining power, we may be able to obtain access to their common markets.

Mr. MURPHY. I certainly did not intend to convey the impression that we would give concessions as to anything to which we are entitled under article 24 of GATT.

Representative REUSS. I maintain that under article 24 of GATT, if they are going to raise their barriers against our farm products—which I don't think they ought to be doing at all—then immediately they will have to begin making equivalent concessions, either in farm products or industrial products.

Mr. MURPHY. I do not disagree with you in the least about that.

Representative REUSS. But that isn't our position. We haven't said that. We have just said, "Won't you please not raise your agricultural tariffs."

Mr. MURPHY. I don't think that is exactly the case, Mr. Chairman. At the present time we have, with respect to these most troublesome, difficult commodities, what we refer to as a standstill agreement, under which we have preserved whatever rights we had on September 1, 1960, under article 24 of GATT. And there is some difference of opinion about exactly what these rights are. We think that they are important and valuable, and we propose to negotiate on that basis.

Senator BUSH. I just asked you, are these enforcible rights under that article of GATT, or is that article more or less just a statement of general policy, without any enforcible provisions?

Mr. MURPHY. It is my understanding, Senator—and I will yield to Mr. Ioanes to give you a really expert answer—it is my understanding that under this article, under GATT, if a nation does not live up to its obligations, another nation that is hurt by reason of that is entitled to compensation, and in the absence of compensation is entitled under GATT to take retaliatory action. I don't understand that you can go to any court and enter a lawsuit, but there are some steps that can be taken.

I think that the United States is more serious about this, perhaps, than it has been until very recently, and is proposing to take advantage of and utilize the rights that it has under these international trading arrangements.

I would, if I may, like to see if Mr. Ioanes has something he would like to add on this point because I think it is a very vital and significant one.

Mr. IOANES. Very little, except to say this, that what we did was to carry forward unimpaired that part of the total bargain that is reflected by the standstill agreement, certain commodities, certain feed grains, wheat, rice, and poultry. And what we in effect said was, "You owe us new bargains in the value of approximately $294 million," which was the volume of trade covered for those items.

Representative REUSS. $290 million?

Mr. IOANES. Roughly $294 million.

Representative REUSS. That is the first go-around?

Mr. MURPHY. In other words, we settled everything, and said, "We have a clean bargain overall, but there is $294 million of our trade as to which we haven't made permanent arrangements, we have made a certain standstill arrangement on these items, and therefore when we sit down on our next bargain you owe us in trading rights approximately $294 million." And therefore when we sit down to negotiate on these items we in effect ought to have bargains extended to us in a traditional way, or in some new way that reflects $294 million worth of trade.

Representative REUSS. I still think, with all due respect, that our U.S. attitude has been unbelievably pusillanimous. Why did we let the Common Market last July put these variable levies into effect? It is this country that is having the balance-of-payments trouble, not the Common Market countries. Yet ironically, at a time when the Common Market should be extending to us unilateral concessions, because they are in balance-of-payments surplus and we are in balance-of-payments deficit, they unilaterally raised their tariffs against us.

This is crazier than Hawley-Smoot or Ford-McCumber, or any of the other sins in the past. Why did we not last July tell the Common Market, "Look, you, under article 624 of GATT you aren't allowed to do this; therefore, if you attempt to put on unilaterally your variable levies, we will refuse to recognize this except under the GATT principle of nondiscrimination and most-favored-nations treatment, and we aren't going to let you raise your tariffs against us."

We could have said that and stopped it then and there and brought them to their senses.

Senator BUSH. I would like to ask Mr. Murphy apropos that, Mr. Chairman, as to how we could stop them. How could we do that?

Mr. MURPHY. I don't think we could stop them, Senator. This was an internal matter as far as they were concerned, and within their control in a legalistic sense.

Senator BUSH. Why have they adopted this new severely protective position on these agricultural items that constitute this half a billion dollars worth of our exports? Why have they done it? What have they sought to accomplish by that, now? Let's look at that just for a moment.

Mr. MURPHY. Well, they have had an extremely difficult and complex problem in merging their economies. Apparently this is more difficult in the case of agriculture than it is in the case of anything else.

In our negotiations with them we found that the agricultural part of it was the toughest, in their negotiations with each other, that agriculture was the most difficult subject with which to deal. And I understand from the press that in the case of their negotiations with the United Kingdom that they hang up on agriculture, and the problem is that, as they sought to bring their economies together, each of them had their separate protective systems for their own agriculture, and merging the agriculture, getting a common protective system for their farmers in all of these six countries is undoubtedly an extraordinarily difficult and complicated task.

Now the machinery of the levy system might be used to do this in a reasonable way, but it gets to be particularly, I think, a question of the level of protection.

If they started out to set internal prices at reasonable levels, and use a variable levy to protect those reasonable levels of prices, I don't think we would have our present basis for complaint about this.

Senator BUSH. Is it going to be difficult for them to achieve the production that would replace this enormous volume of exports by the United States, or is that something that they can accomplish within a year or two?

Mr. MURPHY. They cannot accomplish it within a year or two. I think that one of the very purposes of this system is to move in this direction. It can be done more readily in the case of some commodities than others.

France, for example, is a surplus producer of wheat, and would like to have as much of the Common Market for its wheat as it can get. The other countries have producers who produce other agricultural commodities, and they have similar aspirations. There may be a certain amount of what we would call logrolling in this country.

Their major decisions in agriculture still have to be arrived at by unanimous vote in the Council of Ministers. In the industrial section they have moved on to the second stage where by what they call a qualified majority of the Commission they can make a change in the industrial tariffs.

But in agriculture it requires agreement of all the countries. And each of them has some agricultural producers, has some farmers that they are interested in protecting, I think.

Senator BUSH. The Common Market basically, as I gathered here, when we first had hearings on this thing, is designed as a mutual protective and advancement society for the members of the Common Market, is that not so?

Mr. MURPHY. Well, I am afraid that there is too much of that element in it. I would hope that that is not so. And certainly we are in no position to say this categorically at this point.

This is the nature of the problem we have in agriculture. We hope it is not an absolute matter, one that is all black and white.

Senator BUSH. The announced policy of the Common Market from the start has been to reduce tariffs internally and to increase tariffs externally so as to promote trade within the Common Market, is that not so?

Mr. MURPHY. I don't think it is as clear-cut as that, Senator. For instance, we have been told repeatedly—and I hope that this is true—that many of the leaders of the Common Market feel that the longrun interest of the Common Market itself lies in a liberal trade policy so far as raw materials are concerned, including agricultural products.

There is some question as to whether the actions that they actually take are consistent with that concept. But we don't think that the battle is lost, or that it is in absolute terms put together just as a protective arrangement for the members of the Common Market.

Senator BUSH. I hope you are right. But it certainly looks as though all the evidence of recent months seems to indicate that that is exactly what they intend to do. And they have rebuffed it time and time again here recently on this question of exports. I am just as unhappy about it as anybody on this committee or anybody in this room or yourself, but I am very much afraid that we are faced with a very determined policy on their part to stimulate trade basically, and primarily within that market, and if it affects the others like ourselves, adversely, why, that is going to be too bad. And I think we are going to have to be prepared to face that policy, and I don't know just exactly how we are going to do it.

You spoke of concessions that we might make to them. Would you care to develop that a little bit? Where can we make concessions that would be appropriate in order to persuade them not to do what they think basically is the right thing to do; namely, to stimulate their own agricultural production so as to make themselves self-sufficient or, so far as possible, self-sufficient in the field of agriculture, within those six countries? What can we offer in the way of concessions to persuade them that that isn't a sound policy?

Mr. MURPHY. I think in the first place, Senator, that we ought to develop and utilize to the full the things that Mr. Reuss spoke about, our existing rights, before we get to the point of making concessions. And we ought to insist on preserving the rights, the amount of access that we had.

Second, when it comes time to talk about negotiations, when you swap something for something else, there has been some talk, I understand, that you might put agriculture aside and just go ahead with negotiations on industrial commodities. This we think would be, if not fatal, extremely bad. And this is the point that we would like to make and emphasize at this time, that when and if the time does come for negotiations under the Trade Expansion Act, agriculture has to be considered in the same package with industrial commodities. And this will be a time for swapping, when we get our money's worth, get the value received for concessions that are given.

I do not have in mind at this time any specific concessions with respect to any commodities, industrial or agricultural.

Senator BUSH. I would point out that the chairman has already mentioned the serious threat that this proposes, additional threats to our already serious balance-of-payments deficit problem, that a move of this kind would further aggravate that, as the chairman has said. And the effect of this would be to further inhibit our ability as the protector of the free world under our foreign aid program, militarily and otherwise, and have a very serious effect on the whole free world picture.

In other words, it seems to me that one of our trading points should be that if the Common Market countries, the heart of Europe, expect us to continue to be their protector and the protector of the free world, how can they take action which is going to so seriously impair our balance-of-payments problem that we won't be able to furnish, to provide the dollars that are necessary to implement a very substantial foreign aid program both in military and economic aid, which is in some respects just as important as the military aid, and in some countries just as important?

It would seem to me, Mr. Secretary, that that would be a weapon that we would have to pull out from the sheath, and talk seriously about that with them. What do you think about that? Or would you rather not comment on it? I won't pressure you.

Mr. MURPHY. I would be happy to comment on it.

We share the general point of view that is reflected by your comment.

I think we ought not to overstate it or make intemperate statements about what we will do. We would like, though, for everyone to realize that agricultural trade is really a very critical element in this whole picture of Western unity and Western strength. It is—and I think it has been rather clearly demonstrated in the last 2 years—I think it is the key to trade relations generally. And trade relations generally in turn are the key to the economic ability to continue to do the kind of things that you have been talking about, to assist in maintaining the freedom of the free nations both by military means and by economic means.

I suppose it would be rather irresponsible to say, "If you don't do this, we will pull a division out of Western Europe." But I think there ought to be a full appreciation that all of this is tied together, and that agricultural trade is a critical, a key element in the picture.

Senator BUSH. Another question on this matter of concessions. We are already faced with very serious competitive problems in some areas of our industry, excluding agriculture, manufacturing industries and so forth, and steel. I have noticed in the papers recently that the steel people are screaming with pain, some elements of the steel business, that imports are coming in here that are very seriously affecting their business and the employment in their great industry, which has for some time been in a very depressed state.

Where do you visualize—or have you taken the trouble to find out in what areas we might make concessions that would be acceptable to them and to ourselves, that would induce them to relax this terribly restrictive trade policy on agriculture?

Mr. MURPHY. I do not have any specific areas in mind, Senator. It is my understanding that under the new Trade Expansion Act that these areas in which concessions might be made are to be determined by the new chief negotiator, and after considerable study and public hearings. And I think it would be at least premature and probably very indiscreet for me to even guess at any of them.

Senator BUSH. I think you are right about that. But I do think that presents a pretty serious problem, too. The whole darned thing is pretty serious, isn't it?

Mr. MURPHY. It certainly is. But I want to return to what the chairman said earlier, that we have something to negotiate about before we get to the question of concessions, exchanges of concessions, under the new law.

Representative REUSS. We have got about $300 or $500 million worth to talk about before we start giving; is that not so?

Mr. MURPHY. And we have our rights under article 24 of GATT as to these commodities.

Representative REUSS. Let me return to the point I was making before. I put it to you that it was unpardonably pusillanimous of the U.S. negotiators to let the Common Market, last July, start this system of high protective tariffs against our commodities without giving us any immediate compensation; it should have been the other way around in view of our balance-of-payments difficulties. They should have been giving us a unilateral reduction; instead they gave us, if that is the word, a unilateral increase in tariffs, which worsens our balance-of-payments position.

I put it to you that we should not have allowed that; that it is contrary to the letter and the spirit of article 24 of GATT; and we should have politely said, "Look, you cannot do this, and if you do it, it will be like any other tariff-raising violation of GATT, and we will have to respond by retaliation."

Senator BUSH. I would observe, if I might, Mr. Chairman, that we were inhibited at that time from making any such ultimatum by the fact that this administration was trying to pass a Trade Expansion Act, and it would hardly have been consonant with the spirit that was behind this act to say, "If you do this we are going to slap you down; we are going to come right out and take a counteraction that will—you are going to feel that, too."

I think that is probably the reason, or at least it seems to me to be a valid reason, as to why such action as you say, namely, to forbid them from doing it, was not taken at that time.

Mr. MURPHY. I think that is certainly one of the very valid reasons, Senator. There were others. In the first place, it was not within our power and in absolute terms to tell them they could not do this any more than they could tell us that we couldn't pass a law making the 10th of July a legal holiday.

Representative REUSS. Here we have a substantial legal disagreement, I guess, Mr. Secretary, between you and me, and maybe Senator Bush is on your side.

Mr. MURPHY. If we made the 10th of July a legal holiday they could cut off trade relations with us, but otherwise it is a matter of internal power, and if they entered into an agreement with these other six countries to extend the tariffs, that would be the same.

Representative REUSS. But this violates GATT.

Mr. MURPHY. They have an absolute right to violate GATT. But there are certain consequences that follow.

Representative REUSS. We should have invoked those consequences.

Mr. MURPHY. The question is, Why couldn't we prohibit them, or did we prohibit them? We wouldn't. The question might be whether or not we should take retaliatory action, whether we should have taken it earlier. This in turn, I think, is involved with many very complex, extremely important questions involving the whole question of Western unity and the economic strength and health of Western unity and economic strength and health of Western Europe.

I think it is well known that the United States did encourage, has encouraged, and I suppose is still encouraging the Common Market. It has some very troublesome consequences, as we are finding out.

Representative REUSS. But these "consequences" of the Common Market as we envisage it, are a perversion of it.

Mr. MURPHY. I think it is probably true, the best I can judge, that this common agricultural policy with these variable levies was necessary if the Common Market was going to continue. We will never know what went on in all the meetings of these ministers over there. We do know that about a year ago in December and January they had sessions that went from day to day, night after night, far into the morning, they had people dropping out from exhaustion, and they were having extreme difficulties coming together on the question of any common agricultural policy.

And I got the impression then, which I still have, that this really involved the question of whether or not the Common Market was going to be a Common Market, or whether it was going to disintegrate.

Now, perhaps the United States should have taken an extremely hard position if it could have, at that time and said, "If you have this kind of common agricultural policy we are going to do anything we can to prevent the Common Market from coalescing and continuing."

This is a matter of judgment. If this had been within our power—but the way it looked at that time I doubt if it was. I think we did come back to the question of when we should insist, how we should insist, on the rights that we have under the GATT as to these commodities on the basis of the situtaion that existed prior to September 1, 1960.

And I think it has become perfectly clear that if we don't insist on these rights that nobody else is going to insist on them for us.

Representative REUSS. I have been critical of our negotiators, and impliedly of the Department of Agriculture. Let me say in this connection that I think that the one functional group in the United States which has begun to approach adequacy in its representations to the Common Market about what is being done to us is you agriculturalists. And I think what you and Secretary Freeman have been doing is excellent.

I point out that other segments of the economy have not received that kind of advocacy. For example, on page 7 of your paper you point out that there are some commodities on which things are pretty good vis-a-vis the Common Market; they aren't being too progressive there.

You mentioned that on hides and skins, because the Common Market doesn't produce them in any volume, they are being let in on liberal terms. I will be glad to give you some plaudits for seeing that the hides and skins tariff arrrangements is not too atrocious.

However, hides and skin under our industrial processes are shortly made into leather. I don't know whether you know, for example, that the Federal Republic of Germany today, while it allows hides and skins from the United States to enter it, quotas are complete on leather made from those hides and skins in the United States, even though we admit that is almost without quota arrangements at all, so that West Germany will today take from the United States only $50,000 a year worth of tanned calf hides and skins.

Mr. MURPHY. I am not familiar with those things.

Representative REUSS. The difficulty is that after a certain amount of processing a given commodity falls out of the agricultural orbit, and then it becomes an orphan. Nobody seems to want to break a lance for it.

So I return to my plaudits, that the Department of Agriculture for all its lack of results so far does deserve a lot of credit points for vigorously pursuing the national interest. And I hope you can continue.

Mr. MURPHY. Thank you.

Senator BUSH. I think you have made a fine statement here, Mr. Secretary. It is a realistic facing of the situation, which I think we should have faced long ago.

I think we have taken much too pollyanish an attitude about what this Common Market was designed to do for its members. And now that they are going ahead in full swing, we are up against some of the realities which I thought were apparent a year ago, and even before.

We have built up a spirit in this country, a sort of atmosphere that this Common Market was going to be a great boon to the United States. I think we are——

Mr. MURPHY. I hope this will be true.

Senator BUSH. I hope it will, too.

But your statement, which is one of the finest that has been made since we passed this Trade Agreements Act, indicates now that we are up against an awfully tough proposition, because those countries are doing what we historically have done within the States, which is tried to promote trade within this country, and that is what they are trying to do within those six countries, and stimulate their own production, so that they won't be so dependent on the outside world for these basic essentials of life.

Now, I do not like it one single bit. But if you were Secretary of Agriculture for the Common Market, I just wonder whether you might not be doing what they are doing right now. I won't ask you to reply.

Mr. MURPHY. I would like to comment.

Senator BUSH. All right.

Mr. MURPHY. I believe that international trade is a good thing. I think we should encourage international trade. I think that all of us should work, generally speaking, for more liberal trade policies. I think that is involved here, and involved in the Trade Expansion Act. But I think there is something else involved here. As good as it would be to go forward, I think it is very bad to go backward.

Senator BUSH. Especially if we are the ones that have to go backward.

Mr. MURPHY. In agriculture, we have a tendency to start with a given situation, the existing situation, to see what we can do to improve it. I think we do resist, and certainly we should resist, backward movements.

I can understand why ministers of agriculture in European countries want to afford protection for their farmers. This is perfectly right.

It does seem to me that it would be a good thing if, in affording this protection, they try to avoid going actually backward, so far as international trade relations are concerned—make progress if we can, but in any event, do not lose ground.

Senator BUSH. Well, it does not necessarily follow that what they are doing—I mean just looking at it realistically—and I deplore it the same as you—that what they are doing within this field of agriculture necessarily is going to be a backward step for them in respect to the whole international trade policy. Do you see what I mean? In other words, if they can advance their own economy in this way, they will strengthen their economy and——

Mr. MURPHY. Well, they might be advancing temporarily the interest of one rather small sector of their economy at the expense of their whole economy, overall.

Senator BUSH. Well——

Mr. MURPHY. Excessive protection for agricultural production is not necessarily in the best interests of the total economy of these countries.

Senator BUSH. Let me ask just one more question.

To what extent have we pursued, historically, protective policies with respect to agriculture imports into the United States.

Mr. MURPHY. Not nearly so much as most people think.

Senator BUSH. I do not really have a good idea about it. But I have been under the impression that there were some segments of our agricultural field where we have rather restrictive policies respecting imports.

Is that true or not?

Mr. MURPHY. There are. But these sectors are relatively small. And I would like—if I may take this opportunity, Mr. Chairman—to have Mr. Ioanes comment on this just briefly, because he can do it much more authoritatively than I, and I think it is a very important point.

Representative REUSS. I would interrupt to say, Senator Bush, right before you entered the hearing we had had five very interesting pages of Mr. Murphy's testimony which were addressed to this exact point.

Mr. MURPHY. Again, I would make the point that we are trying not to move backward, whatever restrictions we have—we are trying not to become more restrictive in our policies.

Senator BUSH. Yes. I see in your statement—

> import controls limiting the quantity which foreign suppliers can sell in the U.S. market are applied to only five agricultural commodities—cotton, wheat, wheat flour, peanuts, certain manufactured dairy products, and sugar.

Mr. MURPHY. I think a very important point to be made about these commodities, Senator, is except in the case of dairy products, we do limit the production of them in this country.

In the case of sugar, for example, as you will recall, we passed a law earlier this year which in effect guarantees to other countries something like, I think, 40 percent of the U.S. market for sugar.

If we could be guaranteed a historical percentage of the European market for these difficult commodities, we might think that would be a pretty good settlement of this question.

Senator BUSH. Of course, my recollection is the reason for sugar, is that historically we have needed substantial imports of sugar, just like we need substantial imports of certain minerals and so forth.

Mr. MURPHY. Well, that is true. But we could expand our output of sugar at present U.S. prices.

Now, here, it is true that we seek to have a U.S. price level for sugar that is above the world price level. But at the same time we also restrict the quantity that is produced in the United States, and do assure other countries a share of the market.

Senator BUSH. Well, did your colleague wish to comment? You were going to ask him to comment. Maybe we have lost the thread there.

Mr. MURPHY. I would like for him to have this opportunity, if he has something to add, about how liberal or illiberal our trade policies are in this country as to agricultural commodities.

Mr. IOANES. Well, I think we have dwelled on the subject fairly well. This is not a completely black and white issue. What we are talking about is direction. And what we are saying about our own import policy is that we are restricting imports that account for perhaps, oh, I would guess, one-fifth of the value of the output of American farms. By comparison, the variable levy system that we are talking about encompasses perhaps 85 percent of the value of the output of the farms in the Community. So what we are talking about here, in terms of protection, is how far should we go. And I would add only one other point, which the Secretary emphasized, which is that under the GATT—if a country restricts its own farmers' rights to grow a particular commodity, then import controls may be applied in order that the burden is not shifted from one area to another. And we would understand, in this whole process, if there were restrictions on output, commensurate with our own, in Europe, then we would get trade access of the same kind.

But in the United States generally what you can say is that we have import restrictions, quantitative restrictions, on about a fifth of our output, and in the case of most of that we also limit the production of our own farmers.

Senator BUSH. Now, in connection with the items which are not restricted, do we have substantial imports of those?

Mr. IOANES. Yes, sir. We import in agriculture roughtly $4 billion worth of products a year. And of that $4 billion worth that we import, a little over $2 billion are things that compete directly with American farmers, the kind of things that we hear about in the agricultural area, the way perhaps others hear about them from domestic industries. So we have this same problem.

The one thing I would add, Mr. Secretary, is that agriculture is part of this bargaining process. We do not escape the need to reduce our own tariffs. Our tariff on tobacco, for example, is around 12.5 cents a pound. Now, we would be quite happy if the tariff in Europe were 12.5 cents a pound. We are now one of the world's largest importers of tobacco, oriental tobacco. So that we are at this bargaining table as well. And we have to emphasize in our negotiations with Europe the historical kind of bargains which are sought, because they are largely an industrial area. But when it comes to a large part of the rest of the world, then they will be coming to our table to ask us to reduce tariffs on agricultural imports into the United States.

Senator BUSH. Thank you.

Representative REUSS. Mr. Humphrey, do you have a question?

Mr. HUMPHREY. Just one brief question, Mr. Secretary.

Referring to the table which shows that the tariff has been raised on certain products, were there other products on which duties were lowered that are not shown here? I ask not to imply criticism, but to ask a basic question. And that is, Do you find that the items or countries which have increased their tariffs really restrict our exports, while the items and countries that have reduced duties on the average do not give us any additional access, so that the averaging really is damaging to American exports?

Mr. MURPHY. There were some reductions. For instance, in the case of cotton, as I recall, most of the six countries permitted imports of cotton without tariffs. There was one country, as I recall, that had a tariff on the cotton. Cotton has been put on the free list, so this tariff was taken off in the one country.

I think that—generally speaking, they are these commodities where we are not having great difficulties—there was an observance first of the obligation under article 24–6 of the GATT to leave things on the average no worse than they were when they started.

In addition to that, there were some reductions that were obtained in the negotiations, in what was called the Dillon round of negotiations.

I do not think that we owe the Common Market countries anything at this point for any reductions that we got in levies on agricultural commodities.

Mr. HUMPHREY. But if we can just leave out the Dillon round—this is the principle of averaging. They lower some, they raise others. And this is quite basic, not only——

Mr. MURPHY. These commodities were not involved in the averaging.

Mr. HUMPHREY. They were not—I see.

Mr. MURPHY. This is one of the things, I believe, that we do agree with the Common Market about—that the averaging that has been done up until this time did not include these commodities.

Mr. HUMPHREY. I see.

Representative REUSS. Thank you very much, Mr. Secretary, and gentlemen. We appreciate your contribution.

I am going to take this opportunity, while we are changing witnesses, to say a word to our fine colleague, Senator Bush, who I am so glad is here this morning.

Senator, this series of hearings is probably the last contribution you will be able to make to the Joint Economic Committee because of your retirement, but I and your other colleagues on the committee want you to know how very much we, and I am sure the entire Nation appreciates your dedication and your intelligent concern with economic questions over the years, and also your devotion to the committee work.

So, we have all signed our names to a little manifesto of our appreciation to you.

I know our colleagues regret that they cannot be here this morning to wish you well with us.

But I do want, on behalf of your friends on the committee, to present you with this plaque, containing the good wishes of all the members of the Joint Economic Committee, and also the members of the Council of Economic Advisers and the U.S. Treasury with whom you have worked so devotedly.

We are sorry you are leaving us. We cannot think of anyone who better deserves a little chance to pursue the many interests that you have. And our thoughts will always be with you.

Senator BUSH. Well, thank you very much, Mr. Chairman. This is a very welcome surprise, and a very complimentary one. I certainly deeply appreciate the expression of the chairman's feelings and the sentiment which is behind this very lovely plaque. I will cherish it.

I look back on my service in this committee with a great deal of satisfaction. And of course it is with deep regret that I find myself moving out at a time when we are facing all of these serious matters in which the chairman and I have worked rather closely together, I think—although we have not always agreed.

I think that you, Mr. Reuss, have shown a great dedication to this major problem of the balance of payments, and others, of course, too—other important problems too.

So I am grateful to you, sir, for this very fine presentation.

Representative REUSS. As you know, Senator Bush, you have honorary life membership in the committee, and we hope you will exercise your rights.

Senator BUSH. Thank you.

Representative REUSS. Now we are going to hear from an important panel of experts consisting of Mr. Balassa and Mr. Krause of Yale University, Mr. Kravis of the University of Pennsylvania, and Mr. Ruttenberg—still of the AFL–CIO, Mr. Ruttenberg, but shortly to be transferred to the Department of Labor?

Mr. RUTTENBERG. At the moment I am director of research of the AFL–CIO, Congressman.

Representative REUSS. We are very glad to have you all with us. Some of you, at least, have prepared papers. Those will all be made part of the record. I will now ask you to either present your paper or summarize it or comment in any way you choose.

We will start with Mr. Balassa.

STATEMENT OF BELA BALASSA, ASSOCIATE PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. BALASSA. Thank you, Mr. Chairman.

Before reading my prepared statement, I would like to make a short comment on some of the agricultural problems that were discussed here before. I believe these comments might be helpful in evaluating the prospects for our agricultural exports.

We find that while up to 1961 the U.S. producers could compete on equal terms with the French producers on the German market, this possibility will not exist in the future, in the sense that we will be able to enter the Common Market only after all Common Market producers have sold their produce.

Therefore, the question arises, by how much can the Common Market production expand? And here we have some interesting evidence which, to my knowledge, has not received attention in this country.

One piece of evidence is that the French fourth plan foresees a 30 percent increase in agricultural production between 1959 and 1965, and at the same time a doubling of exports.

Now certainly this doubling of exports would go to a large extent to other Common Market countries.

Another piece of evidence is a report recently released by the Common Market, the report being prepared by five professors of agricultural economics in Germany, which says that even if the new agricultural prices in the Common Market would be set as a simple average of the higher German and the lower French level, German production would fall very little. There would be no decline in the production of livestock products although some decrease in the production of several crops is expected.

Now these two pieces of evidence imply that an averaging of prices will result in a considerable increase in Common Market agricultural production as a whole, and hence in a reduction of imports from nonmember countries, endangering thereby American exports of agricultural products to the EEC.

I would like to turn now to my statement which concerns U.S. competitiveness in manufacturing.

In the period 1953–61, the United States has seen her share in the combined exports of manufacturers of the seven largest exporters of manufactured goods to fall from 31.4 to 24.4 percent. About one-third of this decrease can be explained by the relative decline of exports to traditional U.S. markets, Latin America, and Canada; the deterioration of the American competitive position accounts for the remainder.

Competitiveness is affected by changes in relative prices as well as by nonprice factors—shortening of delivery dates, introduction of new products, et cetera. In the following, I will be concerned with developments in costs and prices which appear to have played an important role in changes in trade patterns during the past decade.

The United States suffered the greatest setback in industries, such as electrical and nonelectrical machinery and transport equipment, where American prices rose the most. This experience has been shared by the United Kingdom where price rises of similar magnitude have taken place. The export share of the United States and the United Kingdom in these industries declined by about one-third between 1953 and 1961, while other countries—especially Germany, Italy, and Japan—who experienced more favorable price developments have captured an increasing share of the world market.

The pattern of price movements, in turn, can be explained to a large extent by developments in labor and material costs. In the United States, the increase of labor costs was especially pronounced in the steel industry and the concomitant rise in steel prices—between 1953 and 1961 steel prices rose by 29 percent as compared to an average rise of wholesale prices of 11 percent—contributed to price increases in the machinery and transport equipment industries and thereby had a detrimental effect on the export possibilities of the latter industries.

Since 1959, however, the competitive position of American industry has shown signs of improvement, inasmuch as cost-inflationary pressures have developed in Europe while labor costs have been relatively stable in the United States. The short-term outlook is also encouraging. While in the United States strong pressures for wage increases outrunning the rise of productivity are not apparent at the present time, there is plentiful evidence that the wave of wage increases continues in Europe. The origin of these differences can be found in conditions of the labor market, here and abroad.

The over-5-percent unemployment in the United States weakens the bargaining power of the labor unions, while serious labor shortages have developed in most of Europe. In each of the Common Market countries, a fall in unemployment has been accompanied by a continuing increase in vacancies in recent years. The labor shortage is most acute in Germany, where the number of vacancies exceeds the number of unemployed six times. Even in Italy, with an unemployment of 1,100,000, shortages have developed in skilled labor.

The unsatisfied demand for skilled labor in Italy indicates that the European labor problem is not solely quantitative but also qualitative. Unemployed or underemployed workers are found, particularly in the south of Europe, but these do not possess the necessary skills and qualifications. Consequently, bottlenecks develop in manufacturing industries that require skilled or semiskilled labor and upward pressures on wages are generated. Not only do labor unions press for higher wages, but employers also often offer wages above contractual rates to lure away workers from other companies. Finally, the continuing rise in living costs provides a further element in wage demands.

For the time being, increases in labor costs have not been fully transmitted into price rises in the countries of continental Europe but rather reduced profit margins. The squeeze on profits can hardly continue, however, and hence further increases in the prices of manufactured goods are expected. At the same time, changes in relative prices have a delayed effect on export sales, especially in the machinery and transport equipment industries where the delivery period often exceeds 1 year. In the case of Germany, for example, we find that although exports continued to rise in the first half of 1962, the volume of new export orders declined, indicating a possible fall in future exports.

Between the second quarter of 1961 and 1962, American prices declined relative to prices in most other countries and U.S. exports increased at a faster rate than the foreign sales of other major industrial exporters, with the exception of Italy. Our previous considerations as well as the continuing tightness of European labor markets give promise for further improvements in the relative position of the United States. A comparison of conditions in the United States and Germany offers an especially sharp contrast. During the fifties the increase of the labor force was larger in Germany than in the United States, but in the coming decade the U.S. labor force is expected to rise at a yearly rate of 1.5 percent, whereas the natural increase of the active population will be nil in Germany. The high unemployment provides a further reserve in the United States, while German unemployment is negligible and the importation of foreign workers possessing the necessary skills becomes increasingly difficult.

Various factors may reduce the gains expected from the continuation of cost-inflationary pressures in Europe, however. A reduction of unemployment to 4 percent in the United States would give rise to greater pressures for wage increases, and an inflationary settlement or a marked price increase in a key industry can again create an inflationary psychology. Also, in the absence of multilateral reductions in duties on manufactures, the elimination of internal tariffs in the Common Market will lead to discrimination against American exports. It should be noted in this connection that while the 10- to 20-percent discrimination existing in the second half of 1961 represents only an approximately 1- to 3-percent price differential to the detriment of U.S. manufactures, the average degree of discrimination will rise to about 12 to 13 percent by 1967. The prospects for our exports will thus depend to a large extent on economic policies followed here and abroad, and on the successful implementation of the Trade Expansion Act.

Representative REUSS. Thank you, Mr. Balassa.

Mr. Krause?

STATEMENT OF LAWRENCE KRAUSE, ASSISTANT PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. KRAUSE. You will notice, Mr. Chairman, that my statement is in relation to agriculture, and rather than read it and repeat much of what Mr. Murphy has already said, I will not.

However, there is one aspect of the agricultural problem that I would like to point out, because Mr. Murphy did not cover it in his statement, and that refers to the question of tropical agricultural products.

As you know, the Common Market gives preferential treatment to the associated oversea countries of Africa. This annex of the Rome Treaty was recently renegotiated, and presumably will be approved by the parliaments to take effect on the 1st of January.

Now, this affects the United States really in two ways: First, certain export products of the United States which the Common Market themselves do not produce are produced in the oversea countries. I am thinking primarily of oilseeds. Even though the tariff on these products may not be restrictive, it is discriminatory in the sense that our products face it, while the products coming from the African countries do not. This is a direct threat to another area of agricultural production in the United States.

Second, there are products of Latin America, such as coffee and cocoa, which will also be discriminated against in the European market. The discriminatory tariff will provide a great spur to African production in these products, since their products will enter at favorable rates.

To the United States, this means that countries which are very good customers of ours will be denied foreign exchange.

If you take some sort of rough average, Latin American countries spend 50 to 65 percent of their foreign exchange earnings in the United States. If you now translate this into earnings to African countries, they spend on the average only 4 percent of their foreign exchange in the United States. So a transfer of a dollar earned from Latin America to Africa costs us a substantial amount in exports.

Now, I think that all of us would agree that we are happy for the Common Market to aid the development of underdeveloped countries.

On the other hand, we deny that they should do this at the expense of other underdeveloped countries, and possibly other methods of stimulating Africa should be chosen in preference to trade preferences.

That is all I have.

(The complete statement of Mr. Krause follows:)

STATEMENT BEFORE THE JOINT ECONOMIC COMMITTEE, DECEMBER 12, 1962, BY LAWRENCE KRAUSE

THE EUROPEAN ECONOMIC COMMUNITY AND AMERICAN AGRICULTURE

The ability of the United States to sell agricultural products in foreign markets is of major concern to the United States for two reasons. First, the tendency for American agriculture to produce farm products in excess of domestic requirements at existing support prices requires a foreign market to dispose of the surplus. Second, the maintenance of a healthy balance-of-payments position demands an expansion of export sales of products in which productivity growth has been substantial to offset the decline of sales of those products whose slow productivity gains have led to a loss of competitiveness. In the United States, the increase in agricultural productivity has been above the national average within recent years and larger export sales should be expected.

The foreign markets of greatest interest to U.S. agricultural exporters are to be found in Europe and Japan. In both of these areas consumer demand for agricultural products is high and expanding and these areas have remained net importers. Furthermore, sales in these areas can be made for cash in contrast to aid-financed sales to underdeveloped countries. The six members of the European Economic Community have been purchasing a billion dollars worth of U.S. agricultural products annually and the United Kingdom another half billion. Together this represents 30 percent of total U.S. agricultural exports and close to half of all cash sales. Productivity gains in European agriculture, while not small, have been less than the gains in European industrial production. This suggests that American agricultural products should be improving their competitive position in European markets. However, governmental restrictions on the trade of agricultural products have prevented market forces from determining international trade in these goods in contrast to the liberalization of such restrictions of the flow of manufactured products. Therefore future export sales of American farm products will be greatly influenced by agricultural policies adopted in Europe.

While the European Economic Community was begun in 1958, the first common agricultural policy was not approved until January 1962. The policy is far from complete; however, the mechanism for controlling the trade of agricultural products has been decided upon and its implication for U.S. agriculture should be noted. The Common Market has established a variable levy system that acts in such a way as to raise the price of imported agricultural products above domestic support prices regardless of the level of domestic prices. During the transitional period until 1970, the market in each member country of the Common Market will be reserved for the farm output of that country and if a shortage of goods exists, other member country sources of supply will be given first preference. If there is not sufficient supply within the Community, then nonmember products will be allowed to enter the market. In short, the mechanism provides for absolute agricultural protectionism for the member countries.

Since foreign prices cannot influence international trade with the Common Market, future export sales by nonmember countries will depend on the demand for agricultural products within the EEC and the supply of such products by member countries and by countries associated with the EEC. The effect of the common agricultural policy will be to increase the level of member country supplies above what they would have been in the absence of the EEC. While this conclusion is tentative, the economic and political conditions of the Common Market point toward a level of price supports which will stimulate production. Furthermore, the continuance of a sheltered market for tropical agricultural products from the African countries associated with the EEC will spur production in those areas at the expense of exports from the United States and Latin America. While the prospects for future sales differ from product to product, in general a decline of 30 percent in our exports of agricultural products to the EEC can be anticipated if the current trend in the agricultural policy of the EEC continues.

The prospects for a change in the policy of agricultural protectionism adopted by the EEC are unclear. Attempts by American negotiations to date at dissuading the Common Market from holding to the variable levy system have been to no avail. The EEC has indicated that the system is nonnegotiable. Nor does the Trade Expansion Act with all its tariff bargaining potential promise much by way of freeing agricultural trade since tariffs are not the major barriers used to inhibit trade. A possible solution in the form of an all-encompassing agricultural agreement among the major exporting and importing nations is conceivable, but only if all countries, including the United States, are willing to let a whole range of policy decisions previously made in national legislatures be determined by international bargaining. Such agreements seem to be far off in the future.

Representative Reuss. Thank you, Mr. Krause.

Mr. Kravis?

STATEMENT OF IRVING B. KRAVIS, PROFESSOR OF ECONOMICS, WHARTON SCHOOL OF FINANCE AND COMMERCE, UNIVERSITY OF PENNSYLVANIA

Mr. Kravis. The advent of the Common Market has added to forces that are reducing the strength of the American position in world trade.

Some of the factors working against the United States are economic. The margin of advantage conferred upon U.S. manufacturers by cheap natural raw materials has been reduced both by the exhaustion of certain low-cost domestic supplies and by economies in the use of raw materials in manufacturing processes. The advantage to the United States of a low-cost agriculture has been offset by governmental policies that limit increasingly the ability of the United States to market its agricultural products commercially.

In former years, aggressive and up-to-date management, advanced know-how, and abundant capital were possessed by the American economy to a unique degree. As a result, the United States was able to export many products that either were not available elsewhere or available only at higher costs. Now modern transport and communications have so shrunk the world that there is no part of the earth that is not within the geographical span of managerial control of an American home office in New York, Pittsburgh, or Chicago. Thus American management, know-how, and capital are mobile today. They can be and are put to work in foreign countries, and advantages that once favored American exports tend to be equalized.

The growth of income and wealth in foreign countries, especially in Western Europe, have made it more possible for foreign plants to take advantage of the economies of mass production. Sizable markets have begun to develop abroad for high-quality products and materials which formerly could be marketed only in the United States on a large enough scale to warrant domestic production.

The Common Market has strengthened many of these adverse tendencies. It has favored more rational practices with respect to raw materials, especially coal and oil, than might otherwise have been followed in Western Europe. The Common Market has also provided a further attraction for American capital and enterprise, accelerated the movement toward larger plants and firms which achieve lower costs and are better placed for research and for marketing, and stimulated economic growth. The agricultural policies of the Common Market threaten to reduce imports from the United States and other countries; unlike the factors previously mentioned, this would tend to raise rather than lower the level of costs and prices in Europe.

It is, however, in the political area that the Common Market may have its most profound effect upon American policy with respect to trade and tariffs. In the past, retaliatory action by European countries against American protective measures has been infrequent and never so prompt and forthright as last summer's reaction to the U.S. increases in the duties on glass and carpets. It is clear that the Common Market represents a new center of political and economic power that can retaliate quickly and effectively against any increase in American protectionism. Furthermore, the new bloc may in any case be driven by internal forces to use its power to curb foreign competition.

There are in the Common Market, just as in the United States, divided opinions on the choice between protectionism and liberalism. A distinct choice of one position or the other by either entity would undoubtedly have strong repercussions on the other's policy.

It is possible, of course, that the American trade position might be revitalized by a new flowering of innovations, particularly in various fields of application of atomic science such as energy, medicine, and telecommunications.

Even if this does not occur or if its impact is too small to offset fully the factors working against the United States, it does not mean that the United States would be left without a comparative advantage in a significant range of products. Indeed, the rapid growth in trade between the more equal partners of the Common Market suggests that trade need not diminish as the economies of the United States and Europe become more similar.

However, there would be major differences from the past relationships. Economically, trade within the Atlantic community would be trade between equals rather than trade between a technological leader and a number of other countries, none of which has so high a per capita income or so extensive a market as the leader. The real terms of trade—i.e., the amount of imports that can be obtained for a unit of exports—that can be maintained by a technological leader are superior to those than can be attained by one of a group of equals.

The reason is that the leader's currency is placed at a premium as a result of its power to command goods that cannot be obtained elsewhere. The adverse movement in the terms of trade would result only in a small diminution in or check to the expansion of U.S. real income, but it would be important to find the optimum means for the adjustment in terms of trade to take place. In a world of generally rising prices, the necessary result could be achieved by confining the movement of the U.S. price level to a smaller rise than that which takes place in other countries.

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On the political side the main implication that has to be drawn from the rise in the political and economic power of Western Europe and particularly the Common Market is that the United States is no longer able with impunity to adjust its tariff and trade measures unilaterally when difficulties arise for domestic industries. The day is at hand when it will be in the interests of the United States to accept stricter intergovernmental controls over escape clauses in order to limit their use by foreign countries against U.S. goods.

Now I would like to add to this statement, Mr. Chairman. When you were talking earlier this morning about the United States—the possible U.S. reactions to the variable levies—my mind went back to the actions of the United States 10 or 12 years ago in imposing quantitative restrictions on dairy products, initially an outright violation of GATT, and subsequently when the facts of life became clear to all members of GATT, under a waiver that was granted by GATT.

I think we have to recognize that GATT in fact has been a highly permissive organization. The code of conduct that has been laid down in GATT is a general code, to which nations subscribe. But when it becomes too inconvenient, almost by common consent this code has been set aside—the code requiring international obligation and international commitment has been set aside to make way for a pressing domestic interest.

I think that the creation of a new locus of economic power and political power in the Common Market is going to make it more in our interest to have international trade organizations with some real control over the situation.

Representative REUSS. Mr. Ruttenberg.

STATEMENT OF STANLEY H. RUTTENBERG, DIRECTOR, DEPARTMENT OF RESEARCH, AFL-CIO

Mr. RUTTENBERG. Thank you, Mr. Chairman.

If you will bear with me, with my cold, I will try to read the statement. I do not normally like to read a statement, but I have five specific points which I really want to make, and in order to make them within the allotted time, I think I had better stick to the text.

Fear of underutilization, not of inflation, should concern those economists who look at the problem of balance-of-payments pressures. America's great economic danger, both nationally and internationally, is persistent underutilization of manpower and physical resources.

Our lagging economic growth itself adds to payments problems and pressures as much, if not more, than some other causes discussed in papers presented to this subcommittee.

Although the dangers of underutilization are apparent to many, some are guided by fears of a nonexistent inflation. Underutilization is a major problem of the present. The danger of any inflation tomorrow is theoretical.

The data presented in support of inflation fears and the analysis of the inflation thesis growing out of fuller utilization of our economy are hardly compelling. There has been relative domestic price stability over the past half-decade. There has also been high unemployment. There are some, indeed, who view this as a fair price to pay for price stability. I refuse to agree that men and machines must be junked as the price of combating some inflationary ghost that walks mostly in the minds of fearful theoreticians.

It is time to enter the sixth decade of this century. We live in a time of revolution—an electronic revolution complete with transistors, computers, and automation. The need for greater expansion of internal markets as well as world markets, is evident.

Yesterday's pony-trot pace won't do for the age of missilery. It's time to say "A–OK" to policies that will spur us ahead. Modern economists should agree that what we need most is internal expansion.

The Organization for Economic Cooperation and Development looked forward recently to a 50-percent growth in free world economic strength by 1970. It looked to the United States to provide the major part of that growth. Unless U.S. growth is sharply stepped up, Europe will suffer. The OECD interest is not academic or based upon any altruism.

If the United States generates sufficient economic strength at home effective solutions to payments problems can be found. Costs could be more evenly spread over increased levels of output. Productivity advances certainly could be greater. Prices could be based on a more reasonable level of capacity utilization. Capital—instead of flowing out of the country—could be retained and even be encouraged to flow back.

CAPITAL OUTFLOWS

The payments problem results largely from capital outflows and from U.S. international commitments. Only because of the U.S. favorable competitive position in products is our trade balance favorable enough to offset much of the present outflow.

The question of U.S. aid commitments can be resolved only if other nations help to pick up some of the check for the cost. I do not intend to argue this point because decisions of this nature must depend upon considerations beyond the purview of this panel.

I would say only that the United States cannot and has no pressing need to avoid her world commitments or to abdicate her leadership position.

But the question of capital outflows is something else again. The United States has experienced large capital outflows. They have made up large parts of the payments imbalances in 1960 and 1961. But the Nation does not publicize the problem of capital outflows to any great extent. It focuses attention on competitive problems.

While I would not advocate strong restrictions on capital outflows, I have never understood why wage suppression—which is quite remote from direct effects on payments pressures—receives so much public attention, when liquid capital movements are treated as if they represented an almost ideal freedom of movement. Capital movements to other nations do not necessarily benefit this economy. They may eventually prove detrimental.

But a peculiar logic prevails. Capital outflow as a cause of payment imbalances seems to create only small excitement. Most talk seems to turn to wage competition. As you well know, wages and labor costs are horses of two different colors—which is why we now ship coal to Newcastle, or, at least, to Hamburg.

Wages, of course, enter into costs and competition. But the United States has a very large trade surplus. We have remained competitive in spite of all that has been said about America's competitive problems. The fact is that the U.S. worker now produces 2, 3, and even 10 times as much product per hour as workers of other industrial nations. That's no cause for gloating, since greater hourly output in those nations is the road toward consumerism, internal markets, and higher living standards.

The return on capital invested abroad can help the U.S. payments position—if it is returned to this Nation. And without doubt, factories built abroad by U.S. companies do expand trade. That's why we do not advocate capital control.

But to talk wage curbs while advocating full freedom for capital is nonsense. Our system can't and shouldn't operate that way. Actually, wage increases can benefit our payment position very markedly, maybe even more markedly than the free flow of capital.

FREE WORLD STRENGTH

What has always disturbed me has been the implications of the emphasis on reducing our payments deficit by further increasing our trade surplus—especially since the deficits grow out of the U.S. international commitments and continued free flow of capital.

Concentration on improving our competitive position and further enlarging the U.S. export surplus may well prove disastrous for some nations of the world more dependent on trade than the United States.

Our objective, after all, is to strengthen America's international position and enhance free world strength. If the United States actually does improve its sales in world markets enough to offset all the minus signs in the balance of payments, which of our free world friends will lose sales?

For example, the United States will be competing with Japan, whose exports account for 12 percent in relation to its gross national product.

Japan has had serious payments imbalances. The United States will be competing with Canada, whose trade and payments balance worries its Government from time to time. The United States will be competing with Britain which has had serious trade and payments problems in recent years. No one will be able to choose which sales will be taken from which nation.

The dangers of hurting allies dependent on sales in world markets may prove more serious than the need to improve the payments surplus through an enlarged trade surplus.

PERSPECTIVE ON MARKET SHARES

Analyses that point to the loss of shares of world markets as a reason to spur our competitive strength also overlook historical perspective. If one looks at the facts, the United States has shown remarkable strength in world markets. To complain, as Professor Balassa does, about the loss of shares of world manufactures markets in the 1950's is to ignore or to minimize two important realities:

For many years—some economists say a quarter of a century—the United States faced no fierce competition for sales in world markets. Economic changes, unusual circumstances, wars, and postwar developments kept the United States relatively protected. Suddenly in the fifties, fierce competition from nations desperately seeking markets began to challenge the United States.

Despite their vigorous efforts, despite their rising industrialization, these nations fail to deprive the United States of her large share of world manufactures markets. U.S. exports of manufactured goods—in each of the classifications used by Professor Balassa—rose. Some rose more than 100 percent. (See table 1.)

At the same time, the United States continues to export $2 of finished manufactures for every $1 imported. That's not a record of shame or of serious competitive loss.

America's competitive prowess can and should continue to grow. Success will be assured, however, only if problems are treated in perspective with major emphasis on strength at home.

These reasons—the importance of a strong U.S. economy, the influence of capital outflows on the payments picture, the free world allies' needs for markets, and historical perspective—suggest that too much attention to U.S. wage-price competitive relationships distort the balance-of-payments picture and can do more harm than good.

COMPETITIVE STRENGTH

But even if the mere use of statistics to view wage-price competition were an appropriate target for major emphasis, the statistics show that the United States has already done relatively well in comparison to other industrialized nations.

U.S. wages have risen less rapidly during the period of fierce competition, 1953–61. (See table 2.) U.S. prices have risen less rapidly than those in other countries. Those who complain of rapid U.S. wage and price rises fail to recognize that other nations had more rapid wage rises both in terms of hourly earnings and in terms of "real wages."

Almost every analyst has stated that the U.S. competitive position in the past year or so has looked quite strong—with improvements, they believed, starting in 1959.

Their worries are almost entirely about what might happen tomorrow—the continued demand in Europe, the possibility of wage rises here, etc. Speculation may be inaccurate, but the competitive strength of the United States is already clear in terms of 1962.

What is not clear is the evidence of ending the plague of this economy—underutilization.

(The tables referred to by Mr. Ruttenberg follow:)

TABLE I.—*Increases in exports, 1953–61*

Base metals (SITC 67–68):	
1953	625
1961	936
Total increase	+311
Percent increase	+49.8
Electrical machinery (SITC 27):	
1953	567
1961	955
Total increase	+388
Percent increase	+68.4
Machinery other than electrical:	
1953	2,129
1961	3,532
Total increase	+1,403
Percent increase	+65.9
Transport equipment:	
1953	1,184
1961	1,817
Total increase	+633
Percent increase	+53.5
Chemicals:	
1953	818
1961	1,755
Total increase	+937
Percent increase	+113.8
Textiles:	
1953	474
1961	492
Percent increase	+18
Total increase	+3.8
Other manufactures:	
1953	1,365
1961	1,860
Total increase	+495
Percent increase	+36.3

TABLE 2.—*Increase in wages and prices, 1953–61*

[Percent]

	Consumer Price Index	Hourly earnings in manufacturing	"Real wages" in manufacturing [1]
Belgium	+11	+43	+29
France	+37	+96	+43
Germany, Federal Republic	+14	+74	+53
Italy	+18	+47	+25
Netherlands [2]	+21	+67	+38
Sweden	+27	+62	+28
United Kingdom	+25	+64	+31
United States	+12	+33	+19

[1] Change in hourly earnings divided by change in the Consumer Price Index.
[2] 1953–60.

Source: OECD, "General Statistics."

Representative REUSS. Thank you, gentlemen.

Senator Bush?

Senator BUSH. No, Mr. Chairman. These things have come so rapidly—I have not made notes here to ask questions. But I find all these statements very interesting indeed.

I will defer to you, if I may.

Representative REUSS. I have a few. Maybe you will have some by the time I am through.

Mr. Krause, you made an interesting point concerning the Common Market's increased restriction on hot country agricultural products. You pointed out that what is being done about commodities like coffee and cocoa, for example, by the Common Market countries, may result in building up coffee and cocoa plantations in African countries which used to be French colonies, which will then, by reason of a discriminatory preference, take over more Common Market outlets formerly enjoyed by Latin American countries.

That was your point, was it not?

Mr. KRAUSE. That was my point.

Representative REUSS. It seems to me that this is a very serious thing. Since the whole Alliance for Progress program of the United States is posited upon the idea that social and political stability is only possible with a given level of economic activity, and that it is up to this country to agree to see that a minimum level of economic activity is maintained.

If Latin American exports are cut off by Common Market protectionism, then the United States, in addition to all the other difficulties we are getting into, if it wants to maintain the Alliance for Progress, will have to raise its ante by precisely the amount that the Latin American countries lose by reason of this discriminatory protective tariff of the Common Market.

Would you agree with that analysis?

Mr. KRAUSE. Well, certainly the effectiveness of the Alliance for Progress will be reduced if foreign exchange earnings of these countries go down because of the discriminations implied by the annex of the Rome treaty dealing with the associated oversea countries.

I am not sure that our ante would go up directly. Certainly there would be pressure to replace those earnings with other forms of foreign exchange.

Representative REUSS. Thank you.

I have a question of Mr. Ruttenberg.

Mr. Ruttenberg, I admire the way you think big about the U.S. economy in general. I have never heard you come before us and talk about the U.S. economy as if it were a static piece of pie. You view it as a growing thing.

I was accordingly a little disturbed when this morning you turned your attention to our exports. You seem to regard world trade as a static thing. You display a considerable lack of enthusiasm about the prospect of increasing the absolute amount of the U.S. exports, and the reason you seem to be giving is that if we increase our exports, it must necessarily be at the expense of some friend, like Japan.

Don't you recognize that it is not only quite possible, but quite desirable that the free world's total exports and trade increase, and that this is a function of the well-being of the peoples of the free world?

Mr. RUTTENBERG. Well, Congressman Reuss, don't misunderstand me, and I am sure you do not, what I have said.

I have not argued, nor do I argue, that the United States should not continue to increase its exports. We should. And we should work very hard through all the various techniques of our trade fairs and trade centers and even in our pricing policies to encourage our export trade. And this will happen.

We have seen an absolute dollar amount increase from year to year. This will continue, and it should continue.

My only argument is that if we are going to think in terms of taking whatever our export trade surplus is—whether you figure it with or without Government—with or without the agricultural or Public Law 480—whether it is $3.5 billion or $5 billion—our export surpluses remain very large. We seem to be approaching the problem of reducing our balance of payments by trying to increase the relative amount of favorable trade surplus.

I am saying that the relative amount of trade surplus may not be the way—should not be increased and may not be the way to offset our balance-of-payments deficit, because of its harmful effect upon other nations.

Now, this does not say that we are not going to increase our exports. It simply says that we ought to look very carefully at whether or not we ought to increase the relative share at the expense of many nations around the world who need export markets just as strongly and just as desperately as does the United States.

If we could take all our increased exports relatively from Germany, or from those countries in balance-of-payments surplus, it would be fine. But this is not possible for us. We will be taking them from Britain, and it has many problems in terms of its balance of payments, to say nothing of taking it from Japan, whose relationships with us in terms of the recent cabinet group that came to this country was quite significant, it seems to me.

Representative REUSS. Well, I want to be sure, as you want me to be sure, that I do understand you.

Are you suggesting that we should pull our overall export punch because this may hurt the exports of other friendly countries? This would seem to me really something that you do not want to advocate, from all I know of you.

Mr. RUTTENBERG. Let me put it this way, Mr. Reuss.

I think the United States, as I said earlier, should make every effort to increase its exports. But we ought not to make that kind of an effort which means increasing our exports relatively to the rest of the world.

Representative REUSS. I do not understand how you can segregate out those two efforts.

Mr. RUTTENBERG. Well, there is and has been a normal growth in the total volume of world exports and world trade. We should continue to maintain our fair share of that expanding world trade market. We should make every effort to maintain it.

I think if we pursue it exclusively to the purpose of not only wanting to maintain our relative share of the increased export market, but for the purpose of taking a larger and larger amount of it, we very well may find repercussions against the United States, retaliatory actions, that might prove more disastrous.

In taking a look at the balance-of-payments problem, let us not say that because we have $1½ or $2½ or $3.8 billion deficit in our balance of payments, that the way to offset this is to look at our trade surplus. Instead of having a $5 billion trade surplus, we should have a $6.5 billion or $7.5 billion, or an $8.8 billion surplus.

Representative REUSS. Where should we look?

Mr. RUTTENBERG. We should look to the other areas.

Representative REUSS. For example?

Mr. RUTTENBERG. We should be looking, for example, as we are in terms of the Common Market, in terms of the OECD and the Development Assistance Committee, to getting some of these nations in Europe that do have substantial balance-of-payments surplus to share with us the cost of development aid and assistance in many of the less developed countries, as DAC is trying to do.

We certainly should be, it seems to me, I think, looking carefully—

Representative REUSS. Before you leave that, do you advocate cutting down our American foreign aid?

Mr. RUTTENBERG. No, I do not advocate cutting——

Representative REUSS. If you do not, you have not saved a nickel on your balance of payments.

Mr. RUTTENBERG. I am no so sure of that, because it is possible to do what has been done by U.S. Government negotiations with some of the countries in Europe. For example, an attempt to have a country like Germany or France or Italy buy military equipment in this country—military and otherwise, which is of an amount equal to that of the dollar exports which are involved in our payments or activities abroad, which they get through third country arrangements. This is possible and should be pursued.

We have reduced our balance-of-payments deficit without cutting down on the total load of foreign aid assistance this country has rendered in the last 2 or 3 years. We have done it, not by increasing our trade surplus, but through other actions which have tended to try to relate to the outflow of short-term capital.

Mr. KRAVIS. Many of them are one-shot affairs, you know, involving repayments of debts by foreign countries or military purchases of equipment which for the moment is not being produced in foreign countries, and whose obsolescence is in sight.

Mr. RUTTENBERG. The U.S. Government has made a recent arrangement with Germany and is negotiating with France and Great Britain to do the same: to make long-term (not only 1-year but 2-, 3-year) forward commitments on the part of those countries to buy in the U.S. market the equivalent of what they are receiving from third countries in terms of dollar accumulations. That is more than a one-shot operation. It differs from the recent repayment of debt from Germany and from France. It has helped our balance of payments.

We are engaged in some activities trying to maneuver, if I can use that word, in the short-term money market by having the Fed and Treasury hold foreign currencies. In addition an attempt by the United States to maintain what I would urge as a very strong policy—which seems to be weakening at the moment—is the so-called "twist" in the interest rate program and policy of the Federal Reserve. This has been weakened considerably because the Fed has not been pushing as hard as it can or should. This policy involves keeping up short-term rates and lowering long-term rates.

I think this is a way to help stop some of the very quick flows of short-term capital.

The action taken was certainly more than short term in terms of the recent tax bill. That included taxation of income earned overseas in U.S. tax havens. That type of action is a means of getting at some of the outflow of capital—at least that part of the outflow of capital which is attributed to differential in tax rates.

I think, therefore, there are ways and means of meeting the problem.

I would not minimize the necessity of moving in the trade area. But I think it is terribly important not to put all our eggs in the basket of saying, if we just solve the problem of wage competition we will resolve all our difficulties. I am afraid that seems to strike me as the main thesis running through some of the papers I have read that have been presented to the subcommittee.

Senator BUSH. What about this capital outflow business, Mr. Ruttenberg? I am a little bit in doubt as to what you think we ought to do about that.

Now, that is approximately a $2 billion item, isn't it?

Mr. RUTTENBERG. I think you have to divide it certainly between the short-term and long-term flows. And I think what has been done in the short-term capital flow has been helpful. We ought to continue to do more of that.

In terms of the long-term——

Senator BUSH. You think we should in that connection firm up our short-term interest rates in this country?

Mr. RUTTENBERG. What I said, I believe very strongly in the policy of maintaining a short-term interest rate, somewhere in the neighborhood of where it has been, somewhere between 2½ and 2¾ percent, as a means of offsetting differentials.

At the same time, however, I do not want to see this kind of a policy result in higher long-term interest rates. I do not think it necessarily will, if you have the proper kind of policy, by the Open Market Committee of the Federal Reserve. That is what I referred to as the policy of twist.

I do not know what the answer is to the question of what to do with long-term capital. But I think there ought to be as much public discussion about it as there has been about the problem of wage competition in the trade surplus area. I just do not see any discussion in this area. I do not know what the answer is.

Senator BUSH. I think you are right—because it is not understood. There is not much talk about it, because not many people do export capital, in numbers of people. It is a relatively small number of companies that go over there and establish plants and export capital that way. Occasionally somebody like Mr. Ford will transfer $350 million into pounds sterling in order to acquire an interest over there, which has an unfortunate effect, of course.

But I agree with you there isn't much talk about it. But I do not know how you can stimulate talk about a thing like that, unless you have got a program or recommendation that you want to accomplish—don't you see? And I wonder whether you felt that something ought to be done to restrict the flow of long-term capital in order to help deal with this balance-of-payments deficit.

Mr. RUTTENBERG. We need to study very carefully and consider the possibility of imposing some form of controls over the flow of long-term capital. This is not an unusual practice for the European countries. They engage in it. They have engaged in it up until very recently, and some still engage in it. In many of the countries of Europe the laws are still on the books. They might not be enforced. But every bit of capital outflow from France must be approved. Most applications, I think, in the past year or two have been approved. But it is necessary to go to the French Government for such approval. I think this is generally true.

Now, I do not see why the United States should not engage in—at least consider, at least begin to talk about this as a problem in terms of our balance of payments. If one looks at the across-the-board balance sheet of our balance of payments, as we all know, the deficit does not exist on the trade side. The deficit exists on the capital side. But we concentrate all of our attention on trying to force the trade side into surplus, in order to offset the overall picture.

Senator BUSH. The most palatable reason is it is the most palatable approach to it, isn't it?

Mr. RUTTENBERG. Maybe it is because—as Professor Balassa says, in a totally different connection in his paper, that we will deal only with costs and prices—I assume in effect this is the only area in which you have some statistics and figures and material you can lay your hands on. It is very difficult to lay your hands upon the nonpricing factors affecting competition, just as it might be very difficult to lay your hands on some of the problems relating to capital outflow. But I dare say that is no reason why we should not discuss the problem.

Mr. BALASSA. Could I comment on some of the points Mr. Ruttenberg has made here?

To begin with, I think there is a conceptual misunderstanding here. When Mr. Ruttenberg argues that although we have a deficit in the balance of payments we should not increase exports for fear of hurting other countries, he seems to forget that if you sum over the surpluses and deficits for the world as a whole you get zero. If the same accounting procedures are used in every country, then the sum of deficits will equal the sum of surpluses. Therefore, I do not see any reason why we could not reduce our deficit, and thereby decrease the surpluses of other countries.

This leads me to the question of competitiveness and the need for increasing our exports.

It is very easy to say all is well, since our exports have been increasing over the past decade. But if we look at the data, then we see that our exports have risen much less than exports elsewhere.

Between 1953 and 1961 our exports of manufactured goods in volume terms increased by 31 percent, as compared to 117 percent for France, 181 percent for Germany, 346 percent for Italy, and 282 percent for Japan.

Thus, a small absolute rise in exports means little if this is overshadowed by larger absolute and relative increases in other countries.

Another problem is that of the use of statistics. It is frequently said that you can prove everything with statistics, no matter what statement you make. But I am afraid Mr. Ruttenberg did not use statistics properly when he tried to show that there is nothing wrong with U.S. competitiveness. He did mention at one point that wages and labor costs are two different animals, or horses of different colors. But later, when he disputed the conclusion that U.S. competitiveness deteriorated, he included only wages in his table, but not labor costs. But since the rise of productivity in the United States was even slower than that of wages, labor costs in this country were relative to labor costs in most other countries.

In this connection, I emphasized in my paper that we have two distinct periods—one from 1953 to 1958–59, and another period since.

If we look at the 1948 figures, we see that labor costs in the United States rose by 11 percent between 1953 and 1958 as compared to smaller increases or actually decreases in other countries, with the exception of the United Kingdom. Correspondingly, the average price of manufactured goods rose as compared to prices elsewhere. And this, rather than the cost-of-living index is relevant, if changes in competitiveness are to be compared.

Let me also add that the deterioration of our position has been much greater in the basic metal industries than anywhere else.

Even in 1960 U.S. labor costs in these industries were 20 percent higher than in 1953, while in other countries there was little increase, as we find a decrease, as in France, Belgium or Italy.

Now, basic metals, and especially steel, are important inputs in the production of electrical and nonelectrical machinery, and transport equipment. And as higher labor and material costs were accompanied by higher prices in these industries in the United States our export performance declined. This will be clear if you consider any of the steel-using industries.

Let me just mention one—electrical machinery.

Our prices rose by 23 percent between 1953 to 1961, as compared to a 9-percent rise in Germany, a 3-percent rise in Italy, a 5-percent rise in Japan, and a 21-percent rise in the United Kingdom. It is no wonder that our exports—as well as British sales—of electrical machinery increased very little, while exports of electrical machinery rose at a rapid rate elsewhere. In 1953 our sales abroad were more than double of German exports but by 1961 German producers surpassed the United States in sales on the world market.

Turning to capital movements, we note that a short-term capital outflow cannot continue indefinitely. These are temporary movements, since there is a certain fund of short-term capital which is moving in response to interest-rate differentials and we can expect an inflow of short-term capital if and when interest rates change to our advantage.

So we should not consider a short-term capital outflow as a permanent cause for a deficit.

In regard to long-term capital movements, we should realize that some of our capital is moving out because of a decline of competiveness in this country. Instead of setting up more plants in the United States manufacturers are building plants elsewhere, where labor and other costs are lower. Therefore, competitiveness appears to have an impact on long-term capital movements. And I would be against trying to restrict capital outflow by use of administrative fiat, because we know how easy it is to evade any such restrictions by not repatriating foreign earnings for example. The experience of the United Kingdom provides plentiful evidence on this point. Also, we should not forget about the benefits derived from capital exports in the form of interest payments and dividends.

I agree with the administration's policy that we should not subsidize capital exports by preferential tax treatment on foreign earnings. But I would not speak for some kind of a restriction through administrative methods.

Representative REUSS. I would like to——

Mr. RUTTENBERG. Could I respond to him?

Representative REUSS. All right.

Mr. RUTTENBERG. I do not want to take the time of the Committee—I won't respond to all the questions. But I want to make two points in connection with the many comments which Professor Balassa has made.

He said that productivity in the United States was rising at a lower pace, even though our wages had remained lower, and therefore labor costs have gone up more than elsewhere. He also said that capital was moving out of the United States because the competitive position was declining.

I should just like to reemphasize the first point of my presentation. I think it relates to both of these.

Underutilization of the American economy, excess overcapacity, excess physical resources, and high levels of unemployment and underemployment are in part greatly responsible for the lower level of productivity rise in the American economy, and for the failure to hold American capital in the United States. If we could only—if I can use a phrase that has been popularized—get on the move again, we might be able to do something about retaining capital in the United States and productivity increases might respond accordingly.

Now, I just want to make one comparison.

Professor Balassa used the problem of declining shares in electrical machinery and transportation. I would like to set these two against each other in a different perspective.

In electrical machinery, according to the August *Survey of Current*

Business, it shows, for example, that we have had an improvement in our trade position in electrical machinery. Taking 1961 as compared to the base period 1950 to 1953, we have had a net improvement. That happened in spite of identical bidding and pricing problems in the electrical machinery industry. That problem might have some bearing of equal importance to what has happened on wages——

Representative REUSS. What was the citation?

Mr. RUTTENBERG. August 1962, *Survey of Current Business*. In this same *Survey of Current Business*, pages 30 and 31, is a table showing we have lost out considerably in transportation equipment and in passenger cars in 1961 compared to 1950–53. I would challenge anybody to say that this had anything to do with cost problems, that is, anybody who understands it—I am sure Professor Balassa does. What has happened is due to the good commonsense of the European people who don't want to ride around in these great, big, long, expensive, high-maintenance-cost American cars. That is partly responsible for the development of an internal automobile industry in Europe that has expanded greatly. In this we have not lost because of price or competition; we have lost because of design.

Representative REUSS. I wanted to pursue the point raised by Senator Bush, namely, Why hasn't there been more public discussion of the possibilities of certain controls on long-term capital outflow by this country? This might not be so calamitous to free trade principles.

Specifically let me ask the members of the panel this question: Suppose that, try though we may, we are not able to bring our payments deficits under control in the periods immediately ahead, and that our deficits, with all their untoward consequences, continue. Would you or would you not—I am going to ask each member of the panel to comment on this—favor the imposition by the United States of controls on new issues financing in this country by foreigners; specifically, prohibitions or at least screening of applications as the one that was made a few months ago by the European Coal and Steel Community, which floated a long-term issue, or part of it, in Wall Street?

I would like each of you to comment on whether, if we are unable to bring our balance of payments into equilibrium through other means, we should attempt some sort of screening of new issues.

Mr. KRAVIS. It would seem to me that the list of alternatives that I would like to see this country come to is very long before I would like to see us come to that. If we are driven to a point where we absolutely must select an alternative that involves a further suspension or interference with the market, whether it be restrictions in the trade area or restrictions in the capital area, then I think that some kind of control over new capital issues might be one of the less obnoxious measures.

Representative REUSS. Yes. Now, I want to be sure that our minds are meeting here.

I ask this question predicated upon the assumption that doing what we are now, namely, trying to expand exports, to get our friends to pick out more of the foreign aid and military burden, does not for one reason or another result in the goal we seek, that is general equilibrium in our balance of payments.

Now, I would like to hear your views of what we ought to do then, in order of their noxiousness or lack thereof.

Mr. KRAVIS. Well, I suppose that I would place control over new capital issues as being less obnoxious than a devaluation of the currency, for example.

Representative REUSS. What do you regard as least obnoxious—control over new issues?

Mr. KRAVIS. I think so, yes. I think that would be less bad than direct quantitative controls over trade, I would think.

Representative REUSS. Let's have a go-round on that. Mr. Kravis has said in effect that if we do need to adopt restrictive measures, measures other than those we are now attempting—and they are well known to us, they do not need repetition—that in his opinion control or at least screening over new capital issues is the least obnoxious. Do I understand you correctly?

Mr. KRAVIS. I would like to just make one little addition to that.

I think there are more forceful ways of dealing with the situation that have been followed to date.

You see, I think we have to recognize two things in our approach to the Common Market. First of all there are two ways to look at the problem of international trade negotiations. One way is to regard world trading relationships as a jungle in which each country uses its power and its bargaining position to get what it can. Another way to look at it is to adopt the view that there ought to be an orderly community of nations, and the nations ought to abide by certain principles.

Now, if you accept this approach, then I think the United States ought to try to enter negotiations with the Common Market with cleaner hands than it has at the present. What we are presently saying to the Common Market—"Oh, well, we are not going to take any more oil, and we are not going to take lead and zinc, and we are not going to take carpets and glass, and we are not going to take this and that, but we favor free international trade, and indeed we are going to expand trade. Except for the things that you might really be able to sell us in embarrassingly large volumes—we are going to lower our restrictions." Now, we cannot go to them that way. Of course, they will laugh at us, and they are right to do it.

The second thing we have to remember is suggested by the postwar history of intra-European trade negotiations. Nothing in this history—including the OEEC Code of Liberalization, the Coal and Steel Community and the Common Market itself—suggests that the European countries ever approached negotiations with one author in an altruistic spirit. They bargained hard, the bargaining was tough. I think that we have to be prepared for a hard-headed attitude on the part of the Common Market in their trade negotiations with us. We have to be prepared to be hard and tough ourselves, even to the point where we are prepared to break off negotiations and invoke retaliatory measures. A soft approach will only worsen our trade position.

But first we have got to get ourselves in a better position than we are in now. We have got to be willing to accept international competition in areas where it hurts us, as well as in areas where it helps us.

So that before we get to—before I would like to see us get to the list that you are talking about, it seems to me there is much more we can do along traditional lines.

Representative REUSS. All right.

Mr. Ruttenberg, what do you have to say about this new issue proposal?

Mr. RUTTENBERG. Yes. My own feeling is that this would be a good measure, to begin screening the new equity issues in the American market. I think we ought to screen also (I do not know whether you meant to include or exclude in your question, from your question, Congressman Reuss) that long-term borrowing other than through the equity market in the United States by foreign countries. I would include that. I would also screen that, along with equity issues. I think it is clear from what I have said that I believe this is an area we ought very definitely to explore.

Representative REUSS. Mr. Krause?

Mr. KRAUSE. I would like to take some issue with the approach to control of that kind, because I think surprisingly little can be gotten from it, and you give up a great deal of freedom when you do this.

In the first place, for most of the bonds, the form in which long-term capital through securities has gone out, the major borrower has been Canada. As we know, Canada has very close commercial relationships with us and has been under balance-of-payments problems of their own. When they run into balance-of-payments problems, Canada cuts back on its purchases from the United States primarily. So when you refuse to lend to Canada, you in fact cut down U.S. exports to Canada.

Furthermore, of Canadian issues floated in the United States, we know about 25 percent on the average are bought by Europeans. So that our market provides a mechanism through which savings in Europe are funneled to Canada. As a matter of fact, of European issues floated in New York, we have some evidence that indicates that as much as 70 percent of the issue may be bought by Europeans themselves. We have some evidence of this kind with respect to the Kingdom of Belgium bonds recently issued.

In addition, of course, Americans as underwriters earn 2 or 3 percent on the gross value of the flotations. And this is a rather substantial service earnings in balance of payments.

Now, if you really wanted to have a big balance-of-payments impact, you would try to distinguish between countries that have close commercial relationships with the United States and those that do not.

Representative REUSS. That is why I use the word "screening," and obviously one of the first criteria of screening would be whether the country which seeks the financing is in a balance-of-payments surplus or deficit position. And I would think that there would be exclusion or relaxation only of those in a balance-of-payments surplus position.

Mr. KRAVIS. Or whether it was likely to use the proceeds of the loan to buy American exports.

Representative REUSS. That, too. Now, that may be more difficult to sort out.

Mr. KRAUSE. If you are thinking of a discriminatory rule, then I think that we ought to think very long and hard about it, because we are giving up not only liberalism in a general sense, but we are giving up the principle of nondiscrimination. Nondiscrimination is very important to the United States, since we are arguing that our goods and other aspects of our international relationships also be treated in a nondiscriminatory manner.

I am also concerned by Mr. Ruttenberg's presentation of long-term capital movement as a causation factor.

Now, I am not sure it is not a causation factor, but it is certainly not clear cut. The balance of payments should be considered as a whole. If we had not made direct investments abroad, then there is a good chance we would have exported less capital equipment. From what evidence we have and particularly with respect to direct investments in areas other than Europe, direct investment promotes American exports of machinery.

Also direct investments stimulate raw material exports, and other related exports the long history of the hearings of the Revenue Act of 1962 brought all this evidence into the record.

I am suggesting that in the first place capital movements may not be a causation for us because they bring back offsetting flows in other parts of the balance of payments. In addition, even if they did cause a deficit at the time when a new flow or an increase in the flow occurs, you are building up equity, and therefore will stimulate return flows in the future and therefore it is self-correcting. What we may need is a better definition of the balance of payments, or a better approach to it.

I for one would not be concerned if, as a result of long-term foreign investment, we ran a basic deficit for a few years, because it is clear that we will get returning inflows in another few years. Our concern about the balance of payments should take into account the time period in which equilibrium should appear.

Representative REUSS. If you can sell that point of view to the central bankers of Europe, we have got it made.

Mr. BALASSA. I think we have to take account here of the prospective gains and losses. I believe that if we consider that a large part of European bonds sold on the New York market are bought by foreigners, we find that the floating of new issues in the United States accounts for a relatively small part of our capital outflow.

So the possible gain from restricting the floating of new lines on the New York washes would be rather small.

Against this, there is the interference with convertibility, and an admission of weakness on the part of the United States by using such restrictions. At the end, this might hurt us not only because discriminatory actions could invite retaliation by other countries, but also because we would lose some of the benefits we enjoy as a financial center. Furthermore, if we wish to achieve a multilateral reduction of tariffs in the framework of the Trade Expansion Act, we should not start out by imposing restrictions on capital movements. Given the expected improvement in competitiveness, we can gain more from expanding trade than from restricting the movement of capital.

Representative REUSS. Thank you.

Mr. Humphrey?

Mr. RUTTENBERG. Congressman Reuss, could I just ask Mr. Balassa a question?

How can you say that if we place controls over any form of capital this step might result in discriminatory, reliatory action? This may be true. But all the European countries have done this for many years, and persist in doing it. Only very recently have they let up, as they get to balance-of-payments surplus.

What is wrong with forcing discriminatory or retaliatory action? We never engage in retaliatory action against countries overseas for doing this. Why would they do it against us—as long as it is done in the context of a balance-of-payments deficit?

Representative REUSS. Do you care to comment on that, Mr. Balassa?

Mr. BALASSA. Well, this really means that after the Europeans got to the point of establishing convertibility by removing discrimination on payments; that is, when they have made a step forward, we should make a step backward. Thus, I do not see how this argument would hold.

Mr. RUTTENBERG. We have moved backward. We have moved into a serious balance-of-payments deficit situation which is considerably different from the average of less than a billion dollars of deficit that we had from 1950 to 1957. Since then it has been averaging something—I don't know—like $2.5 billion, $3 billion.

Mr. BALASSA. Yes. But we have to compare the prospective gains and losses attendant upon any measure designed to improve our balance of payments. And I for one feel that in this case the losses might be quite large as compared to the gains.

Representative REUSS. Well, I think both views are present in the record on this point.

Mr. HUMPHREY. Mr. Krause, may I start with you on the question; I am interested in the views of all of you.

Let's take it as a premise that something has to be done more than we are doing. How good a case can you make for insisting on a unilateral tariff reduction on the Common Market, pending the big reciprocal negotiation?

Mr. KRAUSE. Well, are you asking about the technique, how we should go about asking them for it?

Mr. HUMPHREY. No, the reality—how good a case do we have on balance-of-payments reasons—for balance-of-payments reasons?

Mr. KRAUSE. On balance-of-payments reasons, there is not a direct relationship. There are aspects of the Rome Treaty that are causing us balance-of-payments troubles and they can be attacked. A very forceful case can be made for these aspects to be amended, and I think the common agricultural policy and the trade preferences afforded the associated oversea countries can be attacked through the GATT negotiations.

If the United States wants to take the issue to the Council of GATT, we can ask that the Common Market be ruled in violation of article 24–6, and if a violation was found they either have to amend the offending provisions or the United States can retaliate.

I do not think that you can argue that since the United States has a balance-of-payments problem, the Common Market should drop its tariffs. I do not think that is a very forceful argument.

Mr. HUMPHREY. Well, would they prefer, if it comes to a necessity of taking some important action, that we restrict imports?

Mr. KRAUSE. I really cannot say what they would prefer. I would prefer to see something done in currency values before that.

Mr. HUMPHREY. How much of a case do you think we have, Mr. Kravis?

Mr. KRAVIS. It has the danger that it might introduce a new and dubious principle in the international order that the degree of liberalization of trade and tariff would vary according to the balance-of-payments needs of the countries. And I think this could get very messy.

If it is a long-run problem, then more basic remedies would be necessary. If it is a short-run problem, then the thing ought to be met in financial terms—that is, through some kind of credits or other aspects of international liquidity. I feel that this is not a very promising line of inquiry myself.

Mr. BALASSA. Let me comment on the legal aspect of it. Article 24 of the GATT is far from being clear on this point. According to this article:

> The duties and other regulations of commerce composed (by the union) * * * shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such a union.

It is not easy to tell what is meant by this ambiguous formulation. Mr. Loveday, a former high official of various international organizations, interpreted it in the following way: The new tariff of the union should not be higher than the average of the old tariffs. And many people took this position.

I wonder, therefore, whether we could really say, on legalistic grounds, that since the establishment of the Common Market leads to trade diversion to the detriment of U.S. exports, the Common Market should reduce her tariffs unilaterally.

Mr. HUMPHREY. Mr. Ruttenberg?

Mr. RUTTENBERG. I find myself in agreement with what Mr. Kravis has said.

Mr. HUMPHREY. Mr. Krause, could you summarize briefly your findings using the dominant supplier approach in the averaging in the Common Market tariff, and what this implies for the discrimination against us.

Mr. KRAUSE. When a common market is formed, and a number of separate tariff areas come together, what is important from the point of view of nonmember countries is not how the average tariff is arrived at, but what is the average protectiveness of the tariff that is arrived at.

And the question then becomes what is the effect of reducing the internal tariff barrier.

With the removal of all restrictions on trade internally, a purer form of competitiveness will prevail. For a high-cost producer to be able to survive within the community, it must meet the competition of the lower cost producers within the group. The low-cost producers, as they expand, will set the competitive tone for the community as a whole.

Now, if you want to test or look at the protectiveness of the external tariff, you should measure it against that amount of protection given the low-cost producer.

I did this by trying to identify which were the low-cost producers of a product before the Common Market started. I assumed they were located in the country that had the largest share of intercommunity trade. Then I looked to see if the tariff was going up or going down for them. In fact in most cases, the tariff is going up, and rather substantially.

To give you an illustration, the German machine tool industry was the most competitive in Europe. The tariff is going up rather substantially on machine tools as compared to the old German tariff.

This suggests that the level of competition in the community will force all competitors to meet the German level for survival, and the tariff as it now exists will yield a substantial increase in protection over what it was before the formation of the community.

Mr. HUMPHREY. And this is fairly general—this is the general picture?

Mr. KRAUSE. Of 21 3-digit SITO classes that are of importance to the United States, 19 are of this kind.

Mr. RUTTENBERG. Very dramatic in automobile and automobile parts.

Mr. HUMPHREY. What is your outlook for our balance of payments? Do you think we will be in balance within 18 months, or is it much more serious than that?

Mr. KRAUSE. I think dating the reaching of balance-of-payments equilibrium in the future is dangerous for a number of reasons. In the first place, probably we are going to be wrong in our prediction. In the second place, it suggests that we are in so critical a position now that whether it takes 18 months or 36 months makes a lot of difference.

I think our balance of payments is improving, and I think it is improving very substantially. I do not know whether it is going to take 18 months or 36 months. From my point of view, I do not think it is critical that we know now whether equilibrium is reached within 18 or 36 months, as long as we are moving toward an equilibrium position.

Mr. HUMPHREY. Mr. Balassa.

Mr. BALASSA. I would certainly join Mr. Krause in saying that we better refrain from making predictions as to what will happen 18 or 36 months from now. I would perhaps add that I see an improvement in our export performance as a result of the expected improvement in the competitiveness of American industry. On the other hand, as we move toward full employment, imports will rise and the discriminatory effects of the Common Market, too, will become stronger in the coming years. And since the outcome depends also on the economic policies followed in other countries, it requires a lot of crystal-ball gazing to come up with an answer.

Mr. HUMPHREY. Do you have any comment?

Mr. KRAVIS. Well, I do not have any great light to throw on this question. I think that much depends upon relative price movements in the two countries—in the United States vis-a-vis foreign areas.

I think to some degree, despite Mr. Ruttenberg's reply, the improvement in our balance-of-payments position has been illusory—that is, they have been measures that help temporarily.

Also I think some of the things that are being done have their feedback in the opposite direction.

For example, the export drive, to the extent that it is effective in turning the attention of American businessmen abroad, may also familiarize them with new sources of foreign supply. So that may help our imports as well as our exports.

But in general I would agree—I think there has been some improvement in our balance of payments. But I would not want to forecast when we are suddenly going to find a world dollar shortage again, or if.

Mr. RUTTENBERG. I am not so sure, Mr. Humphrey, that it is a worthwhile objective to strive for complete equilibrium of our balance of payments, unless we are going to be able to do something about international reserves and international currencies.

If we create a shortage of U.S. dollars by a balance-of-payments equilibrium in the United States, this action will either force some other nation to become part of the world reserve currencies, or, more preferably from my point of view, move toward some international reserve plans of the various kinds that have been discussed by Mr. Bernstein, for instance.

Mr. HUMPHREY. That is all, Mr. Chairman.

Representative REUSS. Thank you very much, gentlemen. We appreciate your contribution.

We now stand adjourned until 2 o'clock.

(Whereupon, at 12:50 p.m., the hearing was recessed until 2 p.m. of the same day.)

AFTERNOON SESSION

Representative REUSS. The Joint Economic Committee will be in session for a continued series of hearings on the outlook for U.S. balance of payments.

We are pleased to have with us this afternoon Assistant Secretary of Defense Charles H. Hitch.

You have a prepared statement, Mr. Hitch. Please proceed in your own way.

STATEMENT OF CHARLES J. HITCH, ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

Mr. HITCH. Thank you, Mr. Chairman. I will proceed to read the statement.

It is a pleasure for me to appear before this subcommittee. Although I have previously appeared before your parent committee, and just last summer before the Subcommittee on Economic Stabilization. Automation, and Energy Resources, this is my first appearance before your subcommittee.

For some years now the United States has had an unfavorable balance of payments. During the year 1958–61, our annual balance-of-payments deficit increased significantly, totaling over $13.5 billion for the 4-year period. We cannot continue to have deficits of this size without seriously endangering the position of the dollar as the world's chief reserve currency. Moreover, this problem is of special interest to defense planners, as continued large deficits would jeopardize our ability to maintain our oversea deployments and thereby threaten to undermine the entire mutual security structure of the free world.

There are many ways to attack our payments problem. President Kennedy outlined them to the country in his special message to the

Congress in February 1961, and I will not attempt to repeat them all here. As he pointed out, however, much of the final solution will have to come from a renewed effort on the part of the private economy to expand our export trade. However, on its own account, the Government too must take action, and because we are such an important contributor to the balance-of-payments problem, the Department of Defense has a special responsibility in this regard.

I would like to emphasize as strongly as I can, however, that in our efforts to reduce the net foreign exchange impact of U.S. defense expenditures, we do not intend to reduce in the least our combat effectiveness abroad or create hardship for the individual serviceman or his dependents.

The U.S. gross defense expenditures entering the international balance of payments have been averaging approximately $3 billion a year. Approximately $2 billion of the total is spent in NATO countries, principally in Canada, Germany, France, Italy, and the United Kingdom. These expenditures represent only the foreign exchange costs of maintaining U.S. forces overseas, not the budgetary costs to the United States which are, of course, much higher.

There can be no doubt about the necessity for the United States to maintain large forces overseas for our own security, for that of our NATO allies, and for the entire free world. As Secretary McNamara has stated, we are prepared to maintain fully effective military forces overseas—wherever required and as long as needed. Always, in administering these forces, we have tried to eliminate all nonessential costs. Now we have another goal, that is to reduce to the lowest possible level the foreign exchange costs of maintaining these forces overseas. Accordingly, Secretary McNamara has established as a prime objective of the Department of Defense the reduction of the net adverse balance of U.S. defense expenditures entering the international balance of payments by $1 billion between fiscal years 1961 and 1963. Present indications are that we may be able to achieve this objective. This net adverse balance—that is, the gross military foreign exchange costs less receipts arising from purchases of U.S. military supplies and services by foreign countries—was about $2.7 billion in fiscal year 1961 and we now estimate that it will be reduced to $1.6 billion during the fiscal year 1963.

Our long-range objective is to reduce the total net adverse dollar outflow stemming from our defense programs to $1 billion by fiscal year 1966. We recognize that this is a difficult undertaking and that its accomplishment will be complicated by the increases in world price levels. For example, during the past few years, there has been an average annual price increase of 3 to 4 percent a year in Western European countries. While such foreign price increases are helpful to the competitive position of U.S. products in world markets and in that sense have a favorable effect on the U.S. trade balance, from the point of view of the Department of Defense they simply represent an increase in our foreign exchange costs. We believe that the most promising method by which we can reduce the net adverse balance is to raise the level of our receipts by encouraging increased procurement of U.S. military equipment by our allies.

The Department of Defense efforts to reduce its own oversea expenditures can be divided roughly into the following areas: the reduction of oversea expenditures by individuals, the reduction of oversea expenditures for major equipment and supplies from the military functions appropriations, the reduction of oversea expenditures for the military assistance program, and the review of oversea bases and construction projects to preclude unnecessary foreign exchange costs.

First, I will take these up in order.

OVERSEA EXPENDITURES REDUCTION PROGRAM—INDIVIDUAL

As I noted before the full Joint Economic Committee on April 10, 1961, President Kennedy, immediately upon taking office, ordered a reappraisal of the balance-of-payments situation with particular reference to the then outstanding order to reduce the number of dependents of Department of Defense personnel overseas. His conclusion was that, while it was clear that the United States must exercise maximum prudence in its dollar outlays abroad, the limitation on dependents' travel to oversea areas, ordered by the previous administration, was not the best way to accomplish the needed savings since the limitation was seriously damaging morale in the armed services. Accordingly, on February 1, 1961, the President directed the Secretary of Defense to rescind the order, and to find and implement alternative measures which would produce equivalent dollar savings, including limitations on expenditures abroad by military personnel for the purchase of durable consumer goods. The Office of the Secretary of Defense on March 6, 1961, directed the military departments to institute a voluntary program for reduction of individual expenditures overseas.

Military and civilian personnel and their dependents have been urged to reduce their personal expenditures overseas, to channel their family expenditures to U.S. sources, and their savings to U.S. savings bonds and other American securities and institutions. Although it is indeed difficult to measure results in this area, it is estimated that foreign exchange savings of approximately $50 million were achieved in fiscal year 1962.

REDUCTION IN EXPENDITURES FOR MAJOR EQUIPMENT AND SUPPLIES

President Kennedy also directed on February 1, 1961, that the policy inaugurated in November 1960, emphasizing procurement in the United States for military forces abroad, be continued wherever practicable even though some increased budgetary costs might be incurred. It is necessary at this point to distinguish between the actions we have taken relating to purchases for use overseas and those which relate to purchases for use in the United States. The latter, of course, are governed by provisions of the Buy American Act and Executive Order 10582. The former are governed by our own Department of Defense directives.

With respect to purchases of goods and services for use overseas, subject to a number of exceptions concerning emergency requirements, conformity to treaty obligations, small purchases, and contracts for items which cannot be furnished from the United States, procurement initially was returned to the United States whenever it was estimated that the cost of U.S. supplies or services (including transportation and handling costs) will not exceed the cost of foreign supplies or services by more than 25 percent. On July 16, 1962, the percentage differential was increased to 50 percent.

Reports submitted by the military departments in calendar year 1961 indicated that approximately $71.4 million of procurement contracts that normally would have been placed abroad were returned to the United States because of our instructions. During this period the additional cost of placing this $71.4 million in the United States was approximately $10.4 million, or about 17 percent more than the estimated cost if procurement had been made from foreign sources. During the first 6 months of calendar year 1962, approximately $19.7 million of procurement was returned to the United States at an increased cost of $3 million or 15.2 percent. During the July-September 1962 period, when the 50-percent differential was in effect, the military departments reported that $57.6 million of procurement contracts was returned to U.S. sources at an increased cost of $15.3 million or 36 percent.

On purchases for use in the United States, as I pointed out, the provisions of the Buy American Act and the Executive Order 10582 apply. The Buy American Act requires that we buy, for end products to be used in the United States, only from domestic sources, except where the price of such end products is unreasonable or their acquisition could be inconsistent with the public interest. Executive Order 10582, issued on December 17, 1954, establishes 6 percent, plus duty, as the price differential beyond which the price of domestic products will normally be considered unreasonable. It also provides that the head of an agency may deviate from the general rule, on a case-by-case basis, when he deems it in the public interest to do so.

Secretary McNamara has directed that our procuring activities buying for use in the United States should continue to evaluate bids in accordance with the provisions of Executive Order 10582. However, when such evaluation indicates that under the prevailing criteria there should be an award for supplies of foreign origin, the case is first referred to the Secretary for decision. This unusual procedure is, of course, only an interim measure until a pattern can be established, and then, if considered appropriate, recommendations will be made for changes in the present percentage differential in the Executive order. It is too early to predict how this pattern will ultimately develop but, under this procedure, we have already directed a few procurements to be made from domestic sources even though the differential exceeded those presently stipulated in the Executive order. The authority for these actions was the Buy American Act itself and the "national interest" authority in section 3(a) of Executive Order 10582.

Understandably, there has been some adverse reaction on the part of foreign suppliers who have been precluded from obtaining DOD contracts. We have attempted to deal with these complaints through diplomatic and other channels, explaining the purpose and need of our present policies.

REDUCTION IN EXPENDITURES FOR THE MILITARY ASSISTANCE PROGRAM

The 25-percent differential originally applied to procurement from military function appropriations has also been applied to the military assistance offshore procurement program.

It is estimated that military assistance offshore procurement expenditures were reduced by approximately $25 million during calendar year 1961. Also, in implementation of the Foreign Assistance Act of 1961, as amended, and the Presidential determination of October 18, 1961, the Department of Defense issued Department of Defense Directive 2125.1, dated January 2, 1962, which provided that funds made available for the military assistance program are not to be used for procurement outside the United States except to procure items which are not produced in the United States, to make local purchases for administrative purposes, and to use local currency for military assistance purposes. The Presidential determination in accordance with the Foreign Assistance Act provides that the Secretary of Defense may authorize further exceptions whenever failure to procure outside the United States would seriously impede attainment of military assistance program objectives.

REVIEW OF OVERSEA BASES AND CONSTRUCTION

A comprehensive review of our requirements for each of our foreign military bases or installations required by our military services has been undertaken. As a part of this overall review a special study group has been reviewing selected activities in Western Europe to determine the feasibility of increasing joint utilization of depots with our allies as well as to explore the possibilities for the reduction, elimination, or consolidation of headquarters, training, and major logistic support activities. To date this continuing project has resulted in the announced intention to close 67 installations or activities overseas with ultimate foreign exchange savings of as much as $120 million annually.

In addition, we are reviewing our oversea construction program in order to reduce the foreign exchange costs, including use of such techniques as shipping overseas entire units which have been prefabricated in the United States.

RECEIPTS

A major effort is being made to persuade our allies to increase their procurement of U.S. military equipment and services. The Federal Republic of Germany has already agreed to increase its purchases in order to offset our defense dollar outlays in West Germany, which amount currently to $675 to $700 million a year, by far our largest single foreign exchange drain. This agreement has recently been extended to cover the period through calendar year 1964. The agreement with the Federal Republic of Germany provides for a cooperative logistic system for the armed forces of both countries. Further, the Federal Republic of Germany has agreed to increase its military procurement in the United States and utilize American supply lines, depots, and maintenance and support facilities.

In addition, within the last few weeks, Italy has agreed to purchase over $100 million of military equipment from the United States as a first step toward offsetting our foreign exchange costs in that country. We are negotiating similar arrangements with other countries and contemplate approaching still others in the near future. You will recognize, of course, that the details of many of these arrangements as well as pending negotiations are politically sensitive and cannot be discussed in open session.

We believe that this approach offers the most equitable way to reduce further the net foreign exchange cost of our forces stationed overseas. In addition, through such agreements, our allies can strengthen their own military forces at a minimum cost, thus building up both the military and economic defenses of the free world.

RECENT ACTIONS

We have recently undertaken a comprehensive, long-range program designed to reduce further the net outflow of dollars resulting from our programs. To achieve this reduction, we have initiated the following actions:

First, over 60 separate projects and studies have been established to minimize expenditures and maximize receipts entering the international balance of payments. These studies include:

(*a*) Review of the use of foreign nationals as employees at our oversea military installations to determine whether requirements can be reduced without interfering with our combat and support capability.

(*b*) Development of additional programs to reduce oversea procurement of materials and supplies.

(*c*) Development of a program to reduce expenditures for contractual services overseas, including expenditures for repairs, alterations, maintenance, and so forth.

(*d*) Review of dollar expenditures overseas associated with the military assistance program and investigation of ways in which they may be reduced.

(*e*) Development of means for expanding the present credit sales program so as to facilitate additional sales of U.S. military supplies and services and thereby further offset our own expenditures overseas.

Secondly, Secretary McNamara has established separate organizational elements in the Offices of the Assistant Secretaries of Defense for Installations and Logistics, International Security Affairs, and in my own Office, specifically to facilitate the Department of Defense efforts in the balance-of-payments area.

Thirdly, along with other Government agencies, the Department of Defense is now collecting and reporting both actual and projected data on its international transactions to the Bureau of the Budget. These quarterly reports from the Federal agencies will permit the preparation of Government-wide estimates of future foreign exchange needs of the Federal sector and should be of great value to our monetary and fiscal policymakers. These data are sometimes referred to as the "gold budget."

One final point: while it would be inappropriate at this time for me to speculate on either the size or substance of the fiscal year 1964 defense budget which the President will send to the Congress in January, one facet of our budget review procedure this year might be noted here. For the first time, the service requests have been reviewed not only for their budgetary implications but also for their foreign exchange costs. Literally hundreds of individual decisions which Secretary McNamara has made on the tentative 1964 military program have been made in full knowledge of their likely impact on the U.S. balance of payments. In the months ahead we hope to refine and perfect this system for determining the foreign exchange implications of every major program choice which is made in the Department of Defense.

It is impossible at this time to give any precise estimate of the cost in dollars expected to accrue by virtue of the reduction of dollar outflow abroad. We will achieve balance to the maximum extent possible by increasing sales of U.S. military equipment to allied countries and by cutting out nonessentials; the latter will save budget dollars as well as foreign exchange.

Nevertheless, there will be some net increase in dollar costs resulting from the return of procurement abroad, from increased unit rotation, and from other measures. We are confident that this increase will be only a fraction of a percent of the defense budget. I believe that this is a reasonable price to pay for a major contribution to the stability of the U.S. dollar and hence to the stability of our military deployments abroad in support of our international security commitments.

In spite of the steps we and other agencies of the Government have taken, the deficit in our balance of payments in the first three quarters of calendar year 1962 was at an annual rate of $1.9 billion compared with $2.5 billion last year. Nevertheless, the situation today looks more encouraging than it has in a long time. As President Kennedy stated at this year's annual meeting of the International Monetary Fund and World Bank in Washington:

> * * * our commercial trade, excluding exports financed by AID, produces a surplus of nearly $3 billion * * *. The United States could bring its international payments into balance overnight if that were the only goal we sought. We could withdraw our forces, reduce our aid, tie it wholly to purchases in this country, raise high tariff barriers and restrict the foreign investment or other use of American dollars.

But he went on to say—

> the basic strength of the dollar makes such actions as unnecessary as they are unwise.

While the measures already taken and those being planned will, in time, we hope and believe, bring our international transactions into better balance, our very large and still-growing short-term liabilities to foreigners will continue to leave us vulnerable to a sudden flight from the dollar. Under these circumstances, the Department of Defense is now gearing its programs and policies to minimize to the greatest extent possible, its foreign exchange requirements—consistent, of course, with fully meeting at all times the needs of national security.

Mr. Chairman, we have prepared a series of tables which we hope will be of some assistance to the committee and its staff. If additional information or explanation is desired, we will be glad to provide it.

(The tables referred to follow:)

U.S. defense expenditures and receipts entering the international balance of payments

[In millions of dollars, by fiscal year]

	1961 (actual)	1962 (preliminary)	1963 (estimated)	1966 (objective)
Expenditures:				
U.S. forces and their support:				
Expenditures by U.S. military, civilians, and dependents [1]	$775.2	$765.0	$775.0	
Foreign nationals (direct hire and contract hire)	362.2	394.2	400.0	
Procurement:				
Major equipment	52.9	56.6	61.4	
Construction	170.1	129.1	80.8	
Materials and supplies	550.8	590.1	560.0	
Contractual services	487.5	492.1	470.0	
Subtotal	2,398.7	2,427.1	2,347.2	
Military assistance program:				
Offshore procurement	131.0	101.1	117.1	
NATO infrastructure	104.4	35.3	87.0	
Other	76.0	91.3	66.7	
Subtotal	311.4	227.7	270.8	
Total expenditures	2,710.1	2,654.8	2,618.0	
Less excess foreign currency obtained from U.S. Treasury	10.0	6.0	6.0	
Total dollar expenditures (DOD)	2,700.1	2,648.8	2,612.0	
Receipts	375.2	898.6	1,244.2	
Net adverse dollar balance (DOD)	2,324.9	1,750.2	1,367.8	
Other expenditures (AEC and other agencies included in NATO definition of defense expenditures)	343.5	278.1	253.6	
Net adverse dollar balance (NATO definition)	2,668.4	2,028.3	1,621.4	$1,000

[1] Includes expenditures for goods and services by nonappropriated fund activities.

Source: OASD (Comptroller), Dec. 12, 1962.

TABLE 1.—*Estimated expenditures for direct and contract hire of foreign nationals, fiscal year 1963*

Country	Number of personnel		Approximate cost
	Direct hire	Contract hire	
	Thousands	*Thousands*	*Millions*
Canada	3.3	(1)	$15
France	1.6	22.6	56
Germany	.2	81.1	177
Italy	4.3		8
Japan	.2	53.4	61
Korea	20.8	6.2	24
Philippines	10.0		17
Ryukyu Islands	15.1		9
Spain	3.3		3
United Kingdom	.5	3.3	10
Other countries	9.9	3.6	20
Total	69.2	170.2	400

[1] Less than 100.

TABLE 2.—*Materials and supplies, estimated expenditures, fiscal year 1963*

[In millions of dollars]

Country	Fuel	Subsistence	Other	Total
Bahrein Islands			$0.1	
Belgium and Luxembourg		$1.3	2.5	
Canada		3.5	12.5	
Denmark and Greenland		11.6	1.7	
France		1.8	33.0	
Germany		12.8	54.7	
Greece		[1]	.6	
Iceland		.8	.2	
Indochina		.3		
Italy		4.1	5.1	
Japan		12.6	50.0	
Korea		7.8	4.2	
Netherlands		12.9	.4	
Netherlands Antilles				
Pakistan			.1	
Philippines		1.1	2.5	
Ryukyu Islands		4.3	12.0	
Saudi Arabia				
Spain		.6	3.4	
Thailand		.5	.5	
Trinidad and Tobago				
Turkey		1.2	8.5	
United Kingdom		3.8	22.0	
Venezuela				
All other		3.8	6.2	
Total	$255.0	84.8	220.2	$560

[1] Less than $50,000.

TABLE 3.—*Contractual services, estimated expenditures, fiscal year 1963*

[Millions of dollars]

Country	Travel	Transportation	Communications, rents and utilities	Other (repairs, alterations, maintenance, etc.)	Total
Belgium and Luxembourg	$0.1	$0.4	$0.3	$3.4	$4.2
Canada	2.3	3.0	13.5	18.7	37.5
Denmark and Greenland	1.0	[1]	.1	.9	2.0
France	8.9	4.8	11.7	26.9	52.3
Germany	18.0	16.9	38.0	58.2	131.1
Greece	.6	.2	.3	1.3	2.4
Iceland	.2	.2	.3	1.6	2.3
Indochina	.8		.3	2.8	3.9
Italy	1.5	.6	3.2	5.5	10.8
Japan	8.1	3.1	16.4	36.3	63.9
Korea	1.9	3.9	3.2	15.9	24.9
Netherlands	.2	1.2	.2	3.4	5.0
Pakistan	.4	.2	.3	.3	1.2
Philippines	2.7	.9	1.1	4.3	9.0
Ryukyu Islands	4.2	.6	6.8	5.2	16.8
Saudi Arabia	.1			.3	.4
Spain	2.4	.9	3.4	7.9	14.6
Thailand	.4		.2	1.2	1.8
Turkey	7.3	1.7	1.4	8.8	19.2
United Kingdom	4.3	3.1	9.7	24.2	41.3
All other	6.6	1.2	2.0	15.6	25.4
Total	72.0	42.9	112.4	242.7	470.0

[1] Less than $50,000.

TABLE 4.—*Estimated military assistance expenditures, fiscal year 1963*

[Millions of dollars]

Military assistance offshore procurement	$106.3
Mutual weapons development program	6.1
Weapons production program	4.7
NATO infrastructure	87.0
Other (administration of MAAG's, construction, travel, repair and rehabilitation of facilities, etc.)	66.7
Total	270.8

TABLE 5.—*U.S. defense expenditures and receipts entering the international balance of payments, by country, fiscal year 1962*

[Millions of dollars]

Country	Expenditures	Receipts [1]	Net adverse balance
Austria	$5.6	$0.1	$5.5
Azores	6.2	.2	6.0
Bahrein Islands	42.7		42.7
Belgium-Luxembourg	14.6	9.0	5.6
Bermuda Islands	13.2	.2	13.0
Canada	292.3	20.9	271.4
Denmark and Greenland	37.3	4.3	33.0
Finland	.7		.7
France	266.6	22.0	244.6
Germany	691.1	668.2	22.9
Greece	10.7	.2	10.5
Iceland	12.3		12.3
Indochina	20.9	.8	20.1
Italy	88.2	6.5	81.7
Japan	371.0	23.5	347.5
Korea	99.0	5.2	93.8
Libya	6.5	.3	6.2
Morocco	20.2	.9	19.3
Netherlands	32.2	6.0	26.2
Netherlands Antilles	54.0		54.0
Norway	9.5	1.0	8.5
Pakistan	6.1	2.3	3.8
Philippine Islands	49.0	2.0	47.0
Portugal	6.6	1.4	5.2
Ryukyu Islands	91.3	1.1	90.2
Saudi Arabia	40.7	2.1	38.6
Spain	52.2	.5	51.7
Sweden	2.9	.4	2.5
Switzerland	4.9	1.5	3.4
Taiwan (Formosa)	22.4	.1	22.3
Thailand	18.8	.3	18.5
Trinidad and Tobago	18.4	(2)	18.4
Turkey	64.1	1.2	62.9
United Kingdom	207.0	23.2	183.8
Yugoslavia	2.6	2.2	.4
American Republics	64.3	13.7	50.6
Other countries	186.8	77.3	109.5
Total	2,932.9	898.6	2,034.3
Deduct excess foreign currency	−6.0		−6.0
Grand total	2,926.9	898.6	2,028.3

[1] Includes shipment of military supplies procured through the Department of Defense, reimbursement to the United States for logistical support of United Nations and other nations' defense forces and other sales of goods and services by the military departments.

[2] Less than $50,000.

Mr. HITCH. The first of the tables shows for fiscal years 1961, 1962, and 1963 the total picture of defense expenditures broken down by categories and receipts. You can see that we have been fighting very hard to just stand still with respect to total expenditures, and that our real progress has been made in the field of receipts.

The second table, table 1, shows a breakdown by country of the expenditures for direct and contract hire of foreign nationals, which is one of the items appearing on the first table. This was the breakdown in fiscal year 1963.

The next table, table 2, shows the breakdown by country of our expenditures for materials and supplies, which is also an item that appears on the first table as a single item.

The next table, table 3, shows the breakdown by country and by various functions of contractual services, also for fiscal year 1963.

The next table, table 4, shows the breakdown in military assistance expenditure.

And the last table, table 5, shows for 1962, rather than 1963, because 1963 is just estimated at this time, total expenditures and receipts by country for all the important countries.

Thank you, Mr. Chairman.

Representative REUSS. Thank you very much, Secretary Hitch.

It seems to me that you have presented a remarkable report on behalf of the Defense Department of a very serious and purposeful compliance over the last couple of years with our balance-of-payments needs. These broad categories, of course, conceal a lot of things that can't be discussed publicly that you and I are aware of, and perhaps if we could discuss them there might be some disagreement about the deployment of American troops here and there where a different deployment would lead to different consequences through our balance of payments. But overall, certainly every heading you have here shows a very serious awareness of the problem, and a no-fooling effort to do something about it. And I am proud of the work you and Secretary McNamara and the Defense Department have done.

I have no questions, but Mr. Humphrey, our staff consultant, has a number that he would like to put to you.

Mr. HUMPHREY. As regards German expenditures here, or those of other countries that you are now negotiating, are these net figures? Would they be making some of these expenditures here in any event, because this is a cheap place, or because we produce products they don't?

Mr. HITCH. That is always a very difficult question to answer, because it involves assuming what the state of the world would have been if everything had been different.

Mr. HUMPHREY. I am sure you understand I am just trying to get the balance-of-payment effects.

Mr. HITCH. Yes. We would really like to know ourselves the answer to this question. We think for the most part these are net expenditures. These are expenditures that we have negotiated with the Germans. Before the negotiations they had not anticipated spending anything of this order of magnitude here. So we think that these are for the most part net expenditures. But they might have bought some of these things here if there hadn't been the negotiations.

I can't answer any more specifically than that.

Mr. HUMPHREY. Are you able to add anything, Mr. Secretary, as to the inducement to get them to spend here? As a straight, economic calculation, is this usually advantageous to them, and they are just giving up producing their own defense goods, or are they sacrificing in terms of cost?

Mr. HITCH. In general the answer is that they can do better procuring from us. These are certain individual exceptions to that. But for most of these major equipment items, military equipment items, we have had so much more experience than they have had, and they have the privilege of buying at the end of a long production line, and taking advantage at little or no cost of all of the research and development that we have done, and all of the earlier production that we have done. So it is, we think, in most cases, a real bargain for them.

Mr. HUMPHREY. This is another kind of a question, but I hope you will allow it. We hear and read so much about efforts to get our allies to assume a larger share of our cost of European defense. Is this a hopeful line of approach? Is there something there or not?

Mr. HITCH. It is one that we are pursuing to the very best of our ability. The Secretary of Defense is engaged in such a mission this week. We are not happy, for example, about the share of NATO infrastucture that we have been paying for in the past. We think that the U.S. share should be smaller. We are not happy about the extent to which the armies of various NATO countries rely upon us for backup and supply. We think that they ought to be providing those things themselves. We are pressing this view as hard as we can and negotiating as hard as we can.

Mr. HUMPHREY. Is this strictly a security affair, or does it have relations to other trade and international negotiations? I am trying to raise the question, I guess, Do we have any real inducement here to get them to pay a larger share?

Mr. HITCH. To the best of my knowledge, this particular thing has not been tied in with general negotiations on trade.

Mr. HUMPHREY. Do you think it could be effectively?

Mr. HITCH. Sometimes by broadening the scope of negotiations you can achieve things which you couldn't otherwise, I think. It is something that ought to be looked into.

Representative REUSS. Thank you very much, Mr. Secretary. We appreciate your help.

I see Mr. Frank Coffin in the hearing room.

If you are ready to come forward, Mr. Coffin, we will be glad to hear from you now.

Mr. Coffin is Deputy Administrator of the Agency for International Development, and is also a distinguished alumnus of this committee.

We are particularly happy to welcome you on the other side of the bar this afternoon.

STATEMENT OF FRANK C. COFFIN, ACTING ADMINISTRATOR OF AGENCY OF INTERNATIONAL DEVELOPMENT; ACCOMPANIED BY BARTLETT HARVEY, CHIEF OF ECONOMIC PROGRAM DIVISION OF PROGRAM COORDINATION STAFF; AND RICHARD B. PALMER, PROGRAM OFFICER, INTERNATIONAL DEVELOPMENT ORGANIZATIONS STAFF

Mr. COFFIN. Thank you, Mr. Chairman.

What I would like to do, with your permission, is to insert my statement and tables in the record, but talk briefly from points that are raised in the statement, make an oral summary of what the statement is.

Representative REUSS. Without objection the statement prepared by Mr. Coffin will be received and made a part of the record.

(The statement referred to follows:)

TESTIMONY OF FRANK C. COFFIN, ACTING ADMINISTRATOR OF AGENCY FOR INTERNATIONAL DEVELOPMENT

Apart from the pleasure of a homecoming to this committee, I appreciate this opportunity to discuss with you two aspects of the relationship between the efforts to accelerate development of the developing nations and the U.S. balance of payments. The direct impact of the AID program on the U.S. economy and the somewhat less direct impact resulting from the efforts of other countries are related to each other. However, for ease of discussion I will treat them separately and in that order.

I. IMPACT OF AID PROGRAM ON THE U.S. BALANCE OF PAYMENTS

Major steps have been taken in the past 3 years and are still being taken to reduce the burden of foreign economic assistance on the U.S. balance of payments. The results have already been striking and promise to be more so.

The following tables show that the share of directly purchased U.S. goods and services in the economic assistance program has increased from one-third to one-half of AID expenditures and under current policies should further increase to over three-fourths. This means that the payment of dollars abroad under the program for offshore procurement or as cash transfers has been cut from $1.2 billion in 1960 to an estimated $0.6 billion out of funds to be obligated in fiscal year 1963. Because of the growth of the program, the corresponding increase in direct financing of U.S. exports of goods and services is far larger, more than tripling, from $0.6 billion to $2 billion.

Agency for International Development estimated MSP/AID Program direct purchases in the United States

	Expenditures			Obligations fiscal year 1963
	Calendar year 1960	Fiscal year 1962	Fiscal year 1963	
	Millions of dollars			
DLF commodities	$68	$151	$411	$949
Grant commodities	369	367	358	342
Other	131	368	538	738
Total	568	886	1,402	2,030
	Percent of total in each category			
DLF commodities	33	73	81	95
Grant commodities	42	60	63	66
Other	21	39	56	65
Total MSP/AID	35	50	65	76

I would like to discuss several aspects of this shift: How it was done; the results of the measures taken; why it needed to be done; what the changes mean; and what the remaining dollar outflows consist of.

A. Measures taken to reduce the AID burden on the U.S. balance of payments

Three years ago Under Secretary of State Dillon, then Coordinator of Foreign Assistance, and President Eisenhower decided that the apparent burden of the International Cooperation Administration and Development Loan Fund programs on the U.S. balance of payments, which exceeded $1 billion, had to be reduced. This basic decision has been implemented in three stages.

Loan-financed commodity procurement tied to United States.—First, in November of 1959 the procurement policy governing the Development Loan Fund was reversed. The DLF had operated on a worldwide competitive bidding basis with the result that a substantial share of the equipment financed was supplied from Europe. From then on, however, the DLF was "to place primary emphasis" on the export of U.S. goods. This policy has been followed since that time and still governs the use by AID of development loan funds, and Alliance for Progress funds on a loan basis. There have been relatively few waivers of this policy to cover parts needed for already installed European or Japanese equipment, or to add another element of such equipment to an already existing series where a U.S. item would greatly complicate the maintenance problem.

For the development loan program, which consisted entirely of major development projects and of balance-of-payments support for major development programs in the case of India and Pakistan, the issue presented by tying AID to U.S. suppliers was essentially one of economy, i.e., whether to buy the needed equipment in the cheapest market or from a U.S. source even though more expensive. These being largely additional imports which would not have been needed in absence of the development projects or programs, the question of disruption of trade patterns did not arise in an acute form.

Grant-financed commodity procurement barred in 19 countries.—The problem was more complex with a substantial part of the ICA program, where the United States was often providing financial support for the maintenance of existing import patterns. However, late in 1960, Under Secretary Dillon and President Eisenhower decided that the balance-of-payments difficulties of the United States were sufficiently critical that here too everything possible should be done to reduce the load of foreign assistance on the gold outflow problem. In December of 1960 it was announced the ICA would no longer finance the procurement of goods from 19 listed countries, mainly in Western Europe, which were generally characterized by a relatively high state of industrial development and at least partially convertible currency. These were and are the countries with the major increases in reserves, whose collective balance-of-payments surplus was the opposite side of the U.S. balance-of-payments deficit. This limitation on grant procurement remains in effect, as does the corollary of continuing procurement from the less developed free world countries on a competitive basis.

Dollar transfers restricted to purchase in the United States.—The third stage of implementation measures to reduce the foreign assistance burden on the U.S. balance of payments dates from this year and is, in fact, still in the process of being worked out. This third element relates to the use of AID funds to cover local costs and budget support. Techniques are developed, through the banking system, including segregated accounts or irrevocable letters of credit, of insuring a U.S. origin for the real resources which are imported by the recipient country when it uses AID dollars received in cash.

In the absence of these techniques the dollars might well, in any event, have been used to pay for imports from this country. But since the direct aid transaction would have been a cash payment to the foreign government, this would have been reported in the U.S. balance of payments as a debit item not related to a corresponding export or credit item. The requirement that the dollars be in fact used for imports from the United States will result in this relationship being clear in all cases, and in some will result in a net increase in U.S. exports.

B. The results

The detailed results of these policies for commodity expenditures in 1962 are shown in the attached booklet prepared by our Statistics and Reports Division. I would like to emphasize, however, that last year was still very much one of transition in that a substantial share of both grant and loan expenditures derived from obligations made before the changes in procurement policy I have just discussed. In fact, one-quarter of the loans approved prior to November 1959 were still unliquidated last June. Thus, the new procurement policies are by no means fully reflected in the 1962 expenditure data. We estimate that there will be a continued improvement in the share of expenditures supplied from the United States during 1963 with a rise from an overall portion of 50 percent in 1962 to 65 percent in 1963.

A clearer reflection of current policies is presented by our estimates concerning obligations in 1963. We estimate that at least 85 percent of obligations for AID-financed commodity procurement will be of U.S. origin and that at least 76 percent of all AID obligations in 1963 will be directly attributable to U.S.-supplied goods and services. The share on an overall basis is lower because of the $150 million to be contributed from AID funds to international organizations and because it will be impossible in a number of critical budget support situations to insure use in the United States by the country in question of the dollars received for budget support. I have here and would like to submit for the record, a table showing in greater detail the estimated offshore share of 1962 and 1963 expenditures and 1963 obligations. We are not at this time able to divide these estimates of offshore expenditures between the 19 hard-currency countries and the rest of the world, but I can assure you that the entire decline will be in the former group.

We are making solid progress toward the administration's goal of 80 percent of AID expenditures paying for U.S. goods and services. Because of this progress the apparent impact of the assistance program on the U.S. balance of payments is sharply reduced despite the substantial increase in the size of the program from the $1.8 billion 1962 expenditure level to the $2.7 billion 1963 obligation level.

AGENCY FOR INTERNATIONAL DEVELOPMENT

AID and the U.S. balance of payments, fiscal year 1962, fiscal year 1963 expenditures and fiscal year 1963 obligations: Share paid to non-U.S. recipients

[Millions of dollars]

	Fiscal year 1962 expenditures			Fiscal year 1963 expenditures			Fiscal year 1963 obligations		
	Total	Off-shore	Per-cent	Total	Off-shore	Per-cent	Total	Off-shore	Per-cent
Development loan, total	430.7	174.9	41	903.4	156.4	17	1,425.0	99.1	7
Commodities	206.0	55.4	27	631.7	120.7	19	999.9	49.9	5
Cash	74.5	74	100	155.1	7.0		263.6	7.0	
Other	150.2	45 1	30	116.6	35.0	30	161.0	48.5	30
Development grants and supporting assistance, total	1,124.7	573.4	53	1,006.6	393.4	40	1,031.7	376.5	36
Commodities	609.9	242.6	40	561.5	208.0	37	518.6	176.8	34
Cash	268.0	268.0	100	195.2	120.7	62	195.2	118.0	60
Other	246.8	62.8	26	249.9	64.7	26	317.9	81.7	26
International organizations	119.6	119.6	100	190.0	190.0	100	149.0	149.0	100
State	99.4	99.4	100	115.0	115.0	100	119.0	119.0	100
Industries and refugees	20.2	20.2	100	30.0	30.0	100	30.0	30.0	100
Inter-American Development Bank Trust Fund				45.0	45.0	100			
Administrative	52.9	9.9	19	50.0	8.5	17	54.4	8.5	16
Personnel overseas	16.5	4.3	26	18.9	4.8	25	18.9	4.8	25
Other overseas	7.6	5.6	75	4.9	3.7	75	5.0	3.7	75
Other	28.8			26.2			30.5		
Cuban refugees	36.4								
Total	1,764.3	877.7	50	2,150.0	748.3	35	2,661.0	630.9	24

C. How the problem arose

I would like now to turn briefly to the background: how it is that a pattern of foreign aid arose in which only one-third of mutual security economic assistance expenditures were made directly for U.S. goods and services.

The predecessor agencies of the AID did not operate on the basis of financing the outflow of U.S. goods and services but rather on a basis of financing the resource gap, generally the net import requirement, of recipient countries with little regard for source. There were two reasons for this. The first is historical.

Historical background.—When the Marshall plan was established, the great problem faced by Europe was the dollar gap, a shorthand way of saying that the U.S. economy was the only one then capable of supplying the goods and services needed for recovery and reconstruction, and that the Europeans were then incapable of earning enough foreign exchange to pay for them. In this suppliers' market the Economic Cooperation Administration could and did focus on the net import requirement for recovery and reconstruction of the recipient European countries rather than on stimulating U.S. exports. It financed those needed imports on a worldwide competitive bidding basis in the sure confidence that most of the imports would come directly from the United States and that those dollars which flowed through other suppliers would, in turn, be used virtually immediately to buy U.S. exports of goods and services. So long as the effective limitation on U.S. exports was the inability of foreign importers to pay for them, the supply of additional dollars to foreigners resulted in an equivalent increase in U.S. exports. The aid program could focus properly on the analysis of the requirements of the recipients, and ignore the question of the source from which the needed imports were to come. The momentum of this sound ECA position stayed with the assistance agencies through the 1950's.

Nature of a requirements-oriented program: Trade patterns.—The second group of reasons for this method of operation by AID's predecessor agencies lies in the nature of some of the problems faced by the U.S. foreign assistance program. The program is the servant of U.S. foreign policy and oversea interests, which means that it must be requirements oriented. The United States, for strategic and other reasons, has undertaken in Korea, Vietnam, Laos, Jordan, Libya, Morocco, and in many other countries of the world, to enable these countries to sustain an extraordinary defense effort, to permit location within the country of U.S. bases, and to enable these countries simply to exist and to grow in the face of inadequate resources and technology. Frequently the import gap literally cannot be met totally with U.S. goods and services. The price relationships would be too far out of line, the disruption of trade patterns too great, the impact on the total commercial, social, and political structure of the country too much. In many cases the United States, despite current best efforts, finds itself of necessity financing requirements which can only be supplied from other countries which are unable or unwilling to finance the need themselves.

Budget support and local costs.—A variation of this need is the frequent and growing necessity for aid to provide dollars for internal budget support and to cover the local costs of development projects. We meet this requirement in several of the support countries, such as Laos and Jordan, where the financial and government institutions of the country are simply incapable of mobilizing the internal resources needed for the defense or development task at hand, where, in fact, the only way to get the job done is to pay for the use of local resources with dollars. This simply increases the recipient country's dollar reserves until these dollars are used for increased imports or other foreign exchange requirements. We do our best to keep this use of aid funds to an absolute minimum and have managed to switch a number of our support situations such as Korea and Vietnam from budget support to a balance-of-payments support basis. However, we are finding that in a number of African and Latin American countries the institutions for mobilizing internal capital are incapable of keeping pace with the local costs of accelerated development and that a substantial share of our aid to these areas must be used in the first instance to cover part of the local costs of development projects.

Contributions to international organizations.—A third aspect of aid requirements which necessitate direct payments abroad of dollars are our contributions to international organizations. The assessed contribution to the U.N. and its special agencies are in the State Department's budget, but the voluntary additional contributions for the U.N. Special Fund and expanded technical assistance program, for the special assistance to the Congo and for the Indus waters program are in the AID budget. In all of these cases the United States is contributing only a share of the need of the international agencies, no more than 40 percent in the case of the U.N. programs. As is the case with us so is it generally true of the other members, that contributions are made in unrestricted dollars. These international agencies spend nearly as much in the United States as the total of our contributions. Thus except in the technical sense in which balance-of-payments figures are defined, our contributions to international organizations have a very little effect on U.S. balance of payments. For example, some of the major projects in the Indus waters program were let by the IBRD on a competitive bidding basis to a group of American contractors. It is essential to the freedom of action and continuing growth of these international agencies and the strength of the programs they conduct that the contributions to them by all member nations should be unrestricted.

D. What the shift in procurement means

The reversal of pattern I have presented to you this afternoon from two-thirds dollar outflow of economic assistance to a prospect of less than one-fourth is striking, but questions remain. We do not know to what extent the shift which is apparent in the figures I have cited is real and to what extent it is only one of appearance. Money after all is fungible, trade patterns are complex, foreign exchange is supplied from many sources, and whether or not an increase in the proportion of AID dollars which are used to pay for U.S. exports to a developing country results in a net overall increase in U.S. exports depends very much on what that country does with its other dollars and foreign exchange. If it uses them to buy in a third country, it depends on what the third country in turn does with these dollar receipts.

It is clear that aid increases a recipient country's foreign exchange resources. It normally could be expected to spend a part of this increase in the United States, part in countries which in turn would spend part in the United States, and so on, until the entire amount has been spent in the United States, except for that part spent in each round in countries which will hold the dollars as increased reserves rather than spending them.

In some areas such as the Caribbean, the trade patterns bring nearly all dollar payments back to the United States very quickly. In others such as tropical Africa, dollars will tend to gravitate to Europe and return to the United States far more slowly if at all.

More work is needed on this question, and we are discussing a research contract with Professor Bell, of Haverford College, to develop such a study by next summer. However, preliminary indications are that estimates based on these "reflection ratios" of the use of additional dollars by different countries will show that the impact of aid on the balance of payments was far less than the 1960 figures indicated, but that the burden is considerably lessened by tying, so long as there are countries running large dollar surpluses which are major trading partners of recipients.

At any rate it is clear that the limitations on the sources from which AID may finance procurement do have a real impact. They assure the entry of U.S. capital goods and manufactures into markets which they would otherwise be unable to penetrate on a pure price competition basis. They force in some instances a change in trade patterns and an opening of commercial channels to U.S. exports which would otherwise have remained effectively blocked by tradition or exchange controls.

These gains, however, are not without cost. U.S. foreign policy cannot be so well served with a given amount of foreign assistance as it could be without them because of the higher prices that must be paid in many instances for American goods. To this extent the program is serving two masters—foreign, and domestic. These limitations also frequently result in very considerable negotiating difficulty, administrative friction, and program delays. They generate a very unfortunate administrative burden on an already overcomplex and extremely difficult program. We look forward to the day when overall dollar balance is restored and these limitations can be removed in the confidence that AID financing will return to purchase U.S. goods and services on a freely competitive basis, even when the initial use is for a payment abroad.

E. The remaining dollar outflow

Before turning again to the problem of the continued burden, I would like to place it in context. The AID program covers only a fraction of the total U.S.

Government foreign assistance efforts. The other parts of that effort include long-term loans from the Export-Import Bank to finance the export of U.S. capital equipment; the Public Law 480 shipments of surplus agricultural commodities on a foreign currency sales basis, a long-term credit basis, or a commodity grant basis; the service abroad of the Peace Corps volunteers or of exchange professors and research personnel under the educational exchange program; and military assistance which covers the provision primarily of U.S. military material and training. All of these aspects of U.S. foreign assistance inherently involve the direct flow of U.S. goods and services to the recipient country. They create no balance-of-payments problems since they directly expand U.S. exports rather than resulting in payments to foreigners.

Not all foreign assistance can be carried out in this way. We in AID are providing in many respects a residual assistance which cannot be covered by these other programs. If they are taken into account, the share of total foreign assistance which is a burden on the U.S. balance of payments would nearly be cut in half in percentage terms.

Thus what remains is nearer to an eighth of the total flow of U.S. Government grants and credits rather than the 24 percent of fiscal year 1963 AID obligations indicated on the tables. This remaining dollar outflow consists of four major elements:

1. *Offshore procurement of commodities: $230 million.*—Much of this consists of procurement in less-developed countries of petroleum, rubber, and sugar of which the United States is an importer, or of heavy items like cement where freight cost gives the nearby supplier a large advantage. To a small extent it includes essential exceptions to procurement restrictions for items available only in the 19 countries. Eliminating this procurement would greatly increase the cost of supplying these items and could cut off a substantial source of dollar earnings from aid recipient countries who spend a considerable share of these receipts in the United States.

2. *Contributions to international organizations: $150 million.*—Other countries are contributing heavily, the strength and growth of the international agency depends on unrestricted contributions, and international agency expenditures in the United States counterbalance in large part the U.S. contribution.

3. *Offshore component of AID and contractor operations: $140 million.*—Every effort is made to reduce this inevitable component of an oversea program through use of local currencies derived from Public Law 480 or counterpart, through host country cost sharing, and through channeling dollars needed for local costs into banking arrangements set up to insure that budget support dollars are used in the United States.

4. *Unrestricted cash transfers: $120 million.*—In a few countries the trade pattern is such or the difficulty of negotiating a restricted procedure would be so great that accomplishment of aid purposes would be thwarted by procurement restrictions placed on cash transfers. Such cases are being reduced in both number and size as fast as possible.

We have a good deal yet to do in terms of refining our estimates and improving our reporting and control systems. However, the major shifts have been accomplished. Any further major reduction in the direct share of aid offshore expenditures will cut deep in terms of our effectiveness in accomplishing program purposes.

II. AID EFFORTS OF OTHER INDUSTRIALIZED COUNTRIES

The subject of the aid efforts of other industrialized countries should be of particular interest to this committee in its consideration of the U.S. balance of payments. Aid from these countries to the developing nations can have both a direct effect on the U.S. balance of payments, depending on their procurement policies, and an indirect effect, depending on the amount and terms of their aid and other factors. This relationship of their aid programs to the U.S. balance of payments is one aspect of the broad question of aid "burden sharing," and I should like to discuss it with you today with that context in mind. I shall first take up the question of tied procurement, then review the larger question of the indirect effect of other donors' aid efforts on our balance of payments, and finally assess the extent in broader terms to which they are sharing the aid burden.

A. The question of tied procurement of aid

The United States supports the objective of untied aid coupled with effective free-world-wide procurement procedures as a norm for aid programs. This goal is desirable in order to insure that aid flows cause the least distortion of normal trade patterns and international specialization and that aid funds purchase the greatest value in goods for the benefit of the developing countries.

But we equally recognize justified exceptions to the desired norm and believe these should enjoy full acceptance by other donor countries. In 1960 in Bonn, the Development Assistance Group, the predecessor of the Development Assistance Committee (DAC), agreed on a communique to the effect that "members should move in the direction of providing assistance without tying it to their own exports to the extent feasible, having regard among other things to their balance-of-payments situation and the international payments position."

The U.S. current policy on aid tying is consistent with the Bonn communique. The pattern of aid tying and balance-of-payments situation of the other DAC members varies considerably from country to country. Because of the complexity of the question there is not enough data available as yet to make precise assessments. However, we believe that in general most of the other DAC members probably could undertake an increased amount of aid procurement outside their own boundaries, and we have proposed that they consider such a step.

Our principal initiative in this direction was a proposal last spring that the DAC sponsor a study of tied aid which could lay the groundwork for more fruitful DAC discussion of the problem. The DAC agreed on the study and gave a strong mandate to the Secretariat of the Organization for Economic Cooperation and Development to undertake it. We hope that the study will not only assess present policies and practices, but also produce the needed statistical data, currently unavailable, on actual sources of procurement of other donors.

B. The indirect effect of other donors' aid efforts on the U.S. balance of payments

The aid efforts of other donor countries have an important indirect beneficial effect on the U.S. balance of payments that is probably roughly proportional to the amount of their aid. And from the standpoint of realistic alternatives open to the United States, this indirect beneficial impact on our balance of payments more than offsets any direct effect of tied aid policies.

This impact cannot be stated statistically, but it is no less a real one for that. The fact is that the principal European countries, Canada, and Japan are sharing with us on a fairly equitable basis the overall cost of providing assistance to the developing nations throughout the free world.

If they were not engaged in this task on a major scale, two alternatives would face the United States. Either our aid would have to be considerably greater in amount, with the likelihood of additional impact on our balance of payments because we would be under pressure to finance aid goods more efficiently supplied from other sources; or vital interests of the free world which other donors are now supporting with aid would be in significant degree impaired or sacrificed. The existence of aid from other countries does not permit us to contemplate a cut in our aid. Rather it makes possible a combined free-world effort more nearly commensurate with the challenge. Its disappearance would place us in a grave financial, political, and security dilemma.

One could try to analyze in detail the specific indirect effects of the aid of other donors on the U.S. balance of payments. However, the argumentation would be largely hypothetical. Suffice it to say that were we in the United States to assume today the $2.5 billion aid burden borne by the other donors, and provide the same level of benefit to underdeveloped countries, we would either have to engage to a considerable degree in additional offshore procurement (to the detriment of our balance of payments) to provide needed goods we do not specialize in, or we would have to make available a considerably larger sum of money than $2.5 billion for 100 percent U.S. procurement. This would be in addition to our existing effort which amounted to $3.4 billion in expenditures in 1961.

C. The extent to which other donor countries are sharing the overall aid burden

We might now turn to examine more in detail the extent to which other donor countries are sharing the burden of the overall cost of aid. Three questions regarding their aid efforts seem to me of particular pertinence:

First, what is the magnitude of their effort in amount and terms; second, how does the scale of their aid effort correspond to their ability to provide aid and to the extent of their national interest in the developing countries; third, how well do they and we cooperate in our bilateral aid efforts?

The amount and terms of aid from other donors.—To take the question of the amount and terms of aid from other industrialized countries, the fact that they are providing any aid at all is news to the average American. The fact that their aid effort has for several years totaled in the billions of dollars per year and is rising astonishes most of us. I should like to give you a few statistics.

The total volume of net official aid disbursements[1] of 10 major aid donors including the United States increased from $4.9 billion in 1960 to almost $6 billion in 1961. This was a 22 percent rise. The U.S. increase was 21 percent from $2.8 billion to $3.4 billion. The total for the other donors combined rose at a slightly faster rate of 23 percent from $2.1 billion in 1960 to $2.5 billion in 1961.

The performance of several individual countries is interesting to note. German assistance, increasing from $320 million to $574 million, showed the sharpest increase—79 percent, while Japan's increased 45 percent, rising from $159 million to $232 million. France also showed a considerable increase in 1961 over 1960—from $837 million to $953 million, or 14 percent; the United Kingdom aid level rose from $405 million to $445 million—a 10 percent increase. The Netherlands and Belgium also increased their contributions.

In terms of percentage of GNP devoted to aid, the French, with 1.82 percent were the highest. Germany was at 0.86 percent of GNP and the United Kingdom at 0.67 percent, while the U.S. aid program totaled 0.72 percent of GNP. The other countries combined actually exceeded U.S. performance in this respect with a figure of 0.81 percent of GNP.

The central trend in 1960–61 in the terms of aid of both the United States and the other major donors as a group was a modest decline in the proportion of aid provided on a grant basis accompanied by a moderate, but significant, liberalization of the terms of loan aid. In absolute levels, grant-type aid rose slightly while loan-type aid more than doubled. The overall effect was thus a larger total aid effort on somewhat more liberal terms with both the United States and the other countries as a group sharing in the liberalization.

In 1961, $4.5 billion, or 76 percent of official aid expenditures by all DAC members was grant or grant-like (Public Law 480 sales for local currencies, capital subscriptions to IBRD, contributions to international organizations and reparations) as compared with $4.2 billion, or 86 percent in 1960. The level of grant-type expenditures in the case of the United States rose slightly from $2.7 billion in 1960 to $2.9 billion in 1961, while U.S. net official lending jumped from $131 million in 1960 to $561 million in 1961. In the case of other donors, grant-type contributions again rose slightly from $1.5 billion in 1960 to $1.7 billion in 1961 while net lending (including consolidation credits and purchases of IBRD securities) rose sharply from $555 in 1960 to $861 million in 1961.

While the proportion of grants declined relative to loans, the maturity periods of loans increased significantly. Gross disbursements of loans of 20 years or more more than trebled from $215 million in 1960 to $713 million in 1961 (an increase of from 24 percent to 40 percent of total gross loan disbursements). Loans of 20 years or more by the other donors more than doubled from $176 million to $372 million, while U.S. loans of 20 years or more increased from $38 million to $341 million.

To cite some country cases, German loans prior to 1960 did not exceed 5 years, but in 1960 and 1961, 10 percent and 43 percent, respectively, of German loan expenditures were for 20 or more years. Loans disbursed by France for 20 years or over in 1961 accounted for 57 percent of the total of French loans. Fifteen percent of French loan commitments in 1961 were for 45 years. Eighty-seven percent of loans disbursed by the United States in 1961 were for 20 years or more as compared with 74 percent in 1960.

Data on interest rates likewise reveal a trend toward softer terms. Fifty percent of new French commitments for loans in 1961 were at 2½ percent or less, with one-third at 1½ percent. One-third of German loans in 1961 were at 3 percent; prior to 1960 all German loans were at commercial rates.

The efforts of other donors in relation to ability and national interest.—The record cited is fairly impressive, particularly so when one considers that the other DAC countries represented 40 percent of combined GNP in 1961 and provided 43 percent of the aid. But this record is nevertheless not cause for begging the second question: does their effort correspond to their ability to provide aid and to their interest in the developing countries?

[1] Including bilateral grants, loans over 5 years, contributions to multilateral agencies, consolidation credits, reparations, and purchases of IBRD securities.

Taking GNP as a general indicator of ability, the other DAC countries as a group admittedly in 1961 edged ahead of the United States in providing aid. Their combined effort, as stated before, was 0.81 percent of GNP; ours was 0.72 percent of GNP. Furthermore, if one admits that the relative standard of living also should bear on the question of ability to pay, it is pertinent to mention that the average per capita GNP of the other donors was $904 in 1961 compared to $2,597 for the United States. (Allowing for purchasing power the gap is narrowed somewhat.) However, these economic aid efforts are really marginal to the much greater cost of the other major common endeavor of the free world, namely, defense. Here the other major industrialized countries continue to fall somewhat short of the American effort. In 1961 they devoted an average of about 5 percent of GNP compared to 9.8 percent of GNP for the United States. Combining the aid effort and the common defense effort, it seems reasonable to expect the other DAC members as a group to continue the upward trend of their aid efforts.

In addition, there is variation in the level of performance among individual countries. Some countries are already providing aid in a very substantial volume. We hope some countries will be able to make significant increases in the near future. With few exceptions, most other industrialized countries could provide for further increases in their aid levels and for more liberal aid terms consistent with the debt servicing capacity of the developing countries.

We also believe that from the standpoint of national interest there is room for improvement in the aid efforts of the other countries. Their individual stake is equal to ours in the security, stability, and growth of the underdeveloped areas as integral parts of the overall free world community. We hope that in recognizing this stake, they will increase their flexibility to provide assistance to developing countries facing security problems, balance-of-payments crises, or other difficult problems where aid may offer the least immediate prospect of commercial reward to the donor. The responsible performance of a few donors like France and the United Kingdom should be an example for others to follow in providing aid in the political interest of the free world in particular countries.

A second major interest of the aid donors is in promoting their own exports. Here the benefits are direct, often immediate, and largely quantifiable. Here, too, we believe the other DAC members could improve their aid efforts in their own interest by providing more aid of the types and to the countries where it would indirectly serve their trading interests. While they are willing to finance their exports or build projects for which their domestic suppliers gain equipment contracts, they have not extended adequate amounts of aid for needed social and economic infrastructure, that is, for nonprofit making needs and social benefits or provided other forms of financial aid which would strengthen developing countries and provide greater assurance of the long-term availability and growth of these markets.

But these comments on desirable increases in effort in other donors' aid performance should be kept in context. As I pointed out earlier, the aid efforts of these countries have grown very rapidly, more rapidly than our own, and I am merely identifying areas where I think continued improvement should be sought.

Cooperation between other aid-giving countries and the United States.—The third question I asked was how well do other aid donors and the United States cooperate. I believe the answer is a cause for optimism. Three years ago, the major aid-giving countries joined in an ad hoc group to meet periodically to discuss comon aid problems. A year ago, this group was formalized as the Development Assistance Committee (DAC) of the newly established Organization for Economic Cooperation and Development (OECD) in Paris. The history of the DAC thus far has been marked by a growing exchange of useful information among the member countries on an expanding basis of mutual confidence and willingness to cooperate. Much of the data I have provided today represents the fruit of this cooperative exchange. More important, the DAC has had a direct effect on the size and quality of the aid efforts of its members.

The members of DAC agreed on a resolution in 1961 citing the need for an expanding flow of resources to developing countries on more liberal terms and last year instituted an annual aid review as a means of assessing the progress of the member countries toward fulfilling that resolution. The annual aid review, in which I personally participated last June when the U.S. program was being discussed, is a vital confrontation process in which the member countries freely and frankly criticize one another's efforts in a constructive fashion designed to stimulate improvement on the part of all. The report of Chairman Riddleberger on the first annual aid review is a document of considerable importance and a milestone in cooperation among donor countries.

The Development Assistance Committee is also designed to be the principal forum for discussions of policy matters by donor countries. In support of these efforts, DAC undertakes studies of particular questions of importance through the Secretariat of the OECD. Two examples of interest and importance at the present time are the study of tied aid and a working group established for assessing the need for more liberal terms of aid.

Another extremely important area of cooperation among the donor countries is their coordination of aid for specific developing countries. In this sphere the industrialized countries have for several years been cooperating in the World Bank consortia for India, Pakistan, and the Indus Basin and more recently have begun discussions on a less formal basis to coordinate assistance for several additional countries. Such discussions, proceeding under the name of coordinating groups or consultative groups, are being organized both by the World Bank and by DAC.

The sum of these elements of cooperation among the industrialized countries in carrying on their growing aid efforts is an aid community. This aid community is performing the historic function of institutionalzing a common aid effort to assess the problems of the developing countries, their aid needs, and the basis on which we and our partners can best share the effort in carrying out this common task.

TABLE I(*a*).—*Aid resource flows from DAC donor countries in 1961 in amounts and as a percentage of GNP*

[Aid values are disbursements in millions of U.S. dollars]

DAC countries	GNP at factor cost (millions of U.S. dollars)	Population (thousands)	Per capita GNP	Grants and grant-like contributions [1]		Official net lending [2]		Total net official aid	
				Value (millions)	As percent of GNP	Value (millions)	As percent of GNP	Value (millions)	As percent of GNP
Belgium	$11,540	9,203	$1,254	$107	0.93	−$1	−0.01	$106	0.92
Canada	32,139	18,335	1,753	64	.20	−3	−.01	61	.19
France	52,341	45,980	1,138	880	1.68	73	.14	953	1.82
Germany	66,775	54,070	1,235	169	.25	404	.61	574	.86
Italy	29,664	49,549	599	47	.16	21	.07	68	.23
Japan	40,058	94,000	426	80	.20	151	.38	232	.58
Netherlands	11,058	11,637	950	70	.63	−1	−.01	69	.62
Portugal [3]	2,180	9,196	237	11	.51	20	.92	32	1.44
United Kingdom	66,090	52,800	1,252	248	.38	197	.30	445	.67
Total DAC, excluding United States	311,845	344,770	904	1,678	.54	861	.28	2,539	.81
United States	477,000	183,650	2,597	2,853	.60	561	.12	3,414	.72
Total all DAC countries	788,845	528,420	1,493	4,531	.57	1,422	.18	5,953	.75
United States as percent of total	60.47	34.75	------------	62.97	------------	39.45	------------	57.35	------------

[1] Includes grants, reparations, transfers of resources for recipients' currencies, and grant and capital subscriptions to multilateral agencies.

[2] Includes bilateral loans, consolidation credits, and purchases of IBRD bonds, loans and participations. Excludes official loans for 5 years and less.

[3] Percentages based on unrounded data.

Source: Various DAC documents, principally C (62) 153.

TABLE I(*b*).—*Aid resource flows from DAC donor countries in 1960 in amounts and as a percentage of GNP*

[Aid values are disbursements in millions of U.S. dollars]

DAC countries	GNP at factor cost (millions of U.S. dollars)	Population (thousands)	Per capita GNP	Grants and grant-like contributions [1]		Official net lending [2]		Total net official aid	
				value (millions)	As percent of GNP	Value (millions)	As percent of GNP	Value (millions)	As percent of GNP
Belgium	$11,138	9,153	$1,217	$105	0.94		−0.04	$101	0.91
Canada	32,566	17,852	1,824	75	.23			75	.23
France	48,441	45,540	1,064	772	1.59	$65	.13	837	1.73
Germany	58,000	53,373	1,087	128	.22	192	.33	320	.55
Italy	27,955	49,361	566	31	.11	56	.20	87	.31
Japan	38,845	93,200	417	93	.24	66	.17	159	.41
Netherlands	10,184	11,480	887	48	.47	−2	−.01	47	.46
Portugal [3]	2,088	9,124	229	2	.09	35	1.68	37	1.77
United Kingdom	62,443	52,539	1,189	259	.41	143	.23	405	.65
Total DAC, excluding United States	291,660	341,622	854	1,513	.52	555	.19	2,068	.71
United States	461,590	180,670	2,555	2,695	.58	131	.03	2,826	.61
Total all DAC countries	753,250	522,292	1,442	4,208	.56	686	.09	4,894	.65
United States as percent of total	61.28	34.59		64.04		19.10		57.74	

[1] Includes grants, reparations, transfers of resources for recipients' currencies, and grants and capital subscriptions to multilateral agencies.

[2] Includes bilateral loans, consolidation credits, and purchases of IBRD bonds, loans and participations. Excludes official loans for 5 years and less.

[3] Percentages based on unrounded data.

Source: Various DAC documents, principally C (62) 153.

TABLE II(a).—*The flow of long-term financial resources to developing countries and multilateral agencies, 1961 (disbursements)*

[In millions of U.S. dollars]

	Belgium	Canada	France	Germany	Italy	Japan	Netherlands	Portugal	United Kingdom	United States	Total DAC countries
A. Total official and private, net (B. + C.)	(1)	(1)	1,264.5	784.5	233.7	376.1	195.5	(1)	(874)	4,632	[2] 8,703.8
B. Total official, net	106.4	61.0	952.7	573.6	68.2	231.6	69.0	31.5	445	3,414	5,953.0
I. Grants	84.1	48.5	795.0	91.1	32.5	67.8	31.7	3.0	206	1,397	2,756.7
Memo Reparations, etc	(3)	(3)	(3)	63.8	14.3	65.1	(3)	(3)	(3)	(3)	143.2
II. Loans repayable in recipients' currency, net [4] [5]	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	277	277.0
III. Transfer of resources through sales for recipients' currencies (net of resources realized by donor country by use of these currencies)	(3)	(3)	(3)	4.2	(3)	(3)	(3)	(3)	(3)	891	895.2
IV. Loans, net [4]	(3)	−3.4	58.6	174.4	25.8	134.1	6.0	20.3	200	561	1,176.8
1. Total loans extended	(3)	1.0	113.0	219.7	37.8	148.7	6.0	20.4	220	997	1,763.6
(a) Loans for 20 years or more	(3)	(3)	64.7	94.3	(3)	(3)	6.0	15.1	192	341	713.1
(b) Loans for more than 10, up to less than 20 years	(3)	1.0	37.8	94.9	(3)	65.5	(3)	4.4	3	358	564.6
(c) Loans for more than 5, up to 10 years	(3)	(3)	10.5	30.5	37.8	83.2	(3)	0.9	25	298	485.9
2. Amortization received [6]	(3)	4.4	54.4	45.3	12.0	14.6	(3)	0.1	20	436	586.8
V. Consolidation credits with maturities up to 5 years, net [7]	−1.0	(3)	4.0	18.0	−6.0	0.9	−7.3	(3)	−3	(3)	5.6
(a) Loans extended	(3)	(3)	4.0	30.6	(3)	6.7	(3)	(3)	(3)	(3)	41.3
(b) Amortization received	1.0	(3)	(3)	12.6	6.0	5.8	7.3	(3)	3	(3)	35.7
VI. Contributions to multilateral agencies, net	23.3	15.9	95.1	285.9	15.9	28.8	38.6	8.2	42	288	841.7
(a) Grants and capital subscription payments	23.3	15.9	85.1	73.9	14.7	12.6	38.6	8.2	42	288	602.3
(b) Purchases of bonds, loans and participations with maturities of more than 1 year	(3)	(3)	10.0	212.0	1.2	16.2	(3)	(3)	(3)	(3)	239.4
C. Flow of private capital, net	(1)	(1)	311.8	210.9	165.5	144.5	126.5	(1)	[8] 429	1,218	[2] 2,750.8
I. Direct investment and other new lending	(1)	(1)	307.0	156.1	118.3	102.5	98.4	(1)	[8] 422	1,220	2,499.0
1. Direct investment (including reinvested earnings)	(1)	(1)	307.0	78.9	[9] 67.2	102.5	74.6	(1)	420	970	2,094.9
2. Other private capital and portfolio investment	(1)	(1)	(3)	77.2	51.1	(3)	23.8	(1)	[10] 2	250	404.1
II. Contributions to multilateral agencies	9.5	27.0	4.8	−2.7	25.5	−4.6	18.4	(3)	1	−2	76.9
III. Guaranteed private export credits for more than 5 years	33.4	(1)	(3)	57.5	21.7	46.6	[11] 9.7	(3)	6	(1)	174.9
D. Guaranteed private export credits for more than 1 up to 5 years	32.7	−4.6	148	11.1	2.3	3.1	25.5	(3)	−23	(1)	195.1

[1] Not available.
[2] Total includes Secretariat's estimate for Belgian and Canadian net private investment.
[3] Nil or negligible.
[4] Excludes assistance extended in recipients' currency.
[5] Amortization representing resource transfers in other than recipients' currency.
[6] Less amortization paid to developing countries.
[7] Where original and additional credit periods reach more than 5 years.
[8] Preliminary.
[9] Excludes reinvested earnings; includes short-term banking loans.
[10] Represents net private consolidation credits only.
[11] Included under D.

Source: Development assistance efforts and policies in 1961 of the members of the Development Assistance Committee (report by the chairman of the DAC on the annual review), OECD, September 1962.

TABLE II(*b*).—*The flow of long-term financial resources to developing countries and multilateral agencies, 1960 (disbursements)*

[In millions of U.S. dollars]

	Belgium	Canada	France	Germany	Italy	Japan	Netherlands	Portugal	United Kingdom	United States	Total DAC countries
A. Total official and private, net (B. + C.)	165	126.9	1,204.0	541.2	172.2	259.3	217.1	(1)	837	3,866	[2] 7 425.6
B. Total official, net	101	75.3	837.2	320.1	86.7	159.2	46.7	36.9	405	2,826	4,894.1
I. Grants	86	48.1	708.2	69.4	18.6	66.9	26.1	1.8	164	1,312	2,501.1
Memo: Reparations, etc.	(3)	(3)	(3)	61.7	7.1	64.3	(3)	(3)	(3)	(3)	133.1
II. Loans repayable in recipients' currency, net [4] [5]	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	217	217.0
III. Transfer of resources through sales for recipients' currencies (net of resources realized by donor country by use of these currencies)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	901	901.0
IV. Loans, net [4]	(3)	(3)	57.5	121.4	50.2	57.5	5.4	35.1	149	131	607.1
1. Total loans extended	(3)	(3)	110.6	127.8	51.5	61.1	5.4	35.3	174	333	898.7
(*a*) Loans for 20 years or more	(3)	(3)	} 100.2	10.7	(3)	(3)	5.4	32.4	128	38	214.5
(*b*) Loans for more than 10, up to less than 20 years	(3)	(3)		74.4	(3)	18.5	(3)	(3)	2	217	412.1
(*c*) Loans for more than 5, up to 10 years	(3)	(3)	10.4	42.7	51.5	42.6	(3)	2.9	44	78	272.1
2. Amortization received [6]	(3)	(3)	53.1	6.4	1.3	3.6	(3)	.2	25	202	291.6
V. Consolidation credits with maturities up to 5 years, net [7]	−4	(3)	11.2	28.3	−8.8	−6.5	−7.0	(3)	−3	(3)	10.2
(*a*) Loans extended	(3)	(3)	11.2	61.6	(3)	(3)	(3)	(3)	(3)	(3)	72.8
(*b*) Amortization received	4	(3)	(3)	33.3	8.8	6.5	7.0	(3)	3	(3)	62.6
VI. Contributions to multilateral agencies, net	19	27.2	60.3	101.0	26.7	41.3	22.2	(3)	95	265	657.7
(*a*) Grants and capital subscription payments	19	27.2	63.7	59.1	12.2	25.8	22.2	(3)	95	265	589.2
(*b*) Purchases of bonds, loans and participations with maturities of more than 1 year	(3)	(3)	−3.4	41.9	14.5	15.5	(3)	(3)	(3)	(3)	68.5
C. Flow of private capital, net	64	51.6	366.8	221.1	85.5	100.1	170.4	(1)	432	1,040	[2] 2,531.5
I. Direct investment and other new lending	50	24.7	357.8	141.2	85.9	83.5	171.0	(1)	426	916	2,256.1
1. Direct investment (including reinvested earnings)	50	24.7	352.0	71.6	[8] 52.4	83.5	151.7	(1)	440	622	1,847.9
2. Other private capital and portfolio investment	(1)	(3)	5.8	69.6	33.5	(3)	19.3	(1)	[9] −14	294	408.2
II. Contributions to multilateral agencies	14	26.9	9.0	3.5	+.4	(3)	−.6	(3)	−3	124	173.4
III. Guaranteed private export credits for more than 5 years	(3)	(3)	(3)	76.4	(3)	16.6	(3 10)	(3)	9	(1)	102.0
D. Guaranteed private export credits for more than 1 up to 5 years	14	8.2	83.0	51.4	88.7	−1.4	28.0	(3)	17	(1)	288.9

[1] Not available.
[2] Total includes Secretariat's estimate for Belgian net private investment.
[3] Nil or negligible.
[4] Excludes assistance extended in recipients' currency.
[5] Amortization representing resource transfers in other than recipients' currency.
[6] Less amortization paid to developing countries.
[7] Where original and additional credit periods reach more than 5 years.
[8] Excludes reinvested earnings; includes short-term banking loans.
[9] Represents net private consolidation credits only.
[10] Included under D.

Source: Development assistance efforts and policies in 1961 of the members of the Development Assistance Committee (report by the chairman of the DAC on the annual review), OECD, September 1962.

Representative REUSS. And you may proceed in your own way.

Mr. COFFIN. I suppose my chief qualification for talking on these economic matters, Mr. Chairman, is the education which I received from this committee. I want to commend the subcommittee and the committee as a whole for this project. I think it pulls together the various programs of the various agencies of Government addressed to the balance of payments and international exchange problems, and is an invaluable contribution.

I have two general themes that I have been asked to comment on. The first, is the impact of the AID program on the U.S. balance of payments. And the second has to do with the aid efforts which other industrialized countries are making.

To take up the first subject, the impact of AID on the balance of payments, the basic fact, which I think is fundamental and encouraging, is that in the past 3 years there has been a rather dramatic shift in the impact of AID on the balance of payments. Between 1960 and 1963 the purchases financed by AID made in the United States rose from one-third of the total program to about two-thirds, or about one-half in terms of expenditures for fiscal 1962, two-thirds for fiscal 1963, with a goal in sight of three-quarters in the near future.

The shift is remarkable in terms of dollars, because in 1960 the offshore procurement financed by the economic aid program was $1.2 billion. And in this current year it is about $600 million. That has gone down absolutely by one-half, and this despite an increase in the program from $1.8 billion in terms of 1962 expenditures to $2.7 billion in terms of 1963 obligations.

Now, this is not an exact comparison because I am comparing expenditures with obligations. But I am making the general point that although the total program has increased by roughly one-half, the offshore procurement has decreased by about one-half.

The U.S. procurement in this same period from 1960 to 1963 has tripled in absolute terms, from $600 million in 1960 to about $2 billion in this current fiscal year.

For the loan portion, which is coming to be the major portion in the program, the record is very dramatic, because in 1960 one-third of the loans resulted in U.S. procurement. In this current year we are up to 81 percent. And in terms of our obligations this year we are up to 95 percent.

The grant portion of the program is declining percentagewise. And there, too, there is improvement though the record is not so exceptional. Forty-two percent U.S. procurement in 1960 went up to 63 percent in 1963, and in terms of obligations in 1963, 66 percent.

Now, how was this done? There are three basic categories of procurement policies, two which were instituted before this year, indeed, before this administration, and one being instituted currently.

In November of 1959 the Development Loan Fund was shifted from a worldwide procurement basis to a basis giving "primary emphasis" to U.S. procurement. The emphasis was indeed much more than primary. There were very few waivers given. This did not cause problems for the United States other than increasing the cost of the program: because the components of the loan program were usually particular investment subjects or were additive to the large country programs in India and Pakistan, we didn't face the difficulty of interfering with trade patterns.

This policy was inaugurated in November of 1959.

The more complex area of grant-financed commodity procurement came under new policy direction in late 1960, where the directive stated that procurement could not be made in 19 listed countries, most of them being in Western Europe, they being industrialized countries, with major increases in reserves, collectively having a balance-of-payments surplus which was the other side of the coin to our balance-of-payments deficit.

The third policy has to do with dollar transfers. There are a number of cases where it is important, if we are to meet our foreign policy objectives, for us to make assistance available for local costs in other nations or for budgetary support. And we are working out, and have it pretty well worked out now, a system of segregated accounts or, alternatively, irrevocable letters of credit, which makes it mandatory that money will be released from either the account or from the Federal Reserve bank only for purchases in the United States, as evidenced by invoices or vouchers, so that this isn't just a cash transfer with the cash being used without attention to our own balance-of-payments problem.

Now, this does not entirely result in additive purchases of U.S. goods. Money is fungible, and some of the resources in these accounts would probably have been spent for U.S. goods in any event. But at least it makes clear that for the input into the account the outgo must be represented by purchases of U.S. goods or services. And we are confident that some net increase will result.

The results of these three policies are contained in the tables in the booklet, which I believe has been made available to you, the green booklet. If it has not, it will be when my staff arrives on the scene. This booklet was prepared by our Statistics and Reports Division as of June 30, 1962. It is entitled "Source of AID Commodity Procurement."

The basic fact about the result is not only the figures I have given you of the steady increase in U.S. procurement, but the steady decline in offshore procurement. And this is shown in the table in my statement on page 6. Loans, for example, show an offshore procurement in fiscal 1963 of 17 percent, with the obligation rate a 7-percent figure, this being compared with 41 percent in fiscal 1962.

And I can say that most of this procurement will not take place in the 19 developed or industrialized countries.

I would like to talk now about the problems we face in implementing these policies. We are in the process of facing a radically different world situation than when the Marshall plan started, and indeed, a different situation from that which prevailed during most of the fifties, where the key fact describing international economic relations was the dollar gap, where the U.S. economy was the only one able to supply goods and services and attack the problems faced by the countries we were then trying to help. And we were confident that in worldwide competition, without any particular regulations or strictures, that AID-financed purchases, most of them, would come from the United States and that additional dollar aid in general would generate an equivalent amount of additional exports. This is no longer the situation. With the increased productive and competitive power of the Western European and other industrial countries, a substantial share of any aid that is not tied to purchases in this country may be expected to "leak" to these countries and simply increase their reserves. To prevent this we have shifted to the three policies I have talked about. There remain, however, three limitations within which we will have to live or suffer the consequences.

The first is impact on trade patterns. Our program, insofar as we would try to help the defense effort in Korea and Vietnam, or Laos or Jordan, or Libya or Morocco, would be directed toward the maintenance either of a sufficiently stable economy so that defense efforts could be mounted through joint local and U.S. efforts or—sometimes the aid is directed to insure access to bases. And many times the aid is to insure growth despite inadequate local resources and technology.

Now, in these countries in these situations if all U.S. aid were U.S. procurement we would find a very substantial increase in the cost of aid, we would find a very substantial dislocation of trade patterns, and we would find that countries which we were trying to help and which were trading with other countries which we were trying to help would often be disadvantaged by dislocation of trade patterns even more than the help which we were giving them.

A second restriction and limitation that we face in this new kind of world situation is that of budget support and local costs. In a number of the countries which we are helping there does not exist the entire machinery for mobilizing internal resources—by that I mean the tax system, I mean the savings mechanism, and the atmosphere—and where the institutions do not exist for raising local resources for things that we would think in a highly organized country could be paid for by the local government. What we have done, however, is to face this situation by converting a number of these countries from a basis of supporting their budget to a basis for giving support to their balance-of-payments needs. I would mention Korea and Vietnam in that category. There are still some countries, however, in both Africa and Latin America where this has not been accomplished.

A third requirement or limitation is our voluntary contribution to international organizations. The assessed contributions, as you know, are contained in the Department of State budget. But the voluntary contributions are in the AID program, contributions for such purposes as the United Nations Special Fund, United Nations expanded technical assistance program, the Congo, the Indus Basin, et cetera.

Our contributions to these programs are generally about 40 percent of the total contributions from member nations. These are not tied; neither our contributions nor most of those of other countries. In fact, however, however, these programs spend in the United States nearly as much as our contributions. For example, I mentioned in my prepared statement contracts relating to the Indus Basin project which have been awarded to U.S. firms.

I wish I could tell the committee in precise terms what the shift means, these policy shifts, and the allocation of expenditure offshore or to the United States within these policies. This, as you can very well recognize, depends not only on the first round of uses of money, but on what happens to dollars when they go to third countries. And the impact on our balance of payments varies greatly. In the Caribbean area, for example, U.S. dollars would return very quickly. In Africa, U.S. dollars might go to Europe first, and the return to the United States would be slower.

It is to obtain a more precise fix on these ultimate impacts that we are discussing a research contract with Professor Bell of Haverford to do a study for us on what the economists call these reflection ratios to see where the impact is greater and to what extent it varies from area to area.

I should say this to this committee, that we are engaged in the tying of aid for the moment because of our balance-of-payment problem. We look forward to the day when we can untie aid, when we can engage in worldwide competition and all countries can, without damage to our own economy.

To conclude this part of my statement, Mr. Chairman, I would say that we have been talking about the AID program as you know it and we know it. But in terms of all the programs mounted by the United States engaged in assisting other nations, the dollar outflow is about one-eighth if we count Export-Import Bank long-term loans, all of the Public Law 480 surplus agricultural commodities, Peace Corps volunteers, exchange professors, and the military assistance program as well as AID.

The outflow at present consists of offshore procurement for commodities to the extent of about $230 million. This would typically be a situation where petroleum or rubber or sugar would be purchased in one developing country with AID funds for the use of another developing country.

The second category would be our contributions to international organizations in the order of about $150 million.

The third category is the offshore component of our AID and contract operational expenditures. And this would amount to about $140 million.

And finally, cash transfers to the extent of about $120 million.

Now, if I may go the second theme which the committee has asked us to report on—and this would be in my prepared statement—I have just finished saying that we are resorting to increased measures aimed at tying procurement to U.S. goods and services where we can do so and still meet vital U.S. foreign policy needs. This ties in with my opening thought on reporting on other countries. In 1960 at Bonn, the Development Assistance Group (the predecessor of the present Development Assistance Committee), in stating that members should move in the direction of providing assistance without tying it to their own exports, implicitly acknowledged that situations did arise where countries were facing balance-of-payments difficulties where they should not reduce their level of aid, but were justified in tying their aid. A Development Assistance Committee study is currently underway which we think will be valuable, because it will not only address itself to the formal policies of tying of aid, but the many informal devices and mechanisms which are sometimes resorted to to accomplish the same purpose.

Of course, we can say that as far as the effect on the U.S. balance of payments is concerned, the extent to which other donor countries untie aid may be of direct benefit to the United States in that their aid money could result in purchases of U.S. goods.

Most of what I have to say today, however, will have to do with the indirect effect of other countries' aid efforts on the U.S. balance of payments.

Roughly we can say that the indirect effect is proportional to their total level of aid. We think that it is more important for them to increase the amounts of aid and liberalize the terms than simply to untie. We say this because if they did not provide their official aid, which in 1961 amounted to $2.5 billion in expenditures, we would be faced with the dilemma either of vastly increasing our own aid, and thus placing a greater strain on our balance of payments, or else sacrificing U.S. interests and interests we share with the whole free world.

The facts on the sharing of this aid burden by other industrialized countries are more impressive than is generally recognized by the American people. For example, between 1960 and 1961, calendar years 1960 and 1961, the official aid of the United States and other DAC members rose some 22 percent, from $4.9 to $6 billion. Our increase in that period was 21 percent. The increase of our partners in this enterprise was 23 percent.

Looking at the individual countries, the record is even more impressive. In that same period Germany increased its official aid from $320 million in 1960 to $574 million in 1961, an increase of 79 percent.

Japan, an increase from $159 to $232 million, or 45 percent.

France, an increase of 14 percent.

And the United Kingdom, an increase of 10 percent.

If we try to measure the ability of countries to contribute, we find that in France total net official aid was about 1.82 percent of GNP in 1961. And Germany's figure was 0.86 percent; the United Kingdom, 0.67 percent; the United States 0.72 percent; and other DAC countries combined, about 0.81 percent of GNP.

If we think of terms of aid, again, although we have a long way to go until all of our partners have as liberal terms as we think they should, there is still a better record than most of us appreciate. The grantlike contributions for all the DAC countries were $4.2 billion in 1960, and $4.5 billion in 1961. Of these amounts the other DAC countries provided $1.5 billion in 1960 and $1.7 billion in 1961. Compared to lending, I would say that grants, while rising slightly in amount, have gone down a bit in relative emphasis between 1960 and 1961. But this has been more than compensated by the increase in loans on more liberal terms. (The total loan figures are impressive in themselves. In 1960, the U.S. level was $131 million, and in 1961 it was $561 million. And the other industrialized countries went up from $555 to $861 million in the same year.)

When we look at the value of loans of 20 years and over, we face the impressive statistic that they trebled from $215 million in 1960 to $713 million in 1961 for all donors including the United States. And these 20 and 20-plus year loans increased from 24 to 40 percent of the total loans in this period. The share of these longer term loans provided by other donors rose from $176 million in 1960 to $372 million in 1961.

Individual cases are illustrative. In Germany before 1960 they did not loan for more than 5 years. But in 1960 10 percent and in 1961 43 percent of their loans were for 20 or more years. In France in 1961, loans of 20 years and over were 57 percent of the total, and

France even had a category of loans of 45 years which were 15 percent of its total. The U.S. figure for 1960 was 29 percent of its loans for 20 years or over, and in 1961, 61 percent of its loans for 20 years or longer.

The interest rate picture is spotty, but there has been progress. In France in 1961 50 percent of its loans were for 2½ percent or less, and a third of its loans were for 1½ percent. In Germany a third of the loans were 3 percent—bear in mind that before 1960 all of its loans were on a commercial basis.

Now, I say that much more can be done, but I also say there has been progress, both in levels and in terms, in relation to ability to pay. In 1961 our DAC partners comprised 40 percent of the gross national product of the total DAC membership including the United States. There official aid was 43 percent of total DAC aid. At the same time their average GNP was about $904 a person in 1961, whereas ours was $2,597 a person.

Now, this would tend to make you feel that they are doing as much as could be expected. But the one thing that I have left out is defense. Our defense effort was 9.8 percent of our GNP in 1961, while their average rate was about 5 percent. And so we say that if you look at both defense and economic aid, you can see that there is a further distance which they should travel, both for their security interests and also, too, we think, to give evidence of a proper interest in their own exports.

As for cooperation among all of us as we engage in aiding less-developed countries, I can report qualitatively that the Development Assistance Committee, hardly a year old, has, I think, laid some excellent foundations. The chief single pillar is the annual aid review which took place for the first time last May and June in Paris. Every member country, including ours, presented its aid program and was interrogated by a panel from other countries on the amounts, terms, and other aspects of its aid effort. And we, ourselves, cross-examined some of our partners.

I have spoken of the study on the tying of aid which is going on under DAC sponsorship. And I should also mention that the concept of coordinating groups of donor countries meeting to discuss aid problems concerning individual recipient countries has taken hold in DAC, and there have been DAC meetings of donor countries interested in helping either a particular recipient country or a region. There has been a meeting on Latin America. There is one, I think, currently going on with regard to the Far East.

I would close my statement, Mr. Chairman, by saying that, as far as other industrialized countries are concerned, I think we are on the verge of an era where there will be increasing coordination, increasing response, by these nations to the demand for better terms of aid, so that one donor country doesn't in effect underwrite the debt repayments received by another. There will be coordination as to kinds of programing and general policies such as the tying of aid. And I would hope to be able to report in the future more precisely what the impact of this kind of effort is on our own balance of payments.

Representative Reuss. Thank you, Mr. Coffin.

I am a little confused by these percentages realized in proportion of aid which will be spent on U.S. goods. For one thing, I had thought that AID had said some time ago, as long as a year ago, that currently 80 percent of our aid program was domestically purchased.

Mr. COFFIN. I think the statement made a year ago was that this was our goal, that we were shooting toward 80 percent. And I think the testimony was that at that time we were up to about 70 percent. And this is roughly true in the obligation rate. Even in expenditures, if we look at the DLF commodities for fiscal 1962, we would reach 70 percent on an expenditure basis. But I think the 80-percent figure was a figure for our target generally for all types of economic aid, not just commodities, but including all the programs for which we are responsible.

Representative REUSS. I am a little confused by the statement on the first page of your report in which you say—

the following tables show that the share of directly purchased U.S. goods and services in the economic assistance program has increased from one-third to one-half of AID expenditures and under current policies should further increase to over three-fourths.

Mr. COFFIN. Yes.

Representative REUSS. Is it only 50 percent now?

Mr. COFFIN. In the table on page 2 the last set of figures are the figures which substantiate that. The accounting is 35 percent to 1960, and 50 percent of expenditures in 1962. The reason for this, Mr. Chairman, is that from the inauguration of the Development Loan Fund in 1958 until the shift in policy, the obligations were made with worldwide competition. Now, the impact of those early obligations would not be felt for a year, 2 or 3 years. We are still feeling today the impact of some of the pretied obligations. So what we are saying is that there is a long leadtime before a change of policy is reflected in expenditure figures.

Representative REUSS. Then the good or the favorable figures relate to DLF commodities, where we started looking good pretty early.

Mr. COFFIN. That is right.

Representative REUSS. But overall we are just at the 50 percent now.

Mr. COFFIN. Yes. We have favorable figures in DLF and in grant. And the other has to do with such things as our contributions to international organizations, which is untied, plus cash grants, which are probably the hardest problem to deal with from a balance-of-payments situation.

Representative REUSS. Then you go on to say that under current policies it should further increase to over three-fourths. Well, that is 75 percent. Is that figure to be compared with the 80 percent that you use?

Mr. COFFIN. I would say so, yes. And I would say that in the fiscal 1963 year, which is the year we are in now—and we are reporting on expenditures, not obligations—we are up to 65 percent. So now we are talking of 65 and not 50.

Representative REUSS. I don't want to get into a numbers game, but I would feel a little better if we didn't have almost 5 percent loss under errors and omissions between the 75 on page 1 and the 80 percent on page 5. Is your goal 75 percent or 80 percent?

Mr. COFFIN. Our goal is 80 percent. Now, we are talking about 76 percent as the rate of obligations in this current year. We expect that we can reach 80, but the present obligation rate has not yet reached it.

Representative REUSS. Assuming an AID program for the purposes of this question, at the present overall levels what balance-of-payments savings would you envisage this year, next year, and thereafter, in dollars?

Mr. COFFIN. I think in 1961 our offshore economic aid expenditures were about $1.283 billion. We would expect this year, fiscal 1963 that we could bring that down from over $1.2 billion to something around $800 million.

Representative REUSS. In the current fiscal year?

Mr. COFFIN. That is what we are trying to accomplish.

Representative REUSS. And what do you envisage thereafter? Does that about play things out as far as balance-of-payments savings is concerned?

Mr. COFFIN. I would say, Mr. Chairman, that it plays all the dramatic changes out, that is, from that point on.

Representative REUSS. You have got the irreducibles of international contributions, political grants, and so on?

Mr. COFFIN. Exactly.

Representative REUSS. So that what you are telling us—and I don't say it is in any way a discredit to AID—is that we who are concerned with overall balance in our international payments will as of the end of the current fiscal year have scraped about all we can scrape out of the foreign-aid program, give or take $20 million here or there?

Mr. COFFIN. I think so. If I were asked to make a judgment now, I think the effort should continue. But I think that the gains balance of paymentswise from that point on will be accompanied by a very serious cost in terms of money, trade patterns, friction, delay, and other disadvantages.

Representative REUSS. I think it is important that we all understand this, because we still are running a balance-of-payments deficit on the order of $2 billion plus, and it is so easy—not for you, but for me—to repeat all the old cliches like "we are going to fix this up by sharing on foreign aid," et cetera, et cetera.

Mr. COFFIN. Yes.

Representative REUSS. What you are saying is that the easy things have been done, and from now on don't expect too much out of aid savings.

Mr. COFFIN. That is my judgment.

Representative REUSS. You spoke in your statement somewhere about the activities of our foreign-aid partners, particularly in the DAC, on untying their aid. You were necessarily a little vague about it. I have the impression from my travels abroad that they really haven't done much untying, that the great bulk of the aid programs of the continental countries amounts to tied aid and cannot be spent in the cheapest market.

Mr. COFFIN. Yes. And I didn't want to indicate, Mr. Chairman, that the progress was in the untying, I think the progress was in the increasing levels and in the better terms of the period of repayment and interest rate. I think that the tying is either there formally or informally.

Representative REUSS. Who is in charge of the U.S. effort to secure untying of the aid programs of our friends? AID is in charge, obviously, of the effort to reduce the balance-of-payments loss on our own aid program, and you have shown what you have done on that. Are you in charge of persuading our DAC partners to untie, or is it the State Department, or is it the Department of Commerce, or is it nobody?

Mr. COFFIN. We have immediate responsibility in AID through our Washington mechanism, a unit called the International Development Organizations Staff, which backstops our representative at the DAC in Paris, who is there all the time working on terms, on levels, on untying. There always comes a time in waging a campaign on aid, whether it is to persuade country A to increase its level, to take into account other U.S. Government interests, miltiary, financial, and political, when there has to be an intragovernment coordination before a specific proposition is pushed with a specific country.

Representative REUSS. I ask this because it seems to me the untying of aid programs in countries with balance-of-payments surplus is a most salutary and constructive way of helping ourselves. When we get our DAC partners to assume a high level of aid, this tends to be good for the underdeveloped world, because it gives them more total aid. In the realities of life it doesn't really mean that we can give them any less ourselves, or at least it doesn't work out that way.

Mr. COFFIN. That is my feeling.

Representative REUSS. Therefore I would hope that we could be quite vigorous and articulate in pointing out that untying their aid is a great way in which our balance-of-payments surplus partners can, one, make their aid contributions go furthest; and, two, help redress the Western worldwide balance of payments imbalance.

Mr. COFFIN. I agree with you 100 percent. I have had the pleasure of visiting DAC capitals, and have made this point. This is certainly high in our agenda, should be high in our agenda, and I think has been at such exercises as the anual review, and it will involve, I think, a very continual interest by our Government, not only by the AID people, but by other officials when they have occasion to negotiate and deal with finance ministers, aid ministers, and foreign ministers of other countries.

Representative REUSS. And Presidents?

Mr. COFFIN. Exactly.

Representative REUSS. I think this is important enough and constructive enough so that it could well be added to the checklist which the President of the United States from time to time composes. I don't think it has been on there so far, to my knowledge.

Mr. COFFIN. I think this is one of the things which the President is very interested in. Now I can't speak with regard to a specific confrontation with this or that visiting delegation, but I agree that this is one of our consistent policy objectives.

Representative REUSS. Mr. Humphrey?

Mr. HUMPHREY. Do we have some idea of how much this increases costs in the present direction of procurement?

Mr. HARVEY. No, I am afraid we do not have any clear idea on that. One of the problems is that, when suppliers are limited to U.S. sources, the alternative foreign suppliers do not bid, so we don't know what the alternative cheaper prices might be.

On a substantial part of the commodities which we are financing, those which are available on a market basis, it is easy enough to estimate. But on capital equipment, which is usually tailormade for a specific project, this would get into a very complex expensive estimating problem which has not been gone into in any great detail. We are studying this problem to see if we can't figure out more clearly how much it has cost us.

Mr. HUMPHREY. I am sure, Mr. Coffin and you, Mr. Harvey, have had to deal with this difficult question and we just want any information you have on it. Mr. Coffin used the word "fungibility," or I wouldn't use it, but how much of this shift is net? Is there a big difference between the gross change and the net owing to the fact that the country receiving aid uses the receipts of its own exports to procure elsewhere where it is cheaper?

Mr. COFFIN. The only answer we can give at the moment is that we cannot say; we cannot say, for example, if Argentina has a restricted account so that the aid we give has to be spent in the United States, how much really is additive. We—this is one reason why we are contracting for this study.

Mr. HUMPHREY. The Bell study——

Mr. COFFIN. Yes.

Mr. HUMPHREY. Will deal with this.

Mr. COFFIN. We are convinced that our present policy on restricted, segregated accounts or irrevocable letters of credit will result in additive purchases particularly in countries which have not really imported much from the United States before. This is true, I think, in some African countries, where we might have a really substantial program but where the United States was not selling before, and I might say I think this does give an opportunity to U.S. entrepreneurs to see such places where there is an opportunity to take advantage of these resources which are tied to U.S. procurement.

Mr. HUMPHREY. Introduce them to U.S. markets?

Mr. COFFIN. Yes.

Mr. HUMPHREY. Has this resulted in serious delays or procurement problems on the part of the receiving country, the necessity for using certain of the resources they get in the United States?

Mr. COFFIN. Yes; this does encounter delay. It encounters delays even in setting up the account before we get on a restricted account or segregated account system. Sometimes their banking or financial systems are such that a great deal of scurrying around is required to devise this, and then to process the papers and check the papers and submit proper accounting does entail additional work.

This is a cost, but it is a cost which we feel it necessary to bear, in hope of at least reaching the target we have before us. Can you add anything to that?

Mr. HARVEY. No.

Mr. HUMPHREY. This is a question that may or may not have occurred to you but you will see why it will have occurred to us. If one is looking at the last 7 or 8 years of American balance of payments, would you say that a larger percentage of our total foreign assistance program is being procured in the United States now than 1953, 1955, for example?

Mr. COFFIN. Oh, yes, definitely, a larger percentage than ever, because in the early years we just—our job was to make aid flow in response to what we felt were requirements. And whether Germany produced the goods or France or some other country this was not then a factor in decision. So I think that these figures which we have given you show already that in each category more is being purchased in the United States and less offshore, less absolutely as well as percentagewise.

Mr. HUMPHREY. That is all. Thank you very much.

Representative REUSS. Thank you very much, Mr. Coffin, Mr. Harvey, and gentlemen.

Mr. Gilmore of the Department of Commerce has not arrived yet. I understand he is on his way from New York. We will declare ourselves recessed. We will wait 10 minutes or so.

(Short recess.)

Representative REUSS. We will be in session again.

Our next witness is Mr. Voit Gilmore, Director, U.S. Travel Service of the Department of Commerce, who will educate us on expanding American tourism to increase dollar receipts.

Mr. Gilmore, you have a prepared statement. Will you then proceed in your own way?

STATEMENT OF VOIT GILMORE, DIRECTOR, U.S. TRAVEL SERVICE, DEPARTMENT OF COMMERCE; ACCOMPANIED BY JOHN BLACK, DEPUTY DIRECTOR, U.S. TRAVEL SERVICE

Mr. GILMORE. Thank you very much, Mr. Chairman, and members of the subcommittee. Might I read it with your permission, sir?

Representative REUSS. Yes.

Mr. GILMORE. So that as it unfolds questions might develop.

We are very grateful for the opportunity to discuss with you the effect of international travel upon the balance of payments and to explain how the U.S. Travel Service and the "Visit U.S.A." program are attempting to cut back our net loss of gold and dollars due to travel.

Those of you familiar with the legislative history of the International Travel Act of 1961—which established USTS—will recall some of the eye-opening statistics developed by Congress to illustrate the massive impact of foreign travel expenditures on our international accounts. It may be well to begin by bringing some of those figures up to date.

In 1961, U.S. residents spent a total of $1,747 million outside the United States on travel-connected purchases of foreign goods and services. This was $131 million more than we spent on petroleum, our No. 1 import, and $539 million more than on second-place coffee. Last year, Americans spent more on foreign travel than on foreign textiles and foreign autos put together.

For balance-of-payments purposes, we must add another $515 million, representing money spent by U.S. residents on fare payments to foreign-flag carriers, and that brings us to the complete measure of the outflow of exchange attributable to foreign travel.

Balanced against this total of $2,262 million in travel expenditures last year, were receipts of $1,087 million—$975 million spent by foreign residents within the United States plus $112 million in fare payments to U.S. carriers. The difference between these two amounts, $1,175 million, is what has come to be called our travel deficit, or travel dollar gap. In 1961 this travel dollar gap was the equivalent of 47.7 percent of our entire balance-of-payments deficit.

During the postwar years of dollar shortages abroad, and for the foreseeable future as well, we should expect that American travelers abroad would outspend visitors to the United States. What was not expected was that our foreign travel deficit would continue to grow as fast as it did after European recovery and the worldwide relaxation of restrictions by European and other countries on foreign expenditures by their residents. But it did grow, from $366 million in 1951 to $745 million in 1956 to $1,156 million in 1960. Only last year was there any slowing in the trend toward ever-larger annual net outflows.

One of the principal reasons for the persistence of a large imbalance in our pattern of international travel was suggested by Congress during its consideration of the Travel Act; that is, the fact that much more was being done to promote outbound tourism than to encourage travel to this country.

As an illustration, we know that money spent on competitive promotion and advertising by the international travel industry, both U.S. and foreign carriers, travel agents, and so forth, tends to be directed to existing major markets rather than to new market development.

Therefore, when the United States emerged from World War II as the world's No. 1 travel market, the lion's share of all the world's travel advertising money was spent here. The more our market grew, the more promotional effort it attracted. The more promoting done, the more the market grew. And so it went.

Although no exact statistics on the subject have ever been compiled, it is safe to say, we believe, that during the past decade, for every dollar spent by industry to attract travelers to the United States, at least two dollars were spent to lure Americans abroad.

Added to its more than fair share of attention from the international travel industry, the American market has been the prime target for travel promotion by the official tourist offices of approximately 40 foreign governments. Last year these offices spent over $11 million to encourage visits by U.S. residents to their respective countries.

Whereas travel promotion by the international transportation and tourist industry was at least divided in some measure between travel from and travel to the United States, the efforts of national governments to lure tourists abroad had no counterpart in official "Visit U.S.A." promotion until just this year.

This imbalance in promotion expenditures is worthy of some special mention because we believe it offers the best possible clue to our continuing balance-of-payments problems in the travel field. An analysis of the flow of travel to and from the United States during the decade 1951–61 points this up.

In 1951 foreign travelers spent $473 million in this country; in 1961 they spent $975 million, an increase of 106 percent. During the same period of time American expenditures abroad climbed from $757 million to $1,747 million, an increase of 131 percent.

If international travel patterns were simply a matter of natural economic causes, we would expect foreign travel to the United States to increase much more rapidly during this decade than U.S. travel abroad.

As mentioned above, this 10-year span includes the period of spectacular economic advances in Europe and other principal markets for travel to the United States. Increases in gross national product, disposable income, and other economic indexes were much higher on the average for the other industrial nations than for the United States. During this decade, heavy currency and other restrictions on international travel were lifted or greatly eased by most of these nations.

Although the past decade was a period of general prosperity for the United States, we experienced no such corresponding economic growth. Yet the growth of international travel from this country far outstripped the increase in visitor spending in the United States. The stimulation of outbound travel by promotional activity, we believe, was an important element.

In passing the International Travel Act of 1961, Congress went on record as favoring a program for more active promotion of the United States as a travel destination, rather than curtailment of our own citizens' travel abroad, as the best way to deal with the travel deficit.

Before summarizing how U.S. Travel Service is working to reduce this travel dollar deficit and with what results, it may be well to show how the deficit is distributed geographically, based on 1961 balance-of-payments figures (in millions).

Before you, sir, is a table that indicates the area breakdown of our travel expenditures, our travel receipts, and the resultant net balance, showing as it does a net balance there of quite a large minus figure.

(The chart referred to follows:)

Area	Travel expenditures	Travel receipts	Estimated payments to foreign carriers	Estimated receipts by U.S. carriers	Net balance
Europe	604	133	386	46	−811
Latin America	442	302	62	41	−161
Canada	425	451			+(26)
All other areas	276	89	67	25	−229
Total	1,747	975	515	112	−1,175

Mr. GILMORE. You will notice that Canada, our biggest single-country market for travel to the United States, is also the one area where we enjoy a favorable travel balance. Canada is a special case in that much of its citizens' spending in this country is attributable to border crossers who enter the United States for short periods, to work, to shop, or for other nontouristic purposes. However, this year's devaluation of the Canadian dollar to 92.5 cents threatens to reverse the flow of travel dollars between our two countries, in which case more promotional efforts may be called for.

The Travel Service program to promote "Visit U.S.A." in other areas of the world can be divided into three parts:

First, USTS acts as catalyst and spearhead for the promotional work of the private travel industry. Acting through a 36-man Travel

Advisory Committee, made up of leading industry representatives, we have aided and facilitated wherever possible private enterprise programs for encouraging travel to the United States.

These programs include: flat-rate bus and local airline tickets available only to foreign visitors: a special 15-percent discount offered by railroads to foreign visitors; discount hotel rates for foreign guests; a hotel industrywide hospitality, translator, and interpreter program; carrier-sponsored visits of foreign travel agents and sales personnel to the United States; special oversea promotional tours, such as last fall's Pan Am/Greyhound Scenicruiser trip through Europe; and many, many others.

Second, USTS serves as a channel of distribution abroad for the millions of pieces of travel literature now being published by the 50 States, communities, tourist and resort areas, travel trade associations, and other nonprofit tourist promotion organizations. For individual commercial enterprises seeking oversea outlets for their material, USTS provides up-to-date mailing lists of principal travel agents abroad. Travel Service contact with State and local travel organizations is maintained through a network of 53 USTS liaison officers appointed by the Governor or chief executive officer of each State and territory.

Finally, there is the Travel Service's own promotional program built around its 9 offices abroad—located in London, Paris, Frankfurt, Rome, Mexico City, Bogotá, São Paulo, Tokyo, and Sydney—and covering 30 principal countries. Each office is staffed by one or two multilingual travel experts drawn from private U.S. industry, assisted by a small, locally hired staff of information clerks.

A primary task of these offices is the distribution of USTS-produced information booklets, travel brochures, films, maps, posters, counter cards, and other sales aids to industry and the public. Backing up the work of the offices is a worldwide mass media advertising campaign, with particular emphasis on European markets, and a program for gaining editorial support of "Visit U.S.A." in oversea media.

Rounding out the USTS program is our work with other Government agencies to facilitate travel to the United States and a vigorous campaign to help assure a warm welcome to foreign visitors here at home.

The first of USTS's offices was opened in temporary quarters only in October of 1961. Oversea distribution of sales promotion material began in March of this year, and the first travel service advertisements appeared just last April. We therefore believe that results of our travel promotion efforts are best measured from the beginning of this calendar year.

We are pleased to report that these results have been most encouraging. During the first 10 months of 1962, foreign travel to the United States (excluding Canada and Mexico whose figures are made disproportionate by border crossers) increased by 16 percent over the same period in 1961. Percentagewise this is substantially above the average annual increase for inbound travel during the previous 10 years.

A projection of our 10-month figure for the full year gives a total 725,000 visitors from overseas—a gain of over 100,000 from 1961. This is considerably more than any previous year's increase.

The figures given here are for travel to the United States, broken down by foreign countries, including such special categories as aliens in transit, students, and so forth. If we count only the major categories of visitors for business and pleasure—the primary targets of "Visit U.S.A." promotion—1962's increase over last year is even greater. It comes to 18 percent.

We have listed 1962's progress in terms of a head count rather than attempting to estimate the balance-of-payments effect, on which accurate figures are not now available. As a rough measure, however, it is calculated that the average foreign visitor expends approximately $500 on each trip to this country. On this basis projected to the end of the year, 1962's increase in foreign travel would yield about $50 million in new foreign exchange.

However, the decline in receipts from Canada would partly offset that gain. This will help to offset the expected rise in U.S. travel spending abroad. We are hopeful that progress made by "Visit U.S.A." in coming years will increasingly help to hold down the travel dollar gap.

It is clear, therefore, "Visit U.S.A." efforts must be continued and increased. Private industry, particularly U.S. carriers, have responded admirably to this program with expanded "Visit U.S.A." advertising budgets; but industry as a whole still spends more promoting outbound travel. The $11 million spent by foreign government tourist offices in the United States is still more than three times as much as the total USTS budget. And even if our financial resources were more nearly comparable to those of our competition, USTS faces the special problem of having to spread itself around the globe, whereas our competitors can still efficiently concentrate on one big market, the United States.

Optimistic as we are over this year's record increase in travel to the United States, the above facts suggest that our international travel account will not be brought into balance in the immediate future. A vigorous, worldwide "Visit U.S.A." campaign, with industry and Government working hand in hand as visualized by Congress, is the surest formula for limiting our serious travel dollar problem.

Representative Reuss. Thank you, Mr. Gilmore.

Mr. Gilmore. Thank you, sir.

Representative Reuss. I gather that the USTS's activities are largely in these three areas of promotion. I would like to ask what responsibilities, if any, you have to give advice and technical assistance to businessmen in this country as to what kinds of hotels, restaurants, travel, recreational facilities are likely to be appealing to Europeans?

It may be it isn't enough just to publicize that which we have. Maybe because we are new to this business we have not yet learned what the Swiss long ago did learn. What are we doing about making our country more habitable toward foreign travelers?

Mr. Gilmore. Well, you make a most important point. We have, as step one, before we ran our first advertisement or made our first appeal abroad for the visitor under the "Visit U.S.A." program, conducted market research in the nine major tourist producing countries to find out just what deterrents to travel to the United States there were in the minds of these people over and above such things as the obvious one of cost of the transatlantic or transpacific trip to get here.

We found, for example, there were many things in the minds of our prospective visitors such as fear of acceptance here, perhaps an impression of not being really wanted or appreciated. Fear of not having adequate language facilities, and the fear of a completely different life which might be too unusual for them.

Consequently, in making this investigation, which is now being kept up to date by our offices abroad and by continuing research, we have let American private enterprise in the tourist field know what the things are that will attract and make more comfortable and induce a greater flow of visitors to the United States.

Representative REUSS. How do you do that, through what medium?

Mr. GILMORE. We have done it principally through the 36-man travel advisory committee, which we referred to. That is a sounding board policy group that meets on a monthly or quarterly basis, representative of all elements of the travel industry, and through them, and then through the publication and the making available of our market research materials to the American tourist industry, we have let the people concerned with attracting visitors from overseas and taking care of them, know of the things that appeal to the visitor from abroad, and what can be done to increase the likelihood of bringing more people over and making them stay longer when they get here.

Representative REUSS. What are those publications of yours? Do you get out a periodical or newsletter?

Mr. GILMORE. We issue a newsletter at each of our oversea offices, which is constantly radiating news from each of these bases to the travel industry as concerns what we have found out, both researchwise and by the knowledge of meetings with the travel industry in the 30 countries which we are covering from our 9 offices.

Representative REUSS. My question was directed to how you communicate your findings and recommendations on what localities American actual or prospective owners of transportation, hotels, restaurants, and recreation establishments have to do in order to be attractive to foreign visitors?

Mr. GILMORE. Right, I understand.

Representative REUSS. How do they get the message?

Mr. GILMORE. Right. These news letters that I was referring to are made available to the American travel industry. These go out on an automatic mailing list to carriers, travel agents, hotels, various associations. In addition to that in each of the—I should say with the designees of each Governor of each State, the so-called travel coordinator assigned to work with us, we have periodic meetings and one will be held tomorrow with the representatives of the 50 States, in which we are informing them of what we find out from abroad concerning the travel desires and wishes and inclinations of our prospective oversea visitors, and these people then in their own States and through their own channels communicate to their various associations and private enterprise things that we have learned so that they can sharpen up their product.

Representative REUSS. I shouldn't think there would be any problem of protocol or delicacy on your advising our fellow Americans about what we ought to be doing to attract more tourists, is there?

Mr. GILMORE. Not a bit.

Representative REUSS. Anyone take offense at this?

Mr. GILMORE. No. We have attempted to do it in good taste. We point out to the rest of the world that right off the bat the United States has got the greatest tourist plant of any country in the world, approximately 2 million hotel rooms and 2 million motel rooms.

Representative REUSS. Again I was talking about your telling actual and prospective U.S. investors in U.S. tourist facilities, hotels, restaurants, travel agencies, transportation companies. I was talking about your suggesting to them ways in which they can change so as to be more attractive to travelers, principally Europeans.

Mr. GILMORE. No, that has been welcomed by industry, and by the communities. We have, for example, a community checklist which has been made available to every community in America, that lists approximately 40 things that a community can do to make itself a better host community for the foreign visitor. This starts out with a suggestion, for example, that there be somewhere in that city a visitor information center staffed by multilingual personnel. That there be a fact sheet about the community in various languages. That there be a list of people in the community who speak different languages who are willing to serve on a no-cost basis as guides or hosts or interpreters.

Representative REUSS. This is all excellent and relates to the hospitality activities of a particular community.

Mr. GILMORE. Yes.

Representative REUSS. What I meant specifically was the kind of service for people who are contemplating building a hotel or a motel, for the railroads and air carriers and buslines, for local travel agencies, for restaurants, for operators of places of recreation. The same kind of service to them that, let us say, an American who wants to open a concrete block plant can get from the Department of Commerce. He can now go to a regional office of the Department of Commerce and find out how to open a business of that particular character or any one of a thousand other businesses.

Can someone who feels vaguely we ought to be attracting more European tourists to this country but something must be wrong with the way we are doing it, can he get that kind of information?

Mr. GILMORE. Very definitely, yes.

Representative REUSS. How does he get it and how is it brought to him?

Mr. GILMORE. To illustrate, I have just come from a luncheon meeting with about 250 members of the Airline Management Association of Idlewild Airport and those gentlemen are interested in stepping up the flow of international visitors to Idlewild, and so I went equipped with a specific checklist of things we have found out that it is important that Idlewild provide. Members of the Port of New York Authority were there.

Now we talked the specifics of having 24-hour banking facilities for instant conversion of money. They happen to have that. We talked about getting all of their instruction signs and menus and anything else that the visitors needs to know in about eight basic languages. We talked about the specific problems of taxicabs that will overcharge or might overcharge the person who doesn't speak English, the unknowing person. We talked about the specifics of that.

Now just about 3 weeks ago, I met with the Association of Local Transport Airlines of the United States, those are the 34 feeder airlines that are anxious to get the international visitor to come to the interior of the United States. How to do it, they said. Well, we have been working with Allegheny Airlines which serves this area, and they have adopted a $99 ticket for a 30-day unlimited pass on their line. Now two other airlines have adopted that. We have found out that the traveler from abroad wants to have his movement in the United States made simple and easy and understandable, and a $99 ticket on an airline which lets him go to many, many cities is something very easily sold and very easily understood by the travel agent. So we have worked with the feeder lines on that.

Mr. Black, my colleague here, met just recently with the West Side Association of New York which is desperately concerned about improving the reception of the international visitor at the docks of New York, and along with others who have come to bear on that subject we have been working with them concerning everything from how baggage handling can be speeded up to how port receptionists, girls meeting the visitor and helping him process his papers, might make his arrival more pleasant than it is now at the New York dock.

Meeting with the various business and governmental associations in the country and talking the specifics of what will help international tourism to the United States is very much our job.

Representative REUSS. Good.

Many of us are struck by the fact that the European summer visiting pattern could be about the complement of the U.S.-European visiting pattern.

What is the hitch on filling some of the airline and ship space coming to this country in June and going back to Europe in September, the reverse of our flow? Those planes fly around virtually empty, and this seems like a waste.

Mr. GILMORE. A terrible waste.

Representative REUSS. And it would be almost worth our while to subsidize the cost of that and bring people here for nothing?

Mr. GILMORE. We have certainly put it up to private enterprise that rather than have empty planes flying over to pick up one-way loads that they and the steamships should come up with imaginative package or tour type plans, bonus incentive type plans for travel. We just were told this morning of one airline which has a surplus of propeller aircraft and which has worked out a tour from Europe to the United States which aircraftwise will probably cost just about $150 round-trip, and the land arrangements portion will probably cost another $120. That is a package being put together right now, and thus for less than $300, there appears to be the opportunity for off-season travel using propeller craft—which is still a perfectly comfortable way to travel—to tap down to several million people in Europe who, if your price gets to the $300 or $400 range for a 2-week holiday in America (all expenses included) can begin to come.

We are challenging private enterprise, with the challenge of doing this themselves, and they want to meet that challenge, I am sure, within the existing competitive framework that they find themselves in, we are trying by cooperating with private enterprise to so put out our literature and our advertising that we are moving people into the United States on an off-season basis so as to keep our facilities in a better balance, in other words, people in the Southern Hemisphere who are having the reverse of our weather move up here at a time when they would enjoy a season that would not be giving us a boom time.

Representative REUSS. Which European countries still restrict tourist expenditures by internationals?

Mr. GILMORE. Several.

Representative REUSS. Which ones, and how much?

Mr. GILMORE. Your question is about Europe?

Representative REUSS. Yes.

Mr. GILMORE. Spain, Greece, Norway, and Austria come to mind now.

Representative REUSS. How do they do it, by limiting the amount that can be spent?

Mr. GILMORE. By the amount of currency that can be released for coming out of the country. May Mr. Black comment, sir?

Mr. BLACK. Many European countries still limit, even England and France and Italy and so forth put some kind of limitation on the amount of money that can be taken out. But in most cases, in the British case, it is £250 per person per trip which is almost so liberal a limitation as not to be one at all.

The four countries we mentioned are those in which the limitation is a serious restriction on the market, and really of concern to us.

Mr. GILMORE. The point being that the travel agents are getting great cooperation in the United States now as part of this visit U.S.A. program on package trips, and now Britain who might be worried about the amount of pounds that he could leave with can go to his travel agent and with pounds in Britain purchase his entire trip, just about everything including meal coupons and entrance coupons, and this enables him to use the amount that he can leave the country with as pure spending money because the balance of his trip can be purchased locally in pounds.

Representative REUSS. I don't quite see how the countries you mentioned, England and France, for example, are able administratively to limit tourist expenditures. After all there is a convertible currency, why can't a Britisher go to a bank in London and buy in pounds $5,000 and go and blow it all in on a glorious trip to the United States if he wants to?

Mr. GILMORE. He is simply under an affidavit.

Mr. BLACK. I think he is limited on the amount of pounds he can convert.

Representative REUSS. Is it an honor system?

Mr. BLACK. He is limited on the amount of pounds that he can take out of the country, this is where they catch him on it.

Representative REUSS. But can't he buy dollars at any exchange office or bank in London?

Mr. BLACK. Up to a certain point he can but beyond that point there would be some administrative inquiries made. If he has a visa, if he is going to make a trip to the United States, then he is allowed to buy dollars for so much. But if he started to cash in a great amount of his pounds for dollars, I think there would be questions raised.

Representative REUSS. You say it is largely done by affidavit, when he gets his visa?

Mr. GILMORE. There is a declaration of currency being taken out. And there would simply be spot checks, such as we have, to observe expenditures; yes, sir.

One of the sales techniques that we are endeavoring to follow is one that we are finding successful in Australia.

The typical pattern of Australians going abroad is to go back to London which is the home country and is the traditional tie of both blood and business.

The Australian has been traveling at the rate of about 40,000 a year back to Britain, but only a fragment of that 40,000 have been coming via the United States despite the fact that a ticket, an air ticket from Sydney to London costs exactly to the penny the same amount via the United States as via the Middle East.

So we made inquiry why and very knowledgable Australian men, but men who have never been here, say, well, we simply couldn't afford to go through the United States. We found their impression is absolutely incorrect. That generally when they make stops at some of the major European cities their expenses, if anything, are higher than through here. So our campaign is now geared to getting these Australians who are going back to the mother country to come by the United States.

Although our increase this year has been 7 percent from Australia, the increase for November, the beginning of their vacation season, is up to 36 percent over November 1961. So as we find individual sales challenges and opportunities we are boring in on that and we believe the results are backing up the effort.

Representative REUSS. Excellent.

Mr. Humphrey?

Mr. HUMPHREY. I wonder have you tried to make any projections of the travel dollar deficit, with Europe, for example, this 800 million of 1961. What do you think it will look like next year, 2 years from now?

Mr. GILMORE. We have not made such a projection, sir, because we are just so absolutely new that we have just had to feel our way as we have gone, and we didn't want to set up any false targets.

Frankly, we are so new and we have had such little information on which to proceed, that we wanted to get just a little experience under our belt before we could make any kind of a reasonable projection.

We are operating our shop like a business and we are setting up sales curves and we are watching one area's production versus another and we intend to run it like that. But we have had to get the experience of at least our first year before we felt competent to line up anything, and we have thus deferred any real projections because of that.

Mr. HUMPHREY. I see.

Representative REUSS. I would say in this connection, that in justice to yourself, you ought to ask to be judged by the amount and the progress of foreign travel to this country. You shouldn't expect to be judged on the so-called tourist gap, because you have no control over American tourism abroad. Indeed, if this economy gets going again, as some have suggested, presumably higher incomes in this country would mean more U.S. travel abroad, so in justice to yourself, I wouldn't want to see you get impaled on the horn of the tourist gap which is kind of an unrealistic equation anyway.

Mr. GILMORE. I appreciate your comment, and we recognize that we have a curve that could continue to widen unfavorably against the United States.

Our job is to keep a sight on getting these millions of people who now have the time and the money elsewhere in the world to come our way, to keep that tide rising which we believe we can with an intelligent program.

Representative REUSS. Thank you very much, Mr. Gilmore and Mr. Black. Keep up the good work.

Mr. GILMORE. Thank you so much, sir, for the chance to be with you.

(Whereupon, at 4:15 p.m., the committee recessed.)

OUTLOOK FOR U.S. BALANCE OF PAYMENTS

THURSDAY, DECEMBER 13, 1962

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

The subcommittee met, pursuant to recess, at 10 a.m., in room AE–1, U.S. Capitol, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss.

Also present: Don Humphrey, consultant to the subcommittee, Wm. Summers Johnson, executive director, and John Stark, clerk.

Representative REUSS. The Joint Economic Committee will be in order, for a continuation of our hearings on the outlook for the U.S. balance of payments.

We are honored this morning to have with us Under Secretary of State George Ball, who has a prepared statement.

We are very happy to have you here, Mr. Ball. Would you proceed in your own way.

STATEMENT OF HON. GEORGE W. BALL, UNDER SECRETARY OF STATE

Mr. BALL. Thank you, Mr. Chairman.

I. INTRODUCTION

This subcommittee has requested that I discuss with you this morning the role of foreign trade in helping to improve our balance-of-payments situation. You have also requested that I outline the State Department's plans and expectations with regard to the new Trade Expansion Act.

As the subcommittee noted in its request to me, the President has just appointed Mr. Christian Herter as his special representative for trade negotiations under the new act. When he has assumed office—and I believe he was sworn early this week—Mr. Herter will be able to provide a more definitive and detailed projection of the administration's proposed action under the act.

This subcommittee has received ample and expert advice on our balance-of-payments problem. An impressive series of recent studies has been prepared for the committee on factors affecting the U.S. balance of payments. You have heard and will hear more of the testimony of other officials of the administration. I am sure that I need not undertake to review the history of the Nation's position in world trade.

I propose also to take it as given that the United States must find the answer to its balance-of-payments problem primarily through a favorable trade balance in goods and services. We cannot afford any significant cut in our foreign aid or military commitments.

We are entitled to look forward to an increasing participation in these commitments by the other industrialized nations of the West, and we are working constantly toward this objective. But this transition takes time, and our balance-of-payments problem is immediate.

History, as well as analysis, demonstrates that it is realistic to look to an expanded trade surplus as the major instrument for resolving our balance-of-payments problem. For example, when we had a large balance-of-payments surplus, in the years 1946–49, our surplus of exports ran at an average of $6.7 billion per year; when we had an overall deficit in the years 1950–56, our trade surplus averaged only $2.4 billion per year. In the Suez crisis year of 1957, when we last enjoyed an overall surplus, our trade surplus was $6.1 billion.

To use another illustration, in the years 1959–60, when our trade surplus averaged $3 billion per year, our balance-of-payments deficit averaged $3.7 billion annually; but when, in the 18 months of 1961 through the first half of 1962, our trade surplus nearly doubled to an annual average of $5.2 billion, our deficit correspondingly was nearly cut in half to an annual rate of $2 billion.

Other factors may intervene, as in 1960 when our trade surplus resumed substantial proportions while our payments remained in deficit. But, as a generalization, I think we may sensibly look to a favorable balance of trade as the key to a satisfactory balance of payments.

II. RESTRICTING IMPORTS

It is obvious that a favorable balance of trade may be struck either by reducing imports or by raising exports. For the United States, restrictions on imports are both impractical and dangerous. As the President said on February 6, 1961, in his message to Congress on balance of payments and gold—one of the first major decisions of the new administration—and I quote the President:

> A return to protectionism is not a solution. Such a course would provoke retaliation; and the balance of trade, which is now substantially in our favor, could be turned against us with disastrous effects to the dollar.

There are several reasons why the administration has made its firm and conscious decision not to restrict imports in an effort to increase our trade surplus.

In the first place our imports are made up to a great extent of raw materials and other goods which we do not ourselves produce. We need these materials and it makes no sense to exclude them.

In the second place, restrictions on imports invite retaliatory restrictions with respect to our own exports. Particularly for a country like the United States which has a substantial trade surplus, the cost in retaliation would certainly be greater than any saving we could realize by restricting imports. The United States is the largest exporting country in the world and it is exports that must cover our payments deficit.

Third, curtailment of purchases by us from other friendly countries and allies can have serious repercussions on those countries and thereby weaken our combined strength in the defense of the free world.

I should like to add in this connection that this is true politically as well as economically and militarily.

We cannot wage economic warfare with our allies and still have vital and healthy alliances.

Fourth—and this point is seldom given the place of importance it deserves—the United States today plays a leading role in setting the direction of the free world's trade policly. If the United States should retreat to protectionism, it would have instantaneous effects on the policies of the rest of the world trade community.

Many nations would revert to the self-defeating particularism that we have for 30 years struggled to overcome. The United States, particularly in conjunction with the European Economic Community, has it within its power to lead the free world toward a rational and open competitive international economy. We should throw this opportunity away if we were to embrace the false solution of import restrictions.

Finally, imports help us in another way. Imports are a tonic to the growth of our own economy. One may adapt Hippocrates to economics; Strength grows through use; disuse produces weakness. This has been clearly demonstrated by the experience so far of the European Common Market. As Prof. Walter Hallstein, president of the European Economic Commission, remarked last week in Omaha, I believe:

> Sharper competition is the natural consequence for all concerned on both sides of the Atlantic. I am, however, inclined to regard this, too, as an asset. From more than 4 years' experience with the Common Market, we have learned that brisker and keener competition brings advantages—not disadvantages—for everybody. We all become stronger as we vie with each other. For instance, two states as highly developed as Germany and France have given up 50 percent of their tariff protection in a relatively short while, and at the same time the economies of these two states have been striding forward at an almost unprecedented pace.

Clearly the solution to our balance-of-payments problem does not lie in the restriction of imports.

I do not mean to say in a doctrinaire manner that there can never be situations in which it may be necessary to adopt measures that have an effect upon the flow of imports. For example, in a special situation of customs exemption, the Congress recently, last year, in fact, lowered from $500 to $100 the amount of duty-free goods which American tourists may bring home with them from abroad.

In order to reduce governmental expenditures abroad, the Department of Defense has been adjusting its programs to shift purchases from foreign to U.S. sources. This diversion of purchases to the U.S. suppliers avoids a further increase in foreign-held liquid liabilities, but it does so, of course, at the expense of an increase in the budgetary cost of our economic assistance and our defense programs.

In certain highly specialized situations, where a serious market disruption threatens, as in the case of cotton textiles, it has proved possible to achieve international agreement based upon a degree of voluntary expert restraints. And in a handful of instances, it has been found necessary for reasons of national security to impose import restrictions.

With these limited and special exceptions, however, the administration has held firmly to its conviction that the solution to our balance-of-payments problem cannot be found in restricting imports. We must look to the export side of the equation for our answer.

III. COMPETITIVE ABILITY

The fear is sometimes expressed that our balance-of-payments problems are primarily due to a long-range deterioration in our competitive position on world markets. I disagree with this defeatism. Our ability to compete cannot be quantitatively measured with any precision merely by the analysis of relative costs of production. Over the years we have a creditable record in world competition in spite of trade barriers, and in spite of the fact that large segments of American industry have found ample outlets in American markets and have thus made no great effort to develop their export potential—and in spite of the fact, I may add, that we have maintained a higher standard of living in the world. We are still the world's largest exporter and have been for many years.

Our balance of trade has consistently been favorable. As a share of total world trade our exports (exclusive of transfers under military grants) have been substantially constant since 1953.

If we were losing competitive strength one would expect to find some evidence of it on the import side, but no such evidence exists. Since 1959 our imports have been relatively constant in comparison to domestic sales of commodities and have declined in comparison to our gross national product.

As a further test of our ability to compete, consider our trade with Japan and with Western Europe. We continue to export more to Japan than we import from her. As for Western Europe, while both imports and exports have increased substantially in recent years, our exports have increased faster than our imports. These data hardly indicate a wilting or decadent U.S. economy unable to withstand the fresh breezes of international competition.

Those of little faith in our ability to increase exports seem also to misassess the soaring world demand for the products that the American economy produces best. This demand is expanding so rapidly that there should be plently of room for all producers to grow. Rising demand is a phenomenon known throughout the world. It is most dramatic in the European Common Market and Japan.

The six member nations of the Common Market (the European Economic Community) now have a population aggregating 170 million. If the United Kingdom becomes a member, as it has applied to do so, the total population will approach 250 million. The total gross product of the present six member nations of the Community is expected to rise from its present level of $181 to $288 billion by 1970—an increase of almost 60 percent.

Representative REUSS. Mr. Ball, while we are at it, you have just said if the United Kingdom becomes a member of the EEC, the population of the EEC will increase from 170 to 250 million. You mean the United Kingdom and the rest of EFTA, don't you?

Mr. BALL. I would not say the rest of EFTA. I am not quite sure just how these are composed. I think this is wrong as is stated. But if you will take the United Kingdom, which has a population, I think, in the neighborhood of 40 million—50, is it—and if you add to that the population of three countries that already have applied for membership—Denmark, Norway, and Ireland, you would then get up into the neighborhood, I suppose, of some 250 million.

Now, quite frankly, I do not make this monumental leap of the next 20 million, whoever handed me these statistics didn't explain it to me, and I was not sufficiently critical at the moment. But I think you are quite right in calling attention to it.

It aggregates—it might be 230 million. I think the point is——

Representative REUSS. A lot more.

Mr. BALL. Yes; that is right—a great many more people. Let's say more people than there are in the United States.

The total gross product of the present six member nations of the Community is expected to rise from its present level of $181 to $288 billion by 1970—an increase of almost 60 percent. I gather those are not in constant dollars—I think this probably allows for some inflation.

These figures were the figures, I believe, that were given by Professor Hallstein in the speeches he made last week in the United States.

On the basis of past experience, a 60-percent increase in gross national product will bring with it a comparable increase in demand for imports—and the United States is the largest supplier.

Europe is presently at a far earlier stage of consumption than the United States. For every 1,000 inhabitants in the United States there are 340 automobiles; in the Common Market there are 78. In the United States there are 1,030 radio sets for every 1,000 inhabitants and 315 television sets; the corresponding figures in the Common Market are 244 and 60.

Every indication is that the population in the Common Market countries is on the road toward the kind of consumer expansion experienced in the United States in the last 40 years. If American industry and agriculture are not excluded by artificial barriers, our opportunities in this market should be enormous.

Not only does the European market offer a vast potential for growth, but it is the kind of market best suited for American products. European industrialists have been accustomed to selling their products in small, narrow national markets. They have built their industrial plants with that in mind.

We alone in the free world have fully developed the techniques of mass production, for we alone have had a great mass market open to us. If American industry has the will and energy, and if access to the Common Market can be assured to it through the tools provided by the Trade Expansion Act, it should find in Europe new trading opportunities of a kind not dreamed of a few years ago.

Of course the development of the European market for American products will not be easy. It will make heavy demands on our imagination and ingenuity. I will require a considerable effort of merchandising of a kind few American firms have ever attempted in Europe, because in the past the potential of limited national markets has never seemed to justify the trouble. It will require us to do much more than merely ship abroad the surplus runs of the goods we produce for Americans. It will mean much greater attention to the tailoring of products designed expressly for European tastes or European conditions.

Yet I see no reason why American industry should not display the vitality and creativeness that have stamped its performance in the past. Industrial research in the United States continues at a level many times higher than that of Europe.

Each year American industry creates new products and processes responding to the high living standards of our people and creating the improved production techniques that will push those living standards higher still.

Our machinery industries, generating a continuous stream of new inventions for export to the world, are the acknowledged leaders of mass production systems. Our synthetic chemical products continue to provide most of the major advances in the world's new synthetic products—so much so that half or more of the sales of some of our leading producers consists of items that did not exist 10 years ago.

Finally I should like to take special note of the fact that exports are made up not only of tangible goods, but also of services of every kind. One of the most important developments in the 20th century economy of the United States is the shift from blue-collar work to white-collar work, from the production of tangible goods to the generation of services.

Here again, in this aspect of the modern industrial society, the United States is in a position of clear leadership. This leadership shows itself in the export of services such as engineering, advertising, management, communications, and organizational skills.

As Europe moves increasingly from a Balkanized economy to a mass economy, it will inevitably call more and more upon the skills and services which the economy of the United States has had to develop to cope with similar circumstances. We may safely predict that remittances for these exported services, already substantial, will continue to rise.

We are a creative nation. There is every reason to suppose that we shall remain so. We respond with vigor when the challenge is great enough. That we can turn our creative genius to use in this new and promising mass market of Europe and an awakening world I have no doubt.

IV. AGRICULTURE

Agricultural products play a vital part in U.S. exports. The subject of international trade in agricultural products is, as this committee knows well, exceedingly complex and I will not seek to explore it in any depth today. I should like to make a note or two on this topic, however.

It is obviously of great importance to our balance of payments—as well as to the economic well-being of an important segment of our economy—that we maintain and develop more agricultural markets in Europe. It would be highly unfortunate if the member nations of the European Economic Community were to replace their complicated national systems of agricultural protection by a common agricultural policy that was equally or more restrictive. This has been the subject of numerous discussions, representations, and consultations with European governments.

Recently, Secretary Freeman made the U.S. position emphatically clear in Europe. And I also made known our profound concern with regard to this question during the proceedings of the OECD ministerial meeting in Paris last week.

I think it should be borne in mind that about two-thirds of our agriculture exports to the European Common Market consists of commodities that are not domestically produced in the member nations, are not produced in substantial quantities. These exports are, therefore, unlikely to be seriously affected by trade restrictions under the common agricultural policy. Some of our biggest export categories, such as cotton and soybeans, and probably even tobacco, will quite probably share in the expanded market of the growing European economy. It is only with the remaining one-third that difficulties may arise. This remaining one-third consists largely of grains—both wheat and food grains—while another significant item is poultry.

Unquestionably, over a period of time we can expect to see shifts in the emphasis of our agricultural exports to Europe. As the standard of living rises in the Common Market, consumer demand is likely to shift toward a greater consumption of proteins, which will be reflected in a tendency for our wheat exports to drop off while our feed grain exports increase. This tendency has already been noted.

As this committee knows, the cow, for example, is a very inefficient machine. I am told that it takes some seven pounds of cereals to produce one pound of beef. So there is a multiplier factor here, which, as the shift in consumption habits move toward proteins should mean a very much larger requirement, a requirement multiplied by several times in the total cereal intake.

I may say, Mr. Chairman, I did not want to say anything denigratory about the cow, and if any of your constituents are engaged in raising them, I hope they won't regard my remarks in that way.

Representative Reuss. You have picked one of the few States in the country in which the cow is sacred, but I will forgive you.

Mr. Ball. As the committee is aware, the common agricultural policy, as it is being developed by the community, will employ target prices, intervention prices, and through the use of variable levies, gate prices. This repertory of controls is intrinsically neither liberal nor protectionist. The test will be how they are applied.

The crucial test, in fact, is likely to come when the community fixes the common price for grain. It will take its first decisions on this subject next spring.

Obviously, it is of great importance to the United States that the community adopt a system of low grain prices. We are giving serious consideration to the possibility that, rather than approaching the whole question of international trade in grains through bilateral negotiations, global arrangements may be preferable—at least with respect to certain types of grain.

Negotiation on these and many other aspects of agricultural policy will be continuously underway throughout the next year or two.

V. PROGRAM

Administration of the Nation's trade policy is now centered in the President's special representative for trade negotiations. From the beginning, the Department of State has enthusiastically supported this administrative change made by the Trade Expansion Act. Trade matters cut across the concerns of many departments of the Government, and the special concerns of each should be given proper weight.

The administration's trade program will take form under the guidance of Mr. Herter.

I think it would be both imprudent and improper for me to try to suggest in too much detail the kind of program which he may develop. I think, however, that I may be able to give the committee some meager suggestions as to the general time schedule.

The calendar year 1963 will have to be devoted in large measure to preliminary negotiations looking forward to formal negotiations in 1964. This is a function of the requirements of the legislation itself, the administrative preparations which have to be made, as well as anything else.

A special working committee of the GATT is already turning its attention to the 1964 round. Within the United States, 1963 will be the year for the preliminary procedures required under the Trade Expansion Act prior to any tariff negotiation. Work on these preliminary steps is underway. Continuous negotiations will proceed with the European Economic Community, particularly as the outlines of the Common Market's commercial policy begin to assume more and more crystallized form and as the position of the United Kingdom and other countries vis-a-vis the Common Market gradually crystallizes.

The years 1963 and 1964 will be a time when the world's whole underlying economic structure is being redesigned and rearranged. With the Trade Expansion Act in hand, I feel that the United States should be equipped to play a central role.

Thank you, Mr. Chairman.

Representative REUSS. Thank you, Mr. Secretary.

I would like to address a number of questions to you, in your role as Under Secretary, which is in no way a parochial role—and my questions will be about as broad as our foreign economic policy.

Let us first look at our balance-of-payments position. We have not asked you particularly to comment on it this morning, and you have not, but other witnesses have, representing the administration. I would like to give you my recapitulation of it, and see whether you disagree markedly.

Mr. BALL. I would be very interested, Mr. Chairman.

Representative REUSS. As I sensed the matter, from the witnesses and from my studies, we have done a fair job in the last 2 years in bringing our balance-of-payments deficit under some control. But by and large, we have done those things which came easiest and most naturally, and we still find ourselves with a balance-of-payments deficit in the current calendar year which is going to be more than $2 billion—how much more, we won't know for several weeks. It might be quite a bit more. But let us just say it is more than $2 billion.

For the future, I frankly am not gladdened by certain facts which have come to our attention.

For one thing, the people from our international aid agency tell me—and I think they are unfortunately right—that we have squeezed about all we can, in terms of our balance of payments, out of our aid program, and we cannot do much more there.

The Defense Department people have done a good job, and they are still working at it, but they, too, were not able to point to any very significant dollar volume of additional payments deficit-cutting that they would be able to achieve.

If President Kennedy does—and I hope he does—restore the momentum forward of our American economy as early in 1963 as possible, there is no doubt whatever that we are going to import more into this country. We have to, because we are going to chew up more raw materials. There is no doubt also that American tourism abroad is going to increase. This is from the testimony of the head of our tourist agency in the Department of Commerce.

Under Secretary Murphy of the Department of Agriculture told us yesterday that the potential damage on an annual basis to our agricultural exports alone to the Common Market, if its bite turns out to be as bad as its bark, will be on the order of half a billion dollars a year.

I note, too, that even though we are running a deficit on the order of $2 billion or more, were it not for advance repayments of debts owed us by foreign countries, our balance-of-payments deficit would be almost a billion dollars worse than it is. And it goes without saying when we get an advance repayment in one year, like this year, that subtracts from possible repayments in years to come.

My information on what is left in the advance repayment cupboard is that, while something is there, we cannot look for as great advance repayments as we have received in the past.

I go through all this arithmetic, not to cry havoc or to be an alarmist, but to register my considered and, I hope, nonhysterical judgment that we are not out of the woods in our balance-of-payments deficit; that it might even get worse, and that this is a problem commanding our continued vital attention.

I deliberately left out arithmetic from this little summary because I would not ever expect anyone to agree with my, or anybody else's, arithmetical guess.

But do you disagree with my assessment of the balance-of-payments situation, which I would characterize as still serious?

Mr. BALL. Mr. Chairman, I do not disagree with the concern which you express over it, or the fact that your conclusion that we are not out of the woods. I think it is a continuing problem. I think that is a problem where we have made progress toward a solution, but we have not solved it.

I would like to address myself, if I may, briefly to one or two of the points that you made.

Representative REUSS. Yes.

Mr. BALL. First, with regard to the effect of a higher rate of growth in the United States, which would result presumably, hopefully, from some stimulus that might be applied early next year—the question of the balance-of-payments impact on that is important in a matter of time phasing.

I think that you are right in that one could expect some increase in imports. One could also, I think, expect some compensatory balance-of-payments advantage.

First of all, I think that an increased growth rate would tend to increase the possibilities for investment, which, in turn, would contribute to a greater productivity which would improve our position on the world market.

Secondly, it would tend to dry up some of the capital movement which is going outward from this country, because with a higher growth rate, the opportunities for investment at home would be more attractive than they are right now. So that the competitive advantages which Europe may have enjoyed, for example, in the last few years as a destination for American direct investment capital, and even to some extent portfolio investment capital, would be reduced as our own growth rate, rate of expansion, increases.

Now, I think it is very hard to estimate the exact effects of these factors. I would suppost that, as I say, it is a matter of time phasing. The immediate impact might be some increase in imports. Over a somewhat longer range, I would expect an increase in exports as a result of improved productivity.

I would expect fairly promptly some change in the flow of capital, even to the point where one might expect to attract return flows of capital to the United States, either from accumulated earnings overseas of American companies, or actually from European companies beginning to invest in the United States—European, British, Japanese, for example.

There have already been some encouraging signs of this taking place, even with our present rate of growth.

So that I do not think that the impact is all one way.

I think that over the long pull our situation would tend to be improved rather than otherwise by this.

You mentioned also the testimony of the Under Secretary of Agriculture, Mr. Murphy, yesterday in which he suggested—I have not had an opportunity to go over his testimony, but I think you said that something close to $500 million of agricultural exports——

Representative Reuss. He testified that this could be the impact—again, I do not want to misrepresent him. He did not say that this inevitably would be so. But the $500 million figure is based upon the United Kingdom joining the Common Market and a resulting displacement of our imports there. Without the United Kingdom in the Common Market, it would be somewhat less—I think something around $300 or $350 million a year.

Mr. Ball. Well, I understand—I think I understand how those figures are made up. But, quite frankly, I think they are alarmist in character, for several reasons.

First of all, taking that part of our agricultural exports to the present six countries of the Community, which consists of items which are directly competitive with things that are produced in substantial volume within the Community itself, I would not suppose that that figure is somewhere around $400 million—$300 to $400 million—where one will expect to find substantial domestic pressures within the Common Market for a more restrictive common agricultural policy with respect to those items.

That simply means that there is that amount of trade which is exposed to those pressures. But it does not at all mean that that trade is going to disappear entirely, nor does it necessarily mean that it is going to disappear at all. There are counterpressures.

When you speak of the United Kingdom joining the Common Market, the United Kingdom is a nation which has every reason to want low-cost agricultural imports. It lives on that basis. Its influence within the councils of the expanded Community would certainly be in that direction.

Well, when you get into the area of agriculture, it seems to me quite clear—and I think on this Under Secretary Murphy and I are in full agreement, as I think we are on every aspect, as Secretary Freeman and I are, also, of the agricultural picture—when we get into this, the fundamental question is going to be cereal prices.

This is really going to determine the liberalism or illiberalism of the Common Market agricultural import policy. And if we can achieve—help to bring about—a reasonable level of internal prices for cereals in the Common Market, quite frankly I have no great apprehension about the problem.

If we cannot, I think we do have some serious problems, and I think we have to use, then, whatever bargaining counters we may have, particularly those bargaining counters provided under the Trade Expansion Act which consist in the ability to grant some industrial concessions.

But looking at the picture as a whole, I would wholly agree with your characterization of the fact that this is a matter which must require constant diligence. We cannot pretend that we have solved the problem or relax.

On the longer range, again there are things working in our direction—the fact that——

Representative REUSS. Let me say, before you proceed, that I was talking solely about the shorter range, which let us define as the next 3 or 4 years. In the longer range, I, like you, am quite bullish.

Mr. BALL. Even over that shorter range, I think we will begin to get the benefits of the pressures toward higher costs in Europe as compared with the United States—to some extent the pressures toward higher costs in places like Japan and elsewhere, because the fact is that there has been greater inflation there than there has been here, wages are going up at a faster rate, other costs of production are similarly going up, the development of a higher standard of living brings about a number of costs which will tend to affect the competitive ability of those countries in the world markets. If we maintain sensible policies in this country, which I would define as policies of high growth, but restraint on the inflationary pressures, I would look forward toward an increasing relative competitive ability for our own products. And I think we are already getting the benefits of this to some extent. I think we will get the benefits of it progressively over the next year and the year following, and on a rising curve.

Those are some offhand comments, Mr. Chairman.

Representative REUSS. From all of which I gather that, while you do make many qualifications, you do not dispute my fundamental thesis that we still have, at least in prospect for the short term, a serious balance-of-payments deficit problem.

Mr. BALL. Yes. I did not, Mr. Chairman, make the distinction with which I know this committee is thoroughly familiar, between the real balance-of-payments deficit and the balance-of-payments deficit due to short-term movements, of course, and some of that is reflected in the present situation. That obviously is a reflection of a great many things, including this intangible element of confidence.

It is a function of the kind of monetary policy which we maintain as against the monetary policy elsewhere, and so on.

But looking at the problem even from the point of view of the real balance, I would say that we have—the basic balance is perhaps a more apt term—that we have a continuing problem which we have to give our full attention to.

Representative REUSS. Yes. On these short-term capital movements, according to my information—correct me if I am mistaken—they have not played a part this year.

Mr. BALL. Well, in the increase they have not played a part. I think—I have not made the kind of analysis I should have within the last few months.

Representative REUSS. According to my information, we have not had in this year any measurable net outflow of short-term capital. We have had and are having a considerable continued outflow of long-term capital.

Mr. BALL. I think that is correct, Mr. Chairman.

Representative REUSS. Well, having, then, generally agreed, subject to your qualifications, on the first point I wanted to present, let us get on to the next point, which is what we are doing about it.

I am not even going to ask you whether we should do something about it. The answer is, of course, we should. This is a serious problem.

Here I completely agree with you and applaud your emphasis on an expanding favorable trade balance as the best single constructive way toward bridging the gap in our payments. This comes out very strongly in your presentation—and I agree with that.

However, and here we come to a matter on which you and I have had friendly disagreement in the past, and I am afraid still do, I find that your proposed timetable for doing something about our trade balance and for improving it to be very frankly a languid one, and one not dictated by the sense of urgency which I feel from the gravity of our balance-of-payments situation.

Let me spell this out a little bit.

The Trade Expansion Act was signed into law by President Kennedy last October. That law, and I am quite familiar with it, would have permitted the initiation of action the day after it was signed to get going on the necessary negotiations with the Common Market and with the rest of the world.

While there are many statutory procedures for hearing American industry and so on, as I read the act, there is no reason why, by telescoping such procedures, more than 6 months need elapse before we are in a position, with a proposed American bargain, to go before GATT, the Common Market, and whoever else, and say this is our proposal.

Now, I find, both in your statement this morning and in general what one reads about the administration's attitude, a sort of "business as usual" feeling, that in 1963 we will talk about it at home, and then in 1964 we will turn our attention to the first round. There seems to be a feeling that until and unless the United Kingdom gets into the Common Market, we cannot really do much by way of negotiating.

There are several reasons advanced for this. One is that all the administrative talent of Europe is immobilized in this great work, and they would not have time for anything else. Another is that it might knock the United Kingdom train off the tracks if we implied that there could be negotiations for more liberal trade among the nations of the free world, whether or not the United Kingdom joins the Common Market.

I find, for instance, in your prepared statement, this sentence:

> Continuous negotiations will proceed with the European Economic Community—

presumably this means after we start them, which will be sometime in 1964—

> particularly as the outlines of the Common Market's commercial policy begin to assume form and as the position of the United Kingdom and the other countries vis-a-vis the Common Market gradually crystallizes.

In yesterday's Wall Street Journal, I found a news story which sounds like a lot of other news stories I have read recently to the effect that Britain now is talking about delaying its entry into the Common Market until well into 1964—this, according to the story, because it wants something done about the EFTA countries first.

In my visit last month to many of the countries of Western Europe, I found a very general feeling that the United Kingdom is not likely to get into the Common Market for a good, long time—late 1963, 1964, 1965. Even enthusiastic proponents of Britain's entry as fast as possible were unable to give me much more of a timetable than that.

I am therefore concerned that the one constructive way of rectifying our payments in balance is apparently going to be put on ice for so long.

You have a very good section of your paper this morning, Mr. Secretary, in which you talk about the great market in Western Europe for consumer durable goods made in the United States. To this I say hooray. I could not agree with you more. I have been singing this song for some years myself.

What you do not explicitly say in here, however, is that the United States cannot get into that market because the Common Market has imposed external tariffs of 20, 25, 30 percent on these things, like washing machines, driers, and dishwashers. These are things which European housewives are clamoring for, which cannot be made in larger quantities there because the countries are at full employment, and which if the Common Market would reduce its tariffs, perhaps unilaterally and immediately, we could produce for this market. If this were done, we could do so much for our own employment at home, our own growth rate, and, most important of all, for our balance of payments.

But if we wait until 1964 or 1965 to begin negotiating, I think we will miss this golden market. I think there are only about 5 years of

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market there. I think the European market for American consumer durables is about like the American market for European compact cars—wonderful for a couple of years, while it stimulated American motorcar manufacturers to make compacts, but once this was done, the market necessarily diminishes a good deal.

I am afraid that we will be losing many of these things.

Now, you have been very patient listening to me. But would you address yourself to this?

Mr. BALL. I appreciate your apprehension, Mr. Chairman. I did not mean to suggest, nor is it the policy of the administration to try to let our tentative schedule be guided by what happens in the negotiations at Brussels between the United Kingdom and the EEC. We are going ahead as fast as we can, whether the United Kingdom joins now or 5 years from now or never. I agree with your sense of urgency on this.

Nor did I mean to suggest that we are sitting around waiting to begin to crank up the machinery sometime next year.

A great deal of work has been done. In fact, a large volume of work has been done in the form of planning. There have been procedural discussions within the GATT.

What we have been waiting for, quite frankly, is for Mr. Herter to begin to assume his duties, because under the terms of the act he is the only man who can direct the negotiations as the law specifies. And we have been talking with him, and shall be doing so further within the next few days. I think he has every intention of approaching this problem with the greatest sense of urgency himself.

There is the problem of our not wishing to prejudice his arrangements by too hasty crystallization of procedures about which he might wish to find better ones, so that we have been a little hesitant to go too far. And I think properly so.

I do not think the time has been wasted, nor do I think much time has been lost.

The legislation, as you say, was passed in October, and in the meantime we have been discussing these problems in Geneva and elsewhere and within the administration a very systematic and careful set of plans have been prepared subject to the approval of Mr. Herter.

Now, when I say that negotiations will begin on the 1st of January 1964, this again has a somewhat misleading suggestion about it, because this is what appears to us to be the first feasible time for formal negotiations within the framework of GATT to be begun on the broad scale with the various nations.

This does not mean at all that there will not be very serious discussions of a preliminary kind which may determine to a considerable extent the shape of the negotiation, even before the actual formal negotiations start.

We are looking at this problem of negotiations on a very much broader and more comprehensive basis than has ever been before, and I think this is what was intended by the Trade Expansion Act.

As has been developed in this testimony, and in Mr. Murphy's testimony yesterday, we do not at all intend to confine this matter to tariffs. While there may be tariff discussions going on, under consideration, say, on industrial items, and some agricultural products, there will also be simultaneous approaches toward global solutions of some of these problems. There will be approaches looking toward the problems of some of the less developed countries through the commodity agreement work which is going forward.

There will be a constant and unremitting effort to bring about the elimination of the remaining quantitative restrictions and barriers which are of dubious legality under the GATT, if not downright illegal. And this will be related to but apart from the trade negotiation.

So that if I suggested something that is languid or leisurely, it was not my intention to do so. I do have some diffidence in being too specific until Mr. Herter has had a chance to express his own views in detail on this. And I would hope that this committee will have an opportunity to talk with Mr. Herter about it just as soon as he has gotten himself in a position where he feels he can speak with some authority.

At the moment, the statute has made it difficult for us to crystallize things too much.

Representative REUSS. Well, I am very happy to hear what you have said, Secretary Ball, to the effect that, whether the United Kingdom joins the Common Market next month or in 3 years or never, this will make no difference in our trade bargaining—we are going ahead vigorously to bargain down Common Market and EFTA and all other tariffs for the benefit of ourselves and the whole free world on a multilateral, most-favored-nation basis.

That, I take it, is the thrust of what you said.

Mr. BALL. That is right, sir.

Representative REUSS. That is good news to me.

Now, let me take up a legislative point which I think is quite deeply involved in that.

The main section of the Trade Expansion Act of 1962 in the eyes of many observers is the section which permits bargaining down to zero on commodities where 80 percent of the world's trade is carried on by the United States and the Common Market. That was the hope of many of us for a real step in the direction of liberal world trade.

As you know, Senator Douglas and I were proponents of an amendment to that language. As the language is drafted, it is substantially meaningless unless and until the United Kingdom and some other EFTA countries do join the Common Market. This is so because there just aren't any commodities in which the combined trade of the United States and the present six of the Common Market account for 80 percent of world trade.

But if you put the United Kingdom and the Scandinavian countries in there, then you would have a very meaningful list of some 26 major commodity groupings on which you could go to work.

Senator Douglas was able to get this amendment of ours in on the Senate side, and it passed the Senate. But then in conference it was deleted, as you recall. I suppose it was deleted largely because of the effect of your testimony last summer that, in your opinion at that time, it might indicate a lack of confidence on the part of the United States in the United Kingdom's application for entering into the Common Market.

Mr. BALL. Mr. Chairman, as you may recall, I made clear to Senator Douglas and the administration made clear to the conference committee that we had no objection to the Douglas amendment, which I know you were greatly interested in—at that stage in the legislative processes.

Representative REUSS. I was not on the conference committee nor the Ways and Means Committee, and I was not aware of that. Well I am delighted to hear what you say. I take it, then, that the administration would support an adaptation of this amendment, if it were introduced in the new Congress.

Mr. BALL. We advised the committee we had no objection whatever to it. And we did not vigorously support it, very largely for the reasons that I had expressed in my testimony before the Finance Committee, because we did not want to take an action which might appear to be in any way interfering in the discussions which were going forward in Brussels.

Now——

Representative REUSS. You no doubt saw, as I did, the articles in the British press—I am thinking particularly of the London Economist—right after that——

Mr. BALL. I though they were very unkind to me, Mr. Chairman, and rather unfair.

Representative REUSS. I am not talking about the personal aspects of it. But what they said was that, in effect, nobody in the United Kingdom is going to think that the United States is against the United Kingdom's joining the Common Market, just because the United States gets into a position where it can vigorously, on an across-the-board basis, bargain down to zero on a wide range of commodities.

Mr. BALL. On that aspect of what they said, I was very pleased.

Representative REUSS. Because that turns out to be your attitude, too.

Mr. BALL. Yes. And that was the only objection we had. So far as extending it, making it applicable whether or not the United Kingdom would join, my instincts are all on the side of bringing about a general lowering of trade barriers. And I would have thought that that was a step in the right direction.

Representative REUSS. Good. Well, I consider this a very constructive discussion we are having, and I am delighted we are having it.

Let me ask you this. In the light of what you said a moment ago about the need for us vigorously to bargain across the board, just as quickly as we can, and irrespective of the United Kingdom's timetable, is it necessary now that we equip Mr. Herter and his associates with the kind of authority contained in the Douglas amendment; that is, with authority to bargain down to zero, on a meaningful list of commodities? He does not now have it, unfortunately.

Mr. BALL. He does not now have it. I think that perhaps the best thing to do would be to wait 6 months and see what happens. In the meantime, he goes forward with the plans for the negotiation, and if it appears that it is not going to be available within the time span that would permit its utilization, I think that Congress might wish to take another look at it.

Representative REUSS. Well, let's pause there for a moment.

You know how Congress operates. If you wait 6 months from January 1, this comes to the closing days of Congress. So if you wait 6 months, you wait a year and 6 months, probably.

That is one factor.

Another factor is that you have just testified Mr. Herter and his associates are going to be busy conducting these preliminary procedures in this country required under the act. Now, it seems to me that they have to know what the act is in order to conduct those preliminary procedures. And therefore if we are going to equip Mr. Herter with this power, we ought to do it right away.

For example, I think the difference on whether we can get into this very lush Western European market for American consumer durables depends upon whether we can get them to eliminate or practically eliminate their tariffs. Merely reducing them 50 percent is not going to be enough.

I think the differential would still keep us out. This is really basic to our whole discussion on balance of payments. I think we have to move fast.

Therefore, can't I persuade you that congressional action quite promptly in the new year would arm Mr. Herter with rather an essential weapon?

Mr. BALL. Well, Mr. Chairman, I would be very happy to review this matter with Mr. Herter and with my colleagues in the administration, and discuss it with you.

Representative REUSS. Thank you so much. Perhaps if you and I and Senator Douglas and some of the others who are interested in it, could discuss it shortly after Congress convenes, then I think a decision could be reached.

Mr. BALL. I would be very glad to, Mr. Chairman.

Representative REUSS. Let me turn to another related subject.

Why wouldn't it be a good idea, for balance-of-payments reasons, for the United States, at the highest level, and quite immediately, to say to the countries of the Common Market, and perhaps to some of the presently nonaffiliated countries of Western Europe, "Give the United States an immediate unilateral tariff cut in the external tariff of the Common Market, and in the individual tariffs of some of the EFTA countries before negotiations start. If a few countries of Western Europe will do this, particularly in the field of consumer durables, for example, this can accomplish a great deal for the free world. We are going to get to this cut anyway, but if we do it now, we will help enable the United States to restore its rate of growth and its rate of employment, which the OECD and the BLS keep telling us, and quite rightly, that we need to restore. It will provide a constructive way in which the United States could pick up quite soon perhaps a billion dollars a year in balance-of-payments improvement.

Why isn't something like that a good thing to do?

Mr. BALL. Well, we have under consideration a number of different approaches to the problem.

I should point out, I think, Mr. Chairman, that there is quite a difference of opinion on the two sides of the Atlantic as to the relative height of protective walls. The opinion prevails in the Community to a considerable extent, rightfully or wrongfully—and I am saying rightfully or wrongfully in each case—because we get into a statistician's paradise here. And while Mr. Humphrey may be able to figure these things out, I have never been able to do it with any great satisfaction myself—as to whether the common external tariff, which will be set under the formulas provided by the Treaty of Rome, will result in a higher or lower level of protection—let's take industrial products first—than the United States.

Now, the attitude that one finds in Europe is—"Well, we have made some linear cuts which have been a major contribution to the United States, which have been incommensurate with the kind of concessions which the United States has made." On the other hand, one finds a very strongly prevalent view in many circles here that Europe has much higher levels of protection than we do.

The impression that we have from this—and I hesitate to discuss this too much in an open session because these will be elements in bargaining at some point down the line—the impression that we have here is that there is, of course, a very great difference in the structure of protection as between the common external tariff and our own external tariff in the United States—that because the reductions that have been made within the Common Market have been made on an averaging basis, one tends to find the tariff levels within, for the most part, a rather narrow range.

On the other hand, the United States is in a position of having them spread over a much wider spectrum.

We have a great many items on the free list. We have a great many items with very high tariffs indeed, running to 200 or 300 percent—perhaps not so high but running up toward the 100-percent figure, at least.

Now, to try to find out what the average level of industrial tariff protection may be is very difficult. The Tariff Commission made some informal studies of this matter 2 or 3 years ago. I included some of this in my testimony, I think, before the Ways and Means Committee. And at that time they suggested that the average level of protection for industrial products under the Common Market—under the common external tariff would be, I believe, somewhere around 11 percent, as around 8 or 9 percent in the United States. No; I'm sorry—the figures were 11 and 15—perhaps something of that order.

If one looked at the consequences of the reductions which were made on each side as a result of the Dillon round of negotiations, then the figures that were made indicated that actually the Common Market external tariff might be on the average somewhat lower than ours.

I think this was quite deceptive myself, and the people who did those statistical exercises were themselves extremely reluctant to put them forth, because this is a matter where the statistics are such that it is very, very difficult to come to conclusions.

I mention Professor Humphrey, because he has done a very impressive study on this himself.

But to say—to make the suggestion that you put forward would presuppose one or two things—either that the Europeans would generally agree with us, or that enough of them would agree with us that there was some tariff advantage in Europe as against—that their level was in fact higher than ours, in which case what we would be talking about would be some kind of equalizing of the tariff level—or they would agree that because we had shown restraint during periods when they were having balance-of-payments difficulties and permitting the maintenance of quantitative restrictions in the years after the war, that now they might properly be called upon to make some efforts themselves through an adjustment of this kind to help us out.

To some extent I would anticipate an answer along the lines—as I say, I hesitate to discuss this too much, because these are elements which will enter into the bargaining—I would anticipate an answer from some European quarters along the lines that there are mechanisms under the GATT which contemplate a country in extreme balance-of-payments difficulties—this does not describe the United States, the United States is on a basis of full convertibility under the IMF, and therefore that procedure is not applicable, and therefore this should not be an element.

Now, we have ourselves been extremely insistent about the elimination of QR's for countries that have moved to the status of the full convertibility under the IMF. So that this is not an easy proposal to put up.

Let me say to you, Mr. Chairman, because I share the same concerns that you do, that we are not going to rule out any kind of an approach which would help this balance-of-payments problem.

I think myself that over a period of time what we must contemplate is a greater reallocation of responsibilities in the world.

I think that this is the key to the imbalance which we now have. The imbalance arises because of the fact that our own assumption of world responsibilities, which came about in the postwar years, when Europe was withdrawing from its responsibilities around the world for complicated reasons, the shattering of the old colonial structures as well as the fact that it had enormous internal problems—that this day is drawing to a close, that we can look forward hopefully to some reallocation in which the Europeans with their new-found strength, would play a greater role in world responsibilities, both on the defense side and on the assistance that they are giving to the less-developed countries.

This will be the correction of an imbalance which is itself a reflection of dislocation that has arisen, this failure of perfect phasing that has arisen, as a result of these very large changes that have been taking place.

Representative REUSS. I think that is a very good description of it.

What I had in mind was a request to the Europeans for an immediate unilateral tariff cut on goods which the United States was in a position to supply, with the expectation that when the tariff bargain was ultimately struck, after negotiation, that all or part of the unilateral feature would be sopped up.

Mr. BALL. A deferred-payment basis.

Representative REUSS. A deferred payment. But I suggest to you that this is precisely what the free world needs. If our analysis is right, our balance-of-payments problem is one that is likely to persist—unless something is done—for the next 3 or 4 years. Well, you know the dismal arithmetic—less than $16 billion worth of gold, and $20 billion worth of short-term liabilities, $10 billion of them due to official sources, they have been pretty good so far, but $12 billion of our gold is mortgaged under the 25-percent gold cover, leaving $4 billion free. It is some cause for concern to them as much as to us, because the dollar is their currency, too. What more constructive, wholesome way from the standpoint of every politician on both sides of the Atlantic, could there be than in an arrangement which gave to German, French, and Italian workers a chance to earn higher wages in a noninflationary manner by seeing that there were goods in being in those countries which they could buy, which gave American workers a chance to go back to their jobs in closed factories, which enabled us to satisfy the pleadings of OECD and the BIS to get our growth rate up, and which lopped about a billion dollars' worth off of our balance-of-payments deficit.

I should think this is an awfully good package. And it should not be put to them on a basis of, "You Europeans owe this to us because your tariff is higher than ours." This, as you say, leads to a statistician's mare's-nest from which you never emerge. But it should be put to them on the basis that "In 1947, gentlemen, when you had your problems, we, in the United States, reacted to the requests of the Committee for European Economic Cooperation and made available balance-of-payments help. Now you can do the same thing in a very relaxed and easy manner."

I should think this could be done. The only reason the Marshall plan worked was because people suggested it at a high level, and in speeches which the public on both sides of the Atlantic then read.

Mr. BALL. I can assure you, Mr. Chairman, this is a suggestion which we will give very serious thought to. It is one—in one variant or another—we have not excluded that as a possibility. And we shall give thought to it and give serious consideration to it.

Representative REUSS. You see, the alternative which is to let the United States sit still for the next 3 years and wait for a little inflation over in Europe to equalize costs. While I do not dismiss this out of hand, and while there is something to be said for it, it is not a very inspiring alternative, and it might not happen that way.

So it just is not good enough. We of the committee here very frankly hope that proposals will be advanced which are a little more purposefully directed than those that we see now toward bridging the gap.

Thank you very much for your usual helpfulness and responsiveness.

Our next witness is Under Secretary of the Treasury Robert V. Roosa. I talked this morning to Under Secretary Fowler and I regret to say Mr. Roosa, who has been ill, will not be able to be with us this morning. However, he has submitted a very comprehensive paper which, under the rule, without objection will be made part of the committee's proceedings.

(The statement of Mr. Roosa follows:)

STATEMENT OF HON. ROBERT V. ROOSA, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

The Subcommittee on International Exchange and Payments is making an impressive contribution to the analysis of this country's international economic problems. My colleagues and I in the Treasury Department appreciate this opportunity to review with the subcommittee some of the challenging issues that have been given new emphasis and focus in several studies recently published by the subcommittee and in the chairman's statements concerning them. We look forward to continuing examination of many of these problems, both through public hearings and through our working collaboration with the subcommittee, for many months, and on some of them for many years, ahead. Today, in anticipation of future opportunities for meeting personally with the subcommittee, I will only try in this prepared statement to comment on some aspects of four of the principal questions that have been raised—emphasizing particularly aspects that have thus far received relatively less attention than some others:

(1) Has recent financial policy for meeting our balance-of-payments problem caused domestic economic stagnation and high interest rates?

(2) Would flexible exchange rates be preferable to the present system of fixed exchange rates?

(3) Should the United States, because of the high costs involved, abandon its role as a banker for the world?

(4) Would a substantial increase in international liquidity free programs of domestic expansion from the constraints of the balance of payments?

Since all of these questions are interrelated, it should not be surprising that my own one-word answer to each is the same "No." But in making that clear from the beginning, I do not deny that there is great value in a searching discussion of these issues. They test the underpinnings of our current financial program at home and of the present financial structure of the Western World. It would be unseemly, at the least, for those of us who have been trying to carry through some mildly revolutionary financial changes on both fronts—this is, both domestically and internationally—to imply that experience and criticism should not have much more to teach.

I

In highlighting the first question, the subcommittee is constructively calling attention to a charge that has frequently been made—that the effort to close the gap in our balance of payments is at the same time choking growth at home. But I am frankly puzzled as to what basis there can be for making that charge, so far as the financial policy of the United States over the past 2 years is concerned. For never in modern history has an industrialized country with a balance-of-payments deficit of such size and persistence been able to keep domestic credit so freely available and interest rates so low. The general level of interest rates for business credit, consumer credit, or housing credit, for example, is now, and has been since the latter part of 1960, below, and in most cases far below, the rates for similar kinds of credit in any other advanced capitalist country regardless of the state of its balance of payments—with the partial exception of Switzerland and the Netherlands. Moreover, long-term rates have not appreciably risen, and in fact have declined in most important sectors, since the recession months of 1960–61.

That has not always been the pattern. There have been times in this and other countries when the charge has had some validity, and concern that such experience might be repeated is quite understandable—I share that concern. But the United States has now set an entirely new pattern, a pattern which began to emerge in part as a result of Federal Reserve action in mid-1960, action that has since been expanded, and has been complemented by Treasury action and supported by an increasing volume of saving. It is a pattern that is well, if incompletely, illustrated by the attached set of charts contrasting the behavior of free reserves in the banking system, and of various interest rates, over the past 2 years with their behavior during the preceding recession and recovery period. Clearly, bank reserves have been kept easy, and interest rates for the major types of credit have remained low, in contrast with previous cyclical behavior.

Quite a different charge can indeed be made against this new, daring, and admittedly experimental financial policy of the United States: That it has neglected the balance of payments in order to assure the abundant availability of credit to domestic borrowers. Some of my colleagues are meeting, and I am sure effectively answering, that argument on this day in a conference being held abroad with some of the most alert and best informed financial officials of the leading countries of the Western World. They are no less sensitive than we to the need, the worldwide need, for a more rapid expansion of the American economy. No one is satisfied with the rate at which our productive activity is absorbing our growing labor force and our large numbers of unemployed. But the further question these critics ask is how we could possibly expect to accomplish anything more toward this objective through a continued easing of monetary policy—through adding more redundant credit to a supply of savings, that is already beckoning in vain for more domestic borrowers, or through further lowering of interest rates that have not themselves been an impediment to the use of funds.

Is not the lesson of our recent experience, in trying to give greater stimulation to the economy, that a combination of monetary policy and debt management to produce easy money is not enough? That we have not (so far as any practicable role of Government is concerned) found the proper "mix" for current conditions between these influences and fiscal policy—the policy controlling the Federal Government's expenditures and that determining the structure and burden of Federal taxation? In any changing of this mix, to be sure, the possible impact on the balance of payments will have to be considered. It must be in every country. But I have yet to see any actual evidence that the methods thus far used to help eliminate the deficit in our balance of payments have impeded domestic economic expansion. On the contrary, it seems to me remarkable that financial measures should have been able to help so much in cutting the balance-of-payments deficit substantially over these past 2 years, despite a sizable rise in imports, while additional credit has everywhere been readily available to contribute directly and importantly toward the 10-percent rise in gross national product that has in fact occurred.

II

In directing attention to proposals for flexible exchange rates, the subcommittee is again making a constructive contribution by bringing forward for reexamination a proposal which has probably through the years fascinated more professors and frustrated more practitioners than any other tool in the kit of international financial machinery. I suspect that every university seminar on international finance in the country has at least one member who views fluctuating rates as the clean-cut answer to every nation's external economic needs: If expansion at home brings in more imports than can be paid for, or produces an inflation that prices one's exports out of foreign markets, or creates unsettling fears for investors who then shift their capital to other countries, let the exchange rate go; let it freely find an equilibrium level at which outpayments and inpayments come into balance. What is more, concern over the adequacy of international monetary reserves can disappear, for with the exchange rate against all other currencies free to move downward whenever outpayments begin to rise, drawing on one's own international reserves would be brought to an end before they had scarcely begun. There would seem to be little need then for immobilizing any very sizable bloc of assets in foreign exchange reserves or in gold.

Unhappily, like all fine, straightforward, across-the-board answers to the crooked and devious problems of the modern world, this one has a catch in it. Perhaps I should say instead—if I might presume to speak for the operating men in foreign trade and finance around the world who have at times tried to contemplate the prospect of conducting trade when every currency could move any distance up or down, against all others, both in the spot and forward markets—the better analogy would be a barrel of fishhooks. Individual countries, in distress or unusual circumstances, may be able through resort to a freely fluctuating rate to conserve their reserves and bring their inpayments and outpayments closer together, but I doubt whether a country can continue to do that unless other counries, and particularly the major industrial countries, maintain fixed rates among themselves. And even these individual countries have often found in time that the real price was paid in a constricting of external trade, or an unsustainable imbalance between trade and capital movements. That in my judgment was the lesson of Canada, the most conspicuous of these individual exceptions that prove the rule (although even there the fluctuating rate—which was finally abandoned last May in favor of a fixed rate—was never wholly free).

As with so many of the issues brought out by the subcommittee's inquiries, the answers to this one are to be found, much more carefully and ably expressed than I could attempt, in other materials also prepared at the committee's request and included in its recent publications. Professor Houthakker, for example, at pages 292–293, summarizes the case admirably, though I hasten to add that I do not concur in the recommendation he goes on to make for a change in the fixed level of the dollar price of gold.

III

The question on abandoning our role as world banker suggests the Wordsworthian nostalgia of an adult wishing he could be a child again. The answer, now that we have grown into our banking role, however, is not likely to be found through renunciation; nor should we wish to find it in senile decline; but there is much that can be done through a sharing of our responsibilities with others who are growing up to a stature capable of bearing some of them. That is what happened as the dollar moved up alongside sterling during the interwar period.

It should be remembered that we would not now be encountering any real difficulties, in our role as commercial banker for a large part of the world's payments needs, if it were not for the other byproducts of our leading position among the Western nations—the military expenditures we undertake which inescapably releases some additional dollars into the stream of world payments; and the economic aid we distribute which in part unavoidably makes new dollars available to the recipient countries (or frees their own dollar holdings) for spending in other countries.

The blunt fact is, moreover, that these claims on our balance of payments will continue, and will forcibly inject balance-of-payments considerations into the formulation of an appropriate policy mix for the domestic economy, even if we could by some sleight of hand dissolve the arrangements through which the United States performs its commercial banking role—that of holding and servicing a major part of the international working balances and the international monetary reserves of other countries. This is not to say that there are not also costs and risks arising from our banking operations; but it is to urge that these be kept in perspective. And it is a part of that perspective also to recognize the very substantial contribution that is actually made toward strengthening our balance-of-payments position over the years by the substantial earnings this country receives from its banking function of "borrowing short and investing long"—earnings that greatly exceed the interest we pay on the foreign holdings of dollars.

Apart from the earnings attributable to the investment aspect of our banking role, which have fundamental importance for our longrun balance-of-payments position, there are in addition the shorter run advantages which we enjoy as banker in being able readily to obtain the credit that finances our net outpayments—credit which we obtain for much longer periods and in much larger amounts than any other leading country (except for the United Kingdom, the other leading banker) could depend upon. The credit standing of a banking center is such that it can, in effect, borrow to meet its needs in almost an imperceptible fashion, without the necessity of arranging and negotiating loans as other borrowers must do. The trouble only comes, and people are only likely to begin to raise questions about undesirable aspects of the banking role, when this facility for borrowing from others is overused.

That, of course, is what has happened to the United States. After we had run deficits in every year but one for almost a decade, the aggregate of dollars (i.e., in effect the short-term notes on which we have been borrowing) that was building up in the working balances of other countries and in the monetary reserves of their central banks began, in the light of the accelerated rate of our deficit, to exceed the limits, both of their prevailing needs and of their tolerance for accumulating additional balances to meet possible future needs.

The point to remember is that the need which eventually became convincingly clear to close the deficit in this country's international accounts was no different from the need we otherwise would have had to face earlier—and with even greater urgency—if our banking role had not given us considerable flexibility in the timing and the methods ultimately chosen for effecting a balance.

Thus what may now appear to be annoying risks or burdens are in many respects no different from the balance-of-payments disciplines that other countries must face much more consciously year in and year out. Even now, because of the readiness of other countries to cooperate with us as their banker, and because they have confidence that we will not abuse our role by failing to balance our own international accounts, it has been possible during the past 2 years to introduce a new dimension in our banking arrangements, through which our own performance can be improved and the monetary system of the world strengthened. The four essential elements of this broadened gold-dollar system have all now been identified through specific action:

(1) forward transactions in other convertible currencies against dollars;

(2) swaps of dollars for other currencies on an activated or a standby basis;

(3) outright acquisitions of foreign currencies (without provision for gold or currency value guarantee) to be held alongside gold as part of the monetary reserves of the United States; and

(4) the contracting by the United States of indebtedness denominated in foreign currencies, for various maturities.

All of the experimental arrangements which have tested these facilities, and provided evidence of their potential, have emerged from the lessons of operating experience. They have not in any sense been imposed on other countries; they are mutual agreements. They have to a considerable extent reflected the suggestions and initiative of one or another of those countries who represent our larger "customers" in the banking business we perform. These four kinds of facilities do not promise complete insulation against banking risks in the future; they do not themselves necessarily provide assurance that all manner of future requirements for international liquidity can be met in these ways; they certainly do not provide an escape from that basic need to balance inpayments and outpayments which every country must face; but they do provide clear evidence that cooperative effort among the banking agencies of the leading countries can provide facilities that do fulfill the world's present needs for reliable international monetary arrangements.

It is that same kind of cooperation—involving a gradual sharing among others of some of the responsibilities that the United States has carried so long and so largely—that will provide the fundamental answer over time to our balance-of-payments problem. If the United States were able to accomplish the same degree of shared responsibility for the joint military obligations of the Western alliance that has already been volunteered on the financial front, most of our balance-of-payments pressures would disappear. If the United States were able to achieve as well comparable results in the shares contributed toward economic aid; if other surplus countries were prepared to reach out beyond any arithmetic calculation of equality and assume the kind of disproportionate share that the United States carried for so long—then no real balance-of-payments problem would remain for the United States.

Thus, not in the interest of absolving our banking role from any further obligations, but only of attaining the perspective already suggested, it would seem clear that the zones for major effort are those which this subcommittee began to explore again yesterday afternoon, alongside the fundamental need for expansion of our exports, which has been of continuing concern to the subcommittee. The significance of any possible further monetary arrangements would be, in comparative terms, quite incidental. If the basic problems are neglected, and our banking role treated as a scapegoat instead, the effect would be, at the least, a prolongation of our balance-of-payments problem, as well as the probable disruption of existing arrangements which are already working so effectively that we take them largely for granted—arrangements which, however, once disrupted, could quickly grind the world level of trade and prosperity to lower and unsatisfactory levels.

IV

A caution of the same kind is appropriate, it seems to me, in turning to the fourth question, that asking whether a substantial increase in international liquidity would not free programs of domestic expansion from balance-of-payments considerations. Substantial achievements in augmenting international liquidity have already occurred, of course, and have been very useful. But in this desire for decisive increases, there is a similarity with the yearning that has always been expressed by those who feel that more money and the facilities for creating it, would assure expansion and proseprity within a particular country.

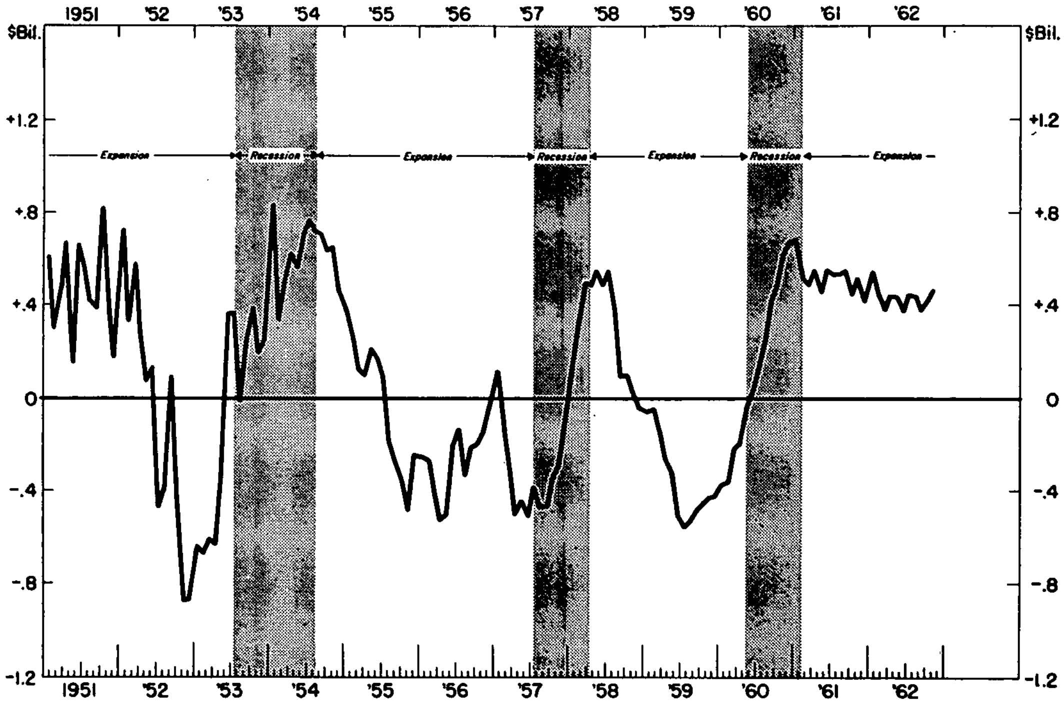
To be sure, much has been learned as a result of those yearnings and there is no denying that modern monetary systems, with their provisions of flexibility through fractional reserve commercial banking, have been necessary for the evolution of modern economic society. But that development has rested upon the link between money and credit. There is no way in which money, whether as the circulating medium of a given country or as the acceptable medium for holding international reserves, can be created, or can retain its acceptability, without a counterpart in the granting and accepting of credit. Even the use of an international institution to provide liquidity does not circumvent the fact that credit must be provided by one country or a group of countries to others that are in deficit.

It is important to have this in mind in considering any suggestions for resolving or moderating the balance-of-payments problems of any given country through reliance upon an enlarged supply of "international liquidity" or international credit. Unless surplus countries are willing and able to extend credit, on terms and through media which are acceptable to deficit countries, there will not in fact be additional international credit, whatever the formal arrangements may seem to be. This is a most important practical consideration, against which all proposals for added international liquidity will have to be tested, over time. It is relatively easy to draw up a plan for a systematic monetary network of conduits, pools, and valves for the storage and release of international credit. It is a very different task to induce creditors and debtors to put into that network the credit itself—without which the whole mechanism remains on the drawing board, or if it exists, has little practical significance.

For in the world of today, I feel reasonably sure, no country will undertake in advance an automatic liability for the extension of large amounts of credit. Arrangements may be established and tested that will permit the ready activation of additional credit, provided the creditor country is willing and able in the given circumstances to lend, and arrangements of that kind are of great significance. But so long as the condition of creditor agreement is required, there cannot in fact be any way of assuring to debtors an automatic credit of indeterminate amount or indeterminate duration. And I am very much afraid that it is an underlying if not always expressed desire, on the part of those who urge heroic new proposals for international liquidity as the means of liberating domestic economic programs from external considerations, that they do indeed visualize the new liquidity as a kind of automatic access to credits, always also assuming that the credits themselves will be automatically available.

There is much more, to be sure, that should be said on this vast and intriguing subject. But as I said at the outset, my aim in this brief statement has been only to mention a few fragments of the argument that may be worth some consideraion, as these four questions—and they are themselves only four among many—are being appraised in the futher work of the subcommittee. I have attempted only to suggest fragments of the kind that I thought had not yet been treated, at least in this way, in the materials already before your subcommittee. I look forward to further opportunities to participate in the work of the subcommittee as it progresses with its comprehensive review of all the relevant questions that must be answered if the United States is to achieve the balance-of-payments equilibrium that must be reached, through methods that will contribute to the more rapid growth of our own economy and of world trade.

FREE RESERVES OF MEMBER BANKS

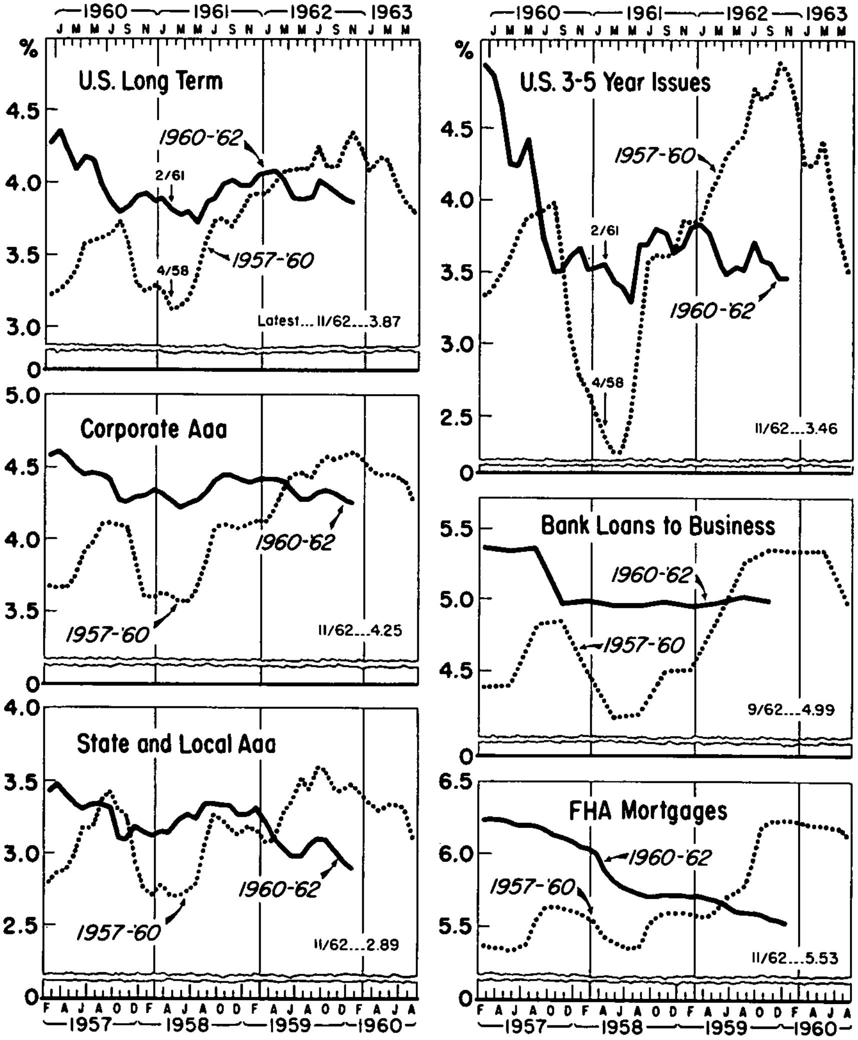


Note: Periods of recession and expansion as determined by the National Bureau of Economic Research.

Office of the Secretary of the Treasury

F-654

SELECTED INTEREST RATES IN 2 BUSINESS CYCLES
(Plotted to align the recession low points of April 1958 and February 1961)



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F-627-B

Representative REUSS. At this time the committee will stand adjourned until 2 o'clock this afternoon, at which time in this chamber we will hear a panel of economists and Federal officials on capital movements.

(Whereupon, at 11:25 a.m., the hearing was recessed, to reconvene at 2 p.m. on the same day.)

AFTERNOON SESSION

Representative REUSS. The Joint Economic Committee will be in order. We shall continue with our series of hearings on the outlook for the U.S. balance of payments.

This afternoon we have a panel discussion centering on capital movements.

We are very happy to have with us Mr. Philip W. Bell, of Haverford; Mr. Peter B. Kenen, of Columbia; and Mr. Frederick Klopstock, who is manager of the Research Department of the Federal Reserve Bank of New York.

I will call upon Mr. Bell first to present his paper, and then Mr. Kenen, and Mr. Klopstock.

STATEMENT OF PHILIP W. BELL, HAVERFORD COLLEGE

Mr. BELL. Thank you, sir.

In my paper on "Private Capital Movements and the U.S. Balance-of-Payments Position," published by this committee, I have tried to present as careful a summary as I could of actual developments over the past 10 years. For various reasons I have largely refrained from discussing issues of policy in this paper.

I would like now to make a brief supplementary statement suggesting certain policy measures which I believe might be taken to alleviate the situation wherein private capital movements of various types have weakened and are continuing to weaken our balance-of-payments position and are, I believe, both a cause and an effect of our failure, to undertake adequate measures to stimulate domestic income and employment in this country.

There can be little question but that the outflow of direct investment capital to other developed countries, European countries in particular, has contributed significantly to our balance-of-payments difficulties over the last few years. We cannot expect to recoup these short-run losses for a considerable period of time. If the stream of new investment continues at about the same level as at present (involving a total investment in Europe of around $700 million a year), it will be 10 to 15 years before inflows from this stream of new outflows catch up to outflows and therefore this wave of new investment in European manufacturing and petroleum facilities begins to "pay off" in balance-of-payments terms. The sharp increase in manufacturing investment in Europe really began after formation of the Common Market and the establishment of convertibility at the end of 1958. Thus, it will be the early 1970's before we will receive any net balance-of-payments benefits from the new stream of investment which began in 1959.

Two years ago the administration proposed to eliminate any tax advantage which favored investment in other developed countries as opposed to investment at home by doing away with the provision in our tax laws which allows business firms to defer any U.S. tax which may accrue on income earned abroad (because foreign income taxes are less than U.S. taxes) until that income is returned to this country. The Congress saw fit to pass a substantially modified version of the administration proposals, eliminating the most serious tax differentials between income earned abroad and income earned at home because of "tax haven" operations in Switzerland, Panama, Liberia, and elsewhere, but other differentials were allowed to stand.

I favored and still favor the original administration proposals, not so much on balance-of-payments grounds as on grounds of optimal resource allocation. If real costs of production are lower in Texas than in Pennsylvania for a given line of activity, because of nearness to raw materials or power resources, greater labor efficiency per dollar costs, or for other reasons, it is wrong economically to promote the location of plants in Pennsylvania through special tax concessions. We cannot prevent Belgium or Italy from enticing new plants into what is economically, on real cost grounds, a poor location, thus malallocating world resources. But we can prevent U.S. capital from contributing to this malallocation by making sure that tax considerations are a neutral factor in the location of new investment. A policy of neutrality would in this case serve our balance-of-payments needs as well, since it would reduce artificial incentives to invest capital abroad and to leave earnings abroad.

I recognize that the Congress is unlikely to change its mind on this issue. Fortunately, a combination of circumstances probably makes the problem less urgent now than it was 2 years ago: passage of the investment credit and the new depreciation rules, which together offset some of the tax advantages of investing in Europe; the possibility that corporate income-tax rates will be reduced in this country; the likelihood that growth in the level of activity will slacken off somewhat in Europe over the next few years; and, hopefully, the prospect that economic activity will pick up substantially in this country. If these things do not combine to cut back on the outflow of manufacturing investment in developed countries, it may be that the Congress should consider some new compromise of the original administration proposals. One possibility, for example, is extension of the so-called "minimum distribution rule," imposed in the 1962 tax bill as an alternative to section 13 on tax havens, to investment in developed countries generally. Income earned abroad which is subject to lower tax rates than exist in the United States would be subject to immediate U.S. tax only if corporations returned less than 50 percent of their earnings to this country as dividends, which is the normal proportion for distribution of income earned in this country. Under the minimum-distribution rule, in effect, income which is left abroad in excess of 50 percent of total earnings after payment of foreign taxes would be subject immediately to U.S. tax. Other compromises might be worked out, but this is one which might be reasonable.

When it comes to long-term-portfolio capital, the best action we can take to improve our balance-of-payments position is to step up our rate of growth here at home. It is very doubtful that raising long-term interest rates would have any significant effect in deterring new issues of foreign bonds in this country, nor would it stimulate much in the way of new foreign purchases of U.S. bonds. But we have a substantial comparative advantage in stock exchanges vis-a-vis Europe, and we will make best use of this domestic asset only if we increase our level and rate of growth in economic activity in this country.

If new issues of foreign securities in this country increase considerably in the next year or two—and this does not now seem likely, although new issues are up substantially in the first half of 1962 compared with the last 2 years—we could, of course, consider imposition of capital-issues control; we could, in effect, say to foreign countries that they must queue up, because we are in temporary balance-of-payments difficulties. But this should prove to be necessary only if foreigners really feel that the dollar might be devalued. In that case there might indeed be a substantial increase in new issues on the ground that dollars can be borrowed when they are expensive and paid back when they are cheap. If I can borrow $280 now and get 100 pounds, and repay my dollar debt with 70 pounds 5 years from now, assuming the dollar goes from $2.80 to $4 per pound, it is a quite profitable transaction.

Although in my study I have pointed out that a substantial amount of the recorded short-term-capital outflow from this country over the last 2½ years has probably not hurt our balance-of-payments position at all, the fact is that the actual magnitude of short-term funds which have been moving overseas and which deteriorate our overall balance may have been many times what has been recorded as flowing abroad. If most of the adverse shift in "Errors and Omissions" in 1960–61 was in fact an outflow of short-term funds moving to Canada and Europe, and was not directly related to the financing of U.S. exports, as my evidence suggests, then the total outflow of "unrequited" short-term funds may be running as high as $1.5 billion or more a year, although I believe that the figure is considerably less than this, because I believe that much of the shift in "Errors and Omissions" reflects funds going into the Euro-dollar market, and probably most of these funds end up financing U.S. exports. But at any rate, the current flow could easily be $1 billion a year.

Furthermore, while my evidence tends to show that, on balance, foreigners in toto have not been switching from dollars to gold or from dollars to sterling in recent years, the fact of the matter is that some foreign commercial banks and private citizens do tend to switch funds from one financial center to another. Even if our agreements with key monetary authorities abroad now assure us, more or less, that such switching operations on the part of the private sector will not deteriorate our gold position, it is probably unhealthy in that it may lead at some point to pure speculative flows against the dollar, flows based on the assumption that the dollar will be devalued.

Short-term-capital movements unrelated to financing U.S. exports are a matter of serious concern. While we have not been able to uncover evidence that clearly links more than a relatively small portion of these flows to interest-arbitrage operations, we know that interest arbitrage exists, that it appears to dominate at least some of the movements which concern us (U.S. funds moving into and out of sterling through banks, as well as some shifts in foreign private capital), and that it probably affects other movements, such as that on the part of U.S. nonfinancial corporations into and out of the Euro-dollar market, much of it through Canada.

I believe that tax considerations (that situation now, hopefully, corrected, as discussed in my study) and working balance needs (now largely met, following the large growth consequent upon establishment of convertibility), as well as outright speculation against the dollar, have been the primary motivations underlying a substantial portion of the net $1 billion or so a year short-term outflow which is probably the maximum that we can consider to have contributed adversely to our balance-of-payments situation during 1960–61. The fact that the recorded outflow appears to be leveling off in 1962, in spite of continued interest differentials which favor investment abroad, would seem to support such a hypothesis. But suppose I am wrong. Suppose that interest-rate differentials are the primary motivation for the portion of short-term-capital flows which do not go toward financing U.S. exports. Suppose that under existing arrangements, unless the short-term interest rate in this country stays near European rates, we can expect to continue to lose $1 billion a year in unrequited funds.

It seems to me to be utter folly to allow such short-term capital flows vis-a-vis foreign financial centers to dictate monetary policy in this country. We can offset the adverse domestic effects of high interest rates by having a large budget deficit, thus achieving the same rate of expansion in income and employment here as we could have with lower interest rates. But why should we? There are alternatives.

The alternative which I suggest is an old one, but one which is, it seems to me, perfectly respectable. Indeed, it is the alternative which is presently practiced by the other great world financial center—London. There is no reason why we have to continue to buy and sell gold at absolutely fixed rates. If we were to widen our gold points so that fixed buying and selling rates were as much as 1 percent or so on either side of $35 an ounce, as in the case of sterling, we would be in a position of offsetting the shortrun effects of practically all of any widening of the London-New York differential or other European-U.S. differentials which is ever likely to occur. Thus, suppose we agreed to buy gold at $34.50 an ounce and sell gold at $35.50 an ounce. In fact, however, we might intervene in the market for dollars at any time to push the price up or down. And suppose initially our short-term interest rates were equal to short-term rates in London but for reasons of domestic policy objectives we wished to lower our Treasury bill rate by 3 percentage points. If the exchange rate for dollars was originally at $34.50 an ounce, we could just offset the $1 excess of interest gained over a year from switching $35 from New York to London ($35 times 0.03 equals $1.05) by forcing the exchange rate to $35.50 an ounce.

Anyone who wished to switch his funds to take advantage of higher interest rates in London, and then move back into dollars if and when our interest rates rose again, would find that he could gain only if the differential were retained for more than a year, for when the differential was about to be narrowed again, the rate would be forced back down to $34.50 an ounce. In the interim period the forward rate would presumably reflect potential short-term losses because of the possibility of a change in the spot rate. As Piquet suggests in his monograph for this committee, the widening of the gold points should also discourage speculative movements from dollars into gold, for now this would not necessarily be free of costs.

Great Britain has used the exchange rate in this way. For example, in 1961 the price of a pound was pushed from around $2.785 to around $2.815 as the British Treasury bill rate was suddenly raised by around 2½ percentage points. An investor stood to gain 7 cents a year on an investment of $2.80 (0.025 times 2.80 equals 0.07), but he ran the risk of losing 3 cents when he wanted to get back into dollars, because the exchange rate might then be back at $2.785. This example shows, however, that the British gold points are not sufficiently wide to allow changes in the interest rate differential to be completely offset. Widening our gold points to $34.50 and $35.50 (which would necessitate approval by the International Monetary Fund since the range is greater than the prescribed maximum of one-fourth of 1 percent on either side of par) would imply that the sterling-dollar rate might fluctuate between $2.74 and $2.86 per pound, rather than $2.78 and $2.82 per pound as is the case now. The wider margin should be sufficient under normal circumstances to allow us to pursue an independent monetary policy geared to our domestic needs; it should obviate the need to raise short-term rates here, at a time when the economy can use all the stimulation it can get, simply to prevent short-term capital flows for purposes of interest arbitrage from further damaging our balance-of-payments position.

Of course, a policy involving a widening of our gold points and thus limited use of a small degree of exchange-rate flexibility would necessitate close cooperation with British authorities. Much the same results could probably be achieved by widening the British gold points still further, but this would not give us any real flexibility, any degree of independence of action. Great Britain may well have to gear her exchange-rate policy more to the continent of Europe as she moves closer to the Common Market countries, and thus we will need flexibility on our own account. The alternative being practiced now, of periodic operations in forward markets in particular situations involving primarily the offsetting of speculative movements of short-term capital, is not, in my opinion, adequate. To repeat, we need more flexibility.

It may be argued that someone must hold to strict rigidity in exchange rates, and that our position as the No. 1 financial center of the world implies that the responsibility is ours. I do not see any reason why anyone has to assume that responsibility. It may be a convenience to other countries to have us hold the line of rigid gold parity, and have them gear their foreign-exchange transactions to the dollar. But this allows them a wide degree of freedom to coordinate domestic and international monetary policies, allows us none. We have special problems as a financial center and deserve some degree of freedom which it may not be proper to allow other countries to exercise.

If we decide to continue rigid adherence to an absolutely fixed exchange rate between dollars and gold, with no flexibility whatsoever, for reasons of "prestige," statesmen 10 years from now may well be talking about U.S. behavior during the early 1960's in much the same terms they were talking, 10 years after the British action of 1925, about the British Government's decision to reestablish its "prestige" as the international financial center of the world by going back on gold at the old, unduly high rate of $5.25 per pound.

Representative REUSS. Thank you, Mr. Bell.

Mr. BELL. Mr. Reuss, I have a few small corrections to my monograph; could I submit those also, and perhaps have them printed as an errata, as part of the hearings, or something? Or would you rather not?

Representative REUSS. I would like those corrections. However, are they ready now?

Mr. BELL. Yes, sir.

Representative REUSS. If you submit that, we will see that it is made a part of the record.

Mr. BELL. Thank you, sir.

Representative REUSS. Would you see that we get that?

Mr. BELL. Yes, sir.

(The material referred to follows:)

ERRATA

"PRIVATE CAPITAL MOVEMENTS AND THE U.S. BALANCE-OF-PAYMENTS POSITION"

(By Philip W. Bell)

Page 408: Order of two diagrams should be reversed.

Page 409, line 10: Change "no" to "little".

Page 415, Table 4. Under title write: "(—: denotes capital outflow from United States.)"

Page 416, Table 5. Same as for table 4.

Page 446, line 5. Sentence beginning "Table 11 * * *" should read as follows:

"Table 11 shows, first of all, that between 1956 and 1958 foreign central banks and other official bodies tended to increase the ratio of gold relative to total foreign liquid asset holdings, partly at the expense of dollars, but mostly at the expense of other currencies, and that the ratio of both gold and dollars to total liquid asset holdings was relatively constant through 1959, 1960, and 1961."

Page 446, line 3, second paragraph. Sentence beginning "It appears that banks * * *" should read as follows:

"It appears that banks lowered the ratio of dollars to total foreign exchange reserves in 1958, increased the ratio substantially folowing convertibility (the increase comprising mostly increased holdings of European commercial banks), and dropped the ratio very much more sharply than did central banks during the last quarter of 1960 and first quarter or 1961."

Page 451, line 8 below equation (4.2)'. Change "1957 and 1958" to "1956 and 1957."

Page 454. Delete footnote 39.

Page 456, table at bottom of page. Substitute the following:

(b) Explained by trend and constant term	578	592	663	680
Total predicted	—580	—644	—646	—718

Representative REUSS. Mr. Kenen.

STATEMENT OF PETER B. KENEN, ASSOCIATE PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY

Mr. KENEN. Mr. Chairman, members of the subcommittee, I am honored to appear again before this subcommittee, especially to participate in these important hearings. I cannot add much to the perceptive paper by Professor Bell, but I would like to take a few minutes to review some simple propositions which the subcommittee and the public should bear in mind when looking at the international financial transactions of the United States.

This afternoon's meeting examines factors affecting the capital account—the collection of transactions involving foreign assets and income-bearing claims on the outside world. These transactions are connected with U.S. foreign trade and with several kinds of service income. They give rise to trade and respond to trade. They are also sensitive to interest-rate differences and to international variations in supplies of credit. But one cannot judge the capital account by taking a statistical snapshot, nor can one explain the capital account by linking it with trade and interest rates. One must view it as a process that unfolds through time, with its own internal logic. Unlike an export sale, which is finished quickly, a capital transaction will produce a stream of payments or receipts reaching forward to the future—dividends, royalties and interest, redemptions and repayments. Finally, one must not appraise the U.S. capital account from a narrow national standpoint. Like all American transactions with the outside world, U.S. lending and investment are mirrored in the international accounts of other nations and have an enormous impact on the less developed countries.

Professor Bell stressed the links between our capital account and U.S. foreign trade. Government grants and loans, whether tied or not, enlarge U.S. exports by placing dollars in the hands of potential buyers. So do private credits, especially bank lending and supplier financing for capital equipment. American direct investment likewise calls forth foreign trade. An act of investment will produce a flow of capital equipment from the United States. Then the plant and equipment put in place by direct investment will bring on trade in parts, raw materials and complementary products supplied by the parent American company. Short-term lending of the type that has provoked so much concern is itself called forth by trade. If credit terms were stable and alike in the United States and foreign countries, steady U.S. exports would produce a stable sum of short-term U.S. claims on the outside world; new lending would be offset by repayments, and there would be no net outflow on the capital account. But growth in trade will give rise to growth in U.S. claims; new lending will exceed repayments, and there will be a net outflow on the capital account.

It is comparatively easy to identify the exports that follow U.S. capital. But this is not the same as ascertaining how much trade is caused by lending and direct investment.

Statisticians can add up the exports that are financed by U.S. foreign aid; but they cannot know which goods would have moved if aid were not tied and, more importantly, cannot spot the substitutions that undoubtedly occur. A foreign government that must spend its aid receipts on U.S. goods is apt to spend more of its other dollar income outside the United States. Likewise with direct investment, company accountants can identify the parts and raw materials sold by the parent company to its foreign affiliate, but cannot know how much of the finished product the parent would have sold abroad if it did not have a foreign affiliate making and selling the same finished product. Simple sums do not answer complicated questions, and we may sometimes overstate the amounts of trade actually caused by lending and investment.

The connections between trade and capital inspire another critical comment. If, in fact, there is a link between U.S. short-term lending and U.S. export sales, the United States cannot be content to reach "basic" balance in its international accounts; it cannot merely balance off trade in goods and services, government expenditure, aid and long-term capital. Barring an unlikely shift in the geography of borrowing and lending, growth in world exports is apt to cause persistent short-term lending by the United States. Do not be misled by the terminology; short-term lending can go on over a long period. Each loan may be paid off after a few months, but total loans can still grow and net lending can continue. The United States must consequently generate a surplus on its "basic" transactions, not bare balance, to offset the structural component of its short-term lending.

Interest rates may influence many kinds of capital transfer. Using different years and data than Professor Bell, and a different analytical model, I have found a few more links between short-term capital and key interest rates. Thus, the recent flow of corporate money to Canada and Europe shows distinct interest-rate sensitivity: it includes large cash placements in the Eurodollar market, as well as commercial lending. Research on this issue, moreover, is always handicapped by the very nature of the economic process. If international arbitrage were perfect, one might never see the interest-rate differences that caused capital to move; arbitrage would erase them, so that one could not connect them with the flows they inspired.

I do not say that interest rates govern business spending on plant or inventory—merely that investors will seek to minimize interest costs and to maximize interest income by shifting debts and cash from one place to another. Nor do I say that interest rates cause the largest capital movements. My findings are complementary to Professor Bell's results, rather than competitive. They do not overthrow his chief inference—that the effects of interest rates may be swamped by trade and other economic changes. Interest rates may have even less influence than other financial phenomena. A payments deficit elsewhere in the world can draw large amounts of capital out of the United States.

This is because a deficit country is apt to fall behind in its debt repayments, becoming a net borrower. In addition, the defensive monetary measures taken by a deficit country may lead to large U.S. lending. If a foreign central bank tightens domestic credit, banks and corporations will go abroad for finance, especially to the United States. The long list of ways in which foreign firms can raise cash amazes the mere academic, and warns against any effort to restrict private U.S. lending by direct controls. Foreigners arrange acceptance credits, bank loans and supplier finance. They borrow dollars from American companies, and can sometimes induce U.S. firms to buy and hold foreign-currency deposits.

Anyone who looks at international financial problems must at once be struck by the strong and intimate connections among key money markets. The growth of the Eurodollar market, for example, has accomplished an informal but effective integration of the European monetary systems. Recent proposals from the Brussels Commission look timid and conservative when compared to the progress made without plans or protocols. The Eurodollar provides Western Europe with something quite close to a common currency, and the many varieties of Eurodollar credit substitute for more familiar money-market instruments, including interbank reserve loans (Federal funds). In consequence, European central banks can hardly execute independent monetary policies. They have even merged their money-market and exchange-market operations. When they intervene in the spot or forward foreign-exchange marekts, it may be to alter commercial bank reserves rather than defend the system of exchange rates. These transactions are reflected in the U.S. payments data; the recent swaps between foreign central banks and foreign commercial banks, for example, changed the composition of U.S. short-term liabilities.

The United States retains much more autonomy in monetary matters, not because American banks and businesses forgo the opportunities for arbitrage that Europeans would exploit, but because the American money market is so much larger than the European. A flow of funds between New York and Western Europe has a smaller relative impact on the American banking system. And the United States has an obligation to exploit this autonomy, to pursue monetary policies that foster growth and full employment. Policies designed to inhibit flows of short-term capital will also slow domestic growth and diminish U.S. spending on the exports of the less-developed countries. Policies to foster growth may draw out private capital and enlarge our payments deficit. But American reserves are still adequate to finance these flows, and the monetary authorities can prevent them from causing massive speculation.

This point deserves emphasis. Our large gold reserves have helped to ward off speculation against the dollar. But if the United States is not willing to use its reserves, they will cease to serve as a deterrent. If it is unwilling to pay out gold so as to buy time for a good adjustment, Americans and foreigners alike will lose their awe of the U.S. gold stock. Other countries have defended their exchange rates with far smaller cash reserves than the United States. And the new international credit arrangements can make reserves go further than ever before.

We are, in fact, watching a dramatic change in the international monetary system. Credit arrangements may begin to take the place of growth in national reserves. It would, of course, be tragic if the United States had to buy international cooperation by adopting monetary policies that brought back payments of balance at the expense of full employment and to the detriment of the less-developed countries. But our friends at the OECD understand this danger—and our friends at Basle must surely see it too.

I began this statement by asking that you view the capital account as a process reaching over time. This is not a new proposition, yet is often misconstrued. In recent hearings on tax policy toward foreign-source income, witnesses argued that direct investment cannot be damaging the balance of payments because the flow of income back to the United States is larger than the outflow of new capital. The arithmetic is unassailable, but the inference is all wrong. The return flow of income has offset new outlay. And debt repayments have offset part of new U.S. lending. The last few years, in fact, have produced an intriguing pattern. By paying off old debt, on schedule and in advance, Europe has been bearing the direct dollar costs of new U.S. lending to the less-developed countries (see tables 1 and 2). Its debt repayments have served as partial substitutes for an expansion of European aid and lending. But debt-service payments and direct-investment income are the result of old loans and investments, not of current outlay. They cannot justify new lending or investment, even if they cover it.

To appraise the capital account, one must look ahead and compare prospective flows. New investments should be matched with the income they will furnish; new loans should be weighed against the debt-service payments they imply, not against repayments on old loans. Examining the capital account this way, two points come to view. First, one starts to look askance at certain long-term outlays and to look less skeptically at recent short-term flows. Second, one begins to question certain of our policies, for they may have a strange effect in the years ahead.

The flow of short-term capital has made all the headlines since 1960. But it may be less damaging, dollar for dollar, than the flow of long-term money liked to foreign borrowing in the New York bond market. In 1961, the developed countries (including Japan) raised about $1.2 billion of short-term capital in the United States. During the same year, they also raised some $500 million by issuing new bonds and stock. In some other years, like 1958, new flotations were much larger than the short-term flow. A growing stream of short-term loans will feed back as debt-service payments much faster than a stream of 10-year loans or bond issues having the same gross growth. They will have a shorter adverse impact on the payments deficit and make a smaller dent in U.S. reserves. One can put the same point differently: Identical net flows of long- and short-term capital imply different growth rates in gross lending. Short-term loans can grow faster with no larger adverse impact. If, then, the United States must reduce any part of its lending and investment, foreign long-term borrowing by new bond flotations may well be the proper target.

I do not advocate direct controls, though they could be used on this part of the capital account more easily than on any other. As in most such matters, we should seek to open up new opportunities rather than impose restrictions. The United States should continue to encourage European governments in their efforts to expand long-term capital markets and should insist that they open up their markets to foreign borrowers.

At the same time, the United States must guard against adjustments that could have a whiplash impact on the less-developed countries. The United States has tied its aid and lending to reduce the current dollar outflow that can be attributed to public capital. In doing so, it has changed the shape of future flows. A steady stream of gross lending will, of course, produce a growing total of debt-service payments. Eventually, repayments will rise to equal lending. If this equality is to be delayed, gross lending must increase year after year. But if our loans are tied to U.S. exports, they must grow still faster or will be overtaken very much sooner (see fig. 1). A simple illustration will sharpen my point. Suppose that the United States lends $1 billion to the less-developed countries every year, and that these loans must be repaid within 20 years. Neglecting interest payments, the net dollar outflow would drop to zero after 20 years of lending; repayments would catch up with gross loans. If, next, the United States tied one-half its lending, the gross cash outflow would be cut to $500 million without any countervailing change in the shape of the return flow. Hence, the net cash outflow would be cut in every single year and would drop to zero after only 10 years. Tied aid may complicate the debt-service problems of the less-developed countries—problems that are quite severe even at this stage.

Here again the answer is expansion, not restriction. The other industrial countries must make larger grants and loans. This is not to ask that they take on bigger real burdens—that they set aside a larger part of total output for development assistance. The discussion of this issue has been damaged by another kind of bad arithmetic. Governments and journalists are both prone to measure the aid burdens borne by this country and its allies using the statistics on total grants and loans. These figures do not measure real burdens, only the financing of true foreign aid. A country does not make a real sacrifice and give aid to others unless it gives up goods or services—unless it exports part of its full-employment output without buying the equivalent in imports. By this test, several other countries are already making larger real sacrifices than the United States. The available statistics are very crude indeed; payments data are not put together the same way by all our allies and cannot be adjusted to allow for gaps between potential and actual output. But the picture they reveal is so very different from the one shown by the aid statistics that it needs attention (see table 3). Some European countries have run current-account surpluses that exceed 2 percent of GNP, while the U.S. surplus on current account has barely been as high as 1 percent of GNP. To say that our allies should provide more foreign aid is not to say that they should increase these percentages; it is to say that they should accept long-term claims on the less-developed countries rather than accumulate short-term claims against the United States (see fig. 2).

There is no reason to forecast drastic change in the American capital account. Commerce Department surveys point toward lower outlays on direct investment by 1964, but other types of long-term lending and investment are apt to stay high or increase. Yet a large net outflow on capital account—whether direct investment, long-term lending, or a short-term cash flow—is not, by itself, something to deplore or to justify restrictive action. Indeed, a steady outflow is required if this country is to honor its commitments in the outside world. Such an outflow merely means that the United States must continue to strengthen its current account by domestic policies that will accelerate the growth of productivity and enhance the quality of our products. It also calls for a strong monetary system so that flows of short-term capital, moving in response to a dozen different signals, need not interfere with domestic policies or cause countries to restrict their foreign trade and payments.

(The tables Mr. Kenen referred to in his statement follow:)

TABLE 1.—*Long-term lending and repayments, Government account, 1950–62*

[Millions of dollars]

Year	Long-term lending [1]	Repayments on past loans		Net long-term lending
		Ordinary	Advance	
1950	414	295		119
1951	458	305		153
1952	847	429		418
1953	716	487		229
1954	306	507		−201
1955	383	416		−33
1956	545	479		66
1957	993	659		334
1958	1,176	544		632
1959	1,051	619	435	−3
1960	1,213	636		577
1961	1,938	625	649	664
1962 (1st half)	994	342		652

[1] Includes foreign currency lending.

Source: U.S. Department of Commerce, "Survey of Current Business" (various issues).

TABLE 2.—*Long-term lending and repayments, Government account, regional distribution, 1961*

[Millions of dollars]

Region	Long-term lending [1]	Repayments on past loans	Net long-term lending
All areas	1,938	1,274	664
Western Europe	278	925	−647
Latin America	798	165	633
Other countries and international organizations	862	184	678

[1] Includes foreign currency lending.

Source: U.S. Department of Commerce, "Survey of Current Business," June 1962.

TABLE 3.—*Real and financial transfers in aid of development, selected countries, 1960*

[Percent of gross national product]

Country	Real transfer [1]	Financial transfer [2]		
		Total	Public	Private
Belgium-Luxembourg	0.4	1.4	0.8	0.6
Canada	(3)	.4	.2	.2
France [4]	2.8	2.2	1.4	.8
Germany	3.0	.9	.5	.4
Italy	.4	.9	.4	.5
Japan	.5	.7	.4	.3
Netherlands	1.8	2.2	.4	1.8
United Kingdom	(3)	1.2	.5	.7
United States	.3	.7	.5	.2

[1] Global balance-of-payments surplus on current account less transfer payments and investment income when identified and included in the national statistics.
[2] Aid and long-term lending as defined in the OECD questionnaire. The total of financial transfers is much larger than the sum of real transfers. This is because the cash transfers include large financial flows that are not matched by resource flows (e.g., reinvested earnings) and the payments data unavoidably include certain offsets to the flows of goods and services.
[3] Negative.
[4] Estimated from trade data and the payments figures for the France area.

Sources: Organization for Economic Cooperation and Development, "The Flow of Financial Resources to Countries in Course of Economic Development in 1960," p. 10; International Monetary Fund, "International Financial Statistics" (various issues); and "Balance of Payments Yearbook," vol. 14.

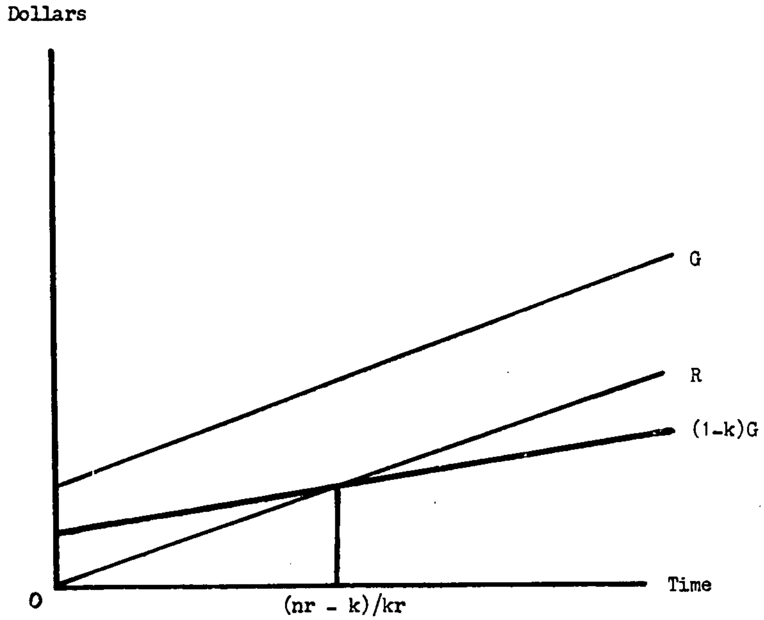

Figure 1

Tied Loans and Net Cash Flow

Describe gross loans, G, by $G_o(1 + rt)$, where r is a (linear) growth rate. Describe repayments, R, by the corresponding formula, $G_o(1 + rt - rn)$, where n is the life of a loan. The net cash outflow will be $G - R = G_o nr$, a positive constant. If, however, a fraction, k, of gross loans is tied to U.S. exports, the net cash outflow will be $(1 - k)G - R = G_o(nr - k) - G_o krt$. The first term is constant (and will be positive if $nr > k$); the second term will grow with time (t) and must convert a net outflow (the lefthand shading) into a net inflow (the righthand shading) when t comes to $(nr - k)/kr$.

FIGURE 2. A SCHEMATIC VIEW OF REAL AND FINANCIAL BURDENS IN DEVELOPMENT ASSISTANCE

The first three panels of this table show ways to finance the same $3 billion of net transfers to the less developed countries. The first panel shows a matched distribution; the second shows a change in the distribution of "real" burdens; the third shows the necessary change in "financial" burdens. The alternative to "Distribution (III)" is, of course, a cut in U.S. aid, shown as "Distribution (IV)." Such a cut would have to exceed $500 million unless the corresponding cut in import spending by the less developed countries were wholly concentrated on "other countries'" goods. If they spent half of each aid dollar on "other countries'" goods, U.S. aid would have to fall by a full $1 billion, as shown in the table.

[Millions of dollars]

Real and financial burdens	United States	Other industrial countries	All industrial countries
I. A matched distribution of real and financial aid: Other countries bear 1/6 of both burdens.			
Export surplus (+)	2,500	500	3,000
Long-term financing (−)	−2,500	−500	−3,000
U.S. deficit (−)	0	0	0
II. An unmatched distribution of real and financial aid: Other countries take 1/3 of the real burden but do not enlarge their long-term financing.			
Export surplus (+)	2,000	1,000	3,000
Long-term financing (−)	−2,500	−500	−3,000
U.S. deficit (−)	−500	+500	0
III. Distribution (II) corrected by an increase in other countries' long-term financing and a cut in U.S. financing.			
Export surplus (+)	2,000	1,000	3,000
Long-term financing (−)	−2,000	−1,000	−3,000
U.S. deficit (−)	0	0	0
IV. Distribution (II) corrected by a cut in U.S. aid (with 1/2 the cut falling on U.S. exports).			
Export surplus (+)	1,500	500	2,000
Long-term financing (−)	−1,500	−500	−2,000
U.S. deficit (−)	0	0	0

Representative REUSS. Mr. Klopstock.

STATEMENT OF FREDERICK H. KLOPSTOCK, MANAGER, RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. KLOPSTOCK. Mr. Chairman, it is an honor and a privilege to appear before this distinguished subcommittee which is making such a valuable contribution to international economic analysis.

We at the Federal Reserve Bank of New York have been conducting very extensive research studies on international capital movements, as I testified before the parent committee of this subcommittee last August.

I am happy to say that we have reached similar conclusions as were just submitted by Professor Kenen.

We have found that interest rate changes in our money and loan markets relative to those in major foreign financial centers have a marked and prompt effect on capital flows from and to the United States. This conclusion emerges not only from a careful analysis of the capital movements statistics gathered by the Federal Reserve banks as agents for the Treasury Department. The lessons of experience confirm this conclusion as well. During the past year it has been brought home to our monetary authorities as they became increasingly active in foreign exchange markets that virtually each component of our short-term capital movements is in some measure affected by variations in international interest rate differentials.

In studying the role of international interest rate disparities for our balance of payments, we must examine a broad range of short-term capital movements. There are, first of all, the very sizable loans extended by banks in the United States to foreign banks, foreign corporations, and to foreign governments and central banks. Acceptance credits opened their credit lines to foreign banks are another important category.

Occasionally financial institutions other than banks are also major suppliers of short-term funds. Insurance companies and other nonbank financial intermediaries are often ready to provide funds to foreign borrowers, notably in Canada. And nonfinancial corporations in recent years have been placing very sizable short-term funds abroad. Four major categories of corporate outflows come to mind: Mercantile credit to customers abroad, funds to finance current operations of affiliates in foreign countries, investments in foreign money markets, and U.S.-dollar time deposits in foreign banks.

The transactions abroad on the part of individual private investors should not be overlooked. Some of their transfers are prompted by attractive interest rates paid by banks and other acceptors of funds in third countries, again notably in Canada.

Turning to inflows of foreign private capital into the United States, we find again a broad range of distinct ownership categories, different motivations for fund transfers and quite a few investment media. Foreign commercial banks and corporations are important investors in our money market and place time deposits in our banks. Some foreign banks, notably those with agencies or branches in this country, make loans to U.S. security brokers and dealers. Very sizable dollar balances are employed for investment in the so-called Euro-dollar market in which banks and corporations abroad place at relatively attractive interest rates dollar balances with foreign banks that then make use of these balances for a large variety of purposes. On occasion, notably during periods of relatively tight money market conditions in this country, foreign banks tend to make loans to U.S. corporations, often under participation agreements with U.S. banks.

In examining the evidence on the relationship between interest rates disparities and capital flows, several considerations need to be kept in mind. First of all, the published statistics on short-term capital movements reported by banks pertain to month-end and those reported by nonfinancial corporations to quarter-end positions. Interest rates during the intervening periods may change considerably, and there is little information on the actual yield earned on short-term investments abroad.

We do not know the proportion of foreign money market investments on which the exchange rate risk has been covered nor do we know much about the actual cost of this cover for the transactions that have been entered into. And yet these factors affect importantly investment decisions. Flows that are initiated and reversed during the period between two subsequent reporting dates are not reportable. And there are good reasons for the belief that many reportable investments escape our statistical dragnet, despite the continuous efforts to improve our reporting system. In view of the foregoing considerations, the failure of some investigators to find significant correlations between interest rate series and capital flow series need not evoke surprise.

In an article entitled, "Short-term Capital Movements and the United States Balance of Payments," which appeared in the July 1962, issue of our Monthly Review, we drew attention to some of the forces that affect short-term international capital flows. We demonstrated in this article that while many such flows are related to the needs for financing international trade, the decision of foreign importers and exporters as to where and how much to borrow are influenced by international differences in interest rates as well as by the relative availability of loanable funds in different centers. We also discussed in this article extensively various types of transactions initiated by investors in response to international interest rate differentials.

Our work has been carried forward to a point where we can set forth with confidence some additional conclusions with respect to some major interest-rate induced capital flows of recent years that have left their mark on our balance of payments. For instance, we have found that in periods characterized by relatively low interest rates in our money market and relatively low demand for domestic business loans, the two dozen banks in the United States that are actively engaged in extending loans abroad are increasingly ready to accommodate foreign banks and other borrowers and tend to add heavily to their foreign commitments. In periods of high interest rates and strong domestic loan demand, on the other hand, bank-induced flows of short-term funds to foreign borrowers generally rise much more slowly and at times even decline.

We have taken another close look at the significance of the Euro-dollar market for our balance of payments. There are several indications that growing amounts of U.S.-owned funds are reaching this market, notably through time deposits denominated in U.S. dollars placed by U.S. corporations in the Canadian chartered banks. It appears that these deposits which are induced by the substantially higher time deposit rates paid by the Canadian banks now amount to more than $400 million. Other outflows of funds owned directly or beneficially by U.S. corporations have gone into the Euro-dollar market. There are, thus important offsets to the beneficial effects of the market on our international financial position. As pointed out in my earlier testimony, the emergence of the market has been helpful in that it has added to incentives for foreigners to acquire dollars, obviated some outflows of U.S. capital for the financing of U.S. exports and tended to lower interest rates in Europe. Against these benefits must be set the fact that the market has set into motion forces making for outflows of U.S. capital.

With respect to the financing by U.S. banks of international merchandise movements, I should like to draw the attention of the subcommittee to statistics derived from monthly surveys by the Federal Reserve Bank of New York of acceptances made for the financing of shipments of merchandise from one foreign country to another foreign country. These acceptances, based upon goods shipped between foreign countries, have risen from less than $250 million at the end of 1959, when our interest rates were much higher than presently, to as much as $912 million at the end of August 1962.

This type of credit which, I should like to repeat, does not involve the financing of exports of U.S. goods, is highly responsive to relative credit conditions here and abroad because in many cases the foreign suppliers and buyers of the merchandise can easily turn to their own banking system for credit. That they chose in recent years to such a substantial extent the alternative of drawing bills on U.S. banks that they then sold in our market for prime bankers acceptances, provides proof that relatively low interest rates in our money market induce foreigners to obtain funds here rather than in money and loan markets abroad that are easily accessible to them.

There is a great deal of additional evidence suggesting that during the last few years capital movements affecting our balance-of-payments positions have become more volatile and more sensitive to credit conditions here and abroad. For instance, reported U.S. holdings of British and Canadian money market paper reached a maximum of about $500 million in the spring of 1961. Such sizable investments—and additional investments probably remained unreported—reflect the fact that U.S. corporations are becoming more perceptive of the opportunities of interest rate arbitrage operations. Recent reports of heavy movements of funds of U.S. corporations into the Canadian money market provides further evidence of the willingness of corporation treasurers to take advantage of higher interest rates in foreign money markets. Actually, covered interest rate incentives required to induce outflows of funds from the United States are substantially less today than in years past, according to knowledgeable observers.

Among other corporate outflows subject to the pull of interest rates are the financing of customers and affiliates abroad. A credit squeeze in foreign countries is quickly reflected in demands from foreign countries for more extended payment terms. Similarly, high interest rates abroad tend to induce many corporations to finance in the United States the working capital needs of their foreign subsidiaries. If yields of money market paper in this country are low, corporations are often prepared to transfer surplus cash reserves to their affiliates so as to put them in the position to repay loans from foreign banks which carry high rates of interest.

Turning now to short-term movements of foreign capital into and out of the United States, it can be easily demonstrated that interest rates play a decisive role in attracting foreign funds to our shores. In 1959, when interest rates for some types of paper traded in our money market rose to close to 5 percent, there occurred a massive movement of foreign liquid holdings into our money market. By January 1960 foreign banks and corporations held approximately $2 billion of investments in our money market against less than $1 billion at the end of 1958. As interest rates dropped in 1960, foreign funds were withdrawn from our money market on a large scale. It is true that total foreign private balances held in this country did not fall significantly, but this was due to relatively high interest rates paid for dollar balances in the Euro-dollar market and the operations of agencies of foreign banking corporations in our call loan market.

During periods of strain, numerous countries have used interest rates as a tool to alleviate balance-of-payments pressure. This policy has usually proved highly successful for the simple reason that interest rates affect the international flow of short-term capital.

I believe all these considerations point to the conclusion that interest rate changes are indeed of very sizable importance for capital flows from and to the United States.

Thank you, Mr. Chairman.

Representative REUSS. Starting with Mr. Klopstock, I have read that article in the July 1962 issue of the New York Fed's Monthly Review entitled "Short-Term Capital Movements in the U.S. Balance of Payments." As I read it last summer, I found it a considerable embarrassment to the position of Chairman Martin and the Fed down here, because it seemed to be underwriting the premise on which they were shouting for higher and higher interest rates.

I am sure that your paper today will remove any embarrassment they might have had.

But just between you and me, what you have told us today is close to 180° different from what you were telling us last July, is it not?

Mr. KLOPSTOCK. Well, I would not agree, Mr. Chairman.

Representative REUSS. How many degrees difference is it?

Mr. KLOPSTOCK. I would say none.

As I just pointed out, in that article we did say that the decision of foreign importers and exporters as to where and how much to borrow, these decisions are influenced by international differences in interest rates. That was part of that article.

Representative REUSS. You went on, however, to say that really movements for speculative reasons and in aid of exports were much more important as far as you could determine.

Mr. KLOPSTOCK. Well, we did say in that article that a substantial amount of U.S. bank loans finance U.S. exports and imports—that is certainly true. But we did not mean to say, when making that point, that these exports could not have been financed somewhere else. Substantial amounts of American exports are in fact financed in foreign countries, whenever foreign importers have access to cheaper sources of credit.

In fact, a growing proportion of U.S. exports to Europe have been financed in Europe for the simple reason that some balances, based on funds obtained in the Euro-dollar market, have been employed for credit extensions at somewhat lower rates than have been available in the United States.

I think this point proves that the decision as to where to finance American exports is to a substantial extent determined by interest rates differentials.

Now, I know, Mr. Chairman—I read your comment in the Congressional Record—that you disagree, but in my view the fact that there is a large amount of financing of U.S. exports does not prove that this financing is non-interest-rate sensitive.

Representative REUSS. I gather from your concluding remarks that your policy recommendations would be higher interest rates in this country right now to alleviate balance of payments pressures, is that right?

Mr. KLOPSTOCK. No, Mr. Chairman, I would not like to make such a positive recommendation. All I would like to do is to point up the importance of interest rates for capital movements, and the need to take this fact into account in any policy decisions.

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Representative REUSS. What do you think of Mr. Bell's suggestion for vitiating the magnetic effect of interest rate differentials by widening the gold points?

Mr. KLOPSTOCK. Well, I have not studied this particular problem in great detail, but instinctively it does have very little appeal to me, I would say.

Representative REUSS. Why is that?

Mr. KLOPSTOCK. Primarily because widening of the range of exchange rate fluctuations would be a major obstacle for U.S. exporters and importers, and for conducting international trade in general.

International traders need a fixed point of reference in exchange rates.

Representative REUSS. Well, there is now a one-half of 1 percent area—one-quarter of 1 percent either way—within which we may move. The suggestion is that this be widened to a total of 1 percent—one-half of 1 percent either way?

Mr. BELL. One percent either way is what I suggested, yes.

Representative REUSS. At what point do you think the commercial community would start falling apart?

Mr. KLOPSTOCK. Well, it is difficult for me to say, but I believe the less the fluctuations, the better for the commercial community, quite obviously. Any large fluctuation of exchange rates means added risks for the conduct of international trade and discouragement to industry, which has often an alternative to sell at home, to enter into international transactions.

Representative REUSS. Let me turn to Mr. Kenen. In a couple of sentences in your paper, Mr. Kenen, you say,

> It would, of course, be tragic if the United States had to buy cooperation from other governments by adopting monetary policies that brought back payments balance at the expense of full employment and to the detriment of the less developed countries. But our friends at the OECD understand this danger, and our friends at Basel surely see it, too.

I want to explore these two sentences with you.

By our friends at Basel, I take it you mean the BIS.

Mr. KENEN. I meant to identify the regular meetings of the central banks, not just the Bank for International Settlements itself.

Representative REUSS. Yes. Now, both the OECD and the BIS have, within recent months, advised the United States to tighten money and raise its interest rates, both long-term and short-term, in order to combat the alleged effect of interest rate differentials on short-term capital movements.

They have accompanied this advice by urging us to run fiscal deficits.

In the light of this advice, I cannot quite understand why you are so sure that our friends at OECD and our friends at Basel understand all this. I will grant you they are our friends and I will grant you they are nice guys. But they have been advising us to adopt a restrictive monetary policy. The only sense I can make out of a restrictive monetary policy is that it will keep us from getting to full employment.

Mr. KENEN. Mr. Chairman——

Representative REUSS. What is the basis of your confidence in their understanding?

Mr. KENEN. Mr. Chairman, you are clearly more familiar with the detailed text of the OECD statements and the BIS report than I am at this moment. It is my recollection that they urged an expansive policy in the United States to be accomplished by an easier budget policy. I do not recall a specific recommendation that we raise interest rates above their present levels, especially that we raise short-term rates. And I do not regard the present level of interest rates as being unduly restrictive. Mr. Roosa's statement this morning, the statement that was presented for the record, gives fairly substantial evidence to this effect. We do not really have a tight monetary policy—though we could obviously ease our monetary policy.

Representative REUSS. But Basel, the BIS, urged us to tighten it. They want higher long-term interest rates. They cannot get much higher short-term interest rates, because everybody, liberal and conservative, in this country is already hell bent for raising them, for some reason. But on long-term rate, there is a dispute on, and there Basel and Working Party No. 3 of OECD are unanimous. They want higher long-term interest rates.

Now, did you have that in mind when you talked about their understanding of our——

Mr. KENEN. I can only concede that their perception is less perfect than I had supposed.

Representative REUSS. Do you, Mr. Kenen, have any comment on Mr. Bell's suggestion having to do with the gold points?

Mr. KENEN. I have, sir. I made a similar recommendation before this committee in its hearings a year and a half ago. But I put the point a little differently.

I was more concerned about the narrow spread on the exchange rates—and I distinguish now between the exchange rates and the Treasury's gold points. The narrow spread on the sterling-dollar exchange rate, for example, may make it difficult to manipulate or to operate on the forward exchange rate so as to offset interest differentials. There is a limit to the forward premium or discount that one can induce, as long as the spot rate is confined within a very narrow range. It was for that reason that I urged a wider spread on the exchange rates.

As to the gold price itself, I cannot see a great advantage in changing the price at which the Treasury buys and sells gold vis-a-vis other central banks. But I should certainly like to see a wider range for the London free market gold price, for the reason which Professor Bell mentions, that this would deter speculation. It is, I think, a very strange situation we face at present. The London gold price has moved no higher than about $35.20 this last year. It is kept within a narrower range than the exchange rates themselves.

So I would surely support a recommendation that exchange rates be free to move over a slightly wider range than at present, and also that the free market price of gold be allowed to move more widely. If you do those two things, there is not much more advantage in changing the Treasury buying and selling rate for gold. You will have accomplished most of the same market changes you would want to make by changing the official price.

Representative REUSS. Mr. Bell, would you like to comment on that?

Mr. BELL. I just raise the question as to how one is going to affect the free London market for gold—one of the ways one can affect that would be by changing our buying and selling rate. So I think we would have the same objective. How would you affect the free gold price in London?

Mr. KENEN. Well, the London gold price is contained within a narrow range only because the Bank of England intervenes in the market, buying and selling gold on its own account and for the account of other central banks, or jointly with other central banks.

I envisage a situation in which it did not intervene at, let us say, $35.20, but let the price move to $35.25 or $35.30, and likewise on the down side. It should allow the price to move more freely.

Mr. BELL. There is nothing the United States could do without getting England to do it, in effect.

Mr. KENEN. In this particular case, there is, and would continue to be, close cooperation. After all, this is a joint operation, and much of the gold involved is Treasury gold. At least that is my understanding.

Representative REUSS. Well, let me see where they are.

On the effect of interest rates on capital movements, Mr. Klopstock thinks the effect is very important. Mr. Kenen thinks it is important, but somewhat less important. Mr. Bell's findings he regards as inconclusive, but says whatever the effect, the policy action should not be the raising of interest rates, but instead, neutralization by fiddling with the gold points.

Mr. BELL. Well, Mr. Reuss, in the monograph that I wrote for the Joint Committee, I tried to do an extensive survey of interest rate effects on short-term capital movements, and there is a whole set of appendixes on what I was able to find statistically. Actually, I think that Mr. Kenen's and my results come to be pretty similar. I can only find one type of short-term capital outflow which is clearly related to—in this case, covered interest arbitrage, and that is the flow of short-term banking funds vis-a-vis London. And at a maximum it has been around $200 or $300 million, from top to bottom.

I suspect that the higher Eurodollar rate—and Mr. Kenen's findings support this—has some influence on certain other types of short-term capital flows. But it is hard to document statistically. My point would be that a large part of those short-term capital outflows go into the Eurodollar market. No one knows how much this is, nor for what, precisely, these funds are used, but Mr. Altman's paper, which is also published by this subcommittee, indicates that he thinks—and he is the world's expert on the Eurodollar market, I think, now—that a large portion is, in fact, financing U.S. exports. To that extent these funds may not have adverse balance-of-payments repercussions.

What I tried to show in my paper was that some of our exports to Europe which were being financed here in this country are probably now not being financed in this country with U.S. short-term capital, but rather are being financed by the Eurodollar market which is supported by U.S. funds.

So there has simply been a substitution, and it really has not had a net balance-of-payments drain, even if it is interest rate motivated.

Mr. KENEN. Mr. Chairman, I wonder if I may make one further comment on this point.

Some people are reluctant to concede the importance of interest rates because they feel that this finding calls for a tight monetary policy—that one must consequently tighten up on domestic credit to the detriment of our own employment position. I do not think that necessarily follows.

One can, I think, concede that interest rates matter in some parts of the capital account, some parts of the short-term outflow and some parts of the long-term outflow, without necessarily prescribing higher interest rates.

To know how much interest rates matter is merely to know what we pay, what the costs are, of pursuing one policy or another. It may follow from these findings that a tighter monetary policy is a more appropriate way of handling a payments deficit than, let us say, restrictions on imports or tying foreign aid.

It may also be the case—I think it is the case—that the price on the balance of payments of a tight interest rate policy is very small compared to the costs at home in high unemployment.

Let me clarify that point. I am afraid my sentence got mixed up.

Representative Reuss. You do not mean the price—you mean the advantage.

Mr. Kenen. That's right.

Let me put it this way: The domestic cost of pursuing a restrictive monetary policy would be excessive as compared with the benefits on the balance of payments.

My point is that though interest rates matter, though they do cause capital movements, our reserves are adequate to handle these capital movements and the disadvantages for domestic employment are such that we certainly cannot afford a tight-money policy.

The statistical finding and the conclusions that Mr. Klopstock summarized earlier do not imply that we should necessarily follow a restrictive interest rate policy.

Representative Reuss. I am in complete agreement with that. This is what I wanted to pursue with the panel.

Let us assume that interest rate differentials do have something to do with capital movements. How much, is a matter of argument. But they have something to do with them.

Do we therefore give up and say, "Well, let's have high interest rates so as to protect our balance of payments at the expense of the domestic economy"? This would be in my opinion shortsighted, indeed, since you are letting a $2 billion tail wag a $600 billion dog, if you do that.

So the question is, What do we do about it? Do we let our balance of payments "go to pot," assuming that is what is going to happen?

Well, that isn't a very edifying alternative, either.

This brings us to whether there are not alternatives which let us have a large part of our cake and eat it, too.

Mr. Bell has suggested one possibility; namely, widening the gold points; and we have discussed that.

What can members of the panel say about another alternative in lieu of exposing ourselves to disastrous consequences from differential interest rate; namely, some sort of a payments agreement between the large industrial countries. Would this be better than the ad hoc temporary, rather limited currency swaps and forward exchange operations than we have now. If, for example, the OECD countries, or many of them, had in existence an arrangement like that which the European countries were perfectly willing to adopt in the 1950's, a payments union arrangement, then you would really not have to fear the discombobulating effects of short-term capital movements brought about through differentials in interest rate. Some day they would come back, and meanwhile each outflow would be matched by an equivalent cover from the country to which the flow occurred. What about that?

Mr. BELL. To some extent——

Representative REUSS. Shouldn't we get busy and put such an agreement into effect, or at least put it squarely at the door of our trading partners, that this is what they ought to do, rather than forcing us to have a depression and recession here in order to pay for our being the world's banker?

Mr. BELL. To some extent foreign central banks, Mr. Chairman, have indeed been offsetting the arrangements by which foreign commercial banks are sending their own funds which were in the United States back home, or elsewhere abroad.

Representative REUSS. You mean by holding more dollars?

Mr. BELL. Yes, they have been holding more dollars.

I have my briefcase over there, but I won't get it—if you take a chart which shows the ratio of dollars held by foreign banking systems as a whole relative to gold from 1952 to 1961, it is almost a perfect linear fit—a few points are just a little bit off—but it is really a remarkable line, running right from the origin on up through the years.

Representative REUSS. They have been holding more dollars in a higher percentage.

Mr. BELL. The central banks have to a very large extent offset the commercial banks switching things around.

Representative REUSS. But here is the vital difference between that and the arrangement which I would like to see. There is no advance assurance under the present system that they are going to do that. Hence we hover always on the edge of a recession here, because we are afraid to have expansionary fiscal and monetary policies.

So really all we need to do is ask the Europeans to do what they are going to end up doing anyway, but to tell us beforehand that they are going to do it.

Mr. BELL. Yes, I would agree.

Representative REUSS. Then all this is "hunky-dory," isn't it? We don't have to worry about interest-rate differentials as long as countries pursue noninflationary domestic practices.

Mr. BELL. In general I would agree with that. It does not really follow, however, that when short-term capital goes out, even if it starts out to be short-term capital for interest arbitrage, that it is going to come back to this country when a widened interest-rate differential narrows again. It may turn into long-term capital and stay overseas, very easily. So I do not look at this is a pool floating back and forth across the Atlantic. This sort of agreement would not prevent that. It could go and it might stay, the funds moving into longer term securities, or direct investment, or anything else.

So I would prefer my way of not letting it get started, shall I say, by widening the gold points.

But certainly, yours would be another alternative. I do not think mine is radical, myself. It is something already practiced by other countries and it is really a rather mild approach, I would say.

But if we could get extensive agreement along your lines, that would certainly be a good alternative which would allow us some flexibility.

Representative REUSS. Let me ask you a couple of questions on your gold points. This could not be done unilaterally; it would have to be done under the aegis of the IMF.

Mr. BELL. That is correct, sir.

Representative REUSS. And hence would require the agreement of our trading partners?

Mr. BELL. Well, except we have a major voting stock in the IMF.

Representative REUSS. But under IMF procedures, these would have to be followed.

Mr. BELL. Yes, sir.

Representative REUSS. Secondly—I should know this, but I do not—it would take an amendment of the the act of Congress to 1935, would it not? Didn't that say $35 an ounce—period?

Mr. BELL. I did not realize that, if it did. It would not take an amendment to the IMF. It is not in the basic articles of agreement; it is in a rule put in in 1947, unless it has been changed, and I don't think it has. I must say, I would not know if it would take an act of Congress in this case simply to widen the gold points. I will look it up.

Representative REUSS. Let's pursue this discussion, which I will recapitulate once again, as follows:

Interest rate differentials we have agreed may cause short-term capital to move around. The interest rate approach, namely, raising U.S. interest rates, particularly at long term, would have a detrimental effect on our domestic recovery. An attractive alternative would be an agreement by our trading partners along the lines of the European Payments Union agreement of the 1950's to cover the short-term capital movements caused by interest rate differentials, as opposed to short-term capital movements caused by bad domestic practices, inflationary or whatever.

Mr. BELL. Mr. Chairman, you slipped there into talking about the long-term rate of interest versus the short. I think that——

Representative REUSS. I want to talk about both.

Mr. BELL. I see. Because I believe—if I am not mistaken—that Mr. Klopstock is really talking almost entirely about short-term rates of interest.

Mr. KLOPSTOCK. Yes.

Mr. BELL. And I think that the Federal Reserve of Philadelphia has just published an article on the effects of interest rates on long-term capital movements, in the latest issue of their bulletin, which in effect says that long-term interest rates do not have any significnant effect on long-term capital flows. And my study would seem to indicate the same thing, except that possibly the timing of the flows may be affected by the long-term interest rate.

Thus, so far as long-term rates are concerned, I do not think that anybody—they have to speak for themselves—I do not think anybody would be recommending raising long-term rates of interest in this country.

Representative REUSS. However, here our friends at Basel reenter the picture.

Mr. BELL. But the latest OECD statement which was reported in the paper this morning did not mention either long- or short-term interest rates.

Representative REUSS. That is true.

Mr. BELL. They may be changing their minds, we hope.

Representative REUSS. Let's hear Mr. Kenen on the proposal to insulate our short-term capital movements induced by interest rate differentials by some sort of a payments agreement. Thus before rather than after the fact we would have assurance that our losses would be covered.

Mr. KENEN. I would certainly agree that such an arrangement, or something very much akin to it, is needed.

I remarked in my opening statement, Mr. Chairman, that we seemed to be moving in a similar direction—one in which credit arrangements of one kind or another begin to take the place of reserves, either of growth in reserves or of reserves in use. That is to say, drawing on international credit agreements or on other central banks are an alternative way of financing one's payments deficit—an alternative to selling gold or piling up dollar liabilities.

As I say, we have begun to move in that direction.

But we have to mave very much further and very much faster than we have. For one thing, as you yourself pointed out, we need the assurance that we can draw on these credit arrangements. As things now stand, there is a risk that we will be refused or that the credits will not exist in proper size and at the proper time. They must be consolidated, they must be made more permanent, more automatic, and I think they must be made larger.

I have in mind not only the bilateral arrangements between the central banks, but also the Vienna agreement involving the major IMF countries, whereby they will supply additional finance to the International Monetary Fund so that it can aid a deficit country.

I think all of these are steps along the way which you have yourself suggested. But we have to consolidate them, we have to make them larger, and we have to make them much more fully automatic.

I hope Mr. Roosa's statement this morning, in which he described the difficulties of extracting credit from surplus countries, does not imply that we have given up our efforts to extract such credit.

Representative REUSS. I like all your conditions and qualifications there. There is one more, however, which I suggest belongs in your checklist. That is if it were done, 'twere well 'twere quickly done, because right now is when we need this protection, in the next 1 or 2 or 3 years.

Mr. KENEN. I quite agree.

Representative REUSS. I do not know how you ever are going to get it unless you ask for it. You may not get it then. But you certainly are not going to get it unless you do.

Mr. KENEN. We must ask for it. And I think we can get somewhat more than we have already. It will take a lot of effort and we will run into resistance in some places. I hope it won't be Basel. But it does have to be done quickly.

Representative REUSS. Mr. Klopstock, if you care to comment on this whole matter, I will be delighted to hear you. I know that you may, for one reason or another, prefer not to.

Mr. KLOPSTOCK. Well, all I want to say really is today there is a large series of arrangements which actually produces quite similar results. I would like to point to the various swap arrangements of foreign central banks that make it more attractive for commercial banks in their countries to invest in dollar assets, to move domestic funds into the dollar market, the Euro-dollar market, or into our own money market.

I would also like to point to the operations of the U.S. Treasury in the forward exchange market. For instance, its forward sales of Swiss francs—so as to make it more attractive for Swiss banks and Swiss investors to go into dollars, to acquire dollars, and to remain in dollar assets—measures of that nature have had the effect of adding to the dollar holdings of private foreigners, and have offset some of the capital outflows that have taken place from the United States.

Representative REUSS. I do not want in any way to seem ungrateful for the swap arrangements, and other mutual support arrangements which have been made. But the fact is that typically they run for 90 days or 6 months, and they involve $30 million here, $50 million there. They are for relatively small amounts. The proof of their inadequacy, I suppose, is the fact that today it still is the conventional wisdom to say that this country cannot, in its interest rate policy, do that which it would otherwise do to bring about domestic full employment and maximum growth. It seems to me that only by making more general, more multilateral, and more automatic, and getting down on paper a much broader system of payments agreements than we now have, can we give ourselves elbow room in domestic monetary policy.

Would you agree that we have not reached that state yet?

Mr. KLOPSTOCK. We have not.

Representative REUSS. And certainly from the standpoint of full employment and maximum growth at home, we ought to reach that state, ought we not? I trust nobody enjoys not having the ability, as we apparently do not have it now, to do everything in fiscal and monetary policy that needs to be done to restore full forward movement.

Mr. KLOPSTOCK. As you know, Mr. Chairman, our monetary authorities do feel that our interest rate policy has not been an obstacle to economic growth in the United States.

Representative REUSS. I know that is what they feel. I won't go into whether everyone agrees with them as of now or not. But the suggestion is being made that if we loosen up our fiscal policy by a tax cut, let us say, that we then ought to tighten monetary policy somewhat. That has been Mr. Martin's testimony. He has said that he does not want to finance the deficit by Federal Reserve credit. He wants it financed, he says, out of real savings. Well, that obviously means tighter money.

The BIS says tighter money. OECD Working Party No. 3 says tighter money. All the bankers say tighter money. So this is not just a minority view. This is quite importantly stressed.

Mr. KLOPSTOCK. I agree.

Mr. HUMPHREY. I have just one question, if I may. Talking about the contingent outflow of capital, Mr. Bell referred to the building up of working balances abroad. Is this a once and for all? The trend may be upward, but have we had a bulge in the trend that we are sort of over, that is, that the job is finished of building up working balances now?

Mr. BELL. I would not, Professor Humphrey, say that now they will level off. But I think there was a substantial bulge following convertibility in 1958. That relates to some extent to something Mr. Klopstock has pointed out here—that in 1959 it does so happen that interest rates in the United States were high, and they went down in 1960. The outflow—the inflow of foreign funds in particular to this country, and some outflow of funds, it seems to me, may be just as much related to the establishment of convertibility as to interest rates. This was a big change. And so we did get a bulge following that.

I suppose that the size of working balances should be expected to continue to increase as activity continues to increase, but not with the sudden spurt that happened with convertibility.

Mr. HUMPHREY. Is it your impression that the same thing would apply to the long-term—was a substantial part of this getting back into business, filling in a backlog, from having been kept out by exchange controls, lack of convertibility?

Mr. BELL. There was a large inflow of long-term funds from Europe in the year 1959. Some of it went into U.S. Government securities, some of it went into U.S. corporate securities. And there is every reason to believe, I would say, since there was no marked change in interest differentials actually at that time anyway, that this was caused primarily by working balance needs—Lloyd's Insurance Co., with a lot of U.S. risks, could now keep more U.S. dollars, for example, and other such companies which wanted to diversify anyway, but were restricted by nonconvertibility until that time, could now freely diversify.

Mr. HUMPHREY. Do you have any dissent, Mr. Kenen?

Mr. KENEN. Well, only to say the building up of working balances probably worked more in our favor than against us. I find it more difficult to identify working balance needs or working balance patterns in the buildup of U.S. claims on foreigners—that is to say, in the short-term capital outflow of the last several years. One can see something of a hump of this kind in the direct investment figures, more so than in the short-term capital or portfolio figures. In direct investment, there was something of a catching up process movement of American corporate funds into Western Europe.

But as I say, the large volume of bank lending, the huge acceptance financing of the last couple of years, these things cannot be described as working balance patterns. On the one hand, one cannot extrapolate and say this lending will go on indefinitely. I do not think it will. On the other hand, one cannot say this is a once-over process that will not be repeated.

Mr. HUMPHREY. Now, just one last question on competitiveness and capital outflow.

We have had, you know, these various statistical studies showing, such as the evidence shows, some deterioration of our competitive position.

Would it be correct to say that with this large increase in capital outflow we needed to increase our competitiveness? In order to transfer the capital, with exports, to equilibrium in the balance of payments, did we need an increase rather than deterioration in competitiveness?

Mr. BELL. I am not sure that I get your point exactly.

So far as our competitiveness goes, if I may suggest it—it seems to me we still have to get the definitive study which would treat our export shares in particular third-country markets vis-a-vis the prices of exporters in these individual third-country markets.

I do not know whether this was brought out yesterday or not. But doing it on an aggregate basis, you still do not know whether switches in trade and switches in demand are the real cause, or it is a decline in competitive position. You have got to take certain key commodities and certain key export markets where we and the Germans and the Japanese and the British compete, and see what happened, and not do it across-the-board.

But so far as its relationship to long-term capital flows, I think that our direct investment did attract, along with it, some both long- and short-term portfolio capital. But I am not sure how I would relate it to competitiveness.

Mr. HUMPHREY. You do not see any reason to suppose that an increase in the competitiveness of the American economy today will in itself reduce the outflow of capital?

Mr. BELL. Oh, I beg your pardon—if that is what you mean—I have stated several times just exactly that, that I believe strongly that long-term portfolio capital flows, both in stocks and in bonds, as well as direct investment are in fact related both to the competitiveness of the American economy and to our general economic condition. And they seem to be more related to that than to interest rates. If we get our economy growing again as it should, we can slowly raise the short-term and the long-term interest rates, if we want to. I am sorry—I did not get your original point. I would agree, I think, wholeheartedly with it.

Mr. HUMPHREY. Thank you.

Mr. KENEN. I would certainly agree with both statements. I think that I made something of the same point when I said that a capital outflow is not necessarily a bad thing. It is a bad thing only if you cannot generate a sufficient surplus on current account to cope with it. And what that means, of course, is that you have to be more competitive, you have to sell more, and perhaps buy less, in order to finance a continuing capital outflow.

My own feeling is that the task is a two-part task. On the one hand, to increase our own current account surplus, so that we can cope with long-term outflows and the structural part of short-term outflows. On the other hand, to persuade our allies to take over a larger part of the long-term financing of foreign aid. Both of these things are needed. And any viable solution to the payments problem necessarily involves these two lines of action.

Mr. HUMPHREY. Just on that—I do want to get into very technical questions, but let's get this into the record.

We have a situation, two situations—one in which our allies make a greater contribution, and we make the same contribution. The second situation in which their increase is offset by a decrease in our contribution.

Does this have a significantly different effect on our balance of payments, these two?

In other words, if we hold the same level and they increase, is this going to help our balance of payments?

Mr. KENEN. If we hold to the same level of absolute cash transfers—this is what you have in mind—and nominal foreign aid, grants and loans, rather than the surplus on goods and services? This would depend, sir, on the character of the financing—whether it was tied to the exports of other countries or not. If, for example, the Europeans gave more foreign aid, but tied it to their own goods, it would not help us directly, although it might help us indirectly and marginally.

If, on the other hand, there was a larger volume of untied grants and loans in Europe, long-term public funds, and if any significant part of it went, let us say, to Latin America, one would expect, I think, a rebound—that is to say, an increase in demand for U.S. exports. If it went primarily to former British, French, and Belgian colonies in Africa, you would find a somewhat different pattern. Then you would find, as is traditionally the case, that most of the new foreign aid would be spent in Europe without very much benefit to us.

So it does depend on the composition as well as the terms of European assistance. But I cannot conceive of a situation in which more European aid, without a reduction in our aid, would hurt the American balance of payments. How much it would help is a matter of conjecture.

Mr. HUMPHREY. Would you care to comment on any of this?

Mr. KLOPSTOCK. All I really would like to say is that the United States, because of its great financial strength, the large savings that it generates, is a natural exporter of capital—a country in that position should be competitive enough to generate a sufficient current account surplus to finance its capital exports, and a prerequisite for that of course is a high degree of competitiveness.

Mr. HUMPHREY. Thank you.

Representative REUSS. Thank you, Mr. Bell, Mr. Kenen, Mr. Klopstock.

We much appreciate your contribution.

We shall next hear from a panel on the cost of having a key currency, in which Mr. Holmes, Mr. Houthakker, and Mr. Geiger will participate.

Will you step forward, gentlemen?

Welcome, gentlemen.

Mr. Holmes, will you begin?

STATEMENT OF ALAN R. HOLMES, VICE PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. HOLMES. Mr. Chairman, I have, too, a prepared statement which I would like to read.

Representative REUSS. Thank you. Feel free to do as you see fit.

Mr. HOLMES. The use of the dollar as a key currency played an indispensable role in the postwar rebuilding of a system of currency convertibility—a system characterized by growing international trade, the gradual removal of restrictive exchange controls abroad, and closer financial relationships among the leading countries. The dominant role of the dollar among the world's currencies, and the preeminence of the United States as an international financial center have provided many tangible and intangible benefits for the United States. More recently a number of problems stemming from the persistent deficits in our balance of payments have demanded increasing attention from the administration, from Congress, from the monetary authorities, and indeed from all segments of public and private life.

Unless the present efforts to eliminate the deficit in our international payments are successful, there is a danger that these imbalances will, by undermining the dollar as a key currency, threaten the viability of the international system that has been rebuilt since the war.

The emergence of the dollar as a key currency was not an event planned by governments or by the financial community or by international experts. It was the natural response to a real and obvious need—particularly in the earlier post-World War II period—for a source of international liquidity that would supplement the limited availability of gold and for a means of international exchange and settlement that would permit the freer international exchange of goods and services indispensable for a growing world economy.

President Kennedy—in addressing the International Monetary Fund last September—emphasized that "if the dollar did not exist as an important reserve currency, it would have had to be 'invented'." Fortunately there was no need to invent the dollar; it already existed and proved readily adaptable to the needs of the emerging international financial system.

It appears to be in the very nature of an international monetary system that, in bringing together individual monetary systems based on national sovereignty, one or two countries must be prepared to accept a special role for their currencies.

This in turn entails special responsibilities and offers special advantages. This is the role played by the pound sterling for so long. It is only fitting that the United States—which has assumed so many international political and economic responsibilities in the past 20 years—should also have a currency that plays a pivotal role in the international financial system. This is not to say that these responsibilities cannot be shared—as they are—through various measures of international cooperation. In fact one of the most encouraging developments of recent years is the growing international recognition that the maintenance of the dollar as a key currency is not the concern of the United States alone but of the entire free world, whose interest it serves.

It is possible to distinguish two separate phases in the postwar development of the dollar as a key currency. The first—in which the dollar can be described as a "nonmanaged" or spontaneous key currency—existed until a relatively short time ago and covered the period of European postwar reconstruction, the rebuilding of European international reserves, and the return to convertibility. The second—in which the dollar has become a "managed" key currency, buttressed by international cooperative efforts—is still in its formative stages, with its main lines of development only gradually emerging.

The "unmanaged" phase of the use of the dollar as a key currency covered the period when a prime objective of U.S. policy was the restoration of the European economies and their currencies and the marked reduction of restrictive trade and financial policies that openly discriminated against the United States. In order to liberalize trade and dismantle wartime exchange controls the European countries had to rebuild international monetary reserves. The deficits in our balance of payments—incurred partly as the result of our liberal aid program—allowed them to do so.

If the dollar had not served as a key currency and if dollar balances had not been in demand as international monetary reserves, the course of postwar economic development might have been quite different. "Ifs" in history are always difficult, but the following figures suggest how widely different the outcome might have been. From 1951 to 1960 our cumulative balance-of-payments deficit amounted to about $18 billion. Less than $5 billion of these deficits had to be settled in gold, however, as foreign official dollar holdings were built up by about $9 billion, while, as exchange controls were relaxed, foreign private liquid dollar holdings rose by about $4 billion. Had the dollar not served as a key currency, we would have either lost the major part of our gold reserves or been required to abandon our assistance to the rebuilding of a strong Europe and our objective of a more liberal trade and payments system. We would have exported far less than we were able to do, and we might well have found ourselves today in a world where discrimination against the dollar was still the general rule. The more restrictive policies that we would have been forced to follow would have been harmful to our own prosperity and to that of the entire free world.

The use of the dollar as an international store of value thus gave the United States a degree of flexibility that would otherwise have been entirely lacking. There have been a number of subsidiary benefits to the United States as well, in the form of invisible receipts in our balance of payments from the services performed by the United States as an international financial center. If foreigners had not been willing to lend us "short term" so large a volume of funds, as a nation, we could not have afforded the buildup in U.S. private investment abroad. The flow of investment abroad has strengthened our long-run international position and is already resulting in an increased inflow of profit, dividend and interest payments from abroad.

Until a few years ago there was little reason for the United States to be concerned about its balance-of-payments deficit. With Europe eager to build up its monetary reserves, and quite ready to add to dollar holdings, moderate U.S. deficits supplied the liquidity that Europe was seeking. But once European reserves had reached a reasonably satisfactory level, the sudden increase in the U.S. deficit beginning in 1959 took on a new and different significance.

There is no reason to review here the many-sided effort that this country is making to right its balance-of-payments position. And there is no need to underscore the urgency of the effort, nor the need to see it through to a successful conclusion. Suffice it to say that the persistence of deficits, together with the presence in our money system of large amounts of foreign-owned liquid assets—both official and private—have exposed the dollar to the potential threat of large-scale conversions into gold.

I share the view of those who believe the real threat to the dollar stems from the continued balance-of-payments deficit and not from the key currency status of the dollar. To be sure, the existence of a large stock of dollar liquidity in foreign hands adds to the vulnerability of the dollar to speculative attack. But in the current phase, when the dollar has become a "managed" key currency, adequate defenses are being built up against such attacks. I refer, of course, to those international cooperative efforts that have included the active participation by the Treasury and the Federal Reserve in the exchange markets for the first time since the 1930's, the increase in International Monetary Fund resources available to the United States and to others in case of need, and the thorough discussion of national monetary policies by governments and central bankers through such forums as the agencies of the OECD, the Basle Meetings, and a host of other bilateral and multilateral contacts.

Even if the dollar were not a key currency, the United States would be subject to the discipline of the balance of payments from which there is no escape in the long run. The discipline would probably have to be even more rigid, moreover, since we would lose the degree of flexibility that we now have from the short-term financing of at least part of our deficits by the buildup of foreign dollar holdings.

There have been fears that an end to the U.S. deficit—the major source of international liquidity in years past—would bring in its train a liquidity shortage that would strike a crippling blow to the international financial mechanism. These fears are exaggerated. Liquidity depends not only on existing stocks of assets but also on credit availability. There have been ample additions to both bilateral and multilateral sources of international credit in the past 5 years, including the possibility of mobilizing funds at the point of need through interest-induced private capital flows. There is no reason to believe that these sources are presently inadequate, or that they could not be increased in case of need. In addition, the activity of the United States in foreign exchange markets opens new possibilities of avoiding a liquidity squeeze from U.S. balance-of-payments surpluses. For if the United States is willing to finance some part of the payments surpluses that may develop as corrective measures take hold by acquiring reserves of convertible foreign currencies, a new source (as yet immeasurable in size) of international liquidity can be counted upon.

There has been concern that measures designed to correct our balance of payments and to maintain the dollar as a key currency have been at the domestic cost of a high rate of unemployment, unutilized productive capacity, and a lower rate of growth than would otherwise have prevailed. The question can be fairly put whether, in our universal dissatisfaction with the performance of our economy and in the search for remedies, the domestic cost of international policy objectives has not been exaggerated. Has, for example, the Federal Reserve's concern over the balance of payments resulted in a restrictive policy detrimental to domestic expansion? While there can be endless debate of "what might have been," the facts bear out the conclusion that the Federal Reserve has followed an easy money policy longer than in the two preceding periods of recession and recovery. (The appendix includes a number of charts measuring the performance of several indicators bearing the Federal Reserve policy in the periods following recession troughs.)

In attempting to reconcile the domestic and international objectives of policy, the Federal Reserve has maintained an adequate supply of reserves to the banking system in order to encourage the business expansion. In supplying reserves, however, it has used techniques that minimize the risk of capital outflows by avoiding downward pressure on short-term rates. These techniques include operations in securities other than Treasury bills, the use of reserve requirements, and a more extensive use of repurchase agreements as a substitute for the outright purchase of Treasury bills. There has been close coordination with the Treasury's debt management policies which provided a major contribution through an expansion of the outstanding volume of short-term debt.

As a result, as chart 1 indicates, Treasury bill rates did not fall as low as they did in the 1954 and 1958 recessions, although I would note that they are at the present time substantially lower than they were in the comparable phase of the 1957–60 period of recession and expansion.

At the same time, the Federal Reserve has kept the commercial banks in a relatively easy position for over 2 years. Free reserves (chart 2), a widely used though somewhat oversimplified measure of the degree of ease in the banking system, have been kept at $400 million or over throughout the business expansion. In sharp contrast, free reserves declined sharply in the two previous periods of expansion to zero and then to negative free reserves of $400–$500 million.

More important than the free reserve situation has been the expansion of over 13 percent in commercial bank credit, including both loans and investments, during the current period of expansion, nearly twice the rate recorded in the comparable periods of the two previous periods of expansion (charts 3–5). While total loans have not moved as fast as in previous periods there has been a notable expansion of mortgage lending, while banks have expanded their investment portfolios, particularly in State and municipal securities. By this stage of the two previous business upswings, in contrast, banks had been forced to run off investments, mainly their holdings of Government securities. Again reflecting the lack of pressure in the banking system, liquid asset ratios of banks (charts 6 and 7) have remained at comfortable levels despite the tendency to move out, to extend mortgage lending and to take on a larger volume of municipal bonds. The fairly sharp dip down for November appeared mainly associated with the Treasury refunding operation; early December figures indicate a return to near October levels.

The behavior of the money supply, as narrowly defined to include demand deposits and currency in circulation, included in chart 8, has been less striking; a sharp rise in the past 3 months has brought the level close to the two earlier periods, but there had been some decline earlier in the year. But the lagging performance of the money supply occurred only because the public showed an increased interest in time deposits vis-a-vis demand deposits. When commercial-bank time deposits—which can be readily converted into money when needed—are added to money supply (chart 9), the picture is strikingly different. The total has increased at a steady pace throughout the expansion period at more than double the rate of earlier periods. The still broader measure of total liquid assets held by the nonbank public (chart 10), which includes short-term Government securities as well as other near-money substitutes, shows a similar, although less striking, pattern.

Thus, while the Federal Reserve has avoided excessive ease, its deep concern with the balance-of-payments deficits has not thus far involved a restrictive money and credit policy. There has been no curtailment of credit availability. And there is ample liquidity—both within and without the banking system—to finance further business expansion.

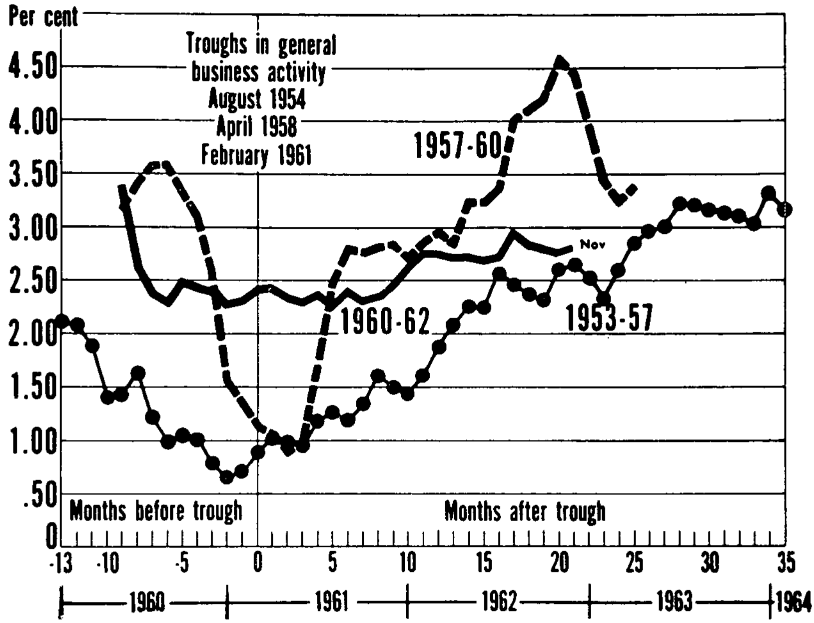
Thank you.

Representative REUSS. Thank you, Mr. Holmes.

(The charts referred to are as follows:)

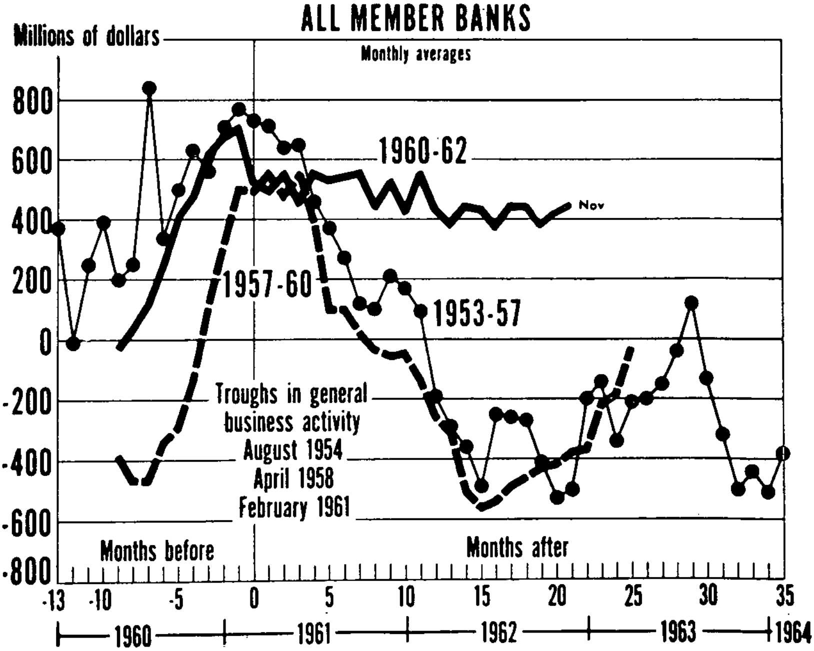
THREE-MONTH TREASURY BILLS ①

Monthly average, issuing rate



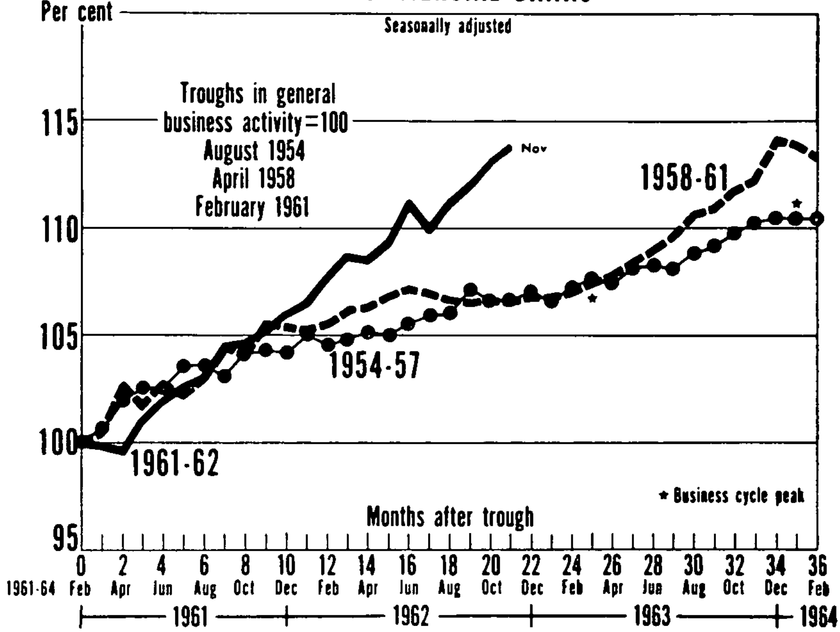
FREE RESERVES ②

ALL MEMBER BANKS



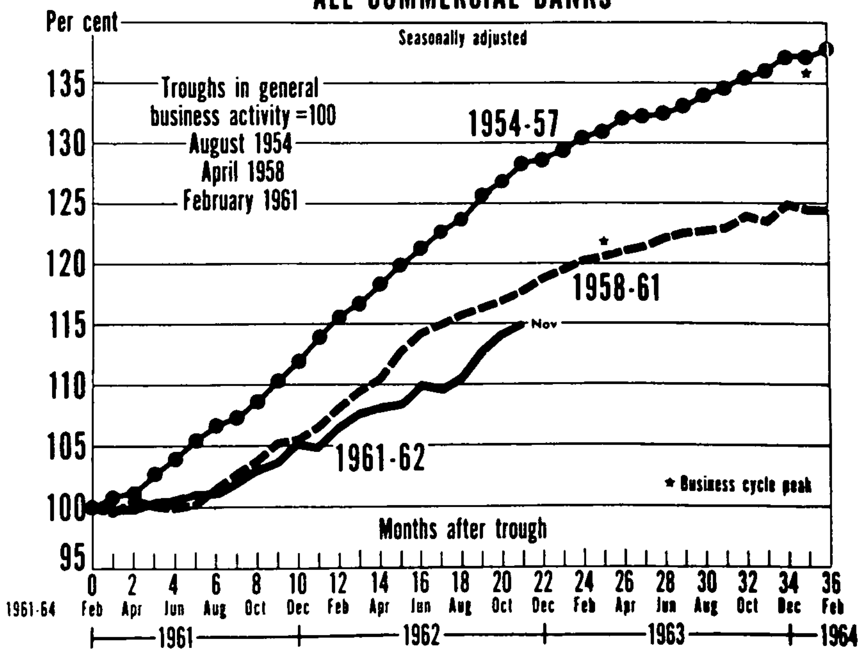
LOANS AND INVESTMENTS
ALL COMMERCIAL BANKS

③



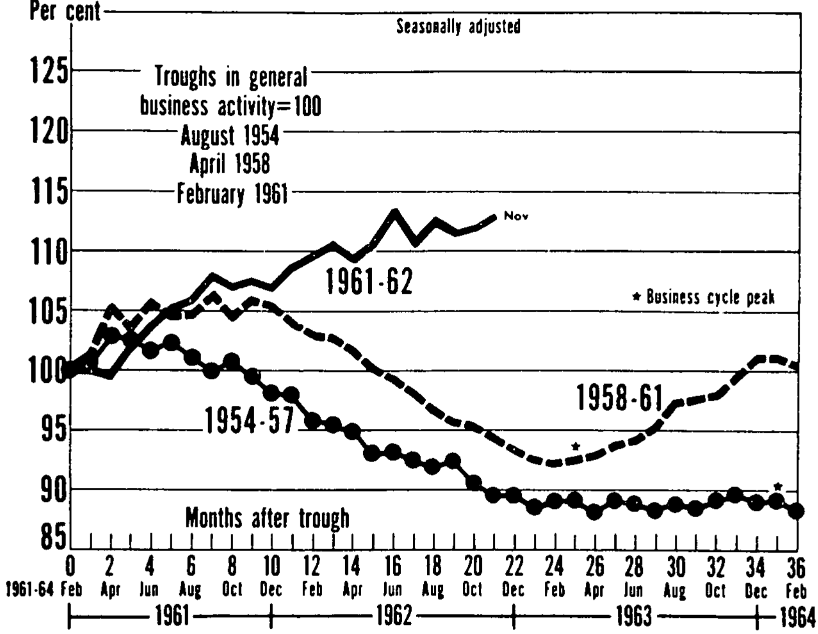
TOTAL LOANS-ADJUSTED
ALL COMMERCIAL BANKS

④



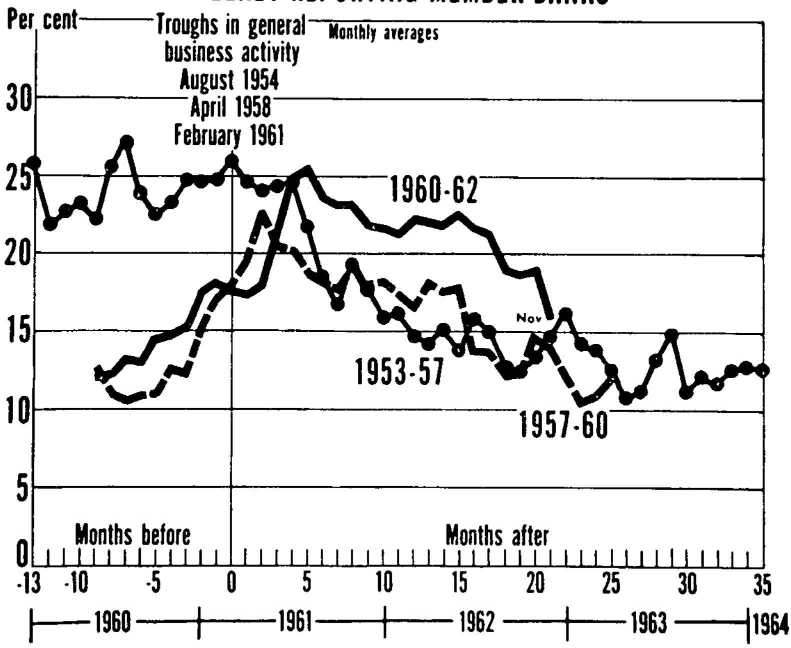
TOTAL INVESTMENTS
ALL COMMERCIAL BANKS

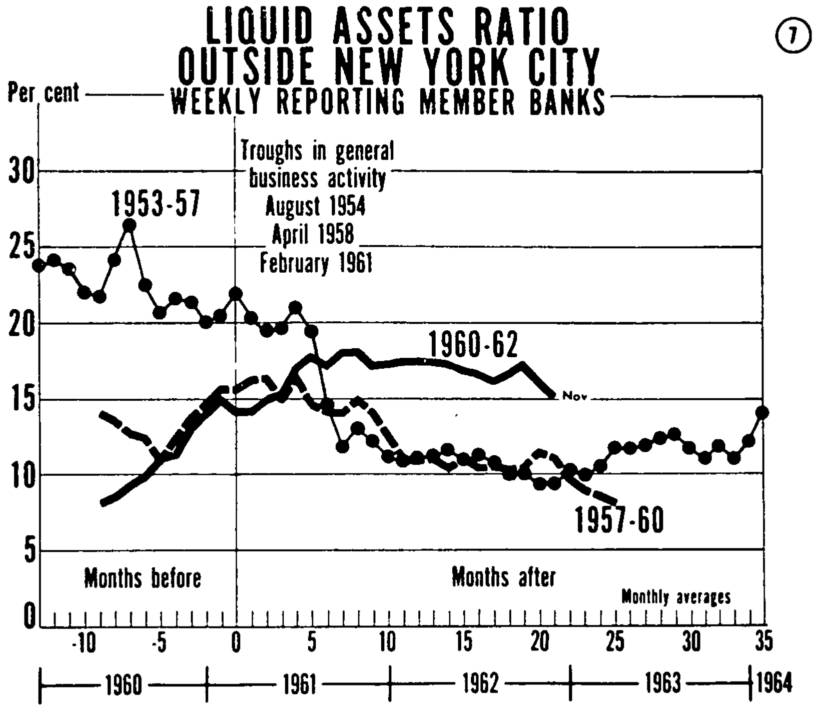
(5)

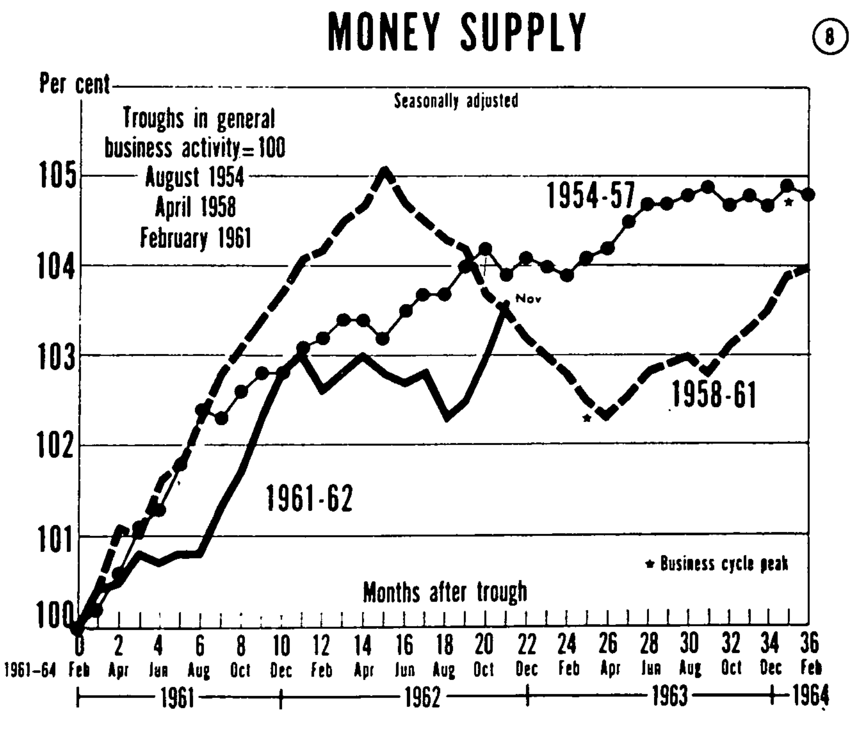


LIQUID ASSETS RATIO IN NEW YORK CITY
WEEKLY REPORTING MEMBER BANKS

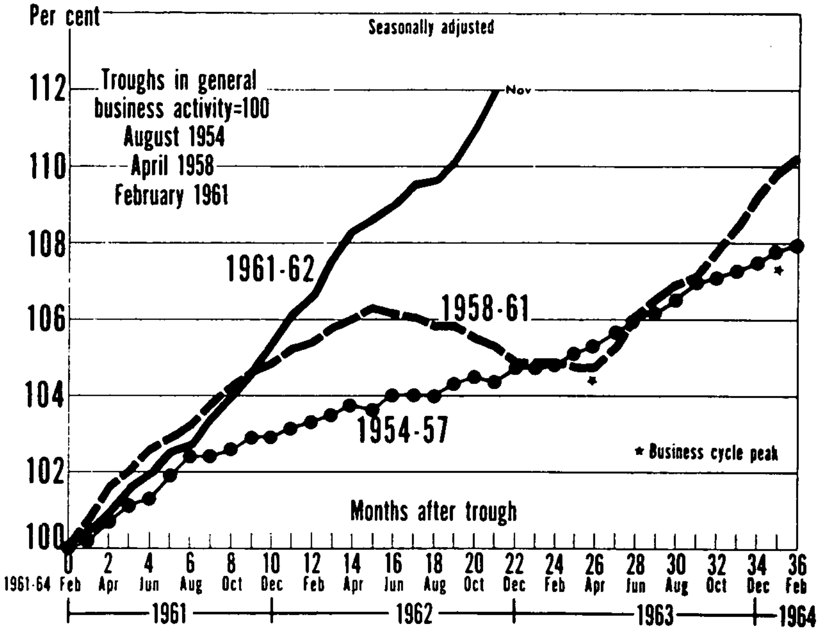
(6)



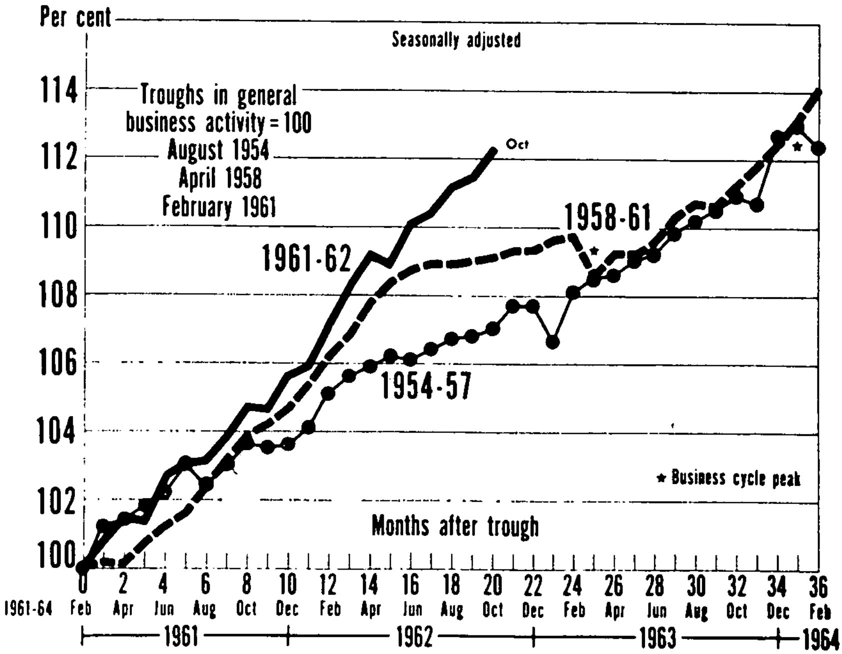

LIQUID ASSETS RATIO
OUTSIDE NEW YORK CITY
WEEKLY REPORTING MEMBER BANKS
7
Per cent
Troughs in general
business activity
August 1954
April 1958
February 1961
1953-57
1960-62
Nov
1957-60
Months before
Months after
Monthly averages
30
25
20
15
10
5
0
-10
-5
0
5
10
15
20
25
30
35
1960
1961
1962
1963
1964


MONEY SUPPLY
8
Per cent
Seasonally adjusted
Troughs in general
business activity = 100
August 1954
April 1958
February 1961
1954-57
Nov
1958-61
1961-62
★ Business cycle peak
Months after trough
105
104
103
102
101
100
0
2
4
6
8
10
12
14
16
18
20
22
24
26
28
30
32
34
36
1961-64
Feb
Apr
Jun
Aug
Oct
Dec
Feb
Apr
Jun
Aug
Oct
Dec
Feb
Apr
Jun
Aug
Oct
Dec
Feb
1961
1962
1963
1964

MONEY SUPPLY AND TIME DEPOSITS ⑨



TOTAL NONBANK LIQUID ASSETS ⑩



Representative REUSS. Mr. Houthakker.

STATEMENT OF HENDRIK S. HOUTHAKKER, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. HOUTHAKKER. Mr. Chairman, the paper I wrote for the symposium deals mostly with the subject of tomorrow morning's session. In my statement, therefore, I shall just give a brief summary, with particular reference to the problem of this afternoon.

In discussing the balance of payments it is most important to look at things in proportion. The United States is the largest economy in the world, and international trade is of only minor significance to it. Exports account for less than 4 percent of GNP, and the gold stock is less than 1 percent of the national wealth. Provided they are properly managed, therefore, international transactions should not have any major repercussions on the things that really matter; namely, domestic output and employment. It is only when international transactions get out of hand that they can become a drag on the general economy.

This is what has happened in the last few years: a deficit of $1 or $2 billion in the balance of payments is in large part responsible for a loss in domestic output amounting to $30 or $40 billion according to the latest estimates. The "tail" is being allowed to "wag the dog."

When unemployment and an international deficit appear at the same time the source of trouble can be pinned down with confidence: it is overvaluation of the dollar in terms of other currencies. This diagnosis is confirmed by direct price comparisons between the United States and other industrial countries. Contrary to widespread belief, the overvaluation has not been materially reduced by price changes abroad during the last 2 or 3 years.

The Bretton Woods Agreement, of which the United States was a signatory and indeed a prime mover, provides that a country in "fundamental disequilibrium" can change the par value of its currency. That the United States is in this condition is clear; in a recent speech Secretary Roosa himself has said as much. The difficulty with devaluation of the dollar is, as we all know, that many other countries hold part of their reserves in dollars. Many authorities here and abroad believe, therefore, that the dollar cannot be devalued without a disastrous crisis of confidence. Not only do they rule out this natural remedy for this country's troubles, but they urge the United States to maintain high interest rates with a view to encouraging foreigners to leave or send their funds here, even though these high rates would be harmful from a domestic point of view. The maintenance of current exchange rates is thus made into an overriding goal of economic policy.

This approach, it seems to me, is mistaken. It does not make sense to subordinate the vast domestic economy to relatively minute considerations of international finance. The unfavorable consequences of dollar devaluation can be dealt with by ad hoc measures, such as the writeup of foreign-held balances discussed in my paper. Reduced confidence in the dollar is not necessarily a bad thing, since this country has no great need for these balances; in Professor Triffin's favorite phrase, bringing reserves to this country is "carrying coal to Newcastle." A multilateral reserve system would be much better than the present situation. Pending the establishment of such a system, foreign holders of dollars have nowhere else to go, so there is no reason to fear a wholesale withdrawal of funds.

We hear much these days about the need to avoid another 1931. We should remember, however, that 1931 came after 1929, and that the financial crisis was merely the consequence of the economic depression. In fact, 1931 has another lesson for the present time: During the late 1920's the pound sterling was strongly overvalued, which meant that the British economy was unable to support a key currency. When all is said and done, high output and employment are the basis of sound finance. The financial mechanism should be our servant, not our master. If some part of it is worn out and starts to interfere with more important things, that part should be adjusted. Devaluation will be a difficult operation, but it is the key to better performance of the American economy.

Representative REUSS. Thank you, Mr. Houthakker.

Mr. Geiger?

STATEMENT OF THEODORE GEIGER, CHIEF OF INTERNATIONAL STUDIES, NATIONAL PLANNING ASSOCIATION

Mr. GEIGER. Mr. Chairman, my name is Theodore Geiger. I am chief of international studies of the National Planning Association, a private, nonprofit research institution in Washington, D.C. The views expressed today are my own and are not necessarily those of the National Planning Association.

In a brief introductory statement, it is not possible to provide the evidence and the detailed reasoning necessary to substantiate conclusions. I hope, therefore, that you will accept, without supporting data, this bare summary of my views on the existing international monetary system and on its adequacy for the future.

For the last few years, the monetary authorities of the United States, in cooperation with those of the European countries, have been engaged in the necessary task of trying to mitigate the weaknesses of the gold/key-currency system. Considerable progress has been made in increasing the resources available to governments in emergency situations and in coordinating the policies of national monetary authorities so as to minimize the adverse consequences of unusually large, temporary swings in trade and in short-term capital movements. At the same time, the administration has been pressing various measures for reducing the balance-of-payments deficit of the United States. All of these actions can help to bolster the key currencies—the U.S. dollar and the pound sterling—against sudden emergencies and speculative waves. Hence, they are of great importance. However, it must also be recognized that they are interim measures, for they do not go to the root of the present and prospective difficulties of the gold/key-currency system.

To my mind, a fundamental weakness of the existing international monetary system is the fact that, to an increasing extent, it rests upon the maintenance of international confidence in the national currencies of the two key countries—the United States and the United Kingdom. This system worked reasonably well when the key currencies were scarce—but not too scarce—as the dollar was roughly from 1950 until 1958. But, increasingly during the last 4 years, the key currencies have become plentiful, as the European countries have rebuilt their monetary reserves; restored the convertibility of their currencies; maintained high rates of economic growth and high levels of exports. Owing to the limited supply of gold, this situation has led to an accelerated accumulation of key currencies in the monetary reserves of most of the European countries.

The larger the percentage of dollars in the monetary reserves of other countries, the more their monetary authorities and bankers must be concerned with those domestic and international economic policies of the United States which affect the stability of, and world confidence in, the dollar. We have seen the major influence which this consideration has exercised in recent years on the national economic policies of the United States. Our belief that restraints were needed to induce other countries to increase their dollar holdings has in part inhibited us from adopting the most effective measures for reducing unemployment, stimulating productivity and raising aggregate demand so as to achieve a higher rate of economic growth in the United States. In the last few months, there have been signs that more vigorous policies may soon be followed, particularly in view of the support for some of these measures expressed by the OECD.

Nonetheless, the fact that the U.S. dollar is the world's major key currency tends to set limits upon the freedom of action of the United States in applying those economic policies which could most effectively serve its domestic needs and its international security and development commitments.

In theory, the gold reserve of the United States exists in order to permit such freedom of action and to provide a breathing spell during which to make those changes in national economic policy required to achieve domestic and international goals while bringing the external accounts into balance. In practice, however, precisely because the dollar is a key currency, the more gold from the U.S. monetary reserve that is allowed to flow out for this purpose, the less freedom of action and the less time the United States has for making such adjustments.

Clearly, our allies and friends abroad incur a greater and greater risk the larger the percentage of their monetary reserves which they hold in the form of the national currency of the United States. And, from our own point of view, we are less and less able to use our gold reserve for one of the major purposes for which it is intended—to provide the freedom of action and the time necessary to make changes in our national economic policies—to the extent to which dollars accumulate in the monetary reserves of other countries. This is the paradox of the key-currency system.

In my judgment, this situation, unsatisfactory to both parties, is bound to get worse over the longer term. Hopefully, world trade and international investment will continue to expand. But, they have been doing, and will undoubtedly continue to do so, at a considerably faster rate than increases in world gold production. In these circumstances, the ratio of key currencies to gold in the international monetary system is bound to increase.

Despite the ingenious interim measures recently adopted, the fundamental instability of the gold/key-currency system will be more and more aggravated as the ratio of key currencies rises, and the freedom of action of the United States will be more and more reduced.

It is for this reason that I advocate going beyond interim measures and accelerating the evolution of the gold/key-currency system into an international reserve system along the lines proposed by Robert Triffin and others. Various technical objections have been made to the Triffin plan and variant schemes, but refinements have already been devised by their authors and by others for dealing with such operating problems. To my mind, the most serious arguments against some form of international reserve system relate to its fundamental nature and not to its technical operation.

These fundamental objections can be grouped into two contradictory types. On the one hand, there are those who regard an international reserve system as chimerical because they do not believe that national governments would make the necessary surrender of sovereignty to an international monetary institution, presumably a revised International Monetary Fund. If it did manage to get established, they believe that the international monetary institution would be ineffective because member governments would flout its authority or recommendations whenever their immediate interests would be served by so doing. On the other hand, there are those who claim that such an international monetary institution would exercise too much sovereignty over its member national governments. Sometimes, both of these objections are made in the same article by opponents of an international reserve system.

Those who object to an international reserve system because the monetary institution might be weak and ineffective buttress their argument by citing situations in which its authority might be ignored and its operating rules impaired. They maintain, for example, that in an international emergency the member countries would immediately convert their holdings of the international reserve unit into gold, and thus bankrupt the system. But, there is nothing to prevent them from doing so under the existing key-currency system. Indeed, I would argue that an internaitonal reserve system would be better able to withstand the strains of war, depression or other international emergency. It would provide a much more rapid and efficient mechanism for coordinating national monetary policies and actions than do the existing information and ad hoc key-currency arrangements. Moreover, the international monetary institution could also resort to the ultimate protection of making the international reserve unit temporarily inconvertible into gold, just as the United States would undoubtedly do if necessary to protect the dollar in an extreme emergency.

With respect to the second type of objection, I believe that the overt and clearly-defined limitation of national sovereignty involved in membership is an international reserve system would constitute less of a restriction on the freedom of action of the United States than would be the case if the key-currency system were continued unchanged, with its concealed, undefined and capricious limitations on the sovereignty of the key-currency countries.

Under an international reserve system, national economic measures which the United States deemed essential for domestic or foreign policy reasons would not be inhibited by fear that European central bankers would refuse to hold dollars in their monetary reserves, and speculation against the dollar could be constrained or offset by appropriate coordinated actions of the international monetary institution and the leading member governments.

In summary, I believe that the interim measures adopted during the last few years—effective as they may be in the shorter term—will be less and less able over the longer term to cope with the increasing instability of the gold/key-currency system. In consequence, the United States will not have sufficient freedom of action to achieve necessary domestic goals and meet essential international commitments. Before the breathing spell afforded by these interim measures runs out, steps should be taken to accelerate the evolution of the existing gold/key-currency arrangements into an international reserve system.

Representative REUSS. Thank you.

Mr. Holmes, I was glad to see that you included in your remarks some attention to the longer-term problem that, for example, Mr. Geiger has been discussing, the problem of international liquidity. You point out that there is no problem of the amount of liquidity at the present time; that, however, if our balance of payments is rectified, foreign dollar deposits are going to disappear, or at least not be increased in any ratio such as we have had in recent years, and then, unless something is done, there will be a shortage of international reserves.

Mr. HOLMES. At some stage, there certainly would be, if our surpluses were persistent.

Representative REUSS. Then you point out that the apparent willingness of the United States to finance part of its surpluses, on that happy day when we start having surpluses again, by not just accumulating gold, but by accumulating foreign currencies, may offer a means of seeing that the world does not starve for liquidity or die of thirst for liquidity because the supply of gold is limited.

Certainly I would agree that our willingness and the willingness of the other countries to hold a variety of currencies—not just sterling, but lire, deutsche marks, francs and others—is all to the good and does add to the international reserves which are necessary in order to finance trade and investment.

However, I am wodnering if this is really likely to prove adequate. Specifically I am concerned about the situation where both countries, both the lending country and the borrowing country, may be in deficit and thus the currencies which they have accumulated are not at the moment particularly wanted by anybody else. You really, in short, do not solve everything just by our willingness to accumulate foreign currencies, though you do some good.

Is that not so?

Mr. HOLMES. I think that is quite true, because obviously if we accumulate a basket of currencies, so to speak, when we have a surplus, in times when we move into deficit again temporarily, we shall not be able to use all of it. I think this is quite likely to be true. But presumably, if the basket is large enough, some of it will be useful. It undoubtedly will not solve all of the problems of the world, but if the deficit is of not too great consequence, it will help. There are other possibilities.

First there are debts to repay. Then there are various credit availabilities that can add to the store of liquidity, apart from this particular one, which would be only part of a fuller system.

Representative REUSS. You are thinking of the IMF supplementary agreements?

Mr. HOLMES. Yes, and the bilateral agreements, all of which form part of the whole system.

Representative REUSS. In view of the fact that the accumulation of additional foreign currencies does not solve everything and particularly does not solve the problem when both countries are in deficit, I wonder if we have not been a little too cavalier in disregarding some of the suggestions along the lines that Mr. Geiger is making—the Triffin, Stamp, Maudling proposals and so on.

Those people, whatever added encrustations there may be on their plans, all do envisage some organization like the IMF issuing some sort of negotiable certificates, perhaps with a gold guarantee which, over a period of time would possibly be acceptable as a reserve medium. If this could be brought off, this would be a good thing, wouldn't it, because this would take us out of our difficulty that we have just described, where if both contries are in deficit, they may be stuck with a lot of currencies that they thought were key currencies, but which turned out not to be.

Mr. HOLMES. Well, one cannot visualize what the long run will really look like. The problem with some of the broader schemes for increasing liquidity, is really the lack of proof that there is a need for them at this time, and also the very practical problem of how you get there. Because on paper, you can work out limitless schemes for international liquidity, and there is certainly no dearth of these plans at the present time.

But their acceptability to others, the need for them, has not clearly been proved.

And I am still deeply concerned by the problem, by this particular problem, are our current difficulties the result of the fact that we have a key currency or because we have had persistent deficits?

Representative REUSS. There you persuade me completely. I think our problem is one, as you say, of deficits. If anything, the fact that we are a key currency has helped us get through those deficits, because people have been willing to hold our currency because it is a key currency.

Mr. HOLMES. That is right.

Representative REUSS. But having said all that, and having recognized that our immediate problem is a balance of payments deficit problem, I still think it is not too early now to be planning what the free world will do with the discontinuance of our deficit. We are not in the position of creating new liquidities here.

Mr. HOLMES. Well, in my own view, we certainly must study all of these proposals, because no one can tell what the long run will look like.

But I think it would be premature to say that the system which is now developing, which does not call for the creation of a supranational body, will not be adequate for a good long period ahead.

Representative REUSS. Well, except that you can get a better and more foolproof reserve currency than the existing national currencies without creating any more of a supranational agency than we now have—that is to say, the IMF could work out an arrangement, do not press me on the details—whereby members put in their own currency in return for IMF negotiable notes of some sort, and these notes, perhaps with a gold guarantee, could then circulate. This would add to the free world's liquidity, yet would not involve any more supranationalism than we now have.

Mr. HOLMES. No, there are many ways the funds could be expanded, through just an expansion of the quotas with the IMF, as we did a few years back. There are many ways you could increase the sources of liquidity without having a supranational government. But there is always the question of automatic access to these funds, which I think is the thing that disturbs many of us. Because automatic access to funds should not mean, in my view, that any one country could go on financing a deficit in its balance of payments forever. I think it is virtually impossible to get an agreement from any group of nations that would permit unlimited access.

So I think it all comes back to the balance of payments. Once you have gotten that in shape, then the liquidity problem is not nearly so important.

Representative REUSS. I am not sure I follow that last. Why is it not important?

Mr. HOLMES. It is not as important.

Representative REUSS. Other countries are going to run balance of payments surpluses and deficits.

Mr. HOLMES. Yes.

Representative REUSS. The free world will need reserves to finance them, and as trade increases, you are going to need a greater total of reserves, I should think.

Now, you can say, you will get greater velocity in meeting them.

Mr. HOLMES. Well, yes.

Representative REUSS. But then, just as in our national economy, over the years, the Federal Reserve has recognized it has to add to the money supply.

Mr. HOLMES. Certainly.

Representative REUSS. So internationally, the analogy is not perfect, but relevant, it would seem to me.

Mr. HOLMES. I think that is true, that additional liquidity will be needed over time, but whether this cannot be developed without an international agency performing that task, I think is an open question. It may well turn out the way you suggest.

Mr. HUMPHREY. Mr. Houthakker, I think we should like an explanation from you of how overvaluation of the dollar affects the domestic economy.

Mr. HOUTHAKKER. Yes; this is a very important point, because there is always a tendency to separate the international and domestic economies from each other in these matters. Of course, there is a very close relation.

Overvaluation affects the domestic economy, I think, primarily in two ways. It reduces the demand for exports, because the current exports are less competitive, compared to the product of other countries; there is a corresponding effect on imports. And it also reduces the tendency to invest at home and increases the tendency to invest abroad.

Both of these things are, of course, to be taken relative to an equilibrium situation. I do not know which of the two is the more important. People usually think primarily about the effect on current exports, but I think that the effect on long-term investment in other countries may be just as large, quantitatively.

I think that the increasing tendency of American business to invest in Europe rather than in this country can be explained by a disparity in the price levels.

Mr. HUMPHREY. In your paper, I think you suggested that we might write up the foreign dollar balances in the event of exchange-rate adjustments. How much would this cost?

Mr. HOUTHAKKER. I think it would cost about as much as would be gained by revaluing the gold stock. The gold stock is about $16 billion. There is some question which balances actually would be eligible for being written up, but I would say it would certainly be not more than $16 billion.

I think it should apply only to net balances, but there is some question what to do about net long-term balances, the claims which this country has on other countries that are of a long-term nature. I am not sure to what extent they should offset short-term balances. I think there are considerable offsets, and the extent to which this guarantee would have to be made good would be considerably less than the present gold stock of $16 billion.

I am assuming now that no other countries follow the United States in devaluing.

As I explained in the paper, the guarantee which I am thinking of is not a guarantee in terms of gold, but a guarantee in terms of other currencies, so that any country which follows the United States completely in changing the par value would not get an increase in the dollar balances it holds here.

Now, I suggested in my paper that perhaps Canada would go along with the United States, although I indicated that in my opinion, other countries, generally speaking, should not go along. So I would guess that the total amount of net balances that needs to be written up would be somewhere between $10 and $14 billion, and the cost of making the writeup, say on a 15-percent basis, would then be anywhere between $1.5 and $2 billion, compared to a windfall gain on the gold stock of something like $2 or $2.5 billion.

Mr. HUMPHREY. Thank you.

Mr. Geiger, I was wondering why you do not feel that the multiple-key currency development—and by that I mean more than the British and ourselves—why this does not mitigate the difficulties that you explained?

Mr. GEIGER. I think it does mitigate them, but it does not remove them. I think the measure that we have taken in the last few years mitigate the difficulties. But I do not think that other currencies like Swiss francs or German marks or even French francs could be used on an extensive enough scale over the longer term to make up the difference. But they do mitigate the situation.

Mr. HUMPHREY. I think that is all I have.

Representative REUSS. Gentlemen, we are very grateful to you for a very important contribution to our studies. Thank you very much.

The Joint Economic Committee will now stand adjourned until 10 tomorrow morning in this chamber.

(Whereupon, at 4 p.m., the hearing recessed until the following day, December 14, 1962, at 10 a.m.)

OUTLOOK FOR U.S. BALANCE OF PAYMENTS

FRIDAY, DECEMBER 14, 1962

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

The subcommittee met, pursuant to recess, at 10 a.m., in room AE-1, U.S. Capitol, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss.

Also present: Don Humphrey, consultant to the subcommittee; William Summers Johnson, executive director; James W. Knowles, senior economist, and John Stark, clerk.

Representative REUSS. Good morning. The Joint Economic Committee will be in order.

This morning we continue our hearings into the general question of the outlook for the U.S. balance of payments. There have been submitted two papers which, without objection, will be received into the record and ordered printed with the record of these hearings, one a paper by Prof. James E. Meade, of the Cambridge University, the other a paper by Robert Z. Aliber, of the Committee for Economic Development.

(The documents referred to appear in the appendix.)

Representative REUSS. We now have a panel of distinguished experts on the general subject of exchange rates, integration versus flexibility: Mr. Ingram, of the University of North Carolina; Mr. Caves and Mr. Vanek, of Harvard; Mr. Halm, of the Fletcher School of Law and Diplomacy at Tufts; and Mr. Kindleberger, of MIT.

You are very welcome, gentlemen. We are grateful to you for coming here. Starting with Mr. Ingram and proceeding across the table, we would like to have each of you set forth your views in a written statement or testimony or both.

Mr. Ingram, will you proceed?

STATEMENT OF JAMES C. INGRAM, UNIVERSITY OF NORTH CAROLINA

Mr. INGRAM. Thank you. I have here a part of a paper, a longer paper which has been printed as part of the committee's record. I would like to read this brief statement, "A Proposal for Financial Integration in the Atlantic Community."

I recommend that careful study be made of the effects on the international monetary system of a greater degree of integration of financial markets in Atlantic Community nations. By "financial integration" I mean freedom for individuals, firms, banks, and Government agencies to trade in securities and other financial assets across international boundaries at rigidly and permanently fixed exchange rates. All legal barriers to repatriation of principal or to payment of current income would be removed. I specifically intend this freedom to apply to domestic as well as to external residents.

The principal thesis is that a vigorous movement toward financial integration would greatly diminish the scope and severity of national balance-of-payments crises, largely because financial integration could release capital movements, especially long-term, and permit them to perform an equilibrating role. Such financial integration could substantially relieve the pressures on international reserves, as traditionally conceived, by engaging a substantial portion of the entire stock of a nation's financial claims in the process of international payments adjustment.

I do not argue that financial integration so defined is necessarily better than a system of truly flexible exchange rates; instead, I simply assume that the nations of the Atlantic community have shown a strong preference for fixed exchange rates, and that the relevant comparison is between financial integration and the present system.

Furthermore, I do not argue that all adjustment problems would disappear if financial integration were adopted. However, I will argue that much of the present concern over short run balance-of-payments pressures, gold outflow, adequacy of international reserves, and threats to the system arising from the danger of a run on a particular currency, would in large measure be dissipated under financial integration.

Developments in the past 15 years have already carried us some distance toward financial integration. Thus, Atlantic community nations have done much to reduce and remove barriers to international trade in goods and services, and to permit currency convertibility at fixed exchange rates. The success of these moves has led to, or been accompanied by, some tendencies toward a greater degree of integration of financial markets. Especially in the market for short-term securities, it has become clear that monetary policies in one nation cannot be determined on the basis of domestic considerations alone. Even long-term capital markets are becoming increasingly interrelated, as exchange controls on capital movements are relaxed, removed or circumvented.

Although the trend has been strongly toward a greater degree of integration of both commodity and financial markets in the Atlantic community, the present international monetary system still is based upon a presumption that a nation can separate its financial market and pursue a separate monetary policy. The IMF system was designed to permit, and even encourage, the separation of national financial markets. It was of course intended that exchange rate adjustments would take care of basic disequilibria, while exchange controls were to check any undesirable capital movements. Actually, however, things have not worked this way, especially in the Atlantic community.

The attempts of individual nations to pursue independent monetary policies have therefore led to trouble, and exchange controls on capital movement have not been an adequate protection and defense.

Although nations have not been able to separate their financial markets effectively, their efforts to do so have hampered the flow of equilibrating capital movements. I would argue that efforts of nations to maintain the fiction that national financial markets can be separated have produced two serious disadvantages for international monetary order in the present system; namely that (1) existing exchange controls plus risk of exchange-rate changes do effectively restrain a vast amount of potentially equilibrating capital movements, and (2) direction and timing of evasions of exchange controls are almost certain to be disequilibrating, with adverse effects concentrated on official exchange reserves. When a currency is weak in the foreign exchange market, speculators are offered the familiar one-way bet, and exchange control is no protection against the outflow of capital that is induced. But when the separate domestic policy gives way, as it must, the existence of exchange controls and uncertainty about the exchange rate hamper an equilibrating inflow of capital. Thus the nation obtains neither the supposed benefits of domestic policy and exchange controls nor the benefits of a sensitive response in capital movements.

The objective of financial integration is to link the financial markets of Atlantic Community nations so closely together that securities of one nation will be freely bought and sold throughout the community, with their prices and yields being determined in competition with other securities of similar quality and maturity. Integration of financial markets would lead to a one-price system for securities of a given type, just as integration of commodity markets leads to a one-price system for given commodities. Such financial integration would be a logical extension of the trend of policy in recent years, and it would be consistent with currency convertibility and removal of trade barriers.

Given a large body of internationally acceptable claims, complete freedom of international payments, and rigid exchange rates, a one-price system for international claims would emerge. U.S. Treasury bonds would sell to yield almost exactly the same return as U.K. Treasury bonds of a similar maturity. A single nation could no longer pursue a separate national monetary policy in the sense that its structure of interest rates could be made to differ appreciably from that of the rest of the community. While this may appear to be a substantial loss of national autonomy, I would argue that imperfections in exchange control have already removed the autonomy allegedly provided by separated financial markets.

Once financial integration were achieved, balance-of-payments shifts of substantial size could be handled by the system without much strain on the payments mechanism and without the pressure on conventional foreign-exchange reserves that we have come to expect. Small changes in the structure of yields on securities of any member would be sufficient to induce equilibrating flows of capital.

To take care of the transfers of funds from one currency to another, I propose that commercial banks in each member nation be made individually responsible for effecting a transfer of funds to any other place within the integrated community and into any other currency. Individual banks would have to arrange suitable correspondent accounts with banks in other financial centers and include internationally acceptable claims in their portfolios in order to meet any sudden demand for foreign exchange. To emphasize the fixity of exchange rates, the principle of par clearance should be clearly accepted.

This responsibility may seem too heavy a burden to place on commercial banks, but it is almost exactly what we require of individual banks within the U.S. common market.

Limitations on national autonomy with respect to monetary policy would tend to produce a greater reliance on fiscal policy. Financial integration would require each nation to finance any budget deficit by issuing securities of suitable yields and maturities to make them salable in world capital markets. A government could still engage in deficit financing, but it would have to pay competitive interest rates. Thus, it could pursue expansionary policies, but the necessity to sell bonds at competitive yields would tend to restrain expansionary tendencies of national governments.

National governments might resent the necessity to submit to a market-determined price on bonds issued to cover their deficits. But what is the alternative they must face? Without financial integration, their efforts to issue government bonds in the domestic financial market at noncompetitive interest rates would be accompanied by pressure on official exchange reserves and fears of a flight from the currency. To combat these evils, governments must either adopt other policies they dislike in principle—such as tied loans, exchange controls, trade restrictions—or they must moderate monetary and fiscal policies. It would seem that acceptance of the price of new issues as determined in world capital markets would be the preferred alternative and, indeed, would interfere less with national autonomy.

Thank you.

Representative REUSS. Thank you, Mr. Ingram.

Mr. Caves?

STATEMENT OF RICHARD CAVES, HARVARD UNIVERSITY

Mr. CAVES. Thank you, Mr. Chairman. I welcome this opportunity to appear today at a discussion of the relative merits of fixed and flexible exchange rates. This is the sort of consideration of alternatives that is not commonly seen in discussions of international finance and monetary problems, and I think it is very desirable that this opportunity be taken to consider a possible solution such as flexible exchange rates that does not receive the discussion in the marketplace of international finance which many professional economists feel that it merits.

I would like to discuss the flexible exchange rate alternative this morning, speaking of some of the principal advantages which economists have seen for it. I would like to speak of it not so much as a proposal to be adopted by the United States at any particular time, but rather broadly, as a system of ordering international payments which might be adopted, or at least considered for adoption by the countries of the Western World in general.

The arguments which economists put forth for a flexible exchange rate are quite similar to their arguments permitting any price in the economic system to fluctuate freely. All the standard arguments for permitting price to adjust to forces of supply and demand in a relatively automatic fashion can be in one way or another applied to the price of foreign currency, just as they are applied to the price of steel or the price of cotton textiles.

I often urge supporters of fixed exchange rates to convert their arguments in favor of fixing the price of foreign currency to arguments for fixing the price of steel, to see how they sound. In fact, the market for steel and the market for foreign exchange are not at all the same thing, true, but they are both markets. And if we are to argue for permitting market forces to adjust the one and fixing the other by government action, we should have in mind some clear and absolute distinction between the characteristics of these two markets if we are believers in the use of market forces in general.

Another way in which the argument for flexible exchange rates is commonly phrased by economists is to allow the exchange rate to adjust to market forces in order to give governments another instrument of policy. When governments pursue a number of objectives which we describe in terms of internal and external balance—that is to say, full employment and appropriate price levels at home, balance in international payments abroad—governments are always strained to find enough instruments or tools to accomplish all of these objectives, or to find instruments and tools which are adequately flexible and quick in their operation.

In a certain sense, permitting the exchange rate to adjust to market forces gives governments another instrument in dealing with the whole range of policy problems which they face. Short-term interest rates can be used then for purposes of achieving proper domestic price levels or controlling inflation, rather than with regard to maintaining equilibrium in the balance of payments.

Having a flexible exchange rather than a fixed one is, in a sense, like having a lot of reserves rather than a small amount of international reserves. It simply provides more freedom and more opportunities for the application of public policy to the whole range of objectives which the governments face in dealing with the problems before them.

Professor Halm's paper, which has been submitted to you, I think takes the very sensible view that the best argument for flexible exchange rates is not that it frees governments from having to worry about the international consequences of their domestic policies, but rather that it gives them more leeway. It provides some flexibility so that the system of international payments can be maintained in an orderly fashion without such close or detailed cooperation between governments as is required under fixed exchange rates in such conditions as we have seen in the last decade. And quite apart from this granting of more freedom to governments for their domestic economic policies, flexible exchange rates also have important advantages for isolating the domestic economy from certain types of disturbances transmitted from abroad—that is to say, the effects of business cycle fluctuations abroad are not transmitted so readily or so strongly to the domestic economy under a regime of flexible exchange rates as they are under conditions of fixed rates. So the greater policy freedom achieved under flexible rates is really of two types—an additional instrument gained in dealing with the whole constellation of domestic policy problems and also, in most cases, at least, a subtraction from the possible range of policy problems that are likely to come up.

In thinking of the merits of flexible exchange rates, it is well to give some attention to some of the principal difficulties we have seen in the past decade with implementing the so-called Bretton Woods system of fixed exchange rates that are to be adjusted in the face of conditions of fundamental disequilibrium. One obvious problem which has emerged under this system is in detecting or admitting the existence of fundamental disequilibrium. Economists' views of this usually imply that one certainly cannot tell whether a country is in fundamental disequilibrium in less than a period of 4 or 5 years, say, over the movement of a complete business cycle.

Even over a period of time such as that, it is often difficult to tell whether a disequilibrium exists which is not likely to cure itself.

Furthermore, establishing whether fundamental disequilibrium exists is really not so much a problem of analyzing the past as forecasting the future, since changes, under the Bretton Woods system, always rest upon a guess about the future equilibrium rate.

In the face of these difficulties, it is not at all hard to see why so few countries have been willing to admit that fundamental disequilibrium existed and that the need to alter their exchange rate was upon them. Another difficulty which has emerged under the Bretton Woods system has to do with the matter of international liquidity, a problem which has received much attention in recent years in the light of the proposals of Professor Triffin and others. One advantage of a flexible exchange rate regime, rather than one based upon fixed rates, is that it would greatly mitigate the problem of securing adequate international liquidity, adequate both in quantity and quality.

First of all, the total requirements which countries feel for liquidity would be sharply reduced under a regime of flexible exchange rates. Countries certainly would still wish to maintain some international reserves in order to perform short-run stabilizing operations on a flexible rate. But the need for reserves would not be one which would have to support long-run disequilibriums, disequilibriums persisting over a period of years.

Furthermore, the problem of the composition of international liquidity, relating to switches between gold and currencies between different reserve currencies, could be at least greatly mitigated under any sort of coordinated international system of flexible exchange rates.

Now, economists have also granted that flexible exchange rates have certain limitations. That is to say, there are reasons why, in the circumstances of particular countries, they might not work as well as the general case which I have portrayed would seem to indicate. There is, of course, the problem of whether short-term international capital movements would be stabilizing in their effect on the balance of payments under a system of flexible exchange rates. Theoretical arguments lead to no definite conclusion in this regard, unfortunately, and so one is forced to turn to the record of experience. Here we have on the one hand the experience of Canada over the last decade in the period when that nation permitted its exchange rate to fluctuate freely. There, according to my reading of the evidence, there were no problems of adverse speculative movements of short-term capital in that, by any measure you care to make, the influence of short-term capital movements seems to have been stabilizing most of the time.

Read first

But on the other hand, some of the evidence from the interwar period points in a different direction. Under the severely disturbed conditions of the interwar period, nations permitting their exchange rate to fluctuate freely did seem to encounter difficulties of short-term capital movements being destabilizing. Perhaps what these two bits of evidence seem to indicate—Canada and the interwar period—is that in a basically stable situation in terms of governmental arrangements and underlying economic conditions, the flexible exchange rate device will work well. Under conditions of highly disturbed economic arrangements neither flexible exchange rates nor anything else other than a sharply restrictive set of quantitative controls on trade and payments will suffice.

Other difficulties that have been mentioned concerning flexible exchange rates turned principally on the effect of uncertainty about the exchange rate upon the actions of traders, especially people making international long-term capital movements. This is again a problem which might be serious or alternatively not serious for particular countries employing a flexible rate. The only point that can be made at a general level is this, that permitting the exchange rate to fluctuate means transferring part of the burden of adjustment to economic disturbances to the exchange rate and away from domestic variables, the domestic price level and level of employment.

What we are doing in adopting a flexible exchange rate, then, is not creating a new source of disturbance where there was none at all before, but rather, transferring part of the adjustment from one set of economic variables to another.

Thus I tend to feel there is not a general argument against flexible exchange rates from the standpoint of creating additional uncertainty in international transactions. That, I feel, is a summary of the main economic arguments for flexible exchange rates. I hope that these can be considered by the nations of the West as they are now pondering a wide range of possible reforms in international payments arrangements.

Representative Reuss. Thank you, Mr. Caves.

Mr. Vanek?

STATEMENT OF JAROSLAV VANEK, HARVARD UNIVERSITY

Mr. Vanek. Thank you, sir. I do not think I will be able to restate the entire content of my paper I prepared for this committee, but rather, I would like to concentrate on one particular point I have made in my paper and elaborate on it, and very briefly, actually. I would not like to spend too much time.

The particular point is the expected effect of devaluation, either through a pegged devaluation or through flexible exchange rates on our national income and domestic employment. There are three reasons why I would like to make this statement: First of all, my definite feeling is that this point has been so far the most neglected one in discussions about the balance-of-payments difficulties. Second, I think it is a point that has been most criticized by some of my colleagues who have read my writing on the subject. And third, I would like to make a few additional qualifications over and above what I have said in my paper.

To begin with, I would like to recall my estimate that 15 percent devaluation, either actual devaluation or through flexible exchange rates, would be likely to lead to an improvement in our domestic income and employment equivalent to about $20 to $30 billion, or corresponding to, say, 2 or over 2 percent of our employment. To remain on the safe side of the estimate, I would like to stick to the $20 billion estimate.

Now, most economists, I would say, would agree with me that there is some relation between the balance of payments of a country on the one hand and the state of its economy, the level of employment, the level of national income. But most or many would disagree with me on the size of this effect. I recall I would estimate it at least at $20 billion.

Now, the argument usually advanced, and I think the right argument to be given, is that we have in the United States in our economy or in our institutional structure something referred to as the built-in stabilizers, and therefore, because of those built-in stabilizers, we would expect that national savings out of additional income would be rather large, or larger than otherwise we would believe on the grounds of economic studies of savings habits.

Now, this is true and I would like to point out here the very important fact that in my estimate of $20 billion, I have taken into account the built-in stabilizer effect. Perhaps we should explain what we mean by "built-in stabilizer."

When income increases for various reasons, people will not only save, there will not only be leakage in spending power deriving from people's preferences, but also there will be leakage because of our tax structure; there will be leakage of national savings into government revenue. Therefore, you could expect that the amount of purchasing power resulting from an increase in income that would leak outside of the economic system would be rather large and therefore, the economic effect of devaluation might be smaller than I have evaluated. This is, I think, the argument as it is presented. But I would like to restate it.

I do take this into consideration. I could go here into a lengthy technical discussion of economic parameters and economic models but I want to spare this committee this kind of discussion. But I would like to make some additional statements that merely derive from this particular fact that we do have built-in stabilizers in the economy. Certain additional effects will arise that I have not discussed in my paper. These are quite important and ought to be pointed out.

First of all, if there are built-in stabilizers, then a devaluation leading to increases in national income and employment will surely and automatically improve the budgetary balance. For example, if you have a $20 billion improvement in national income in the United States, in conjunction with it, we could expect an autonomous improvement in the balance of the Federal budget of approximately $5 billion. This is the additional effect that comes from the fact that we have in the United States the system of built-in stabilizers; they increase the leakage, but at the same time, the other side of the picture is that our Federal budget will improve, our budgetary balance will improve.

Now, this, in itself, has an important secondary effect because if budgetary balance improves by $5 billion, then we can expect, with certainty, actually, that there will be $5 billion less of Government securities sold in the market, and this alleviates the capital market and there will be increased availability of funds for private investment, and this will increase our rate of growth and private investment. So this secondary benefit should be considered. This is something I have not pointed out in my paper.

To sum up, I would like to do it in rather concrete terms by comparing the effect of the exchange rate adjustment, either through flexible rates or through devaluation, to a possible tax cut. The first effect is similar for both policies, for devaluation and tax reduction; namely, improvement, overall improvement in economic conditions and improvement in national income, employment, and profits in the United States. But there are two other effects where a tax cut and devaluation have opposite results.

First of all, a tax cut will definitely worsen our budgetary balance, while the devaluation not only will improve income but will also improve our budgetary balance. Third, of course, the primary purpose of devaluation is the adjustment of the balance of payments. This will be produced by means of devaluation, but if we increase our domestic employment through reduced taxes, then we have to expect further worsening of our balance of payments. Thus, on the one side, the two policies are similar to each other. They both improve the level of income, employment, and growth in the United States.

On two other counts, devaluation has a positive impact; the reduction in taxes, on the other hand, has a negative impact on both budgetary balance and the balance of payments.

Finally, I would like to recall that the effect of devaluation on the capital market is also desirable, because if our income increases without reduction of taxes, then it is likely that our budgetary balance will improve, and consequently, less new Government securities will have to be sold in the capital market. There will be greater availability of loanable funds for the private sector, for growth and for capital formation.

I think this is all I wanted to say with respect to my paper. Thank you.

(See further remarks by Jaroslav Vanek, appendix, p. 264.)

Representative REUSS. Thank you, Mr. Vanek.

Mr. Halm.

STATEMENT OF GEORGE N. HALM, THE FLETCHER SCHOOL OF LAW AND DIPLOMACY, TUFTS UNIVERSITY

Mr. HALM. Thank you, Mr. Chairman. I believe that the system of flexible or floating exchange rates has the following advantages: first, it would permit us to use exchange rates, as Professor Vanek has already stated, as market prices. This, I believe, is a very important point, because as far as possible, all our policies should be so chosen that they fit the system in which we live and this is a market economy.

Second, I believe also that if the exchange rates are permitted to be market prices and to maintain equilibrium, we get along with by far smaller international reserves. I should say that the gold reserves, properly distributed over the world, would be sufficient in this case.

This is an important point for us today, because we then could gradually give up the burden of being a key currency country.

The third point would be that flexible exchange rates would free us from an inconsistent policy. We maintain fixed rates and convertibility, but have not enough integration of domestic economic policies. Therefore, the fixing of exchange rates forces us continuously to adjust another price, namely the rates of interest.

This adjustment may come at the wrong time. It might come at a time when we, for domestic reasons, should have lower rates of interest, yet because of a balance of payments deficit have to increase rates.

A fourth point connected with the second has already been stated by Professor Caves, and that is that our domestic policies are protected against influences from the outside. Take, for instance, the case of West Germany and the difficulties they had to face because of fixed exchange rates and inflationary pressures which did not fit the German concept of the market economy.

Now, with these advantages, I defend the system, but I do by no means give us complete freedom of domestic policy.

I envisage a system of flexible or floating exchange rates as one which is administered through domestic stabilization funds. I also assume that the national stabilization funds will cooperate and that the International Monetary Fund, with emergency resources, will help the national stabilization funds to cooperate.

If such cooperation is achieved, and I think we are achieving it, disequilibrating speculation has not got much of a chance. Furthermore, we can assume that speculation will, in a system of flexible exchange rates, actually be less of a menace than in a system of the adjustable peg which we have now.

When the pegged fixed rate is decidedly a wrong rate and everybody knows it, it leads to a type of speculation which is only disequilibrating. I believe that Professor Meade has some good arguments when he shows that a well-working system of flexible rates would indeed reduce speculation.

However, the second point is more important; namely, that the system will not work when we have no integration of domestic policies. I would say the issue is not integration versus flexibility. Rather we should have the maximum amount of integration that is compatible with domestic employment and growth policies. We should have this amount plus flexibility of exchange rates. The integration will never be quite perfect. Therefore, we need some adjustment mechanism, and in a market economy, flexible rates provide such automatic adjustment

We have often heard extreme statements. For instance, Professor Triffin states the opinion of those who support flexible exchange rates as saying that exchange rates automatically offset the impact of disparate national policies upon the international pattern of prices and costs, or as saying flexible exchange rates give to a country freedom to pursue whatever internal monetary and credit policy it chooses. I do not think that this is true.

Defenders of flexible rates would be foolish to claim such results, because flexible rates cannot possibly integrate what nobody makes an effort to integrate.

In this case, too much trust is put into flexible exchange rates, but there is another group which is equally extreme in saying that there just cannot be any fluctuations, that the rate must be a fixed rate. This is a rather deeply ingrained attitude, and practically generally dominant today. It comes, probably, from a mistaken identification of international currency and exchange rates with domestic money.

The price rigidity of domestic money is the fixed rate of exchange, and convertibility on the other hand stands for the general acceptability of domestic money.

As we look back before 1914 and even into the 1920's, we find that fixed exchange rates were not at all objected to. No, they were rather desired, because the national monetary authorities actually used fixed exchange rates and the maintenance of fixed exchange rates, the maintenance of international reserves, to get rid of any individual responsibility for monetary policy. Governor Strong of the Federal Reserve Bank of New York stated that very clearly when he said, arguing for a return to the automatic gold mechanism:

> Until we get back to the automatic flow of gold which affects bank reserves and brings into play the automatic reactions from loss of reserves, I do not believe we are going to have all the satisfaction from the Federal Reserve System that we shall have after that time comes.

Thus the central banker is relieved of responsibility toward domestic monetary policy. There need not be any, because the only thing we have to do is maintain a fixed rate of exchange.

The so-called commercial loan theory, on which our Federal Reserve System was built in 1913, rests on this assumption.

So I fear we have both too much and too little reliance on the effect of price adjustments in the foreign exchange markets, and I believe we should hope to educate the international financial community to the point where they would accept a system of flexible rates which fully conforms to the principles of the market economy and eliminate the inconsistency of fixed rates without the integration which formerly the gold standard, at least, provided.

I do believe the system could be very gradually introduced within the framework of the existing International Monetary Fund by permitting the members of the Fund to introduce greater margins above and below par value for transactions in gold. That should be done in conjunction with the indicated cooperation of national stabilization funds and should proceed with the greatest effort toward coordination of internal policies, and should probably be undertaken only after we really have gotten out of our present dollar difficulties.

Thank you.

Representative Reuss. Thank you, Mr. Halm.

Mr. Kindleberger?

STATEMENT OF CHARLES P. KINDLEBERGER, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. Kindleberger. Thank you, Mr. Chairman. May I say how much we in the academic community welcome the initiative taken by the Joint Economic Committee in making this valuable set of materials available to us for teaching?

I am afraid, however, that it exposes us rather widely to public view in our disagreement. But I think that is healthy. They seem to be an excellent set of papers and we are grateful to you for them.

For my own part, I am going to agree with my colleague from North Carolina and disagree with my colelagues from Cambridge. I am going to defend fixed exchange rates, but on a somewhat different basis than Mr. Ingram.

Representative REUSS. I do not know who arranged the seating here, but I notice the firm people are at either end and the flexible people are in the middle. It is sort of like a jelly sandwich.

Mr. KINDLEBERGER. In the first place, I want to suggest that the problem has improved a lot in the last 2 or 3 years. Three years ago, Professor Triffin came to your committee and said that we must prepare to meet Armageddon in the international financial sphere: The instability of this system is about to be revealed and we are going to have another 1929 or 1931, or something on that order.

I feel Professor Triffin failed to estimate adequately the stability of the system, as helped by the perimeter defenses of the dollar worked out by the Treasury, by the Basel agreement and by cooperation among central banks. I think then the system might be unstable if it were not steadied by international collaboration. This has been forthcoming and seems to be the solution of the shortrun problem. We are left now with the basic balance problem, rather than what is referred to as the total deficit problem.

If you are going to devalue by 15 percent to handle the basic balance, you are using a club or a bludgeon to operate on something which is not that serious. We have $2 billion, let us say, of basic imbalance out of a total GNP of $550 or $570 billion,. To distort all kinds of relationships in our foreign trade, which runs $20 billions on each side for this small amount of deficit would seem to me to be quite a mistake in policy. I have heard the appeals to the market of Professor Caves and Professor Halm, but I am not moved by them. People who believe in the market system thoroughly would auction off the places in every trolly car as it went by to try to get full utilization of capacity. Flexibility of prices can be carried to extremes. But the lady going shopping would like to know what the price of trolly cars is going to be that day and what it is going to be the next day and the next day after that. Trolley car rates may require changes from time to time, as I notice has happened in this city: but the notion of auctioning off seats in each has, and having every price fully flexible goes too far, it seems to me, in support of the free enterprise system, which we all support.

Now I would also like to speak to the question of the Canadian experience. The Canadian experience is cited as suggesting that short-term capital movements will move in an adequately stabilizing fashion under flexible exchange rates. But to use the Canadian experience as support of flexible exchange rates, when the Canadians themselves fully reject it, seems a rather curious bit of reasoning. It is true that the Canadians, in fixing their interest rates, made mistakes. They attracted movements of long-term capital from the United States which put the fringe exchange rate up too high, hurt employment, overvalued their dollar. This had awkward consequences. But this suggests exactly that what you cannot do by flexible exchange rates is to isolate monetary policy. While the short-term capital movement was stabilizing, long-term capital was destabilizing. If one says, but the Canadian test of flexible exchange rates was corrupted by mismanagement of monetary policy, one is posing the problem unfairly. This is to compare the actual American situation with an ideal flexible exchange rate system. I do not think that is appropriate.

It seems to me one has to compare systems as they operate, and in this case, I would say the Canadian system must be set down on the negative side against flexible exchange rates.

Professor Vanek has himself discussed some of the doubts that economists have as to his estimate of what a 15-percent cut in the dollar would do for employment. I share those doubts. He has a multiplier, it seems to me, that is much too high. I would think the multiplier is in the neighborhood of two rather than eight. But if he were right, let me suggest this: this is the kind of policy which we agreed at Bretton Woods to reject. This is a beggar-our-neighbor policy. This is trying to get a gain in employment at the expense of other countries. This would be subversive of the kinds of undertakings which we have made to other countries, which is to try to work out these things cooperatively. This is why I support the integrated solution of Ingram.

Professor Halm's paper, submitted to you, does suggest that there are burdens of being a key currency, and we are bearing those burdens now. Perhaps those burdens are not appropriately shared, and efforts the administration makes to get them more appropriately shared in OECD, in the Basel agreement, in IMF, seem to me to be worthwhile. But I think it is also fair to say that while there are burdens and costs to the system, the system does, in fact, have benefits for world trade, and these benefits must be weighed against the costs. I would rather claim that for the key currencies to have a fixed relationship to each other over time provides a framework of stability for the world system which, if we could work it out effectively, would redound to the benefit of all on an international basis.

There may have been some undervaluation of the dollar when the sterling rate was set in 1949. But I think we have seen in the 5-percent revaluation upward of the mark and the guilder in 1961 how upsetting an attempt to change these pegs for key currencies is. Professor Halm has indicated in his paper, and I think rightly, that we have altered the nature of the Bretton Woods agreement for key currencies. We no longer want movable pegs, but rather fixed exchange rates for key currencies. Movable pegs have been retained for nonkey currencies. But if key currencies adjust their exchange rates they stimulate investments of short-term capital on an enormous scale, as happened in 1961. Central bank cooperation got us through that episode effectively, but it was still upsetting to people.

My real message, sir, is that you have to have international collaboration in any event. This international collaboration under a system of variable exchange rates is obviously needed. What happens if two countries tried to adjust their rates downward against each other? They would be working at cross purposes.

One of the big contributions the United States makes to the world today is to keep its dollar steady so other countries can adjust their exchange rates. If everybody is adjusting at the same time, you may get chaos.

With the integration of short-term money markets we are about to get much more effective movement of short-term funds. Independent national monetary policy will become limited. But the freedom of fiscal policy which Ingram spoke about remains.

I am a little worried about Professor Ingram's reliance on long-term financial integration. I do not see that there has been much of a contribution of the integrated long-term capital market in adjusting the balance of payments between the United States and Canada, to use the Canadian example again. We have had effective integration of financial markets between the United States and Canada, but perhaps again you can blame this on Canadian military mismanagement, we have not had the effective help in managing the balance of payments from long-term capital as we have had from short.

The study of Mr. Altman, in your papers, suggests how complex, how interrelated international money markets are through the Eurodollar market which connects them to New York. As far as the basic balance is concerned, we are working to correct the overvaluation of the dollar which I agree exists. I think it would be a mistake to try to correct it by a variable rate, or by what Professor Houthakker suggests should be a big devaluation. This would be very upsetting. I think we need a little more time. We are moving in the right direction and I would think we are doing very well.

Thank you, sir.

Representative REUSS. Thank you. I am glad that we have a sharp clash of interests here, because that is the point of these panel discussions.

I would like to ask the trio in the middle, the flexible rate advocates, and probably Mr. Vanek first, just how this proposed devaluation, with its alleged beneficent effects upon our GNP, would come about.

You have said a 15-percent devaluation of the dollar vis-a-vis all the other currencies of the world.

Mr. VANEK. Yes.

Representative REUSS. First of all, under the Bretton Woods arrangement, this would require the consent of the other signatories of the IMF.

Mr. VANEK. If I may answer you—not the flexible rate system.

Representative REUSS. Well, you also advocated a 15-percent devaluation, did you not?

Mr. VANEK. Yes, but through flexible exchange. I would expect that our competitive free exchange rate would probably settle at around 15 percent below our present value under flexible rates.

Representative REUSS. Well, flexible rates would require a radical reformation of the IMF charter; would it not?

Mr. VANEK. Yes.

Representative REUSS. So you are assuming that there is a big Bretton Woods-type monetary conference, and we all agree to abrogate Bretton Woods and start in with new flexible rates.

Mr. VANEK. Also, there could be a U.S. action, a floating of the dollar against all the other currencies.

Representative REUSS. This, under Bretton Woods, would require the consent of our partners, would it not?

Mr. VANEK. Yes.

Representative REUSS. So, however it is done, whether by a universal acceptance of flexible rates or by a unilateral U.S. devaluation, it would require the consent of other members of the Monetary Fund. But let us assume that, somehow or other, that consent is obtained. Otherwise, you never get to your thesis.

Mr. VANEK. Yes.

Representative REUSS. What I want to explore with you is just how does this do all the good you think it would do. Then we shall also look at the other side of the coin, some of the harms it might do. But first of all, on the advantages, will you tell me in a commodity-oriented way how reducing the world price of the products we are now exporting is going to yield added income, and how this is going to multiply out?

Mr. VANEK. Yes.

Representative REUSS. We now export around $20 billion a year.

Mr. VANEK. $25 billion on current account, I counted, counting goods and services.

Representative REUSS. And what do your studies indicate about price elasticity on these things we sell? It seems to me one has to know this.

Mr. VANEK. Well, it is not easy to answer it, not using technical language here. Let me tell you about the assumptions I have made and point out something about the empirical evidence we may hope for in respect of these assumptions.

Representative REUSS. If I may interrupt to give you the flavor of what I am after, it seems to me that a devaluation which reduced the price of export wheat from this country 15 percent would not sell much more wheat.

Mr. VANEK. Yes, but wheat, I think—our exports of wheat out of the $25 billion of exports is probably a very small fraction.

Representative REUSS. That is true, but I think one has to take the whole spectrum.

Mr. VANEK. That is true; one has to take the whole spectrum, and one has to take a certain average of those elasticities. The estimate of approximately $20 billion improvement in our initial income is based on an average elasticity of demand for our exports of about one and a half. This means that a 10-percent change in our rate of exchange would increase our exports by 15 percent.

Now, as you say, the spectrum is extremely wide. There are certain commodities where we are facing certain agreements or certain barriers where our exports would not increase very much, such as in the case of wheat; even basic elasticity of demand for wheat will probably be very low. But there are other commodities, primarily manufactured products, a major portion of our exports, whose elasticity may be expected to be very large, both on grounds of the fact that we are competing in those products with domestic producers overseas, say Germany and the European countries, but especially because we are competing in third markets, in the underdeveloped countries.

The econometric studies of what the size of elasticities are I would not rely on very much. They indicate a certain range between, say, one, and some people would believe two. I talked to Dr. Mundell, who recently came to MIT to give a paper. He believes the elasticity of demand for our manufactured products is as high as four, precisely because of this competitive effect in third markets.

So I have assumed something that I believe is a fairly sober estimate: about one and a half for the elasticity of demand.

Representative REUSS. Now, let us apply that. You are going to devalue, however you do it, by 15 percent. Let us apply that to the $2 billion. That is $3 billion. You claim you will get some English on that of about another 50 percent, so that will be about 22.5 percent of $20 billion, or $4.4 to $4.5 billion.

So the first round effect of devaluation, according to your thesis, would be an additional $4.5 billion worth of goods which we could sell in the world?

Mr. VANEK. If I may object, this is only one-half of the picture. There is another half that we are somehow forgetting, sometimes; namely, if we devalue by 15 percent, foreign goods and services become in the United States 15 percent more expensive. And the other effect is then substitution of domestic products for foreign products on the part of domestic buyers. Because there is a certain symmetry between the two things. Our exports are increasing. On the other hand, our domestic demand for domestic products is being substituted for domestic demand for foreign products, for the very same reason that the parity of prices between foreign and domestic goods has changed.

For example, let us take foreign travel. This is one part of our imports of services—travel abroad. On the margin, if everything would suddenly cost for the American 15 percent more because he has to go into the foreign exchange market to get his dollars there, there will be some marginal people who will either spend less while traveling or will forgo their foreign travel.

Representative REUSS. Of course, when you get the imports, a great percentage of our imports are nonreplaceable, and devaluation would not cause us to substitute homegrown products, because we cannot produce them.

Mr. VANEK. That is right.

Representative REUSS. So how much do you get out of the import on tourism?

Mr. VANEK. On the import side, about the same as for exports, or a little less.

Representative REUSS. There I am very skeptical, frankly, because, first of all, our imports total $15 billion.

Mr. VANEK. Again on current account, $20 billion, with the goods and services. Because goods and services will become more expensive.

Representative REUSS. And tourism; yes.

Mr. VANEK. And, for example, spending by Armed Forces. That is also our imports. We now use some very awkward measures of discrimination, to the extent of 50 percent, when we buy in Germany. I think it is one of the recent rulings that our Armed Forces in Germany have to buy American goods unless the competitive goods in Germany are less expensive than 50 percent of our American prices.

Now, my entire analysis is based on a world free of discrimination.

Representative REUSS. But if you are going to get that $4.5 billion across the board, it seems to me you are not eliminating from your base, as I think you ought to eliminate, the very wide range of imported commodities which we are going to have to keep on importing, even though they are more expensive.

Mr. Vanek. Yes. Let us say, for example, the substitution effect, the second effect we are speaking about, is only about half of the export effect. This means there are quite a few commodities that are irreplaceable.

Representative Reuss. So you would reduce the 4.5 to about 2.25.

Mr. Vanek. And add it to the 4.5.

Representative Reuss. That is \$6¾ billion.

Mr. Vanek. That is right.

Representative Reuss. Yes.

Mr. Vanek. Now, the total effect I speak about, of \$20 billion, then, is approximately three times higher than that.

Representative Reuss. You are using the multipliers that people use when they talk about tax cuts?

Mr. Vanek. That is right. This multiplier, as I was pointing out, and here I would like to partially answer Professor Kindleberger's objection—he was referring to my earlier writing on this subject. He probably is not familiar with my paper for this committee, where the estimates are lower, because I have specifically taken into account the effect of the built-in stabilizers.

Now, I am assuming that in the initial round, we get an effect close to \$7 billion. Out of those \$7 billion, a fairly large amount is assumed to leak into national savings. By national savings, now, I think savings by private individuals and those savings caused by built-in stabilizers, primarily taxes which are progressive. Out of the \$7 billion, I am assuming that on the whole, the national savings, the marginal national savings will be 0.4. This is an enormous figure, because the figure is about five times higher than the average private savings. What we call the marginal savings is very high; 0.4 out of \$7 billion is approximately \$3 billion. This, in the first round would leak into savings, either private savings or savings on grounds of built-in stabilizers.

This, of course, assumes a very unfavorable assumption for my analysis, fixed Government spending. Federal spending is constant, but taxes are increasing because of increased income, and on the whole, there is 0.4 or 40 percent of the additional initial income that leaks into savings. So only a fraction of the initial change returns into the spending of the economy to produce further changes.

So the assumption is not a low marginal national savings propensity, but a high one, five times higher than the average. Then, so the argument goes, this reduces the cumulative effect.

Now, the other asumption, of course, I make, and again I try to base myself on some recent theory, is that there is something you may call propensity to invest.

The commonsense of the argument is that as income increases, our entrepreneurs will use this as a signal for higher investment. All recent theory, certain theories developed in Cambridge recently, showing that there is a high correlation between private corporate investment and corporate retained earnings would indicate this, acceleration would indicate this, the so-called theory of induced investment would indicate this. So we can assume, I think it is a fairly commonsensical argument, if our income goes up our entrepreneurs will invest somewhat more.

Representative REUSS. Let me ask you this—we shall go back to your first round in which we figured that the differences through expanded exports and contracted imports would total close to $7 billion.

Mr. VANEK. Right.

Representative REUSS. These assumptions, in terms of our balance of payments, would mean that instead of running a balance-of-payments deficit now of around $2 billion, we would be running a surplus of $5 billion.

Mr. VANEK. By no means, because we are considering only the first-round effect. By the time the entire effect would work itself out, by the time you get those $20 billion, the first important corrective effect on the balance of payments is that with $20 billion higher income, we shall have a certain increase of imports—this is the offsetting effect. The price effect reduces imports, but the additional income increases imports. So this offsets part of the initial improvement.

Representative REUSS. By how much? How much do you think our imports would increase?

You have assumed a total of $20 billion additional GNP. Our present import to GNP ratio is 3 or 4 percent.

Mr. VANEK. Yes, but on the margin, it will be somewhat higher. This I would correct; 3 to 4 percent is the average. But the marginal inducement to import, I would assume, and many would agree, is somewhat higher, so you might expect out of $20 billion at least $1 billion or a little higher correction.

Representative REUSS. That would reduce our assumed balance-of-payments surplus on your model from $5 to $4 billion?

Mr. VANEK. That is right.

Representative REUSS. Are you going to reduce it any further?

Mr. VANEK. I am not. What appears in the figures is not as high as that. First of all, we have lots of tied loans. We have lots of a sort of discriminatory interference.

This, of course, would have to be taken into account. Also, we might want to have a certain leeway by the time we would come to fuller employment with this $20 billion effect, because inflationary pressures no doubt will be fairly strong by that time and we can expect further worsening in the balance of payments on this account.

I would say the fundamental disequilibrium, not the one Professor Kindleberger speaks about but the one at full employment, is around $4 billion.

Representative REUSS. I will ask Professor Kindleberger or Mr. Ingram, either one, this question: I suspect that the real answer to the utopia which Mr. Vanek paints is that our partners would not sit still for it. They would not allow us to devalue or go to flexible rates. But suppose that they did. Suppose we decide to adopt the Vanek plan and we put it to our partners and, to our surprise, they say, "Fine, let us amend the IMF Charter and act accordingly." What would you have to say then to this proposal?

Mr. KINDLEBERGER. I have a hard time, because of this, I regard this as a beggaring-of-thy-neighbor policy, of the type we agreed not to undertake during the depression.

Representative REUSS. Suppose they do not think so. Suppose they are persuaded by Mr. Vanek that in the period immediately ahead, our expanded imports would——

Mr. KINDLEBERGER. I do think the estimates we have been through favor the case a little bit at the margin all the way and that the $20 billion is still excessive. The multiplier of 3 is excessive and the estimated elasticities are excessive.

As you suggest, there would not be that much. But I am prepared to assume it.

There is one more fact left out. That is the increase of $7 billion in our surplus would have negative effect in the rest of the world. We have left out what we call in international economics the "foreign repercussion."

Representative REUSS. Before Mr. Kindleberger goes on, do you want to give a quick rebuttal to his suggestion that your export figure may be illusory, because as we impinge on their markets, their income will go down, and though our goods are cheaper, they will have less money with which to buy them and hence will buy less. You did use that on the import side.

Mr. VANEK. Yes, I did, except I think that I would like to recall—the argument that I am going to present now is somewhat complex. If anybody is interested in it, I have published on the subject, precisely giving the answers to the problem here.

The situation is really asymmetrical. The situation which Mr. Kindleberger is describing would pertain to the 1930's, when the entire world was in a depressed condition. Then it will be a beggar-ing-of-thy-neighbor policy. We would gain and the rest of the world would lose. We find that in the early 1960's, the situation is quite different. We have asymmetry between the United States and the rest of the industrialized world. We have underfull employment in the United States and what you may call extreme pressure on resources, and overfull employment in the rest of the industrialized world.

This changes the picture very much. My expectation is, well, let me state it this way: If you have overvaluation, it depresses our income and improves conditions abroad. This is exactly what we have been witnessing in Germany, France, all over Europe, in England, for the last 4 years. There we have overfull employment.

We soon come to the full employment barrier.

Now, what can the foreign countries do? There are no additional resources. Today in Germany, there are 600,000 unfilled jobs that they cannot find employees for. The foreign authorities have to combat inflationary pressures resulting from the pressure on this full employment barrier by fairly tight monetary policies.

This is something that comes into the context of Professor Ingram's paper.

Consequently, not to have inflationary pressures with relatively undervalued currencies, they have to have a very tight monetary policy. We observe in those countries interest rates far above ours.

In Germany, they have high long-term rates, in Britain they are around 6.5 percent, while ours are around 4 percent, the same for our short-term interest rates.

If we devalue, the reverse will take place. The Germans and the continental countries would not start immediately moving away from full employment, but first of all, there will be certain more normal conditions created, the monetary policy will not have to be so stringent as at present. Interest rates will be going up naturally in the United States and down in the rest of the world. But will low rates of interest abroad the improvement in our balance of payments in the United States that we obtained through devaluation will be absorbed abroad, not by reduced income but by increased real investment. Again I am being technical. The difference between exports and imports on current account must be equal to the difference between internal savings and internal investment. Low rates of interest will bring about increased investment in foreign countries such as Germany, and the increased investment will take off the downward pressure of the trade balance on income in foreign countries that otherwise would have produced declining employment.

So my expectation is that the devaluation of the U.S. dollar would do a good job on the U.S. side, and also a good job on the side of the other countries, because it would permit them to have a lower rate of interest and higher rates of domestic capital formation.

Representative REUSS. Thank you, Mr. Vanek.

Mr. Kindleberger, returning to your point, we have noted that you are skeptical of some of the arithmetic on both the export and import side of devaluation. But the question I have to put to you was; assuming that we could convince our IMF partners that this was in everybody's interest and thus, flexible exchange rates or a unilateral, U.S. devaluation were permitted, what would be its consequences?

Mr. KINDLEBERGER. Well, it seems to me that if there were an agreement on devaluation which could be arrived at secretly and put into effect suddenly so as not to upset the foreign exchange market, it might be very helpful.

I think the dollar is an overvalued currency, and foreign currencies are undervalued. I am not at all sure they are undervalued equally. I think I would prefer to see the adjustment go forward by having them revalue upward by somewhat different amounts.

In the case of France, they seem to be particularly undervalued. The German picture is much nearer equilibrium with the expansion they have had in that country for the last 2 years. But if we could get agreement of this sort, we could get a somewhat slight adjustment.

I may say parenthetically that I will not accept at all the calculations Mr. Houthakker suggested to your committee in his paper. They seemed to me to be a flagrant misuse of theoretical considerations. He used the absolute purchasing power parity doctrine as if the world had the same wage rates everywhere, calculating from cost-of-living indexes which have a lot of goods and services which do not move in international trade and have a very high labor content. Most international trade economists accept with some diffidence and gingerly the purchasing power parity doctrine on a relative level but do not believe in it at all as an absolute basis.

Nobody I know except Professor Houthakker is prepared to accept this thing in absolute terms.

So I would say, if we could adjust the rate by 5 percent again, somewhat differently against Germany and somewhat differently against

Italy, this might be worth doing. But I submit, sir, it could not be done so neatly. You would have to get the patient, anesthetize him, operate, and have it all done before he wakes up the next morning without him knowing what happened. If you discuss the operation for a few weeks, you will get him so upset that you will never get him into the hospital, if I may use a rather complicated metaphor.

Representative REUSS. Well, then, it seems to me your difficulties with the devaluation suggestion come down to three: First, while you recognize that the world's currencies are not perfectly valued, and the dollar may be somewhat overvalued today, nevertheless you think that a better way of reaching equilibrium, if you are going to do it at all, would be in differential revaluations by other currencies rather than a one-shot devaluation by this country.

Second, you don't think that the idea of a 15-percent U.S. devaluation would appeal to our partners, and they simply would not allow it when the negotiations, however secret, took place.

Third, you envisage disquieting consequences to international financial arrangements if such a devaluation were attempted by this country, or if the subject were brought up in a serious way.

So that even though ultimately you could get agreement, you never would reach that ultimate stage, because there would be runs on the dollar and other untoward consequences along the way.

Is that a good summary?

Mr. KINDLEBERGER. Yes.

Could I make two more small points? One is that the elasticities which Professor Vanek discussed are different in the short run than in the long run. They are very different.

In the long run, the elasticity is much higher than in the short. And one has to consider the time path that one is interested in finding adjustment in.

If you try to get adjustment in the balance of payments with a variable rate through changes in the commercial accounts, you are likely to overshoot the kind of adjustment you want in the long run. That is you tend to devalue by too much. In the long run you will get too big an adjustment, and the exchange rate will have to move over the other way.

Most economists, I think, agree that the short-run adjustments in the balance of payments under flexible exchange rates must come from stabilizing short-term capital movements. If this works well, it becomes almost exactly like the movement of stabilizing capital under a fixed rate.

The second point is a small one on gold. It is better, if you are adjusting exchange rates, to do so that the price of gold stays the same. The U.S. dollar shouldn't be devalued, but the other currencies should be revalued upward, so as to punish the gold speculators, who haven't helped the situation at all, even though they haven't hindered it.

Representative REUSS. Would you add the additional point, so as not to give windfall profits to certain gold-producing countries?

Mr. KINDLEBERGER. That seems to me to be a political concern, rather than an economic one. But I happen to share that political prejudice.

Representative REUSS. Mr. Caves, would you like to comment on the Kindleberger reply to the Vanek thesis?

Mr. CAVES. I could comment on a number of points of Professor Kindleberger. But I think I will be somewhat selective about them.

First of all, the statement that he made about the equivalence of adjustment through devaluation with optimal policies, an adjustment through flexible exchange rates, again with optimal policies, that should be examined a bit, I think, sir.

Under a system of pegged exchange rates, there is a problem of hitting the right one when you change it, a problem that I might have mentioned as a basic difficulty that has turned up in the Bretton Woods system, in addition to those of discerning fundamental equilibrium in the first place, and getting your international liquidity arrangements right.

It is very difficult for Professor Houthakker, Professor Kindleberger or any of us to tell exactly what would be an equilibrium exchange rate in any system of equilibrium.

Certainly it has been said correctly that one of the troubles of the past decade has been that the devaluations of 1949 went too far for achieving long-term equilibrium. And yet at the time it seemed that they had to go that far to convince everybody that they weren't going to go further right then and there.

In short, the difficulties of arranging policies under a fixed exchange rate regime so that you hit the right rate when you make the change are very great, whereas under a flexible exchange rate system the market helps you out.

This is not to say that there will not be fluctuations and overshoots; this is not to say that the thing will work no matter what patterns of short-term capital movements tend to persist, but simply, I would point out, that it is not necessary for the government to nail its flag to one particular mast in adjusting under a flexible exchange rate system. The market does the guessing for the government, as it were, and if the basic climate is one of reasonable stability in short-term capital movements, then the problem of optimal policies under a flexible regime is not nearly so constraining as that under a regime of fixed exchange rates.

In replying to the other points that Professor Kindleberger made, I perhaps should register my general agreement with Professor Vanek's numerical computations. My briefcase is devoid of originally produced numbers, and so I have simply looked over Professor Vanek's work. I might quibble with him on a few small points on the value of certain coefficients which he assumes. But basically I find his estimate in the same rather small ball park where I suspect mine would come down if I were to do it in similarly careful fashion.

Representative REUSS. Thank you.

Mr. Humphrey?

Mr. HUMPHREY. Could we bring this down to very practical signals that may be involved?

The usual impression is that loss of reserves is something that everybody sees and takes seriously, and therefore the fixed rate with loss of reserves is a good signal system. On the other hand, it says that a decline in the value of your currency is always a signal, and can be as good a signal as the loss of reserves.

Does anyone have a reaction to this?

Mr. HALM. I think the second one would be a better system.

Mr. HUMPHREY. Changing the value of the currency is at least as good a system.

Mr. HALM. Because it has an instant stabilizing effect which the loss of reserves does not have, or only at the cost of higher adjustment of domestic interest rates, so that the consequences may not, in certain cases, be the ones we wish to have.

Mr. VANEK. I think the question we ought to ask is, how do your policymakers and bankers feel about it? We would probably have to question a number of important men in this field to find out how their reactions would be.

I know that Professor Haberler, who didn't come here this time, quotes certain examples from bankers in other countries who said that they would consider the flexibility of rates or depreciating currency itself as adverse, as a worse signal than a loss in reserves.

Mr. HUMPHREY. You said worse?

Mr. VANEK. Yes.

He quotes it as a single instance. And there may be others that would take a loss of reserves as a more serious indication.

Mr. KINDLEBERGER. I think it would be useful, if I may, to interject that the central bankers may get the signal in some cases. But it is not quite clear that they always have the power to do what they want to do about it.

In Brazil it is clear what the signals show. The signals show that the rate is going down very fast, and somebody ought to grab the ball, but it is being fumbled.

Mr. HUMPHREY. Does it work in favor of one or the other, or is it just that no signals work in some situations?

Mr. KINDLEBERGER. That is why I would suggest that the distinction between the two for Brazil is really irrelevant.

Mr. CAVES. I feel an academic need to ask Professor Humphrey, signals of what?

Mr. HUMPHREY. A need to change domestic policy?

Mr. CAVES. This is exactly the context that seems to have been emerging from the discussion among the panelists, that is to say, if we can see the problem as being one of telling governments when they are indulging in policies that permit too much inflation relative to developments in other countries, we are dealing with a very particular type of policy problem, though perhaps one of the major ones which we face.

I think the proper attitude of a flexible exchange rate proponent is that there is an open question here about which is the more effective signaling device. There is an open question about whether there is more of a contribution to inflation from permitting the exchange rate to vary than there is from the policies that are necessary to seek to protect a fixed rate. There is a question, as Professor Vanek indicated, of the attitude of those people who are receiving the signals. That is something that I regard as a very complicated question, and one to which there cannot be given a general answer or an answer which is valid for any country as to which you asked the question.

Mr. INGRAM. May I add to that that I think it would be incorrect to have the advocate of flexible exchange rates advance the argument that, given the declining exchange rate signal, the market will take care of the situation and adjust the balance of payments without the necessity for some kind of monetary and fiscal policy action. I think this argument is sometimes made as if it freed the country from that necessity. I believe personally that the system might work perfectly well if it were accepted widely, but that it would require a coordination of internal fiscal and monetary policy in much the same way as the other system would require some kind of internal adjustment, and that they don't differ fundamentally in this respect.

Mr. HUMPHREY. Mr. Ingram, another question for you. If I read the signs coming out of Europe after the up-valuation of the German mark and Dutch guilder, it is that the bankers, at least, seem to be saying, never again. Assuming that something like this is taking place, aren't we getting to your proposal of having fixed rates, Bretton Woods or no? And my question is, Why don't we get equilibrating capital movement, as is implied by your very imaginative proposal and analysis?

Mr. INGRAM. Well, I agree that there is a very strong sentiment against varying exchange rates in the banking community. I think their views are fairly well known on this point.

And I think it is also true that we will tend to have a system of fixed exchange rates among the Atlantic community countries. And the question is whether we may make use of the advantages of this system, or operate as we have been by denying ourselves the advantages of it, and taking all of the unattractive aspects of it.

The reason we don't get a larger amount of equilibrating capital movement in my opinion is that we do not have the kind of complete certainty about exchange rate structures that would permit management of investment institutions to enter the international money market freely and without grave concern about what risks they are taking. That is, there is still the exchange rate risk that is a barrier, in my opinion, to a free flow of portfolio capital movement.

And of course the second item would be the remaining exchange controls which may prevent this flow of funds from occurring. As I have tried to show, I believe the United States also has restrictions on transactions in foreign securities, not in the same form, but that have the same effect, and that furthermore U.S. capital movements and decisions of monetary managers are much affected by exchange controls of European countries.

For example, an insurance company won't buy British long-term bonds, since they know that there are restrictions on the convertibility of the proceeds under certain conditions, and they may be unwilling to buy the securities for that reason, besides the exchange rate risk.

I would think that removal of these two barriers would release considerable amounts of capital which could then respond to the signal, namely, small changes in interest rates.

Mr. HUMPHREY. This next question I would like to direct to you, Mr. Ingram, but also to any member of the panel who has a thought.

For the purposes of this question I take it as a premise that we obtain formal agreement that exchange rates are fixed forever. Do you see any way of making this credible?

Mr. INGRAM. Well, I think that is the acid test. I don't know. I suggest quite tentatively in this paper that perhaps it is feasible to require banks to effect transfers and take care of the transfer problem by the arrangement of their own portfolios and accumulation of reserves, secondary reserves. But I am not myself entirely convinced that this is workable. It is a movement toward the creation of a fully fixed exchange rate system, which is obviously a movement toward a common currency, even though we may call the units by a different name. And I would be interested in the opinion of the other members of the panel.

Mr. HUMPHREY. Mr. Vanek?

Mr. VANEK. I would like to make two comments on Mr. Ingram's paper. It would be useful to start with an example to show what would happen today if his conditions were established as of now, namely, perfect integration of the financial markets. It would imply equality of rates of interest, or approximately the equality of the rates of interest, throughout the western community that he speaks about.

I want to examine the effects today, given our present conditions in the United States and in the rest of the world. I think, as Professor Kindleberger once suggested to me, you take domestic monetary policy from the hands of the National Government and from the central banks by equalizing the rates of interest through long- and short-term capital flows as between nations. Then the policy left to the different countries—with fixed exchange rates—the only policy tool the governments are left with, is fiscal policy, and employment conditions, and so forth have to be regulated by that policy.

Let's take the example of today; what would be required to have the situation Professor Ingram is proposing together with reasonable employment everywhere. This would require, as I see it today, a very strong budget deficit in the United States, and very strong budget surpluses in the countries that we have spoken of before as having undervalued currencies.

As a long-term proposition this is impossible. We cannot have permanently a substantial deficit in the United States, preserving full employment, and permanent substantial surpluses in other countries, preserving also full employment, without inflationary pressures. And consequently I would agree with the proposal of Professor Ingram only provided that we have basically sound conditions in the balance of payments, basically sound conditions in employment, in the different countries.

Then I think his device can be used to cope with cyclical fluctuations in the balance of payments. Always the cycle has to move around a balance in the balance of payments, but if you have a situation where there is an undervaluation on one side and overvaluation on the other side, his system could not be perpetuated indefinitely; exactly for this reason, that there is only one policy left in the hands of the National Government; namely, fiscal policy.

Mr. HUMPHREY. If I may interrupt, do you just mean that the initial condition is an equilibrium?

Mr. VANEK. Yes. And if we have only the cyclical problem then I would subscribe to Professor Ingram's policy, then we need only one policy instrument. But given our present situation this is not the solution. This is my first point.

My second point is rather brief, namely, I do not believe that you can establish perfection of financial markets across national borders of the type described by Professor Ingram.

Let me give you just one example. We have in the United States a single country with a very good mobility of factors of production, and with a single central bank. We observe for certain types of national markets a high degree of imperfection and lack of mobility. For example, I read almost every day in the New York Times advertisements concerning saving deposits in California. And they offer you close to 5 percent, while here in the East we get around 4 percent on savings deposits. And this is within a single country, with a single currency, with a single monetary policy, a single central bank, and a high degree of mobility of the other factors of production; yet you get almost a 1-percent differential on certain types of deposits.

Now, imagine that we were not in the United States but in different countries with different currencies, and with transportation costs among them, and with hardly any mobility of labor. Under such conditions I cannot see that we would get this ideal situation you are speaking about, unless deliberately pursued by the authorities of different countries. This is the second, practical point that I wanted to make.

Thank you.

Mr. INGRAM. May I make a brief comment on each of those?

As to the permanency of the budget deficit in the United States and the budget surplus in Europe, I don't see why it would need to be permanent. There would be some adjustments called forth by the maintenance of the situation for a year or two; namely, the accumulation of financial assets in the hands of Europeans, and I should think at some point they would satisfy their asset preferences and would begin spending for real goods, which would cause the current account to swing. I don't see it as a permanent situation; this position of a deficit in the United States and a surplus abroad.

On the second point, I totally agree that perfection in captial markets would not emerge, nor do I think it necessary. Even if we get as close to it or halfway as close to it as the U.S. regions have come, there would be a large body of claims that would be mobile, that would move quickly, and whose yields would be equalized. But there would remain these other types of claims in the whole structure on which yields would vary, as in the case of the interest paid by the savings and loan associations. And I might say at this point that I think it is what I call de facto exchange controls within the United States that in part account for the existing differential—restrictions on the loan operations of building and loan associations, on the regions in which they can lend, and, of course, the frictions always involved in the movement of funds.

So I think the presence of regional differentials in the United States does not mean there is no role for equilibrating the flow of long-term capital among U.S. regions. On the contrary, I think that these flows are large, and I believe they would be large in an integrated Atlantic community.

Mr. HUMPHREY. Does anyone have a last comment on this or other issues?

Mr. Halm?

Mr. HALM. I should like to make a brief comment, argued in a very old fashioned way. Suppose we assume that different members of the Atlantic community are differently endowed with labor and capital resources. Would you not assume that a tendency toward perfect equalization of interest rates would be the cause of actual goods movements in which these capital movements eventually would have to materialize, movements which would go beyond what we can practically accomplish? In other words, I return to an argument which Keynes made in the second volume of his "Treatise on Money."

Now, I don't think that this would change your argument, short of one point; namely, that the equalization is not one which accomplishes complete identity of interest rates, but which accomplishes movements of capital between individual members of the community, each member having, one, a rate of 5, the other of 6, and a third of 4 percent, determined by more fundamental scarcity relationships.

Mr. HUMPHREY. Mr. Caves?

Mr. CAVES. I have one comment which I think should be made about capital mobility with regard to problems of balance-of-payments adjustments. It is that a persistent differential between interest rates in two regions does not necessarily mean that there will not be a large sensitivity of capital movements between those regions to changes in that margin of interest rates. The United States and Canada furnish an excellent example of this. The whole structure of Canadian interest rates has always been a small margin higher than the United States, one-half of 1 percent, 1 percent—and yet the flow of capital between those two countries is extremely sensitive to changes in that margin. I think this trait of capital markets and capital mobility is important to appraising Professor Ingram's suggestions.

Mr. KINDLEBERGER. I would only want to add that this notion of freeing monetary policy through favorable exchange rates, I think, is given the lie by the Canadian experience. I am sorry that the defendants of the variable rates never did get around to a claim showing where the Canadian experience was a great success, because certainly the Canadians don't think so.

Mr. CAVES. I can't let Professor Kindleberger get away with his interpretation of the Canadian situation. I must go back to the original argument that was made in his opening statement in which he suggested that the Canadians had a flexible exchange rate. And now they do not have a flexible exchange rate. They made some policy mistakes, but that simply proves that one can make policy mistakes under any regime. And so, therefore, he concluded by some process I didn't fully understand that that proves that flexible exchange rates are not as good as fixed ones.

I fail to follow the logical sequence in that argument, I must say. Why does he not consider these two alternatives? The Canadians might have chosen more appropriate policies and kept the flexible rate rather than choosing less appropriate policies and discarding it. Why would not the former have been a sensible procedure for them to follow? Admittedly, people will make mistakes under any regime, under any system of international monetary organization. What we have to ask is what system will provide them the more freedom of action, what system will tend to minimize the impact of mistakes, what system will tend to reduce the requirements for the close coordination of policies between countries.

It is by reflecting on this sort of thing that the flexible exchange rates proponents come out with their answer. And it is indeed defensible by way of comparing what would happen in an imperfect world with flexible exchange rates with what does happen in an imperfect world with fixed exchange rates.

Representative REUSS. Mr. Ingram?

Mr. INGRAM. I want to return to Professor Halm's questions about relative factor endowment, and the trend toward price equalization that the theory implies.

I would say that financial integration would leave that mechanism inoperative. In U.S. regions the structure of interest rates might be higher in the Southeast than in New England, as they are. But there are certain types of financial claims widely acceptable throughout the United States and easily marketable on which the yields are exactly the same in the Southwest as they are in New England, since they are sold in national markets.

And that same kind of thing, I believe, would take place in the Atlantic community, a wide body of claims would move toward almost identical yield rates, those that are readily exchangeable and have certain qualities of confidence on the part of financial institutions. But the locally acceptable claims in the structure would continue to display yield differentials, and would continue to play their part in the allocation of capital.

Representative REUSS. Thank you, Mr. Ingram.

Gentlemen, we are all deeply appreciative of the brilliant quality of the discussion this morning. We knew there were differences in view, which is why we asked you to join in sitting on this panel. And you have contributed greatly to our deliberations. You have done a useful public service.

Thank you. We now stand adjourned until 2 o'clock.

(Whereupon, at 11:50 a.m., the hearing was in recess, to reconvene at 2 p.m. the same day.)

AFTERNOON SESSION

Representative REUSS. The Joint Economic Committee will be in order for a continuation of our hearings into the balance of payments.

Come right up, Mr. Bernstein.

This afternoon we have a panel on proposed reforms in the international monetary system.

The panel members are Fritz Machlup, of Princeton; Mr. Edward M. Bernstein, of this city; and Harry Johnson, of the University of Chicago.

We are happy to have you gentlemen with us.

Dr. Machlup, would you start out?

You have a prepared paper which we have before us, which will be received into the record, and would you proceed in your own way by reading it or any way you wish.

STATEMENT OF DR. FRITZ MACHLUP, PROFESSOR OF ECONOMICS AND INTERNATIONAL FINANCE AND DIRECTOR OF THE INTERNATIONAL FINANCE SECTION, PRINCETON UNIVERSITY

Mr. MACHLUP. Thank you.

I think it might be preferable if I did read it, Mr. Chairman.

Representative REUSS. Yes.

Mr. MACHLUP. Every student of monetary economics remembers the bimetallism debate. When both gold and silver were international money, convertible into each other at a fixed rate, there was periodic trouble. Depending on the relative scarcity or abundance, people were always rushing from one money into the other. Students learned eventually that safety lies in having only one international money.

The world is now blessed with three international moneys: gold, dollars, and pounds sterling. There are periodic rushes, sometimes from sterling into dollars, sometimes from dollars into gold. This is to be expected in view of the faster increase in the supply of these currencies relative to the supply of gold. If three international moneys are convertible into each other at fixed rates, Gresham's law will operate and the scarcest of the moneys will go into hoards.

MORE RESERVE CURRENCIES

Some money experts, instead of seeking safety in a return to a single international money, hope to find safety in larger numbers and urge that there be six or eight international moneys. Thus we are on our way to the multiple-currency-reserve standard. Let us hold our breath and hope it will work. I am afraid it can work only if all issuers of reserve currencies observe strict discipline and keep their currencies scarce.

Even this may not be enough. Assume that different central banks maintain different ratios in their reserve holdings; country A holds 40 percent gold, 30 percent dollars, 10 percent sterling, 10 percent francs, and 10 percent reichsmarks, while country B holds 60 percent gold, 20 percent dollars, and 20 percent francs. Any temporary flow of funds from A to B would change the demand for the various reserve moneys and, consequently, make some scarce and others abundant.

Or assume that general elections are coming up in one of the reserve-currency countries, with a contending party promising to pursue an expansionary monetary policy. The resulting expectations may start hot-money movements out of this and into the other reserve currencies and into gold.

Representative REUSS. You are disccussing purely hypothetical matters, of course.

Mr. MACHLUP. That is correct, sir. This is what the economists always do when they discusss possibilities.

If we actually go into the multiple-currency-reserve system in a big way, I am bold enough to predict we shall end up eventually with a world central bank. I base this prediction on my understanding of monetary history. When in the past the banks of a country held their reserves in a multitude of separate reserve banks which pursued independent credit policies, a series of financial crises occurred which ultimately forced the country to establish a central banking system.

Perhaps, instead of indulging in prophesies, I had better proceed more systematically with a review of the various reform plans and the reasoning that underlies the proposals.

THE PROBLEMS

The discussion of proposed reforms of the international monetary system suffers from a failure to distinguish clearly the objectives which the proposals are supposed to serve. Some of the plans may contribute to the solution of certain problems without doing anything to cope with other defects or dangers.

Three major problems should be distinguished:

1. Fundamental balance-of-payments difficulties of individual countries, particularly the United States.

2. Mass movements of short-term funds, induced by anticipations and fears.

3. The long-run supply of monetary reserves, possibly required to sustain the growth of trade among nations.

Probably no reform can be fully satisfactory on all three scores. Some proponents of schemes for the improvement of the world payments system admit frankly that they can do little to help on the first problem—the imbalance of the U.S. foreign accounts—and do not intend to do anything about the third problem—the longrun supply of reserves.

They hold that the imbalance of payments of the United States must be treated by policies not connected with the reform of the international monetary system. And they hold that, since the supply of monetary reserves is adequate at present and will remain adequate for the next few years, we should not concern ourselves with what may possibly become troublesome in only 5 or perhaps 10 years from now.

Hence they concentrate on the second problem, the speculative hot-money movements, and design systems to deal with it. There may be some danger in this because, fascinated by fine schemes to cope with hot-money movements, we may get complacent regarding the other problems and put off too long the deliberations about their solution.

THE PLANS

I propose to present a quick, a very quick, survey of five major types of reform plans and to indicate briefly what they could do with regard to the problems mentioned. I have discussed all five types briefly in the paper prepared for this subcommittee and published in part 3 of your series, and I have given more detailed descriptions in a special paper, published by the International Finance Section of Princeton University.

These are five types of reform plans:

A. Extension of the gold exchange standard from the present two reserve currencies to several additional reserve currencies.

B. Mutual assistance among central banks either through bilateral operations or through the IMF or other international financial institutions.

C. Centralization of monetary reserves either with or without specific provisions for the creation of additional reserves.

D. Increases in the price of gold either in one fell swoop or occasionally or in small quarterly raises.

E. Freely flexible exchange rates either without any official reserve holding or with moderate open-market operations to smooth fluctuations in exchange rates.

THE U.S. IMBALANCE OF PAYMENTS

The first of our problems, the basic imbalance in the U.S. international accounts, is not touched at all by reform plans of type A and B. Plans of type C and D do not solve this problem either, but they provide more time for its solution; depending on the particular arrangements, they may allow several years of grace, if such a delay should be desired.

Plans of type E remove this problem entirely or, more correctly, change its mode of appearance in that it replaces troublesome payments imbalance with troublesome price movements.

LONGRUN SUPPLY OF RESERVES

Skipping the second problem—hot-money flows—for the moment, let us see how the third problem—the growth of monetary reserves—is dealt with under the various plans.

Plans of type A—the extension of the gold-exchange standard—may not be effective on this score. At first blush one might assume that the promotion of several more currencies to the status of reserve currencies would add considerably to the stock of international reserves.

The question, however, is whether most of the central banks would actually be willing to carry significantly larger and ever-increasing balances in the new reserve currencies, and how the central banks of the reserve-currency countries would react to steady increases of their current liabilities.

It would be essential that the central banks whose liabilities become reserves of other central banks judge their own position by the "gross reserves," not by their "net reserves." It would also be essential that the reserve-currency countries as a group incur regular deficits in their aggregate balance of payments, since this is the only way the reserves of the "peripheral" countries could increase.

Thus, for a continuing growth in total monetary reserves the multiple-currency-reserve standard would depend on perennial deficits of reserve-currency countries. From 1950 on, it has been only the United States whose payments deficit created exchange reserves for the rest of the world. Now the world seems to be saturated with dollar reserves; but if it were willing to accumulate more reserves in the form of some other currencies, the payments deficits creating these reserves could be those of several countries, rather than of the United States alone, and this might be less disquieting.

It still remains to be seen whether the countries whose currencies are eligible for reserve status, namely, the surplus countries of recent years—that is, chiefly, the members of the European Economic Community—would be willing to incur regular deficits of over a billion dollars a year. These deficits need not be on current account if the foreign loans and investments of the new banker countries increase sufficiently.

What has been the trouble with the dollar-reserve standard is likely to remain the trouble with the multiple-currency-reserve standard—and it represents a real paradox: The supply of reserve currencies to other nations depends on payments deficits incurred by the reserve countries; but the demand for these currencies will not endure if the reserve countries incur continual deficits. In a nutshell, the truth about reserve currencies is this: the more easily available, the less wanted.

What can plans of type B—mutual central-bank assistance—do toward a solution of the problem of the long-run supply of monetary reserves? At best they may reduce the demand for reserves, because standby arrangements for assistance make it unnecessary to hold reserves large enough to meet peak requirements of any size.

But this does not dispose of the problem of the long-run supply of reserves. If increasing reserves are needed for all countries together, arrangements under which one central bank can borrow from another are evidently inadequate.

ALL SOLUTIONS REJECTED

The problem, assuming it is a real one, is effectively attacked by plans of types C, D, and E. They operate in quite different fashions: C by creating reserves in the form of increasing liabilities of a world institution; D by creating reserves in the form of gold (partly by putting a higher price tag on existing gold stocks, partly by paying more for new gold); and E by removing the need for monetary reserves altogether.

All three types of reform are viewed with great suspicion; it is hard to judge how they rank on the scale of rejection by conservative bankers. The suspicions are quite understandable. Plans of type C create monetary reserves out of thin air, as it were; would it not be unsound, nay, irresponsible, to vest in any supranational agency the power to create international money at its discretion?

Plans of type D create monetary reserves simply by announcing that gold is worth more than its present price; would this not be a mere trick, cheating those who have been willing to hold dollar balances rather than gold, and procuring windfall profits for the Soviet Union and South Africa, and for gold speculators and hoaders?

Plans of type E do away with the need for monetary reserves by allowing exchange rates to make all the gyrations that would elicit or cut down the demand for foreign moneys so as to make it equal to whatever may be the supply at the moment; would it not be detrimental to commerce and industry if no one could ever be certain how much he would receive for his exports or how much he would have to pay for his imports?

Some of the objections to these reform plans are based on fears of inflation. Empowering a world central bank to create international money could undoubtedly result in worldwide inflation. Up-valuing the present gold stocks and paying higher prices for new gold would obviously invite credit inflation in many countries. Removing the central bankers' obligation to keep exchange rates stable, and freeing them of the concern about the size of their foreign reserves, would probably make them less cautious in their credit policies and more willing to yield to the constant pressures for easier credit and cheaper money.

The dilemma is that any scheme designed to avoid deflation may facilitate inflation. All plans that undertake to secure a "more adequate" supply of monetary reserves may be instrumental in providing an excessive supply. The question is whether this danger is uncontrollable and whether we should allow the fear of inflationary indulgence to condemn us to submit to deflation when it comes.

Economists often ask which is worse, inflation or deflation, and most of them conclude that deflation is worse. Perhaps we ought to ask instead which of the two is more likely to happen if we are not sufficiently vigilant, and one may have to conclude that it is inflation.

If this is correct, we ought to have even more understanding for the suspicions of the men of practical wisdom, who resist any reform which facilitates the creation of new money, international or domestic. But stubborn resistance to any reform that deals with this problem is surely imprudent. If the problem is a real one, we must face it. Let us ask how the three types of reform rank in releasing the brakes against inflation.

CONDUCIVENESS TO INFLATION

A world central bank may be as prudently or as imprudently managed as a national central bank. It may be niggardly in creating monetary reserves or it may be freehearted and full-handed. By granting credit to poor countries it may soak the rich ones, and by granting credit to countries with balance-of-payments problems it may bilk the frugal ones. By increasing the total of reserves it may induce inflation everywhere. But none of this is inevitable, and we may find ways of checking or avoiding excesses of this sort. We may succeed in installing proper safeguards and learn that our fears have been exaggerated.

An increase in the price of gold by a large percentage would not automatically induce inflation, but the temptations would be hard to resist, especially because the responsibilities would be decentralized. Many central banks or treasuries would have profits from the revaluation of their gold stocks, and surely not all of them could be trusted not to make use of these profits. In addition, the profits made by private hoarders of gold would not all stay unspent, and the spending of these profits would probably not be offset by monetary or fiscal restrictions. The inflationary potential of an appreciable increase in the price of gold is large indeed.

The abolition of fixed exchange rates and introduction of freely flexible rates would not per se induce inflationary tendencies, but it is possible that a potent cause for the central banker's self-restraint would be removed if he has no longer to worry about a loss of foreign reserves. That such worries can effectively curb monetary expansion is demonstrated by the example of U.S. policies during the last years. I have no doubt that only the concern and anxiety about continuing losses of gold have prevented our monetary authorities from pursuing more expansionary policies. But it should be possible to transfer the central bankers' sensitivities from the foreign-reserve position to the foreign-exchange level. This would be a matter of political education and of the development of a new attitude in central-bank management.

THE NEED FOR MORE DISCUSSION

All these possibilities and probabilities must be discussed with much more patience than many experts have been willing to bear. The bank managers and others with practical experience ought to stop regarding anything that has never been tried as impractical, and the theorists ought not to give up attempts to advance their favorite schemes just because the bankers refuse to listen.

I admire the persistence of Professor Triffin in trying to sell his plan to an unwilling and sometimes disrespectful audience, and I applaud Professors Friedman, Halm, Sohmen and many others for continuing their support of unpegged exchange rates despite the disdainful rejection by the traditionalists. I also want to pay my sincere respect to this committee for providing the appropriate forum for this discussion and for inviting scholars of various persuasions to present their views on proposals for the solution of the problems before us.

THE GOLD PROBLEM

Let me conclude with some additional comments on the gold question. I started my statement with a reference to Gresham's law and the recurrent or continuing rush into gold. From the U.S. point of view things seem to have improved: the rate at which we have been losing gold has diminished. This is due partly to the solemn promises made by President Kennedy, and partly to the fine cooperation given by the central banks of the leading countries. From a world point of view, however, the situation has not improved, but has deteriorated: the rate at which gold has been added to international reserves had dwindled to almost zero.

For the last 10 years gold sales from new production have added on the average more than $600 million per year to the reserves of the monetary authorities. During 1962 no such increment has occurred. In the second and third quarter the gold reserves increased hardly at all.

That is to say, all the gold from new production and from Soviet sales has been absorbed into private hoards. If this goes on and if the U.S. balance of payments is balanced, neither gold nor dollars will be available for monetary reserves. Then the problem which so many experts want to table for several years will become pressing much sooner.

Now, why does gold disappear into private hoards in increasing amounts? Obviously because people believe that it is a much better asset than any debt security expressed in any currency. Is this faith in the value of gold justified? Does gold have intrinsic value, independent of the will of the U.S. Congress? No, the value of gold rests on a myth which this Congress can destroy whenever it so chooses.

Gold is nothing but a price-supported commodity, widely demanded only because people believe that it has intrinsic value. If we decided to offer all our gold for sale, to throw our entire stock on the market, the value of gold would be reduced to the shadow of a shade. For a while, gold might become even a complete nonvaleur.

To be sure, I would never propose that we commit such a ruthless act. I would be against it, because I see no point in inflicting heavy losses on so many people for no good purpose. But I am not sure that we should not caution the people and make them realize that gold is worth just as much as the U.S. Congress determines it to be. Gold will be $35 an ounce, or $70, or only $30, or $20, or almost nothing, depending on your will.

If the hoarding of gold continues, the Congress should seriously consider teaching the world a lesson by lowering the value of gold a peg or two. The world ought to learn that gold is not always the safest bet. On the other hand, I fully realize that the gold myth may yet serve a useful purpose. It has often served as a chain or brake preventing reckless monetary policies, and we may still need this in the future. Good resolutions and moral precepts may not be satisfactory substitutes for firm superstitions. But when a superstition becomes a major nuisance to the world, we might decide to get rid of it. The golden calf is now a full-grown sacred cow, and perhaps the time to slaughter it is not far off.

Representative REUSS. Thank you very much, Mr. Machlup.

Mr. Bernstein?

STATEMENT OF EDWARD M. BERNSTEIN, RESEARCH ECONOMIST, WASHINGTON, D.C.

Mr. BERNSTEIN. I do not think I will read my statement, if you do not mind, but if you will turn to page 2 there is a table there, and using this table I will comment on the reserve problems as I see them.

Representative REUSS. Yes.

Mr. BERNSTEIN. I think it would be——

Representative REUSS. I certainly do not want to insist that you read it. However, do yourself justice and take as much time as you want.

Mr. BERNSTEIN. Thank you.

The view that the payment difficulties of the United States arise from the inadequacy of the present level of monetary reserves is mistaken. What has happened is that the prolonged payments deficit of the United States has accentuated reserve problems that are inherent in the present reserve system.

As a matter of fact, the reserve problems of the world are likely to become more acute after our balance of payments is in order, because at that stage it will no longer have the supplement of $2 billion a year that has been going into the reserves of other countries in recent years from the United States.

I think we have to deal with the world's reserve problems but, first, I think we have to understand what they are and then we have to deal with them in a proper way. I see three reserve problems.

The first is how to protect the financial centers from the disruption of massive capital movements and large-scale conversions of currencies into gold.

The second is how to meet the reserve needs of the low-income countries that hold, and prefer to hold, very small monetary reserves.

And the third reserve problem is how to provide for the orderly growth of monetary reserves in the future so that world trade and payments can continue to expand.

These reserve problems are specific problems, and they call for specific solutions. I do not believe that a single solution, designed to cover all of them, will, in fact, meet these problems adequately. And I do not believe that the solution of these problems calls for radical changes in the structure of the present reserve system.

Now, first, on the reserve centers: Because the dollar is a reserve currency the gold reserves of the United States are affected not only by our own balance of payments but also by the balance of payments of other countries that hold dollars as reserves and, by the preference of all countries in deciding what portion of their reserves they will hold in gold or in dollars.

I believe that the outflow of gold from the United States, though it has been less in 1962 than last year, is likely to continue even after our balance of payments is in order. And that is because many countries are now holding more dollars relative to gold than they traditionally want to have. Once the fear of pressure on the United States is removed, because our balance of payments is in surplus, we are going to find a renewed demand for gold by the gold-holding countries.

The real difficulty in providing the world with more reserves, through a continued modest deficit in the United States is the fact that the large holders of reserves have a very strong preference for gold.

If you look at the table on page 2, for example, you will find that 11 countries—the United States, the United Kingdom, Canada and Japan, and 7 European countries, including Switzerland—have about 70 percent of the total reserves of the world but they have about 87 percent of the gold reserves of the world.

It would not be possible in the future to meet the gold reserve requirements of these countries if they insist on holding a decidedly large portion of their reserves in gold. It is not merely that gold is not enough for the growth of aggregate world reserves. It is not large enough for the growth of world reserves in the gold-holding countries.

In the 10 years that ended in 1962 the average annual increase in the monetary gold stock of the western world was $550 million. This is an average annual increase of about 1.3 percent. If all of this increase were to be concentrated in the holdings of these 11 countries their gold reserves would rise by 1 6/10 percent a year. Without worshipping any specific figure for the growth of reserves for the world as a whole, it is very unlikely that 1 6/10 percent a year would be regarded as adequate by these large industrial countries whose growth, incidentally, is far greater than the average growth of the world as a whole. As I say, these countries themselves must find a means of satisfying their reserve requirements without that tremendous dependence on gold that they have imposed upon themselves.

There is another difficulty that confronts the great financial centers. In 1960 and 1961 there were $2,800 million of outflow of short term funds from the United States and, additionally, there was $1,200 million in these 2 years of net payments by the United States on unrecorded transactions. These were very largely for capital outflow or the nominal transfer of foreign funds.

This capital movement has already stopped. It has stopped for several reasons. One of the reasons is that interest rates have become much lower in Europe. Nowadays the yield on money market funds in Germany, the Netherlands, Belgium and Switzerland, is lower than the yield on 3-month Treasury bills. That yield today is 2.85 percent per annum. And this has had a big effect. There has not been too much capital outflow so far in 1962, although it may emerge in this month.

While the outflow of funds has been especially large from the United States in recent years, this does not mean that we could not have even larger outflows from other countries in the future. I would just like to recall to you historically that in the past, the movement of funds has been enormous, and that it has generally been to the United States, and that the conditions that created that movement could easily recur again. For example, in the period from 1937 to 1941 the payments to the United States on unrecorded transactions and on capital inflow, short term capital inflow, was $3,700 million. This was at a time when the world's trade and payments were at a level of about one-fourth of what they are today. The equivalent of this today would be $15 billion. In 1947 to 1949 there were payments to the United States on account of unrecorded transactions and short term capital movements of $2,800 million.

Now, this was at a time when the world's trade and payments were about one-half of the level of today, and this is equivalent to something close to $5.5 billion at present.

The fact of the matter is that in the kind of world in which we are living we must count on the possibility of large transfers whenever there is an economic crisis, whenever there is a political crisis, and in my opinion these movements are much more likely to be toward the United States under crisis conditions than from the United States. It is interesting to observe that the dollar in the exchange market became stronger relative to nearly every European currency during the Cuban crisis except the Swiss franc. But it rose relative to the mark. It rose relative to other European currencies.

I do not believe that this problem of the flow of liquid funds from one financial center to another can be solved merely by making tight money tighter in countries from which there is such a capital outflow. I do believe monetary policy is going to be more moderate in both the European countries and in the United States. What I mean is, while we will never have 1 percent Treasury bill rates again, even when our reserve position is very much improved and I do not believe we will ever have 7 percent bank rate in London again either. Seven percent bank rate, they used to say in London, brings gold from the moon. That may some day happen. The trouble is that right now it brings too much gold from New York.

Now, the great financial centers are aware of this problem and they are doing several things to deal with it. They are consulting on the moderation of monetary policy by coordinating the monetary policy of the great European financial centers with the monetary policy of the United States. I have already made note of the fact that money market rates are lower in four important countries of Europe than they are in this country.

Even more important, just a year ago 10 members of the International Monetary Fund—that is the group of 11 countries except Switzerland—entered into a special agreement at Paris with the International Monetary Fund under which they undertake to provide $5 billion of resources to be used primarily for meeting deficits that arise because of the movement of liquid funds from one center to another. And now the managing director of the Fund has been consulting with Switzerland, which is not a member of this agreement, for association in some form with these borrowing arrangements.

As I see it, the big problem on capital flows has really been met. I think that the resources that have been made available through these special arrangements, plus the ordinary resources available from the International Monetary Fund, can meet any large capital movements if they should occur again. But it does seem to me that the financial centers must do something else now to decrease their excessive reliance or gold.

You know, it is not easy to follow Professor Machlup in any discussion because, generally speaking, he has exhausted the subject. I am afraid I am going to have to cover some of his ground but maybe I can find a point or two in which I will differ with him.

I find that the gold-holding countries, these 11 countries, are creating a problem for themselves. The rest of the world, outside the Soviet Union, does not really hold much gold. They hold less gold today than they did 10 years ago. What's more, a good deal of the gold they hold is not at all for the purpose of being used as monetary reserves. It is a showpiece. It is a tradition. India holds gold as do several others, but it doesn't enter into their use of monetary reserves.

These 11 countries account for nearly all of the transactions in gold except newly mined gold. It seems to me that it is for them to solve a problem that they have created for themselves regarding gold.

Now, Professor Posthuma, who is a director of the Netherlands Bank, has proposed a plan which is being studied by the European countries and the United States, under which these countries would agree to hold some large proportion of their gross reserves in foreign exchange: in dollars, in Swiss francs, in sterling, and in all of the other currencies of these countries.

As Professor Machlup has pointed out, such a plan needs some safeguards. For example, it would not do at all if these countries made an arrangement to hold such reserves if each of them tried to escape from a weak currency to a strong currency while still maintaining, say, 40 percent of their gross reserves in foreign exchange. And it would not do if two countries, not in sympathy with the scheme, decided they could escape the whole business by simply holding each other's currency in equal amount, equivalent to 40 percent of the scheme.

What you do have to have is an arrangement under which the holding of the currencies of these 11 major financial centers would be in prescribed proportions in dollars, sterling, French francs, Swiss francs, German marks, and the rest. This bundle of currencies would have a fixed value in gold. It would be held and used by the 11 countries along with gold for all payments with each other. This would be a composite standard, 60 percent gold and 40 percent of the bundle of the 11 currencies.

If the United States, for example, had to convert $100 million for one of these other countries, it would give that country $60 million of gold plus $40 million of the bundle of currencies. The composition of the bundle of currencies would not change. There would be no way of escaping from one currency to another when there is a temporary weakness in the exchange market.

To my mind this plan has promise. It would work. There is no doubt of it in my mind. I think the United States, however, has a special interest in having it work properly.

Ours is already the currency which is held in large enough proportions to fill any assigned amount for the United States. We would like to know that the required holding of dollars in the composite reserves of these countries would not involve any liquidation of their present holdings of dollars. Preferably we should like an accumulation of some more dollars.

As I say, these questions are being discussed by these countries, and I am confident that they understand the problem.

Now, the second reserve problem concerns the underdeveloped countries. If you take the three groups of countries on page 2, Latin America, "other sterling area," "all other countries," the reserves they hold today, approximately $12 or $13 billion, is less than it was at the end of 1951.

Far from increasing their reserves over this 10-year period, these countries have depleted their reserves. They depleted their reserves primarily because their international payments position has seriously been undermined by the continued decline of the prices of basic commodities.

Their export receipts are growing much more slowly than those of the rest of the world, and, furthermore, as these countries feel hard pressed for capital for development they have no inclination to invest real resources, because that is what it amounts to, in holding monetary reserves.

I think from their own point of view, they are making a serious mistake in not holding more monetary reserves. But that is the same thing as telling a poor man he is very foolish to allow his pay to run out on Thursday, knowing that he will have nothing until the following Saturday to buy the things he needs. The truth of the matter is that these countries simply will not hold more monetary reserves, and yet the failure to hold larger monetary reserves imposes on them very sharp fluctuations in their imports because their exports are very sensitive to price fluctuations.

If they are not going to hold reserves of their own I think the sensible way is to devise a method by which they would be compelled to hold reserves. I do not mean by punishing them when they do not hold reserves, but by saying to them, here is a reserve we will set up for you but which you can use only as a reserve. "You cannot run it down as if it were expendable for capital purposes. You have to use it as reserves. When you draw it down in bad years you must replace it in good years."

I wrote a plan along these lines for the Organization of American States which was adopted at the Punta del Este Conference. This was a program for establishing an Export Receipts Stabilization Fund, which is, in fact, a supplementary reserve for the low-income countries that export primary products.

Under this plan when the export receipts of an eligible country fall below the average of the three preceding years, it would be able to borrow from this fund two-thirds of the amount of the short fall in its export receipts, and when its export receipts rise, if it is in debt to the Export Receipts Stabilization Fund, it would repay two-thirds of the excess over the average of the three preceding years.

There would be provisions for safeguarding the institution, to make sure that it is used by countries as a reserve, drawn down when the prices and the volume of their exports decline, and restored when the prices and volume of their exports increase. I want to make it clear that this is not a plan for dealing with the difficult problems confronting underdeveloped countries which are excessively dependent on primary products. Probably the best solution for their problem is diversified development so they will not depend too much on the export of one or two commodities as the principal source of receipts to pay for their imports.

This is not intended to be a substitute for commodity stabilization plans, although I think we must recognize that the number of commodities for which good stabilization plans can be operated is limited, and even with commodity stabilization plans that work reasonably well, as with tin, there would still be very large fluctuations in prices, and that means large fluctuations in the export receipts of the underdeveloped countries.

This is a plan which provides a special and additional reserve for the underdeveloped countries particularly for use when their export receipts decline. This plan has been studied by the United Nations Committee on Commodity Trade. It has been referred back to the United Nations for study, along with other plans. Furthermore, the International Monetary Fund is now considering what it can do to deal with the reserve problems of the underdeveloped countries. Again, here is a case where something is being done, and I think the prospects are that a workable solution will be found.

These are special problems in a sense that these countries have created the problems for themselves: the poor countries, because they are overwhelmed by their poverty; the rich countries because they do not restrain themselves in converting their riches into gold.

Now, the broader problem, it seems to me, is the problem of providing reserves for a growing world economy.

I think a program for strengthening the reserve system of the future must start with the International Monetary Fund. The International Monetary Fund already holds $14,600 million in gold and currencies. It has borrowing arrangements with 10 of the big industrial countries for an additional $6 billion. In fact, the International Monetary Fund is well provided with resources if somehow we can get to use these resources as reserves.

From 1947 until the end of October 1962, the Fund sold $6,700 million of currencies. That is to say, it made available as reserves a cumulative total of $6,700 million, and of this, $5,100 million has been repaid.

Apart from this, it has entered into arrangements with its own members to assure them standby credits. The cumulative total of standby credits is $5.5 billion, of which $1,600 million is still available for drawing by these members. In short, this is an institution that has already done a great deal in providing reserves for its members.

I know of no reason for destroying such an institution. I know of no reason, in fact, for radically changing such an institution. What we ought to do with such an institution is to make it work better. We must somehow make this $14,600 million of gold and currencies a part of the working reserves of the members of the Fund. This does not require any change in legislation. It requires a change in policy.

The first step would be to regard the Fund quota as a part of the country's reserves. That is to say, the United States would count its quota in the Fund as part of its reserve. The United Kingdom would count its quota in the Fund as part of its reserve and so would all other members.

This is not really as radical as it sounds. The International Monetary Fund already publishes in "International Financial Statistics" a table entitled "International Liquidity." This table includes the position of all members with the Fund. It shows the net creditor position, which is called the gold tranche, and it includes the balance of each member's quota, which is called the credit tranche. Many countries include their net creditor position, that is, the gold tranche, as part of their reserves. The Fund has special facilities for use of the gold tranche which members may draw without question. I would like to see every country include in its monetary reserves not only the gold tranche, but the credit tranche as well. Of course, if the quota in the Fund is shown as part of a country's reserves it would be necessary to show as a reserve liability the contingent obligation to deposit national currency to the account of the Fund when a country draws on its quota.

The second step would be to permit members of the Fund to draw on their quotas without prior approval, to the limits prescribed by the Fund agreement. That is 25 percent a year. At present, a country can draw freely until the Fund's holdings of its currency are equal to 100 percent of its quota. Germany could, theoretically, draw $550 million tomorrow without any question, from the International Monetary Fund. The United States could, presumably, draw a very considerable sum from the Fund without any question. Its gold tranche is at present $1,070 million.

I would like to see this unconditional right to draw extended from the gold tranche to the successive credit tranches. As a matter of fact, I would like to have a country free to draw not only the gold tranche but the first 25 percent of its credit tranche in 12 months without prior approval. Thereafter, I would let a country draw only 25 percent a year.

If they wanted to draw more than this in any 1 year they would have to get a waiver, and that means an agreement with the Fund on terms and conditions which the Fund would set. I am not afraid of such a policy at all. This seems to me a very reasonable policy. I do not think it would be abused. The members of the Fund have never defaulted on any financial obligation to the Fund. There might be some countries that would regard this as an easy source of credit and tend to use too much Fund resources for too long. But the Fund could easily tell countries like this to use more moderation and not to regard the Fund as an easy source of credit but as a part of their reserves. There is no reason why the world's reserve system should have to be held back from a natural development because there are one or two countries that might abuse it.

I think the Fund's influence, in advising its members on exchange payments, monetary, fiscal policy, anything the Fund wants to talk about to its members, would be much greater if the Fund's resources were part of their working reserves. Countries will pay a good deal more attention to the Fund when they know they can get help from it instead of having to go through a long and losing fight to get a little bit of credit.

Beyond that, the large financial centers ought to make it a common practice to use the resources of the International Monetary Fund whenever they draw on their own reserves. The Fund has helped 47 countries and, in some instances, it has made enormous sums available to them at one time, such as $2 billion to the United Kingdom, of which $1.5 billion was in cash and a half a billion was in a drawing right.

I think it is a mistake to refrain from using the Fund on the ground that it reflects on the financial strength of a country. I do not like the notion of making transactions with the Fund a crisis matter. I think we can make drawings on the Fund a perfectly normal way of using its resources whenever a country uses its own reserves.

If we have such a system there is no doubt in my mind, not only that the present reserves of the world would be adequate, but that they could be growing at a moderate and regular pace merely through periodic revision of quotas.

I want to make one final observation. These reserve problems are inherent in the reserve system we have today. They have emerged partly because the U.S. balance-of-payments deficit has emphasized the weakness of the present reserve system.

They, however, require a good deal of study and a good deal of sympathetic consideration. I believe that the measures that are now being considered will bring about a gradual modification of the present reserve system to enable it to meet the reserve needs of an expanding and prosperous world economy.

Naturally, I have refrained from discussing the Triffin plan because that would require an awful lot of space, but if the question arises I have brought a short memorandum that could go into the record. (See p. 230.)

Representative REUSS. Thank you, Mr. Bernstein.

(Mr. Bernstein's statement follows:)

PROPOSED REFORMS IN THE INTERNATIONAL MONETARY SYSTEM

Statement of Edward M. Bernstein to the Subcommittee on International Exchange and Payments of the Joint Economic Committee of Congress

DEFICITS AND RESERVES

The balance of payments of the United States has shown a large deficit for a number of years. This deficit has been met by sales of gold by the U.S. Treasury and the accumulation of dollar claims by other countries. The gold reserves of the United tSates have declined by $6.9 billion since 1958. In this period, the short term and liquid dollar claims of foreign official institutions and banks have increased by $5.9 billion. To some extent, this transfer of reserves from the United States has been extremely helpful in restoring the liquidity of the other large industrial countries and in enabling them to undertake the convertibility of their currencies. The continuation of the deficit has, however, caused a greater depletion of U.S. gold reserves than is desirable. Furthermore, the large foreign holdings of short term and liquid dollar assets expose the United States to the danger of massive conversion of dollars into gold in the future.

There is no way in which U.S. gold reserves can be protected except through the elimination of the balance-of-payments deficit. That is and must be a major objective of our economic policy. There are, indeed, problems regarding reserves whose importance has been accentuated by U.S. payments difficulties. The solution of these problems is essential to the functioning of the world economy under a system of fixed exchange rates with convertible currencies. A better system of reserves will make it possible for countries to deal with their balance-of-payments problems without relying on exchange control or quantitative restrictions on imports and without the necessity of imposing harsh deflationary measures on the domestic economy in order to force an immediate adjustment in the balance of payments. For the United States, a better reserve system would minimize the risks inherent in its unique position as a reserve center with large short-term obligations to the rest of the world. Nevertheless, it should be emphasized that no system of reserves can obviate the need for maintaining a balanced international payments position over the course of a reasonable period of time—say, the length of a business cycle.

LEVEL AND DISTRIBUTION OF MONETARY RESERVES

At the end of September 1962 the gross official gold and foreign exchange reserves of all countries outside the Soviet bloc amounted to $60.9 billion. Of these reserves, $38.9 billion consisted of gold. The other $22 billion of reserves was in the form of official holdings of dollars, sterling, and various other currencies, including deposits with the Bank for International Settlements. In the 5 years ending in 1956, the increase in official gold and foreign exchange reserves amounted to $6.8 billion—an average annual increase of slightly more than 2.6 percent. In the 5 years ending in 1961, the increase in official gold and foreign exchange reserves amounted to $5.3 billion—an average annual increase of just over 1.8 percent. There was no increase at all in gross official gold and foreign exchange reserves in the first three quarters of 1962.

Gross official gold and foreign exchange reserves [1]

[Billion U.S. dollars]

	1951	1956	1961	September 1962	September 1962	
					Gold	Exchange
United States	22.87	22.06	17.06	16.53	16.08	0.45
United Kingdom	2.37	2.28	3.32	2.80	2.60(e)	.20(e)
Canada	1.83	1.95	2.06	2.45	.69	1.76
Japan		.94	1.49	1.72	.29(e)	1.43(e)
Belgium	1.05	1.16	1.66	1.63	1.34	.29
France	.62	1.18	2.94	3.53	2.48	1.05
Germany	.52	4.12	6.54	6.47	3.67	2.80
Italy	.77	1.24	3.42	3.25	2.24	1.01
Netherlands	.55	1.04	1.72	1.78	1.58	.20
Sweden		.51	.67	.76	.18	.57
Switzerland	1.64	1.88	2.76	2.63	2.45	.18
Total, 11 countries	32.22	38.36	43.64	43.55	33.60	9.94
Other Europe	2.29	2.44	3.90	4.35	1.81(e)	2.54(e)
Latin America	2.98	3.68	2.78	2.28	1.28(e)	1.00(e)
Other sterling area	7.44	7.54	7.12	7.08(e)	1.03	6.05(e)
All other countries	4.11	3.88	3.69	3.66(e)	1.19(e)	2.47(e)
Total, all countries [2]	49.05	55.89	61.20	60.92(e)	38.91(e)	22.01(e)

[1] Data are for end of period shown.
[2] All countries outside the Soviet bloc.

Source "International Financial Statistics," December 1962, p. 17.

Of the increase of $6.8 billion in gross reserves of all countries in the 5 years ending in 1956, only $2.2 billion was in gold; and of the increase of $5.3 billion in reserves in the 5 years ending in 1961, about $2.8 billion was in gold. The remainder of the increase in the reserves of all countries is accounted for by larger holdings of foreign exchange, primarily dollars. As it is impossible for the United States to continue indefinitely a balance-of-payments deficit of the magnitude of recent years, this source of reserves for the rest of the world may be expected to disappear in the course of the next few years. Foreign holdings of sterling, the other reserve currency, have not increased during the past 10 years. The steady and moderate growth of reserves that is essential for an expanding world economy must be provided in some other way.

The holdings of gold and foreign exchange reserves are very heavily concentrated in the industrial countries. Total reserves of the United States, the United Kingdom, continental Europe, Canada, and Japan at the end of September 1962 amounted to $47.9 billion and constituted nearly 80 percent of the world total. All of Latin America, all of the sterling area outside the United Kingdom, and all of the rest of the world except Japan held $13 billion of reserves. Even more striking is the fact that while the gross reserves of all countries increased by $12 billion in the 10 years ending in 1961, the reserves of the countries outside Europe, North America, and Japan actually decreased by $1 billion in this same period. These countries held nearly 30 percent of the total reserves at the end of 1951; they now hold just over 20 percent. The fact is that the raw materials producing countries do not, and perhaps cannot, hold reserves on the scale necessary for their trade and payments.

The concentration of gold reserves, as distinguished from total reserves, is even greater. Eleven major industrial countries hold their reserves predominantly in this form. The gold reserves of these countries—the United States, the United Kingdom, the Common Market, Switzerland, Sweden, Canada, and Japan—constitute about 87 percent of the total held by all countries. In the past 10 years, these 11 countries have absorbed all of the newly mined gold and the gold sales of the Soviet Union that did not go into private hoards or into international financial institutions. In fact, they acquired, in addition, about $1.5 billion of the gold reserves of the rest of the world. Over 80 percent of the gross sales of gold by the U.S. Treasury to foreign countries in the past 5 years has been to the other 10 major industrial countries. They are the only countries that can put serious pressure on the United States through the conversion of their dollar holdings into gold. The strength and stability of the present reserve system, based on the equivalence of gold and dollars, depends on the willingness of the 11 major industrial countries to hold a reasonable part of their reserves in foreign exchange.

These three practical problems regarding monetary reserves can be summarized as follows:

1. How to protect the financial centers from the disruption of massive capital movements and large-scale conversions of currencies into gold.
2. How to meet the reserve needs of the low-income countries that hold, and prefer to hold, very small monetary reserves.
3. How to provide for the orderly growth of monetary reserves in the future so that world trade and payments can continue to expand.

The reserve problems are specific problems calling for specific solutions. They do not require radical changes in the structure of the present reserve system; but they do require the adaptation of the present reserve system to the requirements of the modern world. The view that the payments difficulties of the United States or of other countries are due to the inadequacy of the present level of monetary reserves or that they can be solved by merely changing the reserve system is entirely mistaken. These reserve problems will grow more acute after the deficit in the U.S. balance of payments has been eliminated.

GOLD AND THE FINANCIAL CENTERS

Because the dollar is a reserve currency, the gold reserves of the United States are affected not only by its own balance of payments, but also by the payments of other dollar countries with the rest of the world and the attitude of other financial centers toward the holding of dollars as a part of their reserves. It is likely that even after the balance of payments of the United States is no longer in deficit, there will be a gold outflow for a time. This is because the dollar component of the reserves of other financial centers is at present larger than they customarily hold. Once the U.S. payments position is strengthened, their reluctance to convert dollars into gold may be very much diminished. To halt a gold outflow in the future, the United States may have to have a sizable surplus in its balance of payments for many years in order to reduce the dollar holdings of other countries. Such a reduction in dollar assets would deflate the gross reserves of the world.

The difficulty in providing more of the world's reserves through dollars and other currencies arises from the fact that some of the large financial centers hold a very large proportion of their reserves in the form of gold. There are various reasons for the preference of these countries for gold as reserves. Prestige, tradition, security, liquidity—all affect the decisions of the financial centers in determining whether to hold gold or foreign exchange as reserves. As a practical matter, it will not be possible for the leading financial centers to continue to concentrate their reserves in gold. The increase in the monetary gold stock outside the Soviet bloc amounted to $550 million a year in the 10 years ending in 1962. This is an average annual increase of about 1.3 percent. If all of this gold were added to the monetary reserves of the 11 major industrial countries, the gold component of their reserves would increase by about 1.6 percent a year. This is not sufficient even for a moderate growth in the reserves of the financial centers. The practice of many of the gold-holding countries, including the United States and the United Kingdom, of keeping their reserves almost exclusively in gold can only lead to a serious deficiency in the reserves of the financial centers. These countries, and particularly the United States and the United Kingdom, must increase their holdings of foreign exchange as reserves. Secretary Dillon has already stated that this will be the policy of the United States.

There is another difficulty that confronts the large industrial countries. As financial centers, they are exposed to the risk of large and sudden movements of liquid funds either for interest arbitrage, to take advantage of interest-rate differentials, or for speculation, in anticipation of changes in exchange rates or exchange controls. The United States has had to meet an outflow of $2.8 billion of U.S. private short-term funds in 1960 and 1961 and additional net payments of $1.2 billion on unrecorded transactions, some of which were undoubtedly capital movements. Such a large outflow of liquid funds can occur in other countries, as happened in fact in the period from 1937–41 and 1947–49. In the former period, unrecorded transactions and short-term capital movements required payments of $3.7 billion to the United States. In the latter period, unrecorded transactions and short-term capital movements required payments of $2.8 billion to the United States. The outflow of gold from other financial centers to the United States was enormous in both periods.

With all of the major currencies freely convertible, occasional large movements of liquid funds from one financial center to another are inevitable. Differences in monetary policy to deal with the domestic economy or the balance of payments will encourage an outflow of funds from countries with easy credit to countries with tight credit. Furthermore, a serious recession or a political crisis in any part of the world may induce large movements of liquid funds in search of security. These are contingencies for which the financial centers must be prepared. It would be a backward step to depend on exchange controls to avoid such capital movements. A more practical way to deal with the problem is to have a greater degree of international cooperation on monetary policy to minimize the outflow of short-term funds and to provide reciprocal credits to finance such capital movements as do occur.

The financial centers have already taken major steps to deal with the problem of short-term capital movements. They have frequent consultations on monetary problems and monetary policies. In the course of 1962, differentials between short-term interest rates in the United States and Europe have been very much narrowed. In Switzerland, Netherlands, Germany and Belgium the yield on money markets funds is lower than the yield on 3-month Treasury bills in the United States. Just a year ago, the financial centers (except Switzerland) subscribed to the Paris Agreement under which they undertake to provide $6 billion of special resources to the International Monetary Fund principally for the purpose of financing short-term capital movements from one country to another. The managing director of the Fund has been consulting with Switzerland, which is not a member of the Fund, for association in some form with these borrowing arrangements. Clearly, a great deal has been done to enable the reserve centers to meet the special problems that may arise from massive capital movements.

The financial centers must now take further steps to decrease their excessive reliance on gold for their monetary reserves. A very ingenious plan for this purpose has been proposed by Professor Posthuma, a director of the Netherlands Bank. If the countries that have subscribed to the Paris Agreement and Switzerland were to enter into an arrangement for holding a minimum proportion of their reserves in foreign exchange, they could bring about the most important advance in the reserve system since the establishment of the International Monetary Fund. The demand for monetary gold comes almost entirely from these 11 countries. No other countries can support the balance-of-payments surplus or the investment in monetary reserves that would enable them to acquire very large amounts of gold. If these 11 countries were to undertake to hold 40 percent of their gross reserves in foreign exchange, their reserves in this form (on the basis of present gold hearings) could be increased by about $11 billion. Some provision would have to be made in the Posthuma plan for an appropriate and predetermined allocation of the various currencies to be held as reserves. This is particularly important for the United States as an increase in the holding of dollars as reserves by the financial centers is desirable in order to relieve the pressure on U.S. gold reserves.

RESERVE PROBLEM OF THE UNDERDEVELOPED COUNTRIES

With very few exceptions, the underdeveloped countries do not hold sufficient monetary reserves to meet the recurrent fluctuations in their international payments. With the decline in the prices of basic products over the past 10 years, these countries have reduced their reserves until they are now at the bare minimum necessary for financing their international payments. As a consequence, when their exports fall because of a deterioration in world markets, the underdeveloped countries are compelled to reduce their imports sharply and immediately. In their own interest, it would be desirable for these countries to hold somewhat larger reserves in order to avoid such severe fluctuations in their imports. Nevertheless, because of their great need for capital, these countries feel that they cannot afford to invest real resources in holding larger reserves.

During the past 10 years a number of proposals have been made to deal with the difficulties arising from fluctuations in the prices of basic products and the recurrent payments problems of the countries dependent on such exports. The United Nations has issued a number of reports recommending measures to compensate countries exporting basic products for a decline in the prices of such commodities. The Organization of American States has studied the commodity problems of Latin America and has recommended the establishment of a fund for the stabilization of the export receipts of low-income countries dependent on exports of basic products. A resolution was adopted by the Allinace for Progress at its meeting in Punte del Este in 1961 supporting this proposal. A tentative plan has been drawn up and it is now under study by the United Nations.

Under this plan, an Export Receipts Stabilization Fund would be established, either as a subsidiary of the International Monetary Fund or as an independent institution. The Export Receipts Stabilization Fund would have resources provided by both the high-income and the low-income countries. However, only the low-income countries would be eligible to make use of the resources of the institution. It is not feasible, whatever its merits, to provide aid to the United States, Canada, Australia and other high-income countries when their exports of primary products decline. On the other hand, it is feasible to secure sufficient resources to provide aid for the low-income countries when their exports of primary products fall.

The principal provisions of the plan for an Export Receipts Stabilization Fund can be summarized briefly as follows: Whenever the export receipts of a low-income country fall below the average of the 3 preceding years, it would be entitled to secure credits from the institution, on a virtually automatic basis, to the extent of two-thirds of the short fall in its exports. When the export receipts of a country indebted to the institution rise above the average of the 3 preceding years, two-thirds of the excess would be used to repay the export receipts stabilization credits it previously received. When any credit has been outstanding 3 years, one-half of the balance would have to be repaid in the fourth year and the remainder in the fifth year, even if a country's exports have not increased.

There are a number of other provisions that are intended to assure the equitable use of the resources of the institution. No country could secure export receipts stabilization credits in excess of 20 percent of the average of its exports in the 3 preceding years. If a country should use the resources of the institution in a manner not consistent with its purposes, the country could be declared ineligible to receive export receipts stabilization credits. Furthermore, if the institution were to find that its resources would not be sufficient to meet all requests for export receipts stabilization credits, it could ration the amount of credits it extends. Notwithstanding these limitations, a country could apply for additional special credits if it finds that the amount of export receipts stabilization credits to which it is entitled does not properly reflect the impact on its economy of the decline in its exports.

This is essentially a plan to deal with the reserve problem of the underdeveloped countries. Needless to say, it would not achieve its purposes if it merely resulted in a further reduction of the independent reserves held by the low-income countries or if export receipts stabilization credits were to induce a corresponding reduction of the drawings of low-income countries on the International Monetary Fund. The plan is no solution to the basic commodity problems of the raw materials exporting countries. On the other hand, there is no reason why it should hamper international commodity agreements in any field in which such cooperation is possible. Within its limited scope, the Export Receipts Stabilization Fund could be of great practical help to the low-income countries in minimizing the adverse effects of large fluctuations in their export receipts.

THE IMF AND RESERVES

Any program for dealing with monetary reserves must start with the basic fact that the International Monetary Fund has responsibilities in this field that it has been meeting for more than 15 years. The Fund holds resources of $14.6 billion in currencies and gold, and it has borrowing arrangements with 10 major industrial countries aggregating an additional $6 billion. From 1947 to the end of October 1962, the Fund's sales of currencies amounted to $6.7 billion of which $5.1 billion has been repaid. The cumulative total of its standby agreements with members is $5.5 billion of which $1.6 billion is still available for drawing. An institution with such vast resources and with extensive experience in dealing with the payments problems of its members is uniquely suited to provide for the orderly growth of reserves. In order to meet the reserve needs of the future, the resources of the Fund must be integrated with the working reserves of its members.

The first step in this gradual process would be to regard the Fund quota as part of a country's reserves. A number of countries already include the net creditor position in the Fund (what the Fund calls the gold tranche) in their reserves. What is proposed now is to include a country's quota (the credit tranches) as part of its gross reserves. The Fund recognizes that the right of members to draw on its resources is in some sense equivalent to reserves. In International Financial Statistics, the Fund includes a member's position in the Fund under the general heading "Gold, Foreign Exchange and IMF." There would be nothing misleading in regarding the gold and credit tranches of a country as part of its gross reserves. Of course, it would be necessary to show among the reserve liabilities the contingent obligation to provide additional currency when a country draws on the Fund.

The second step in integrating the resources of the Fund with the working reserves of members would be to permit countries to draw freely on their quotas, without prior approval, to the limits prescribed in the Fund Agreement. After the Fund's holdings of a member currency have reached 75 percent of the quota, a member may draw only 25 percent of its quota in a 12-month period until the Fund's holdings of its currency have reached 200 percent of the quota—that is, net credit equal to its quota. At present, the policy of the Fund is to give members a virtually unconditional right to draw an amount equal to their net creditor position—the gold tranche. Thereafter, drawings, even within the quota limits, require justification and the justification becomes more stringent as a member draws successive credit tranches of its quota.

A further liberalization of this policy is now called for. Members of the Fund should have the right to draw the gold tranche plus the first credit tranche of 25 percent in a 12-month period. This could be done by a general waiver applying the 25 percent limitation only after the gold tranche. Beyond that, a member of the Fund should be permitted to draw 25 percent of its quota each year, when necessary, until the Fund's holdings of its currency have reached 200 percent of the quota. Drawings within these limits should be freely permitted to any member that has not been declared ineligible to use the resources of the Fund. Larger drawings than 25 percent of the quota in a 12-month period or drawings in excess of 200 percent of the quota would, as now, require a waiver and such drawings would be permitted only on terms and conditions agreed with the Fund.

There is no reason to fear that such a policy would be abused. Members are aware that drawings on the Fund are transactions in reserves, and that their position in the Fund must be restored as soon as possible, in any case, within 3 years with an outside limit of 5 years. No country has failed in its financial obligations to the Fund. There might be some members that would be tempted to use the resources of the Fund as a source of credit rather than as monetary reserves. These countries are few in number and their aggregate quotas are small. As a practical matter this happens now. To prevent this, the Fund could call the attention of a member to the importance of avoiding improper use of its resources and, in an extreme case, it could suspend a member's right to draw on the Fund.

The influence of the Fund in advising members on exchange, payments, monetary and fiscal policies would not be diminished by providing assured access to its resources. The best way for the Fund to influence the policies of its members is not on the few occasions when they come for large drawings under waivers. By that time, the disruption in the balance of payments may already have gone very far. Instead, the Fund must work with its members as their problems emerge. This is the method the Fund now uses in its annual consultations. As countries come more and more to count on the Fund's resources as part of their working reserves, the influence of the Fund with its members should become even greater than it is now.

The third step in integrating the resources of the Fund with the working reserves of members would be for them to draw on the Fund as a matter of course whenever they use their own reserves. Forty-seven countries have drawn on the Fund. Many of them have come to the Fund for very large drawings to help them meet a payments crisis. The Fund has shown a great capacity to cope with such needs while creating an atmosphere of confidence. Nevertheless, it is not wise for countries to limit their use of the Fund's resources to rare occasions and for very large sums.. Such a practice gives substance to the impression that a drawing on the Fund is a sign of weakness rather than a normal use of reserves. The major industrial countries should draw on the Fund for relatively small sums at frequent intervals, in the expectation that their position would be restored when their currencies are drawn by other members.

The present system of charges could be modified to encourage use of the Fund in conjunction with a member's own reserves. The Fund agreement provides for a service charge of not less than one-half percent on all exchange transactions. This charge is levied at the time a member draws on the Fund and is applied to the gross amount of the drawing. If possible, the transactions charge should be levied at the close of the Fund's financial year and should apply to the net currency transactions of a member. Thus, the exchange purchases of a member would be offset by the Fund's sales of its currency to determine its net currency transactions. A service charge based on net purchases would permit a member to draw on the Fund in the expectation that such drawings would be largely offset by Fund sales of its currency.

The Fund agreement provides for a quinquenniel review and a general revision of quotas when this becomes necessary. During 1959, the quotas of nearly all members of the Fund were increased by 50 percent or more. In the future, it should be possible to have a continuous review of quotas and moderate increases from time to time. This would assure a gradual growth in the resources of the Fund to meet the greater reserve needs of an expanding world economy.

With the present quotas, which are generously large, the world would be well provided with reserves if the resources of the Fund were gradually integrated with the working reserves of members. The evolution of the Fund's policy on the use of its resources has been going on for some years. It is necessary to proceed with the further development of this policy. If this were done, there would be no danger that aggregate monetary reserves would be inadequate for financing deficits in world payments.

CONCLUDING OBSERVATIONS

The striking fact about the reserve problems is not that they have become more acute. Gross reserves for the world as a whole are more adequate now than at any time in the postwar period if account is taken of the availability of the resources of the Fund. What has been happening in recent years is a wider recognition of the reserve problems inherent in the present reserve system. Fortunately, the major industrial countries and the Fund are aware of the necessity of dealing with these problems. I am confident that the measures now being considered will bring about a gradual modification of the present reserve system to enable it to meet the reserve needs of an expanding and prosperous world economy.

Representative REUSS. Mr. Johnson?

STATEMENT OF HARRY JOHNSON, ESQ., UNIVERSITY OF CHICAGO

Mr. JOHNSON. Mr. Chairman, I do not have a prepared memorandum. If I had one, it would be rather shorter than those we have had already.

And since I do not have one, I will try to be even briefer than that.

I would like to address myself basically to one idea which has become current in discussions of the international monetary system in the last year and which, I think, is a rather dangerous one.

It is represented particularly by the views of Mr. Roosa, as presented in the papers before you, and this is the view that we need not worry at all about the reform of the international monetary system, because quite adequate arrangements have been made through informal cooperation between central banks.

Now, I feel that this has been a rather unfortunate development of opinion. In the first place, I think it has distracted attention from the seriousness of the balance-of-payments problem in the United States and encouraged the idea that that problem is merely a transitional problem which can be solved with the help of enough temporary borrowing.

I believe that the problem is much more serious than that; and I fear that the concentration on collaboration between central banks has made it difficult to take a rational view of the possible policies that might be followed with reference to the balance-of-payments situation. In particular, I fear that, in the course of central bank collaboration and the promises and arrangements required to effect it, it has become virtually impossible to consider a change in the price of the dollar; and I understand, from the evidence presented earlier in these hearings, that there is good reason to think that such a change might be necessary for the United States to return to a normal position of equilibrium.

I fear that this concentration on central bank collaboration has made it difficult to take a rational view of the balance-of-payments problems and, at the same time, I am not convinced that this approach to solving the international liquidity problem is a very good one.

It seems to me undesirable from the standpoint of either a liberal economic system or a democratic system of government that, a matter as important as this should be left to arrangements by agreement of a secret or delayed-publication kind between individuals who are not representatives of elected governments and who are inevitably concerned with national ahead of international objectives.

We have had experience in the past with efforts to keep the international economy running by agreement between central bankers, particularly in the 1920's; the results of these efforts could be described as successful in the short run but not in the long run. Their effect was to accumulate disequilibriums and accentuate features of the international monetary structure which proved unable to withstand serious crises.

I feel that this will inevitably be the case inasmuch as one cannot prevent considerations of national power and prestige from getting involved in considerations of what looked like purely banking arrangements.

I have the strong impression that in the past 5 years or so the consideration of whether the United States ought to devalue or Germany ought to appreciate has had a very strong political tinge to it, and that such considerations inevitably enter in. I also feel that the consequence of this way of trying to solve international monetary problems is inevitably to impart a deflationary bias to the international monetary system and not only that, but an antigrowth bias.

I am convinced that American policy, particularly in the last 2 years, has been strongly conditioned by the need to preserve confidence in the dollar; and that the results are evident enough in the state of employment and the rate of growth we have experienced.

Now, I would like to comment particularly on the Posthuma plan which Mr. Bernstein has described so favorably.

It seems to me that the difficulty with this plan is the difficulty with any less formal kind of collaboration between central banks, namely, that for such collaboration to work you have to have confidence that the other country will not devalue its currency.

The Posthuma plan, to be agreeable, must assume that no one will devalue. Yet precisely the problem we have had for the past few years is uncertainty about whether countries will be forced to devalue or not, and particularly whether the United States will be forced to devalue or not.

If we could really create that confidence that exchange rates will be maintained, I think we would have neither a need for central bank collaboration nor a problem of shortage of gold.

Further, I believe the direction in which we should look, if we are going to maintain the idea of fixed exchange rates, is not to informal collaboration between central bankers, but to a definite move toward replacing the system of international monetary arrangements, based on gold, by one based on an internationally administered credit reserve currency.

Now, there is an alternative to a system of really fixed exchange rates, and by that I mean the system in which countries not only promise that they won't change their exchange rates but actually act consistently so as to keep the confidence that they will be able to afford the promises.

The alternative is the floating exchange rate system.

Now, I believe that there is much to recommend this alternative, particularly in comparison with the other choice, to rely on collaboration between central banks. That system is, at least, not dependent on the opinions and judgments of a few key individuals.

It is an automatic system and it is consistent with the market system; and I think it has a great deal to recommend it by comparison by what is essentially a discretionary system.

Now, I think Professor Machlup did not, in fact, go as far as he might have in describing the merits of this system, because I detected in his paper what I regard as a by now rather heretical and outdated opinion that the problem of inflation is a very serious one and one which it requires great efforts to avoid.

I feel that past experience, at least the experience of recent years, has demonstrated that our real danger is deflation; that if anything, we are too averse to inflation, real or imagined; and that even with the floating rate system we would probably have the problem, not of educating people to avoid inflation, but of educating them not to be too anti-inflationary.

Now, I do not want to go into the technical argument on this, but much of the opposition to inflation is based on the illusion that inflation has existed where it has not, or on a failure to calculate the economic costs of inflation as compared with the alternative deflation.

My personal judgment is that, by and large, we have put too much weight on the fear of inflation as compared with the fear of deflation and that this has shown up in a problem of unemployment in North America of a serious kind, in a slowing down in the rate of growth of the Western economies, a matter which has serious implications, I think, for the cold war and for the whole problem of the development of the underdeveloped countries.

Well, Mr. Chairman, I promised not to take very much time, and I am going to abide by my promise by stopping at this point.

Representative Reuss. Thank you, Mr. Johnson.

Mr. Bernstein, in your statement there occurs at the end of the first paragraph a very interesting sentence.

You are talking, in that paragraph, about large movements of liquid funds, that which is sometimes called "hot money."

And you say—

> It would be a backward step to depend on exchange controls to avoid such capital movements.
>
> A more practical way to deal with the problem is to have a greater degree of international cooperation on monetary policy to minimize the outflow of short-term funds and to provide reciprocal credits to finance such capital movements as do occur.

To me, that is an extraordinary important sentence even though you only give it the one sentence.

I take it that you are saying two things there, that you wish to free countries, and particularly this country, from the adverse effects of short-term capital movements out of the country which stem not from any fiscal or monetary immorality on the part of the country of origin but from speculative movements, movements due to interest rates, differentials, and other similar causes.

This is the problem you——

Mr. Bernstein. That is right. This is one of the problems.

I would like to see countries work in such a way that monetary policy in the United Kingdom, for example, would not become a crisis policy when sterling is under pressure. A crisis policy would merely have the effect of transferring that pressure to the United States through a big outflow of funds.

I would like to see the extremes-on-interest-rates policy avoided. That means that in the United States, instead of having a range, say, from 1 to 4⅝ percent—that was the range of Treasury bill rates in the cycle of 1958–60—I think we should have a range here between, say, 2 percent and 3½ percent.

In the United Kingdom, instead of raising the bank rate to 7 percent, I would like to see the maximum bank rate at 4 or 4½ percent.

As I see it, we would get, or, the United States would get about as much stimulus to the economy in a period of recession from a 2-percent bill rate as it does from a 1-percent rate.

The difference is not really as big as it looks, particularly when you think in terms of the interaction of the short-term rate with the long-term rate. And it would avoid the need for 4⅝-percent bill rates at the peak of an expansion, as we had in January of 1960.

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On the other hand, I do not think anything is gained by competition between the big financial centers, when one has a balance-of-payments difficulty, by trying to meet the immediate impact by a big inflow of funds. After all, if the United States wanted to resist an outflow of funds to the United Kingdom, when the United Kingdom raises the bank rate very high, we could do it by raising our interest rates very high. That would stop the movements of funds, but both countries would suffer.

Now, when I first proposed this in a publication of the Joint Economic Committee I made the observation in 1959 that we would never again have a 1-percent bill rate in this country, that in the next recession the lowest rate we could have would be about 2 percent. At the same time I called on the Europeans to bring down their very high rates. They had enormously high money market rates in 1959 and 1960. Now, I will not say they responded very much to my suggestion, as they felt they were under inflationary pressures. But these inflationary pressures have eased in Europe and, as they eased, money market rates in most Western European countries today are lower than in the United States.

Of course, the two most important countries for us still have high money market rates. In my opinion, they are higher than is good for them and higher than is good for us. That is the United Kingdom and Canada, but they are under pressure of their balance of payments. In any case, their rates have come down and the pressure on us is not as bad as it was a few months ago.

Representative REUSS. I agree with you that the demonic high interest rate policy of some of the European central bankers has happily eased in recent months.

However, would you not attribute that easing, in part at least, not to an easing of inflationary pressures they still have from full employment over there, but to some education on the part of central bankers, whether by Bernstein or others?

Mr. BERNSTEIN. I would like to believe that the educational process is so effective, but I would be inclined to think, Congressman, that while they still have full employment, the inflationary pressures have eased on the Continent. Where they have not, as, for example, in France, you still have high money market rates. But I do think that they are better prepared to discuss these questions, and even to shape domestic monetary policy away from extremes in order not to put pressure on other countries.

And I might add one other point. Dr. Holtrop, who is the president of the Netherlands Bank, has been the first to propose to go much further and to extend this cooperation into the field of long-term interest rates, and the flotation of foreign securities in national capital markets. I think he is very wise in proposing this. He proposed it initially at a meeting of the Bank for International Settlements. That is a field in which we ought to do more work.

Representative REUSS. To summarize, then, your point of view on differential interest rates, it is your view that it would be a good thing for the free world if on both sides of the Atlantic interest rates were more attuned to economic growth and were no wit higher than is necessary on the European side to counteract real rather than imagined inflationary pressures. And the only part of your package advice which looks in an upward direction for interest rates is that, speaking of this country, you think that absurdly low short-term interest rates like the 1 percent that we had at one point are inadvisable from the international standpoint, and that the last percentage point, that is, the difference between 2 percent and 1 percent, does not do the domestic economy much good anyway.

So that this is a small, infinitesimal domestic price to pay for international stability. Is that a fair statement?

Mr. BERNSTEIN. I think that is a fair statement.

You see, what I do want is this: I want to retain the use of monetary policy for domestic purposes, for the domestic economy. I want it to ease in a period of recession. I want it to tighten, but not too much, in a period of expansion, if we get a real expansion. We have not had one. I do not think there has been any great need for tighter money. I think the range will have to be narrower than it was in the past. It has to be narrower because we cannot go so low in a world in which funds do move out easily.

On the other hand, I think some other countries must take into consideration that interest rate differentials can come from their having excessively high rates as well as our having low rates, and they must restrain themselves in trying to solve their balance-of-payments problems overnight merely by drawing in money with very high rates. This seems to me a reasonable combination of interests.

Representative REUSS. I applaud your policy statement there. The only difference I have with you is that you seem to take all this for granted, as if the wisdom you have just announced were accepted. But I point out that on the other side—well, I am glad to hear that Mr. Holtrop, who is president of the Netherlands Bank, and also the Bank for International Settlements, apparently has come out for lower interest rates and less of a tight money policy in Europe.

Nevertheless, one of his institutions, the Bank for International Settlements, has just finished advising the United States that high interest rates are great, and we ought to have more of them, not just short term, but long term.

The OECD, which ought to be giving the gospel, according to Bernstein, to its European components, if I read it right, is giving just the opposite. It is high interest rate too, and tells us to cure all our problems by fiscal means.

And finally, I do not find any authoritative voice in the United States, while we are very free with advice to Europe about how the United Kingdom has got to join the Common Market, and Sweden cannot, and they can have Skybolts or not. I do not find anyone telling the Europeans that they ought to stop dragging interest rates up and ought to start cooperating.

Mr. BERNSTEIN. Yes, Congressman, I think that plenty of Americans are telling the Europeans——

Representative REUSS. It is awfully muted, because you do not hear it, whereas these other things which are much more volatile were said in the meeting of the NATO ministers this morning.

Mr. BERNSTEIN. I am about to debate this question with Mr. Gilbert of the BIS during Christmas week. I have finished the paper, and I would be glad to submit it for the record here, but I do not think it would be polite to have it printed before I give it orally. But nevertheless, you can read it if you want to.

Representative REUSS. I certainly will.

But the point I wanted to make was that it seems to me that while the advice you give is good advice for the free world, it is not being accepted by the other side, and it is not even being given officially very vocally by this side.

Would you not agree that it should be given officially vocally, and respectfully, by this side, and hopefully heeded by the other side?

Mr. BERNSTEIN. I think, as a matter of fact, it is the policy of the United States to press along the lines that I have mentioned. There are central bankers in Europe who still say that the only function of monetary policy is to protect the balance of payments, let the governments do what they want on full employment. This view leads them to a combination of a large budget deficit and very tight money to deal with the concurrence of a balance-of-payments deficit and unemployment.

In my opinion it is not possible to surrender the use of monetary policy for domestic purposes. First, it is the only instrument which is flexible and in the hands of an administration for early use. Budgets, almost every other policy that could be used to act on the domestic economy requires congressional action. It means delay. And then when the power is given by Congress, quite properly, it is given for very limited purposes, that is to say, it is very rigidly prescribed.

Now, it does seem to me that the monetary authorities need a flexible instrument. And that flexible instrument is credit policy. I do not believe that the mere substitution of an easier budget for credit policy will do the job. We have to keep using credit policy for both domestic and international objectives. In both cases we have to moderate our use with reference to what the environment is, that is to say, you cannot have 1-percent money when you have a balance-of-payments deficit. On the other hand, I cannot see any sense in having 6-percent money when you have a lot of unemployment. This does not seem to me to make much sense.

That is one reason why I have tried to find what I think is a reasonable role for monetary policy without undermining the balance of payments.

Representative REUSS. Would you do one more thing?

Would you file for the record, after you have refreshed your recollection, any and all instances which you know of where U.S. officials have expressed the view you are here expounding?

I would be delighted to find that they have.

Mr. BERNSTEIN. I will find out and place it in the record.

(Mr. Bernstein presented this statement for the record:)

The Treasury has been understandably cautious in making public statements calling on other countries to reduce their interest rates. There is no doubt that the Treasury has explained the U.S. point of view on cooperation on interest rate policy in its talks with other countries and in the meetings of the OECD.

Secretary Dillon has emphasized the importance of international cooperation on interest rates on a number of occasions. His statement to the Senate Foreign Relations Committee on February 14, 1961, contains this pointed observation:

"To illustrate the need for better international coordination of economic and financial policies, I would like to refer to last year's movements of international short-term capital.

"During the first half of 1960 our balance-of-payments deficit on an annual basis was $2.7 billion, down markedly from the level of $3.8 billion in 1959. Last spring, our Federal Reserve discount rate was at 4 percent, the German Bundesbank rate was 4 percent, and the Bank of England rate was 5 percent. In other words, all those rates were close together. Then as business began to slow in the United States, our Federal Reserve began to ease credit and reduced its rate first to 3½ percent, and later to 3 percent. Meanwhile, the German Bundesbank, with its eye on the domestic boom in Germany and with the objective of controlling inflation at home, increased its discount rate to 5 percent in June. The Bank of England promptly followed suit and upped its rate to 6 percent.

"These actions brought about a sharp imbalance in short-term interest rates. The results were bad for all concerned. A flood of short-term funds left New York seeking the higher return in Frankfurt and London. This sharply increased our balance-of-payments deficit from an annual rate of $2.9 billion in the first 6 months to a rate of $4.7 billion in the second 6 months. This sudden and sharp increase shook confidence in the dollar and the result was a substantial increase in the outflow of gold. This in turn brought on the speculative outbreak in the private gold market in London last October when for a day or two. gold sold at $40 an ounce. Meanwhile, the large inflow of American funds frustrated the efforts of the German authorities to tighten up on investment in Germany. When this became clear, the German and British authorities cut back their discount rates, the flow of short-term capital slowed and confidence was gradually restored.

"The lesson to be learned by all this is that in these days of convertible currencies there must be close cooperation and coordination between our financial and monetary authorities and those of the major industrialized countries of Western Europe. This is now recognized on all sides. The OECD is the forum in which this coordination can be worked out and through which we can avoid similar episodes in the future. As such, it is a vitally important element in our drive to right our payments deficit without infringing on the actions that must be taken to reinvigorate our economy at home."

A similar view was expressed by Secretary Dillon in his statement of March 7, 1961, to the Joint Economic Committee and in his statement of June 19, 1961, to this subcommittee on international exchange and payments.

Representative REUSS. But very frankly, unless it has occurred behind very tightly closed doors, I have not been aware of it.

I want to get to Mr. Machlup in just a minute. But I said this was an important sentence you had here, and I have just covered half of it.

The second half, Mr. Bernstein, is the part that states "to provide reciprocal credits to finance such capital movements as do occur".

Earlier in the hearings yesterday, we discussed the possibility of an arrangement between the leading industrial countries whereby, perhaps as a logical extension of the "swaps" arrangements, the mutual support arrangements of treasuries and central banks—which are good as far as they go, but are very limited as to amounts, and are full of clogs as to their automatic character—we discussed the possibility of extending that so as to provide something like a payments union for these flows of short-term capital by reason of interest rate differentials and by reason of speculation. Thus, all or a very large part of the flow would be rather automatically covered, much as was done under somewhat different circumstances in Europe in the European payments union of the fifties.

It sounds to me as if this is precisely what you are talking about by your phrase here.

Mr. BERNSTEIN. I do not think, Congressman, we really want a payments union, if you have in mind the payments union that the Europeans had.

The payments union was in effect a method of clearing claims, so to speak, through the European payments union. This was helpful to them at a time when they all felt very short of reserves. In fact, as soon as their reserve situation improved, all of the countries in the European payments union preferred what they called clearing their position through the exchange market.

Now, I would like a system under which there is this sort of help. I do not think that the "swaps" are a bad way to do it, though I do agree the sums are very limited. Altogether, they amount to only a few hundred million dollars, and in any one currency they are not very much.

Representative REUSS. Also, they are good only for 60 days or 90 days?

Mr. BERNSTEIN. That is right. They are renewable.

Representative REUSS. Let's start with the "swaps." If the "swaps" were considerably larger, and if they did not have the short period, then they would do the job quite well, would they not?

Mr. BERNSTEIN. You are quite right——

Representative REUSS. But this is a vastly different thing from the tiny little arrangements that we now have.

Mr. BERNSTEIN. That is right. They are not large amounts.

The Posthuma plan would do more along that line. The Posthuma plan would in fact give a prescribed amount of credit to each country through the holding of these foreign reserves. Incidentally, they would have carry with them an automatic exchange guarantee for this reason.

Suppose this was set up in the International Monetary Fund. Each of these countries would deposit with the International Monetary Fund certain amounts of its own currency and get credit in these reserve units. They would then pass the reserve units to each other along with gold as a composite standard. As these would be held by the International Monetary Standard, they would carry an exchange guarantee. I do not think anyone can talk of a Posthuma plan without it.

Mr. JOHNSON. I did not gather that from your statement.

Mr. BERNSTEIN. I did not mention it there.

Representative REUSS. The hitch in the Posthuma plan is that it too has limits, and those limits are whatever they agree on as the holding.

Mr. BERNSTEIN. The first thing you want to bear in mind is that we are not trying to solve the whole reserve plan with the Posthuma plan. The Posthuma plan in my opinion is specifically useful for stopping the attempt by the big financial centers to get themselves more secure and more liquid by raising the proportion of their reserves in gold. They attempt to escape from a currency which may be temporarily weak, you see, by selling out.

The Posthuma plan would end that. It would provide actually for the holding of $11 billion more of foreign exchange reserves—foreign exchange as reserves—than are held now. All these countries together hold around $10 billion of each other's currencies. They could hold $21 billion under the Posthuma plan, based on their $33 billion of gold.

Representative REUSS. Let me say this about the Posthuma plan, and I have not studied its details.

If the arithmetic of the Posthuma plan is sufficient to take care of washing out any foreseeable hot money flow or short-term capital flow, then it would seem to me, to achieve the goal that you have in the half sentence we are talking about, necessary to provide reciprocal credits to finance such capital movements as do occur. But it has to be adequate——

Mr. BERNSTEIN. Certainly along with the $6 billion of special reserves under the Paris agreement there is plenty there.

Representative REUSS. The trouble with the Paris agreement, with all due respect to that agreement, is that it is a long ways from being automatic. While it is said that they can convene these gentlemen quite rapidly, they still have to be convened at various levels.

Mr. BERNSTEIN. I do not think that would be the real difficulty with it. There are difficulties with the Paris agreement, but I do not believe the fact that it is not automatic is of great consequence. The truth of the matter is that when there are crises you do get the money.

The trouble in fact with all such arrangements is that they require a present condition of crisis. Now, I would like systems that do not require a condition of crisis before they become effective.

Representative REUSS. But avoid the crisis by being automatic.

Mr. BERNSTEIN. It is not that you cannot get the money when there is a crisis. The history of central bank cooperation on giving aid to each other goes back a very long time.

In 1837 the Bank of France lent money to the Bank of England. In 1871 or 1872, the German Government was very cautious about withdrawing gold when the indemnity of the Franco-Prussian War was paid by drawing bills on London. The German Government was very cautious in withdrawing gold, and got a pat on the back from Walter Bagehot. The United States and the French both helped the British with resources during the 1920's.

There is no difficulty about this. The trouble is that they require a present condition of crisis. That is what I do not like. And that is what I prefer about a reserve system that would get rid of it. That is one thing I want to do with the International Monetary Fund too, get rid of the crisis condition that precedes some drawings.

Representative REUSS. I think you have phrased in very simple language the essential element in any plan for dealing with short-term capital outflows, namely, that it has to try to obviate a crisis rather than merely patch it up after it has occurred. And whether it be an adequately funded Posthuma plan, or a neopayments agreement fixed up for the circumstances of the 1960's, or some other plan, it does seem to be your view in your testimony that this country should promptly take steps to negotiate and put such a plan into agreement.

Mr. BERNSTEIN. Yes, I think we ought to go ahead and try to get such arrangements for meeting these problems, not just the hot-money business, because after all, most of the outflow of funds in the last 2 years of short-term money was bank money, and hardly hot; it was something else. I am also disturbed, Congressman, about the danger that when funds move out there will be a call for gold.

Representative REUSS. Thank you for the moment.

Now, Mr. Machlup, you had something to say. If you do not, I have got a question or two to ask you.

Mr. MACHLUP. If you do not mind, I think one of the purposes of a panel is to disagree. And fortunately Mr. Bernstein said something that went under my skin.

I believe it is dangerous to believe that the presence of unemployment is always a signal for lower interest rates. The idea is, of course, understandable for it is possible that unemployment was brought about through oversaving that was not invested; it could have been brought about through a deflation in countries competing for reserves. But these are not the only possible causes of unemployment. And certainly not all unemployment should or can be cured, or should be tried to be cured, through lower interest rates.

Just imagine the case that, after everything in the economy has been all right, with full employment and perfect equilibrium, suddenly another million people join the labor force,—they become 15 years old or 16 years old, or 18, and join the labor force. For goodness sake, would you want to lower the interest rate in order to create employment for these people? This would be outright inflation, and would not bring about anything helpful in the long run.

Take another case. Assume that wage rates are pushed up, one way or another, by 10 percent. With a given quantity of money that would mean unemployment. Would it be a long-run solution, now, to reduce interest rates, because wage rates have gone up?

It should be clear that we must avoid using this recipe, lower interest rates, for all sorts of trouble. I am afraid, if we are not careful, many people will prescribe this recipe for everything, and always call for lower interest rates. This would have dangerous consequences.

Representative Reuss. The record will note your dissent on this point.

The whole question of unemployment and the interest rate has absorbed a lot of the attention of this committee. But this is not primarily our inquiry in this current series. And I think the record will note your views on it. And I am sure that Mr. Bernstein would want to come back and say that of course he does not think that lower interest rates are the cure for all forms of unemployment.

They certainly, for example, do not come to grips with area unemployment. I am not sure what does, but they do not.

Mr. Machlup. I am satisfied with this caveat, Congressman.

Representative Reuss. I am glad that I have you on the witness stand, because I do want to ask you a number of questions raised by your paper.

You point out three types of reform plans which in one way or another address themselves to the general question of increasing the longrun supply of reserves. You point out that in general the establishment has been much too complacent about the supplier of reserves. In your opinion, it is not just something for the sweet by-and-by, but it is something that has to be faced right now or in the next year or two.

Mr. Machlup. At least we ought to think about it now.

Representative Reuss. You throw away the first two types of reform plans you mentioned as not, whatever their other merits, addressing themselves to the long-term problem of reserves, which leaves you with centralization of monetary reserves, that by and large is the kind of IMF plan that Mr. Bernstein was on the verge of discussing—a little different, perhaps.

Mr. Bernstein. Plus Triffin.

Mr. Machlup. That is right. For I think you would need a bit of centralized creation of reserves.

Representative Reuss. Secondly, increasing the price of gold.

Thirdly, flexible exchange rates.

Then you addressed yourself to the inflationary potential of these three plans. And I think your conclusion was that the least inflationary probably, if properly safeguarded, was this centralization of monetary reserves. Increasing the price of gold by decentralizing matters led to considerable dangers of inflation, and likewise until philosophers become central bankers, freely flexible exchange rates, you felt, had an inflationary potential.

Mr. MACHLUP. On this last one I am not so sure. I think it should be possible to change the attitude of central bankers even faster. So I would not be so gloomy regarding the effects of freely flexible rates—and I assume, from what Mr. Johnson said after me, he would go along with me on that. It is not necessary that this third plan is really inflationary.

Representative REUSS. The second one——

Mr. MACHLUP. The second one is outright inflationary.

Representative REUSS. It seems to me that has more inflationary danger.

Mr. JOHNSON. I think the point is that the second plan is a once over big increase, that is really the inflationary aspect of it, whereas the centralization could create reserves at a relatively slow rate, and the floating rate system does not require reserves.

Mr. BERNSTEIN. I might add, too, that in my opinion any of these schemes depending upon the creation of reserves, as distinguished from the plan in which quotas are made automatically a part of the reserves is distinctly deflationary.

I do not believe it is possible to operate the Triffin plan in the present world without deflation. It would deflate the reserves of the world.

Mr. JOHNSON. Is it a once over deflation or is it chronic?

Mr. BERNSTEIN. It is a bias. Part of it is once for all. For example, the elimination of present quotas in the Fund and the eradication of dollar and sterling balances held by other countries are deflationary. Countries would get a deposit in the Triffin bank for their dollars and sterling. But in turn the United States and the United Kingdom would have to maintain an overall payments surplus to liquidate that obligation to the World Central Bank.

That is a part of the bias. That is a once for all deflation, though stretched out.

But inherently it is impossible in the Triffin scheme to make loans to countries to become part of world reserves. The large industrial countries would not be borrowers. It is very easy for them in fact to earn reserves if the others will borrow. The smaller countries would not in fact qualify as borrowers.

The truth of the matter is that even in the Federal Reserve System, depending upon loans as they once thought they would, has become impractical. In the Federal Reserve System as we have it today—I think less than one-half of 1 percent of the outstanding Federal Reserve bank credit last Wednesday was in the form of borrowings by member banks. Ninety-four percent consisted of the holding of securities.

So you would have to get around to a system really of open market operations.

Mr. MACHLUP. Which is the basis of the Triffin plan.

Mr. BERNSTEIN. This is now part of the Triffin plan, but I want to get to lending too.

May I go on to that?

Mr. MACHLUP. Go right ahead. You are monopolizing this discussion anyhow.

Mr. BERNSTEIN. I will put this into the record, and that will avoid that.

Representative REUSS. Let me identify that.

How would you describe the paper that you have just handed up?

Mr. BERNSTEIN. It is a note on the Triffin plan.

Representative REUSS. The note by Mr. Bernstein on the Triffin plan will be made part of the record.

(The document referred to follows:)

A NOTE ON THE TRIFFIN PLAN

The difficulty of providing for future reserve needs through increased holdings of dollars, sterling, and other foreign exchange, and the danger that the reserve currencies could be exposed to serious pressure from the conversion of present holdings into gold have led Prof. Robert Triffin to conclude that a completely new system of supplying monetary reserves is necessary. He had proposed that this be done by transforming the International Monetary Fund into a world central bank with the power to accept deposits and to create credit denominated in a new international currency unit. These deposits would be transferable among central banks and would act as monetary reserves.

The first step in Professor Triffin's plan would be to abandon the present quotas and to terminate the present drawing arrangements under the Fund agreement. Countries with a net creditor position in the Fund would be given deposits to their accounts in settlement of their claims. Countries with a net debtor position in the Fund would have these debts converted into loans repayable over a period of 3 to 5 years. All countries adhering to the world central bank would be required to deposit a prescribed fraction of their gross monetary reserves, say one-fourth, in the new institution. Countries holding dollars, sterling, and other foreign exchange reserves could fulfill this requirement by depositing balances of these currencies. The United States, the United Kingdom, and other gold-holding countries would have to make their required deposits largely or entirely in gold. The dollar, sterling, and other foreign exchange acquired by the world central bank through such initial deposits would be funded into debts repayable over a reasonably long period.

For all practical purposes, the dollar and sterling would cease to be reserve currencies, although most countries would continue to hold modest balances of such currencies for their ordinary payments needs. Instead of supplying the world with additional reserves through the increase in foreign holdings of dollars and sterling, the United States and the United Kingdom would be compelled to deplete the reserves of other countries by maintaining an overall balance of payments surplus in order to repay their debts to the world central bank. With the change in their status under such a system, the capacity of the reserve centers to act as exporters of long-term capital or as the source of additional short-term international credit would be very reduced. The world central bank would, of course, attempt to provide the additional reserves that would no longer be supplied through increased holdings of dollars and sterling. It would be more difficult to replace the function of the reserve centers as suppliers of capital for the world economy.

The basic technique for assuring an adequate growth of monetary reserves under the Triffin plan would be the extension of credit by the world central bank. To provide the necessary supplement of reserves, the world central bank would have to create reserve deposits (that is, excluding deposits of gold) at an average rate of $1 billion net a year. To achieve this, the new institution would have to undertake a vast lending program. If the loans of the world central bank were repayable in about 3 years, the period now regarded as normal by the Fund, the turnover of loans to assure an average growth of $1 billion a year net in reserve credit deposits would soon reach enormous proportions—say, about $4 billion a year or more in about 10 years. In fact, as many loans would be repaid before 3 years, the turnover of loans would have to reach a much higher level much sooner.

It would be impractical to count on such a steady increase in loans to central banks of member countries to provide for the growth of monetary reserves. The large industrial countries would have no reason to incur indebtedness merely to facilitate the growth of the world total of monetary reserves. Other countries could not be expected to qualify for the enormous increase in loans that would be necessary for the growth of the world total of monetary reserves. The experience of the Federal Reserve System is pertinent on this point. Among the factors supplying reserve funds to the member banks of the Federal Reserve System, discounts and advances (loan) are of negligible importance. In the week ended December 12, 1962, member bank borrowings accounted for $107 million out of a total of $32,629 million of Federal Reserve bank credit outstanding. At present, about 94 percent of Federal Reserve bank credit is provided through holding U.S. Government securities.

Professor Triffin is aware that it might be impossible to make loans to countries on the scale required for an adequate growth of monetary reserves. He would, therefore, empower the world central bank to enter into open market operations through the purchase of Government securities in the leading financial centers. This would, of course, have to be done with the approval and through the agency of the monetary authorities. Countries acquiring reserves through the open market operations of the world central bank would be expected to use the reserves to increase their foreign investment so that the reserves would be spread throughout the world economy. It is difficult to believe that any large country would consent to such an arrangement. It would impose on the reserve centers a greater obligation for supplying capital and reserves to the rest of the world than they now have.

To avoid this difficulty, it has been proposed by the Honorable A. Maxwell Stamp that the creation of reserves by a world central bank should be linked to development loans. This could be done by having the world central bank buy the securities of the International Bank for Reconstruction and Development and the Inter-American Development Bank, leaving to these institutions the responsibility of deciding in which countries to make development loans. If the development loans, which would be the basic securities behind the reserve deposits with the world central bank, had to meet reasonable standards of credit worthiness, it would not be possible to find eligible borrowers for the amount needed to increase monetary reserves at a moderate but steady rate. It is difficult to believe that countries reluctant to absorb additional reserves in the form of dollar and sterling claims would be receptive to holding reserves in the form of international currency units created by a world central bank through credit operations under such a plan.

There is a widespread fear among central banks that the Triffin plan would inevitably involve an excessive creation of monetary reserves and generate inflation in the world economy. There is this possibility, although it is unlikely. Professor Triffin recognizes the desirability of limiting the capacity of a world central bank to create reserve credit by providing for a fractional gold reserve and for the conversion of excess deposits of currency units into gold. Other reasonable safeguards could be imposed on the operations of a world central bank, such as a limitation on the annual increase of reserve credit, or a limitation on the amount of deposits with a world central bank that any country could be required to hold. These are feasible devices for preventing the excessive creation of reserve credit by a world central bank. They would be adequate to restrain any tendency toward a rapid expansion of reserve credit under the Triffin plan.

In my opinion, the Triffin plan is much more likely to be deflationary. As already noted, a world central bank would have great difficulty in finding acceptable borrowers to whom to extend loans on the scale necessary for the growth of monetary reserves. A prospective borrower would have to satisfy a world central bank that it is credit worthy and that it is following responsible financial policies. Even this would not assure a country that it could secure credit when its balance of payments is under pressure. It must be presumed that in determining whether to create reserve credit, a world central bank would have to take account of the state of the world economy. It is quite conceivable that a country with a balance of payments deficit, not attributable to its own inflation, would be denied credit on the grounds that the world economy has adequate reserves and is suffering from excessive demand.

The point that must be emphasized is that the grant of such a far-reaching power as the creation of monetary reserves would impose on a world central bank a corresponding responsibility to use such power with great caution and in the general interest. Inevitably, the policy of a world central bank in creating monetary reserves would be determined by the general state of the world economy. Although the interdependence of countries in the world economy is far greater than it has been in the past, the economic situation differs radically from country to country. It would be unfortunate if the provision of reserve credit for any country had to be dependent on the capacity of other countries to absorb more reserves without putting pressure on their domestic economy. At this stage, it would seem far wiser to give countries access to predetermined, but limited, reserve credit when their own balance of payments position makes this necessary. This is done through the quotas of the International Monetary Fund. The improvement of the reserve system does not require the elimination of quotas, but a more effective means of integrating them with the working reserves of members of the Fund.

Representative REUSS. Now I want to go on with the symposium, and I hope you will all participate in it.

Mr. Machlup, in your analysis of these various plans you asked but did not answer questions.

For example, as to plan D, to increase the price of gold, you asked: "Would this not be a mere trick, cheating those who have been willing to hold dollar balances rather than gold, procuring windfall profits for the Soviet Union and South Africa, and for gold speculators and hoarders?"

Well, it would, in fact, whatever its advantage, have those disadvantages, would it not?

Mr. MACHLUP. Yes, I formulated questions regarding all three types of reform that tackle the longrun problem, questions reflecting the doubts and suspicions in the minds of the bankers. But in this case—regarding the gold price increase—I share their doubts and suspicions, which I do not necessarily do with respect to the other two plans.

Representative REUSS. You then asked a question concerning plan E, the flexible exchange rate plan.

Would not this plan be detrimental to commerce and industry if no one could ever be certain how much he would receive for his exports or how much he would have to pay for his imports?

Mr. MACHLUP. I do not believe that it would be detrimental, because there are two institutions which would avoid that detriment. The one is the institution of the forward market, in which people could at least for current transactions secure a hedge, and therefore know full well what they will get for their exports and what they will have to pay for their imports.

And the second factor is that built into the new system would be the new mentality of the central bankers, that they must not carry on a policy which would lead to intolerable gyrations of the exchange rates.

In other words, this is the transfer of sensitivity of the central banker from watching the reserves to watching the exchange rates. And they would have to carry on a policy that would avoid undue gyrations.

Representative REUSS. I have a question for you, Mr. Johnson. But did you want to comment first?

Mr. JOHNSON. I want to comment on that.

It is usually argued that a fixed rate system with variable reserves puts a great deal of pressure on policy, whereas a floating rate system does not.

I would maintain, on the basis of the Canadian experience, that a floating rate system probably puts more pressure on in the sense that many more people are aware of the exchange rate and fluctuations in it than are aware of fluctuations in the gold reserve. In fact, Canadian experience can be interpreted as an example of monetary mismanagement consisting in the first place of being too pleased when the value of the currency went up, and then panicking when the currency went down.

So the moderation of opinion would have to go the other way rather than the one Professor Machlup is asking.

Representative REUSS. Let me ask your views on a couple of other proposals that have been made.

First, is my understanding correct that you share with Mr. Machlup a feeling that the free world is or will shortly be faced with an insufficiency of reserves, and that something ought to be done about it?

Mr. JOHNSON. Yes, I do.

Representative REUSS. As to that something, I would like your comment on Mr. Bernstein's proposal for integrating IMF quotas in national reserves. Do you favor that?

And would it, in your opinion, be adequate to meet future reserve needs?

Mr. JOHNSON. As to the first part of it, I do favor it, and have favored it since Mr. Bernstein began to suggest it, because it seems to me that if we have this institution, and given that it is easier to develop an existing institution than it is to replace it, this is a logical step to take. I think it does raise some problems concerning the nature of the Fund itself. The Fund was designed to have certain limitations in it which would have to be dropped to achieve this reform, but I think that would be manageable, particularly if Mr. Bernstein is prepared to go around the world saying that it is manageable.

How far this would be adequate, I think, depends very much on his proposal that you should meet reserve needs by increasing quotas.

Now this, I think, raises some problems, because if you are really going to meet future reserve needs, you must be prepared to change the relative sizes of the quotas.

I think, also, that because increases in the quotas have to be agreed among the members, you may have the difficulty that you won't get large enough increases or that you will get discontinuous increases of the same sort as you would get if you changed the price of gold, because, if you remember, the last time there was a very large increase in the quotas after the world had had to be convinced that the quotas were not big enough. In that respect, changing the quotas has the same sort of disadvantage as changing the price of gold; it is a discontinuous operation.

I would prefer to see the IMF evolve gradually into a Triffin-type world central bank. It may be that this is the best step toward that. I would have my doubts whether it would be a permanent solution, but as a way of educating world opinion toward the idea of a more rational system of providing reserves than the gold standard, I would be in favor of it.

Representative REUSS. Your proposal, Mr. Bernstein, at least in the streamlined form in which you presented it today, and previously to this committee, does not involve the use of any IMF reserve deposit or other piece of paper, negotiable or nonnegotiable, which might, in time, grow into an additional reserve currency—or does it?

Mr. BERNSTEIN. No; it does not. It would, in fact, involve the simple proposition that the quotas in the fund are reserves. A country that wants dollars, instead of selling a certificate to the Federal Reserve Bank of New York, merely asks the Fund to have the Federal Reserve Bank of New York put dollars into its central bank account. There would be no deposits. The quotas themselves would be the reserves. As they draw them down it would be the same as drawing down deposits, but we would not call them deposits.

The country that draws down the quota would find it has less reserves just as when it draws down a deposit. A country that, so to speak, provides the means for the Fund to meet a drawing quota by another country, would have a larger unused quota in the Fund the same as an increase in its reserves. You simply would not call it "deposits."

Representative REUSS. The use of a quota would not be evidenced by any new type of negotiable instrument, it would simply be an open book, a contract.

Mr. BERNSTEIN. It could be carried in a country's own accounts and in the Fund accounts, as is done in any case.

Representative REUSS. And since it could get any currencies it wanted from the Fund, it would not need a note from the Fund to buy them elsewhere, because it would already have them?

Mr. BERNSTEIN. That is right.

Mr. MACHLUP. May I ask a question of Mr. Bernstein?

How would this increase the reserves?

Assume quotas have been raised, and each country counts these quotas into its reserves. But now as a country uses their quota, this merely leads to bookkeeping transfers, but not to a regular increase in reserves.

Mr. BERNSTEIN. Integrating the quotas with the working reserves of members—if you did this gradually—would mean that at the end of some time, 5 years from now, all of the reserves of the world would be equal to gold plus foreign exchange holdings plus quotas of the Fund.

Now, these quotas are transferred from one country to another as they are used. Aggregate reserves are not changed by that; they are not diminished by it; they are not changed.

Representative REUSS. This increases the service of existing reserves through increased mobility.

Mr. BERNSTEIN. First it increases the present reserves you have for payments. But as to the future growth of the reserves, what you would have to do is use the power the Fund has for revising quotas at any time, and a compulsory quinquennial review.

Mr. Johnson is right; the last big increase in quotas was imposed on a reluctant management of the Fund by the demands of a few important members. As a practical matter, it would have been much better not to have increased the quotas at that time so much, but to have moved promptly toward including the existing quotas as part of the working reserves.

If the quotas were now included in the reserves, they would certainly make the reserves very adequate. But in time this pressure will again arise, and you can have much more moderate increases much more frequently.

Representative REUSS. So the real question between three people like yourself, which each one believes that reserves need in the immediate future to become more readily available, the question betweeen you is as to whether it is enough, as Mr. Bernstein suggests, to count IMF quotas and then marshall and mobilize them more efficiently, or whether you actually need an additional source of new reserves over and beyond the national reserves which are created by countries running a deficit.

And I gather that Mr. Bernstein feels that at least his proposal should be tried first before you get into the question of whether you need new sources of reserves.

Mr. BERNSTEIN. If you are going to have a Triffin plan at all, you have to wipe out the quotas in the Fund. I know you can change the Triffin plan all along to meet all objections, and I am all for making these changes, but that does not get rid of the notion that until these changes are accepted there is a deficiency in the plan.

Now, the big deficiency of the Triffin plan, apart from all of its operational deficiencies, which I think would be in practice insoluble, is that it would wipe out all the quotas as they exist today. These quotas do have reserve meaning. You would then have to find the equivalence of it through an enormous increase in credit in the very first few years under the Triffin plan.

In good faith it is going to be very hard to find borrowers under the Triffin plan in any case. The use of open market operations actually is a device for throwing back on the United States and the United Kingdom the reserve centers, the creation of reserves for the rest of the world.

I am not sure how much they would want it, particularly if they are under obligation then to repay the new institutions. The Triffin plan does have big deflationary features which would have to be eliminated before you can depend upon the creation of credit as a device for adding reserves for the future.

Representative REUSS. Without getting into details of plans—and as you say, they change before the human eye, so it is sometimes difficult to keep up with them—why could not your plan accommodate itself to a rather prompt next phase in which the IMF does accept deposits from members and issue negotiable instruments? This would be a way of creating new international reserves against the possibility that the reserves created by national methods, by running a balance-of-payments deficit, may not be adequate, because the payments deficients of the key currency countries may not be large enough.

Mr. BERSTEIN. Congressman, if it makes the thinking easier for anyone on earth, I am perfectly willing to stop using the word "quotas" and say that we will have initial deposits of the International Monetary Fund credited to each country equivalent to its quota, and therefore we will transfer these deposits. There is not any difference.

Representative REUSS. That, however, does not produce any new reserves.

Mr. BERNSTEIN. If the quotas are counted as reserves, the world would have a large increase in reserves over the few years during which the new policy is gradually put into effect. Thereafter, new reserves could only come into being by an increase in these quotas. The Fund would credit each country's account as it increased the quotas. At any given time the use of the quota would not affect aggregate reserves. It would merely transfer quota rights from one country to another.

Now, under any credit scheme, you can increase reserves only if you increase lending more than the repayments. Loans are not made once to stand out forever. In any system in which reserves must grow a billion dollars a year, for example, through loans, there would have to be a vast turnover of these loans. Otherwise the credit given by the institution would be a permanent grant to the initial recipient.

I figure that if the Triffin plan had the same test as the International Monetary Fund, that a credit should be repaid in 3 years, or 5 years at the outside, the institution would have to turn over $4 or $5 billion a year in loans, after a few years, to get an annual growth of $1 billion in reserves. And the turnover would have to be much larger the longer the institution operates. That is why we would have to move away from the loan concept altogether to open market operations. And that would not be easier either.

Representative REUSS. One of your main difficulties with the Triffin proposal, in addition to some of its administrative complexities, is that you fear it is deflationary. Now, let me ask you this question.

What additional features need to be grafted on your proposal presented here this afternoon, your two- or three-step proposal with respect to the IMF in order to create new reserves?

Mr. BERNSTEIN. No features, except that I have not emphasized that the Fund should from time to time and more frequently than in the past have a review of quotas and increasing them. That is the only feature you would have to add to have a growth of reserves in this form.

Representative REUSS. And if it did review and did find that the free world reserves were inadequate, these additional reserves would be created by methods other than by the countries incurring a balance-of-payments deficit.

Mr. BERNSTEIN. That is right.

Representative REUSS. They would be created in effect by a stroke of the pen, would they not; that is to say, countries would not have even to put in in their own currency the full amount of the new quota?

Mr. BERNSTEIN. It would not matter whether they did or not. The fact is, the statement you made is that the reserves would be created by mutual credit. You would be giving credit not to one borrower, but everybody would get simultaneously a mutual credit. And this would be a permanent mutual credit.

The only condition would be that the country must in fact use this as a reserve, drawing it down and replenishing it, and not use it as a source of capital. It would be a creation of credit in a sense, certainly. That is the only way you could define it in economical terms.

Representative REUSS. Why is this not a very simple way of proceeding, your plan plus this paragraph?

Why does not this have within it the capability of supplying the free world with the reserves that are needed irrespective of how much gold is mined?

Mr. BERNSTEIN. I am not an unbiased witness on this. You had better ask a witness who finds that this does not do the job.

Representative REUSS. Yes; really I will. I will ask Mr. Machlup.

Mr. MACHLUP. Well, I am delighted that Mr. Bernstein clarified his plan now to make it quite certain that these increased quotas are really a creation of credit. I think these words do not appear as clearly in his previous writings, and indeed the use of the old terminology—quotas rather than deposits—lends support to a misinterpretation of his plan.

Representative REUSS. But as we now have it—and we all heard it very clearly——

Mr. BERNSTEIN. There is nothing in the statement, by the way, that you have today which has not appeared in any number of the papers I have written.

Mr. MACHLUP. Don't be so modest.

Representative REUSS. Gentlemen, we should not bog down on who said what when.

I think the question is, the proposal enunciated here by Mr. Bernstein with the added paragraph that we have just discussed, why does that not do what needs to be done?

Mr. MACHLUP. If it is to be a feasible proposal, I would like to make the reserve increase a year-by-year proposition, not a quinquennial or even biennial one.

Representative REUSS. As needed?

Mr. MACHLUP. No, not as needed. This would be difficult to decide, because who knows what is needed?

The question is whether we should use some rule of thumb, or whether we should use discretion. I do not think we can solve it this afternoon. But if you say "as needed," there is again the danger that we wait for a crisis.

Mr. BERNSTEIN. We can do both things, we can do what Professor Machlup said, do it a little bit steadily, and then if you have a crisis, do an extra little bit at that time.

Representative REUSS. Mr. Johnson.

Mr. JOHNSON. I think it is becoming clear, Congressman, that there is some difficulty in understanding Mr. Bernstein's proposal because it has two separate elements in it.

One is simply to make the present IMF arrangement more acceptable. At present it is a borrowing right that is subject to restrictions. He wants to remove those restrictions so that the borrowing rights can be freely used. That part of his plan, I think, corresponds with other suggestions to the effect that the arrangements by which Central Bank will lend to each other should be made more automatic, so that the credit should be available on demand rather than subject to approval. As long as it is subject to approval, then countries will not count the asset as equivalent to reserves they actually have in their own hands.

Now, that is a change in the nature of the Fund.

The second part of it is the provision of extra reserves by increasing quotas. And here I think the objection that Professor Machlup and

I have is that as the Fund now operates, quotas are increased at widespread intervals and by large amounts. And they are increased by amounts which are determined by how the major countries feel at that particular time.

He and I would both like to see the reserves increased gradually rather than at widespread intervals, and in a fashion which depends less on whether there is a crisis situation or lack of it and more on some concept of what the world needs to support an expanding trade and payments structure.

In his last statement I think Mr. Bernstein has come very close to our position.

Mr. BERNSTEIN. Yes.

Representative REUSS. I think on this——

Mr. HUMPHREY. Do you want to ask a question about the feasibility of this composite currency, where the relations are tied?

We have had no discussions as to that. And I think if some of the panel can comment on it we would be glad to have it.

We had the suggestion of a composite currency in which the various parts of it have to be rigidly tied. Is this a feasible——

Mr. MACHLUP. I will take the question, if you would like me to.

I would say it is a feasible plan, provided that the participating countries observe an unusual degree of discipline, which will deprive them of as much sovereignty in the use of monetary policy for internal affairs as the old gold standard did, if not more so. And I cannot see why any nation that has in the past resisted the fetters of the gold standard would accept the fetters of this multi-currency-bound scheme.

Mr. BERNSTEIN. Excuse me. I may not have been clear.

Is it understood that these funds would be transferable only among the 11 countries?

We are not proposing—these 11 countries are not proposing to impose on, say, Brazil, the acceptance of the multicurrency units. Suppose Brazil has dollars it wants to convert, it would not get the gold plus these currency units, it would get gold if it wants it. It is only these 11 countries. So no country has to accept a standard under which it ties its currency, so to speak, to these units. These 11 countries would do it by themselves.

Mr. JOHNSON. We can put Professor Machlup's point another way which I think is more graphic.

We have two problems:

One is that there is not enough gold to enable all countries to hold the amount of gold they want. And the other is that they are not really prepared to trust each other's currencies as substitutes for gold, and probably quite rightly, given that every country has the freedom to change its exchange rates.

What this proposal amounts to is a piece of gadgetry designed (*a*) to reduce the demand for gold, and (*b*) to make countries hold each other's currency, hold it in bundles containing some of everything. It is like buying a unit in an investment trust, or something like that.

And I think Professor Machlup and I both feel that you cannot really solve these basic difficulties of too little gold and distrust of each other's currencies by this kind of gadgetry unless you have got enough agreement to enable you to adopt a simpler solution such as a world currency, or a new credit reserve currency acceptable by these countries.

Representative REUSS. Why is that simpler?

It seems to be equally good, but no better.

Mr. JOHNSON. Well, if you were smart enough to realize that this is what you had to do, you would be smart enough to accept the simple solution instead of a piece of gadgetry of this kind. That is our contention.

Mr. BERNSTEIN. Mr. Johnson may well be speaking for both of them, and in that case my reply would go to both equally.

May I make this point: The concept—first, calling it gadgetry seems to me——

Mr. JOHNSON. I said I was going to be graphic.

Mr. BERNSTEIN. Seems to me to be a very graphic way of describing a very modest change, really, in the institutional arrangements that exist. But my question is this:

If any country is going to be hesitant among these 11 in holding as a reserve these composite currency units of the 11 richest countries in the world, what makes you think that you could ever persuade these countries to hold as reserves for which they give real resources, deposits in an international unit, a central bank whose assets corresponding to the reserve liabilities consist of credits that it has given to any number of countries, none of which is likely to be as good as these 11, and which holds bonds originating from loans to countries in perpetual financial trouble.

This is one of the difficulties of our present institutional arrangement. We live in a world in which countries hesitate to hold dollars and sterling as reserves—and maybe properly, I do not think so, but maybe properly.

Now we have proposed to these countries, "You have difficulty in swallowing more dollars and sterling as reserves, we are going to give you an easier pill to swallow." It is an international unit whose real assets consist of loans to any number of countries, and of bonds purchased so that they can simultaneously develop and in the course of spending provide reserves for the rich countries.

It is my feeling that if Mr. Johnson and Mr. Machlup think it will be hard for any countries to accept the holding of these 11 currencies, I cannot see how it will be possible to get them to accept the international currency unit based on operations of such an international institution.

Representative REUSS. Mr. Johnson, do you want to comment on that?

Mr. JOHNSON. If this argument of Mr. Bernstein's were all this convincing, then everyone in this country would never hold a deposit in an individual bank, but would instead insist in having a deposit distributed among all the different banks, because that would save them from the risk involved in the assets chosen by any particular bank. In other words, if you are going to use credit money, you will have to start by accepting that you are depending on the trust and the capacity of those who create the credit to do it wisely. And I do not think you can get around that need by parceling things up in bundles and saying, "There you are, there is a bundle that saves us from risk."

It will not save you from risk unless the fundamental conditions are present. And if you are prepared to assume that they are, you might as well have what I consider a more efficient way of doing it.

Representative REUSS. Perhaps I should have adjourned the hearings about 5 minutes ago when there was complete harmony prevailing between the members of the panel. But I think we did pretty well, and I am very grateful to you all for the distinct contribution that you have made to our deliberations.

This concludes the 3-day hearings of the subcommittee on the general question of the balance of payments and monetary techniques.

We will deliberate a while and hopefully issue a report which will draw heavily on the help you have given us this afternoon.

Thank you very much.

The subcommittee will now stand adjourned.

(Whereupon, at 4:10 p.m., the committee adjourned.)

APPENDIX

Comment by J. E. Meade on His Paper "The Future of International Trade and Payments"

My paper was frankly utopian in form in the sense that it contained an outline of a perfect or ideal system of international payments regardless of existing political or other practical difficulties. Such an academic exercise has its practical uses because it helps one to determine what are the general forms which one would like the more immediate and practical improvements to take. As far as international payments are concerned my ideal solution is based upon a combination of two principles:

(1) That there should be some agreed system, under the auspices of the IMF, for adjusting the amount of international liquidity to the increased needs for international monetary reserves arising from the natural growth of international trade and payments; and

(2) That greater use should be made of variations in the exchange rates between national currencies for the adjustment of balances of international payments.

I recognize, of course, that the immediate application of these two principles in the ideal form presented in my paper is not practical politics. But I would urge most strongly that some practical steps should now be taken in both these directions. I do not want to comment in detail on the form which any immediate reforms in the provision of international liquidity should take. I have personally a preference for the method advocated by Professor Triffin. But the essential point is to make adequate arrangements of a flexible kind which will insure that the countries of the free world (in particular the United States, the United Kingdom, and the EEC) should not be hindered in their policies for domestic economic expansion and for freeing their international trade and payments by fears of stringencies of means of international payment due to the fact that international monetary reserves are growing less quickly than their international payments for trade and other purposes.

But I would very much like to comment on a practical immediate step which might be taken to give a small degree of flexibility to exchange rates. But, first of all, I would like to repeat very briefly why, in my view, some move in this direction is essential. It is greatly to be hoped that—

(1) the new U.S. trade legislation together with current negotiations between the United Kingdom and the EEC will result in a substantial removal on a nondiscriminatory basis of restrictions on imports from all sources by the highly developed countries of the free world;

(2) all these countries (and not only the United States) will provide economic aid and capital for the development of the underdeveloped countries on an extended scale in accordance with their own national wealth and resources; and

(3) all these countries will adopt domestic policies for stimulating the growth and expansion of their economies, while avoiding domestic wage, cost, and price inflations.

If effective steps are taken in these three directions, there can be no doubt at all that disequilibriums in international payments will develop from time to time.

For many years to come, however great is the extension of international consultation and cooperation between these countries, it will be the national governments and not a single supranational authority who will be responsible for national policies for wages, taxation, monetary supplies, and so on. Consider only one possible example. Suppose that as a result of national policies in "Surplusia" labor productivity rises at 3 percent per annum and the wage rate rises at 2 percent per annum, while in "Deficitia" labor productivity rises at only 2 percent per annum but the wage rate rises at 3 percent per annum. By all recent experience both countries would be adopting very successful domestic wage policies; but the cost-price structure will be falling by 1 percent per annum in "Surplusia" and rising by 1 percent per annum in "Deficitia." There will be an ever-growing strain on "Deficitia's" international payments; and by the end of 5 years "Deficitia's" costs will be 10 percent too high relatively to "Surplusia's."

Changes of this order of magnitude are quite unavoidable in modern conditions. Yet if "Deficitia" is not to be forced either to restrict her imports or to cut down her foreign aid below the level which is appropriate to her real wealth and national resources or to abandon her domestic policies for economic expansion, there must be an adjustment in the rate of exchange between the two national currencies. By no other means can liberal international policies for trade and payments be reconciled with national policies for wages, full employment, and economic growth.

Many persons are—quite rightly—alarmed at the prospect of large and frequent variations in exchange rates, with the threat of competitive exchange depreciations and of extensive speculative movements of hot money. But to meet the essential needs outlined in the previous paragraph all that is required are extremely moderate changes in rates which would, moreover, occur only in response to basic structural needs. I would propose, therefore, for earnest and immediate consideration a change in the rules of the International Monetary Fund on the following lines:

(1) Each member would as at present fix a gold parity for its national currency.

(2) Each member would be allowed in any year to raise (or lower) this par rate by 2 percent above (or below) the parity fixed in the preceding year.

(3) Each member would undertake never to raise the price of gold in terms of its own currency by the permitted 2 percent unless it was at the time incurring a substantial loss of monetary reserves.

(4) Each member would undertake never to lower the price of gold in terms of its own currency by the permitted 2 percent unless it was at the time incurring a substantial accumulation of monetary reserves.

These provisions would have the following effects:

(1) No country would be called upon to alter the exchange value of its currency unless it chose to do so.

(2) No country would depreciate its currency unless it was in international deficit.

(3) No country could appreciate its currency unless it was in international surplus.

(4) The maximum rate at which a country's exchange rate could vary in either direction would be 2 percent per annum. This should be sufficient over a period of years to make a very substantial contribution to the removal of the inevitable structural cost-price disequilibriums.

(5) Since there would be a firm guarantee that no country's national currency would change in value at a greater rate than 2 percent per annum, the incentives for the speculative movements of funds would be very limited. They could be offset by the monetary authorities in the country whose currency was expected to depreciate (or appreciate) by setting short-term money rates of interest at the most 2 percent above (or below) the rates ruling in the other countries.

Reform on these general lines has in recent years been suggested by a number of people. I would like to give them all possible support in the sincere belief that some greater flexibility of exchange rates is, for the reasons given above, an essential feature of any practicable scheme for the liberalization of trade and payments in modern conditions.

COMMITTEE FOR ECONOMIC DEVELOPMENT,
Washington, D.C., December 4, 1962.

Prof. DON HUMPHREY,
Fletcher School of Law and Diplomacy,
Medford, Mass.

DEAR PROFESSOR HUMPHREY: I enclose a paper on "Policy for the Dollar" in the hope that it may be of some use to you.

Unfortunately it has taken a somewhat larger number of pages than I had expected to make some rather elementary points.

Sincerely,

ROBERT Z. ALIBER.

POLICY FOR THE DOLLAR

Between 1949 and 1961, U.S. payments deficit with other countries have totaled $23.9 billion. More than half of this deficit, $13.6 billion, has occurred in the period since 1957. In 1962 the U.S. payments deficit is likely to be in the range from $1.5 billion to $2 billion. Such large, persistent deficits raise a number of important questions, some factual, and others involving central policy issues. Among the important factual issues are: (1) Is the U.S. dollar overvalued in terms of the other major currencies? (2) How is the deficit in U.S. balance of payments related to the sluggishness in the domestic economy?

The central policy issues include: (1) Are adjustments in the existing structure of exchange rates, either a devaluation of the dollar in terms of gold and other currencies, or an appreciation of a few foreign currencies in terms of the dollar, desirable as a means of helping to restore a satisfactory international payments equilibrium? (2) What measures should the U.S. authorities pursue to reduce the U.S. payments deficit, in addition to the possible changes in the structure of exchange rates or in lieu of these changes?

U.S. balance of international payments, 1951–61

[Billions of dollars, current prices]

Type of transaction	1951–55 average	1956–60 average	1958	1959	1960	1961	1961 1st half	1962 1st half
Current account and unilateral transfers	−0.6	0.8	−0.1	−2.3	1.5	2.5	0.9	1.2
Merchandise trade balance	2.4	3.9	3.3	1.0	4.7	5.4	2.4	2.5
Exports	13.4	17.7	16.3	16.3	19.4	19.9	9.3	10.5
Imports	−11.0	−13.8	−13.0	−15.3	−14.7	14.5	−6.9	−8.0
Military expenditures, net [1]	−2.1	−2.8	−3.1	−2.8	−2.7	−2.6	−1.3	−1.2
Interest and dividends, net [2]	1.6	2.2	2.2	2.2	2.3	2.8	1.2	1.4
Other services, net	.2	−.1	−.2	−.2	−.3	−.4	−.1	--------
Government nonmilitary grants	−2.1	−1.6	−1.6	−1.6	−1.6	−1.9	−1.0	−1.0
Pensions and remittances	−.6	−.7	−.7	−.8	−.8	−.9	−.4	−.4
Long-term capital account	−.9	−3.0	−3.5	−2.1	−3.4	−3.1	−.6	−1.8
U.S. direct investment	−.7	−1.6	−1.1	−1.4	−1.7	−1.6	−.8	−.6
Other private U.S. investment	−.2	−.9	−1.4	−.9	−.9	−1.0	−.4	−.8
Government loans (less repayments)	−.2	−.8	−1.0	−.4	−1.1	−1.0	--------	−.8
Foreign long-term investment	.2	.4	--------	.6	.3	.4	.5	.4
Balance on "basic" accounts (entries above)	−1.4	−2.2	−3.6	−4.3	−1.9	−.6	.2	−.7
U.S. short-term capital and foreign commercial credit	−.2	−.5	−.4	.1	−1.4	−1.2	−.8	−.2
Errors and omissions	.4	.3	.4	.5	−.6	−.6	−.3	.1
Overall balance (deficit (−))	−1.2	−2.3	−3.5	−3.7	−3.9	−2.5	−.8	−.8

[1] Net of foreign military purchases in the United States.
[2] Excludes subsidiary earnings not repatriated.

Source: Based on Department of Commerce data.

Setting policy objectives has several different dimensions. The primary objective is to achieve a satisfactory balance in the U.S. payments, which in terms of the way the deficits and surpluses are now calculated, may mean a deficit of \$500 or \$700 million yearly, and to achieve this objective in a reasonably short period of 1 or 2 years, rather than in an abrupt fashion.[1] A secondary objective is to ensure that the policies which help restore a satisfactory balance contribute to the maintenance of this balance over a more extended period. It is important, moreover, that the policies followed and measures adopted to maintain equilibrium fall within the general scope of acceptable policies for adjustment which are consistent with current international payments arrangements.

The current condition of the U.S. balance of payments and the outlook for the next several years are considered after a discussion of the factual issues, and before the discussion of the policy issues.

[1] The inadequacies in the method of computing the U.S. deficit or surplus are briefly discussed in sec. 3. While the deficit is not unambiguous, the current approach considerably overstates the deficit which is appropriate for policy purposes.

1. THE OVERVALUATION OF THE DOLLAR: A STATISTICAL IRRELEVANCY

There are several ways to determine whether the dollar is an overvalued currency. If an overvalued currency is defined as the currency of a country with a payments deficit, and an undervalued currency is defined as the currency of a country with a payments surplus, then by definition the dollar is an overvalued currency. But this approach sidesteps the analytical issues by defining the problem away; it is not very helpful in formulating appropriate policies. For example, the United States had a payments deficit in the 6 consecutive years 1950–56 which totaled $10.3 billion; almost everyone at that time still felt the major concern was with the dollar shortage. Few observers then believed that the dollar was an overvalued currency. Instead the U.S. payments deficit was attributed both to the large noncommercial payments abroad of the U.S. Government and to the extensive system of import restrictions in Europe, which severely limited European purchases of dollar goods.

An analytical approach to the problem has been to compare prices and costs in the United States with prices and costs in other countries as a means of determining which currencies are undervalued and which currencies are overvalued.[2] Most of these comparisons would appear to show somewhat similar results—that prices and costs in most other industrial countries are less than they are in the United States for the same goods, often by as much as 20 or 30 percent, a statistical result that confirms the impressions of most U.S. tourists traveling abroad.

It is tempting to assume that the reason for the U.S. payments deficit is that the U.S. price level is higher than the price levels in most other countries, as inferred from both the formal statistical surveys and the more casual approach of tourists. This explanation is very simple, and simple explanations are always attractive. The results of these price and cost comparisons, however, prove only what they set out to prove (e.g., how much more expensive a certain parcel of goods is in the United States than in France or Germany) and nothing more. If these results had any general validity for the pattern of international trade, then it would be expected that U.S. commercial imports would exceed U.S. commercial exports—but instead U.S. commercial exports have exceeded U.S. commercial imports during almost every year of the postwar period, in recent years by more than 10 percent.[3] In contrast many countries which have price levels below that of the United States import considerably more than they export. Whether the price level of a particular country appears high or low in

[2] This technique goes back to the early 1920's when it was introduced to determine whether the price level changes since 1913 would permit a restoration of the prewar structure of exchange rates. The assumption behind this technique was that changes in national price levels between 1913 (when countries were believed to have been in payments equilibrium); and the early 1920's would have to be proportional before the prewar exchange rate structure could be restored on a satisfactory basis. Those who developed this technique were extremely hesitant simply to compare the prices of the same goods in different countries as a means of determining which currencies were overvalued and which were undervalued; they recognized that the appropriate structure of exchange rates was greatly influenced by many noncommodity transactions which were neither influenced by nor greatly influenced national price levels. They believed these noncommodity transactions did not change greatly over a period of several years, and so the equilibrium exchange rate could be inferred from relative changes in the national price levels that had occurred after a period in which prices and exchange rates had been in equilibrium.

[3] U.S. commercial exports are defined as total U.S. exports less U.S. exports financed under the U.S. foreign program and shipments of surplus agricultural commodities under the Public Law 480 program.

these international comparisons appears to bear little relation to whether it has an export surplus or an import surplus, unless the country recently has been subject to substantial inflation.

These price level comparisons bear little relation to the U.S. trade position and to the U.S. payments position for three reasons—two of these reasons explain why U.S. commercial exports exceed U.S. commercial imports, and while the third reason explains why the large U.S. commercial trade surplus has not automatically resulted in a U.S. payments surplus. First, in a very wide range of commodities, both agricultural goods and industrial products, the United States is one of the lowest cost producers in the world.[4] In manufacturing the United States has a strong price advantage over the major European countries in the production of both investment goods and durable goods.[5]

Second, in many other goods the U.S. producers have a strong lead in technology, as in jet aircraft, large computers, heavy earth-moving equipment, and so forth. Many of these commodities enter only slightly, if at all, in international price comparisons—indeed in many cases the commodity simply is not available in foreign countries so that it cannot be included in the sample of the goods chosen for the price comparison.

Because of the price advantage and the technological lead, U.S. commercial exports to almost every country in Western Europe have generally exceeded U.S. commercial imports from them. And the U.S. surplus with the major European countries would be even larger if trade barriers were eliminated—European quotas, tariffs, and discriminatory taxes retard U.S. sales in the European market by a considerably larger amount than U.S. quotas and tariffs retard European sales in the U.S. market.

The price and cost comparisons reflect only international commodity transactions. If the objective of policy were simply to secure a balance between commodity imports and commodity exports, then the dollar would appear to be undervalued. To secure a balance in the trade accounts alone, other currencies would have to be devalued against the dollar. This change in the exchange-rate structure would

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[4] Conceivably if a country were the world's lowest cost producer of only one commodity it might have a trade surplus, even though its price level was considerably higher than the price levels in most other countries. All that is required is that the foreign demand for this low cost commodity be very strong. Venezuela and Kuwait are in this class.

[5] The data below show that the purchasing power of $1 for producers durable goods in 8 European countries was below that in the United States in both 1950 and 1955, by 8 to 33 percent. Moreover, in 7 countries, dollar goods became cheaper relative to their foreign counterparts between 1950 and 1955. Using the same data source suggests that European prices for consumer durables are nearly twice as high as U.S. prices.

Internal purchasing power of $1 on producers durables goods

	1950	1955
Denmark	0.92	0.82
United Kingdom	1.04	.92
Norway	.85	.67
Belgium	.88	.84
France	.83	.66
Netherlands	.96	.99
Germany	.90	.83
Italy	.68	.67

Source: Milton Gilbert et al., Comparative National Products and Price Levels, OEEC.

tend to increase apparent disparity between prices and costs in the United States and in other countries.

The reason that price and cost comparisons are not adequate to determine the appropriate pattern of exchange rates is that the payments balance reflects many noncommodity transactions—U.S. military expenditures abroad, U.S. economic aid, and U.S. private investment. U.S. payments on these three accounts were nearly $10 billion in 1961, about two-thirds total U.S. commodity imports of $15 billion.

The price and cost comparisons would clearly become inadequate if world political conditions change, so that it is possible to eliminate U.S. military expenditures abroad in the near future. Then the U.S. payments position would improve by more than $2 billion yearly, and there would be very little concern with "the dollar problem." Yet, the price and cost comparisons would continue to show that the price of a particular bundle of goods is higher in the United States than in most foreign countries.

It seems extremely unlikely that military expenditures abroad will decline this abruptly, just as it is unlikely that the U.S. expenditures for foreign aid will decline. But that it could happen demonstrates that in a changing, dynamic world the price and cost comparisons are inadequate to indicate whether a currency is undervalued or overvalued in a way which is meaningful for the formulation of policy. Even though the dollar is not overvalued in the sense that U.S. prices and costs are too high to attain a large trade surplus, the United States still has a payments problem because of sizable payments associated with noncommodity transactions.

That there is no simple explanation to the U.S. payments deficits has a counterpart in the formulation of U.S. balance-of-payments policy, for there is no simple, easy policy to restore a satisfactory payments equilibrium. U.S. military expenditures abroad and U.S. foreign aid expenditures have contributed to the deficit, as have U.S. imports of Volkswagens, French antiques, and Scotch whisky. No one factor has caused the deficit—in the search for causes it is necessary to determine why every U.S. payment abroad is as large as it is, and why every U.S. receipt from abroad is not larger. If there are many causes, there are many remedies.

2. THE U.S. INTERNATIONAL PAYMENTS POSITION AND U.S. EMPLOYMENT AND INCOME

The international payments position of the United States is related to domestic income and employment in two ways. First, an increase in U.S. net exports of goods and services (exports of goods and services less imports of goods and services) leads to an increase in domestic income and employment, just as an increase in domestic investment does; this is the employment impact. Second, an unsatisfactory payments position may be a constraint on domestic policy and dampen the reliance on expansive monetary and fiscal policies to increase income and employment, for higher U.S. income might lead to larger U.S. imports and worsen an already unsatisfactory payments balance. This may be called the constraint impact. These impacts are discussed in turn.

The employment impact

Changes in foreign spending for U.S. goods and services have an impact on domestic income and employment in much the same way, although in somewhat different amounts, that changes in domestic spending do. Increased U.S. exports of automobiles tend to increase income and employment in the U.S. automobile industry, and in its supplier industries; more people at work in these industries means higher personal income, which, in turn, facilitates an increase in spending for food, clothing, housing, and even more automobiles.

Thus an increase in the foreign demand for U.S. automobiles has an expansive impact on U.S. income and employment, just as an increase in domestic demand for U.S. automobiles has. However, the expansive impact on an increase in foreign demand for U.S. automobiles may be somewhat larger than the expansive impact from an equivalent increase in domestic demand, because the increase in foreign demand is less likely to result in a decline of other expenditures in the United States, whereas an increase in the domestic demand for automobiles may entail a decrease in domestic expenditures for other U.S. products.

Conversely, a decrease in the foreign demand for U.S. automobiles tends to result in a decline in U.S. income and employment, first in the automobile industry, and then, through the spending of those who earn incomes in this industry, throughout the economy. Similarly, an increase in the U.S. demand for foreign automobiles may result in a decline in U.S. income and employment.

Because the U.S. demand for foreign goods and services has not been very much less than the foreign demand for U.S. goods in most years since 1950, the income and employment effects of U.S. imports and of U.S. exports have largely proved offsetting. The offsetting has been less than fully complete, however, and in most years the foreign trade sector has had an expansive impact on the U.S. economy; in a few years it has had a contractive impact. And at times the year-to-year change in the impact of the foreign trade sector on the domestic economy has been sizable.

Estimating the total impact of the foreign trade sector on the domestic economy involves two steps—the first is selecting the statistic which best measures the *direct impact* of the expansive or contractive effect of the foreign trade sector on the domestic economy; the second is evaluating the *indirect impact* on income and employment from the direct impact.

Perhaps the most appropriate statistic for measuring the direct impact of the foreign trade sector on domestic income and employment is *U.S. net exports*, the difference between U.S. exports of goods and services and U.S. imports of goods and services.[6] Net exports ex-

[6] Some individuals have suggested that ***net foreign investment*** is a more appropriate statistic than ***net exports***. Net foreign investment is smaller than net exports by the cash transfer payments from the U.S. Government to foreign governments, which have been in the range from $1.3 billion to $1.6 billion since 1952. (The differences between net exports and net foreign investment have generally been less than $100 million from year to year.) The reason for selecting net exports as the appropriate statistic is that all U.S. exports of goods and services have an expansive impact, regardless of whether they are financed from foreign-owned funds or U.S. aid funds.

Sometimes it is questioned whether some of the Government-assisted exports, especially those under title 1 of Public Law 480 (Agricultural Surplus and Disposal Act of 1953), have an expansive impact on the domestic economy. Some individuals assert that in the absence of the Public Law 480 program surplus commodities would accumulate even more rapidly than they do now, or other disposal programs would be developed, and that agriclude military grants, net government nonmilitary grants in kind, intergovernmental interest payments, and some private transfer payments; it includes exports financed under the foreign aid programs. When U.S. net exports are positive, the expansive impact of U.S. exports of goods and services exceeds the contractive impact of U.S. imports of goods and services; when U.S. net exports are negative, the contractive effect is dominant.

The direct impact of the foreign trade sector on the U.S. economy

[Millions of dollars, current prices]

	1951-55, average	1956	1957	1958	1959	1960	1961	1962 [1]
U.S. net exports	1,063	2,930	4,944	1,249	−759	2,882	3,980	3,600
U.S. overall payments balance	−1,200			−3,500	−3,700	−3,900	−2,500	−1,800

[1] Estimated on basis of data for 1st 6 months.

Source: Survey of Current Business.

U.S. net exports have varied from $4.9 billion in 1957 to minus $0.8 billion in 1959, for a decline in the direct impact of $5.7 billion in 2 years. Such a large shift in the direct impact contributed significantly to the severity of the 1958–59 recession, and impeded recovery in 1959.

Between 1959 and 1960, the direction of the direct impact reversed by $3.6 billion, and the improvement continued into 1961. Indeed, in 1961 the direct expansive impact was larger than it has been in any postwar year since 1948, with the exception of 1957. The foreign trade sector has exerted a highly variable influence on the domestic economy, especially in the last 6 years, but over the period since the end of Marshall plan aid, the foreign trade sector has come to have a larger expansive effect on the domestic economy, despite the persistence of the dollar problem.

Quantifying this expansive effect—determining the total increase in domestic expenditures resulting from the direct impact—involves some complex issues related to the time lag between the direct impact and the indirect impacts. The nature of the problem is suggested by the increase of $2 billion in U.S. GNP between 1957 and 1958, and the increase of $40 billion in U.S. GNP between 1958 and 1959. There was a contractive change in the direct impact of $3.2 billion between 1957 and 1958, when income rose slightly; and another contractive change of $2.2 billion between 1958 and 1959, when income increased markedly.

There can be little doubt that the net impact of U.S. foreign commerce has proved expansive for U.S. income and employment since 1950, and that the expansive impact is now nearly as large as in any nonexceptional year. Nevertheless, an increase in U.S. net exports, resulting from an increase in exports of goods and services relative to imports of goods and services, would further stimulate U.S. income and employment.

cultural production would remain unchanged. This position must remain conjectural. But even if it were true, it would not affect the three major conclusions of this section—that over the period since 1952 the foreign trade sector has had a net expansive impact on the U.S. economy; that in recent years this impact has been larger than in the early 1950's; and that the magnitude of the impact has varied considerably from year to year.

A number of policy measures could be adopted to increase U.S. net exports; it is conjectural, however, whether this is the most appropriate way to increase domestic income and employment. This is because the counterpart of the expansive effect of the excess of exports over imports in the United States is the contractive effect of the excess of imports over exports in other foreign countries. Any effort to stimulate U.S. income and employment by directly increasing net exports would have a contractive impact on income and employment in other countries. During the 1930's many countries sought the solution of their domestic unemployment problems by encouraging exports and discouraging imports; a policy which came to be known as a "beggar thy neighbor" policy.

The constraint impact

Estimating the magnitude of the constraint of the payments deficit on expansive domestic policies in recent years involves several problems—one is determining how much larger the U.S. payments deficit would have been at high-level employment (defined as 4 percent unemployment) than it actually was at somewhat higher levels of unemployment; another is estimating how much nearer to the high employment target the U.S. economy might have been in the absence of the payments constraint.

Higher levels of income lead to larger payments for imports and some foreign-produced services and thus increase the U.S. payments deficit (or reduce the U.S. payments surplus). However, several factors associated with higher U.S. national income may tend to increase U.S. receipts from abroad and reduce some U.S. foreign payments, and thus partially offset the impact of increased imports on the U.S. payments balance. The additional imports associated with high-level employment can be estimated by calculating the gap between actual income in recent years and high employment income, and then estimating the increase in imports that would have occurred if the gap had been eliminated.

Actual and potential U.S. gross national product, 1957–61

[Billions of dollars, 1961 prices]

	1957	1958	1959	1960	1961
Potential GNP [1]	$487	$504	$521	$539	$557
Actual GNP	474	466	497	511	521
High employment gap	13	38	24	28	36

[1] Estimated by assuming a 3½-percent growth trend from 1955 GNP. Some experts who accept the Council's estimate of a growth in potential GNP of 3½ percent per year believe there was no gap in 1957. On this basis, the gap would have been about $13 billion smaller in each year than is shown in the table.

Source: Economic Report of the President; 1962, p. 52.

U.S. imports, which are now about $15 billion a year, have been slightly less than 3 percent of U.S. GNP.[7] This suggests that each

[7] In the December 1961 Survey of Current Business, the ratio between changes in imports and changes in GNP, developed by using seasonally adjusted quarterly data between 1956 and 1960, was about 2.7 percent. Changes in GNP result in changes in imports which are less than directly proportionate, apparently because imports of foodstuffs (which account for about 15 percent of total imports) depend less on year-to-year changes in national income than they do on changes in the population and its eating habits.

increase of $1 billion in national income would result in an increase in U.S. imports of $30 million. Payments for some foreign produced services, primarily transportation and tourism, also vary with income, but most other services are not sensitive to changes in income. Thus, if the U.S. economy had the GNP associated with 4 percent unemployment, U.S. commodity imports might have been larger by $800 million in 1961 and $1,100 million in 1962, and U.S. purchases of foreign-produced services might have been larger by an additional $200 million and $275 million.

But there are a number of offsets, for if U.S. payments to foreigners had been larger, some U.S. receipts from foreigners also would have been larger and other U.S. payments to foreigners would have been smaller.[8] For example, U.S. imports of raw materials would have increased if the high employment gap had been smaller. These imports frequently come from countries which tend to spend nearly all of any increase in export earnings on increased imports, and part of their increase in imports would have meant larger U.S. exports. If U.S. national income had been at the level suggested by high-level employment, then domestic interest rates, especially long-term rates, would have been considerably higher than they have been, (unless high-level employment was attained by an easy money policy) and foreigners would have sold a smaller amount of long-term securities in U.S. financial markets. Higher income levels associated with more rapidly growing U.S. economy would have induced some business firms to increase their investments in the United States, and reduce their investments in other countries. Higher corporate profits might have induced larger foreign purchases of U.S. equities.

There is no easy way to determine the net impact of all these factors; a cautious estimate is that perhaps one-half of the increase in U.S. imports of goods and services that would result from closing the high employment gap would have been offset by increases in U.S. receipts and reductions in other U.S. payments. These estimates suggest that the U.S. payments deficit might have been larger by $500 million in 1960 and $600 million in 1961, if the United States had operated at the income associated with high-level employment.

It is not immediately obvious how much of the shortfall between potential GNP and actual GNP should be attributed to the concern with the U.S. payments deficits. It is obvious that the payments deficits have acted as a brake on expansive U.S. monetary and fiscal policies, beginning in early 1959. What is uncertain is how much different U.S. policies would have been and how much larger domestic income and employment would have been if the payments constraint had been less pressing or negligible.

An extreme position is that the U.S. economy would have operated at high-level employment in the absence of the payment constraint which has hindered adoption of the economic policies appropriate to achieving high employment. Unfortunately, this is not the case—the knowledge of how best to counter domestic recessions and stimulate growth is still incomplete; even more importantly, there remains considerable reluctance to adopt high-employment policies in the absence

[8] Statistical studies of the magnitude of these offsets are not available. It will not be possible to obtain good estimates of their magnitudes until the U.S. economy operates at high-level employment during a period of currency convertibility.

of any balance-of-payments constraint. Certainly because of the deficit more vigorous policies have not been followed to achieve high employment but the U.S. payments deficit has not been the only barrier to reaching high-level employment; indeed it has probably not even been the most important barrier.[9]

3. PROSPECT FOR THE DOLLAR IN THE NEAR FUTURE

The objective of U.S. foreign financial policy should be to bring U.S. payments abroad into a satisfactory balance with U.S. receipts from abroad at an appropriately high level of employment. There are a number of policies which can be adopted to achieve this result. Before discussing these measures, it is helpful to consider the recent changes in the U.S. balance of payments. This discussion is facilitated by showing the relationship between U.S. net exports and U.S. net foreign investment, and between U.S. net foreign investments and the overall U.S. payments balance.[10]

U.S. net foreign investment would be equal to U.S. net exports if there were no cash transfer payments from the U.S. Government to foreign governments under the foreign aid program. Over the last 10 years these cash transfers have ranged from $1.3 billion to $1.5 billion annually, and so net foreign investment has been smaller than net exports by this amount. During the 1950 decade, net foreign investment was positive in 3 years, 1951, 1956, and 1957; it has also been positive in 1960, 1961, and 1962.

Net foreign investment is a form of international saving, since it provides the United States with foreign currencies which can be used to finance an outflow of U.S. funds to purchase foreign securities to make loans to foreign governments to set up branch plants abroad, or to make other types of foreign investment.[11] When the amount U.S. residents and the U.S. Government wish to invest abroad in a particular year is smaller than net foreign investment, then the United States will have an overall payments surplus and its reserve position will im-

[9] The payments constraint was not a factor in explaining the gap between actual and potential income in 1958. In 1961 and 1962 the monetary authorities have struggled between their domestic and international obligations, and have attempted to maintain relatively easy credit (judged by excess reserve position of commercial banks) and yet have relatively high short-term interest rates. Excess reserves have been about as large as they were in the 1958 recession before the payments constraint became important, although they might have been even larger in 1961 and 1962 if the payments constraint had not been as pressing. In 1958, the authorities were concerned that the supply of excess reserves not become too large least they lose control of bank credit expansion in the subsequent recovery.

In 1959, the decision to stretch out Federal expenditures as a means of keeping the Federal budget under control was one of the factors responsible for the slow growth of the U.S. economy. The concern with balanced cash budgets is so strong that it is not obvious that Federal spending would have been substantially larger, or Federal taxes substantially smaller, in the absence of the payments constraint; the intent of the administration is not always the will of the Congress.

[10] The similarity in the language may be confusing. If U.S. exports of goods and services exceed both U.S. imports of goods and services and cash grants to foreigners, then net foreign investment will be positive, even if no U.S. resident wishes to increase his own foreign investments. In this case, net foreign investment would be financed by an increase in U.S. holdings of gold, or a decrease in foreign holdings of liquid dollar assets.

[11] There is some concern that this overstates U.S. net foreign investment, because it includes the U.S. Government's acquisitions of foreign currencies and debts denominated in foreign currencies. Under the Public Law 480 program, the U.S. Government has sold surplus agricultural commodities to foreign governments and received payment in the currency of the foreign government. Some of these foreign currencies acquired by the U.S. Government have been loaned or granted back to the foreign government and some have been set aside for U.S. uses. The buildup of U.S.-owned foreign currencies and the credits due the United States from credits financed in these currencies are treated like a commercial transaction, whereas in fact they may more nearly represent unilateral transfers. It seems appropriate to deduct from the net foreign investment data an

prove—U.S. holding of gold and convertible foreign currencies will increase, and foreign holdings of liquid dollar assets will decline.[12] If the amount U.S. residents and the U.S. Government wish to invest abroad in a particular year exceeds the net foreign investment, the U.S. reserve position will decline—U.S. holdings of gold and convertible foreign currencies will decline, and foreign holdings of liquid dollar assets will increase.

For example, in 1961 U.S. net foreign investment was over $2.4 billion, extremely high by levels achieved in previous years. But the amount U.S. residents and the U.S. Government wished to invest abroad in 1961, $3.5 billion, was also high by previous levels. U.S. international saving was inadequate to finance the amount of investments abroad that U.S. residents and the U.S. Government wished to make, and the excess was financed by reduction in U.S.-owned gold and convertible foreign currencies, and an increase in foreign-owned liquid dollar assets. In effect, whenever the outflow of U.S. capital exceeds the net foreign investment, then the excess must be financed by an exchange of assets—either a sale of gold or foreign purchase of liquid dollar assets. The amount that the U.S. economy can invest abroad each year is limited by net foreign investment, and the efforts to invest more must be financed by selling other assets.

In 1961, the situation differed markedly from 1959, partly because the outflow of U.S. capital was $1.5 billion greater in 1961 than in 1959, and partly because net foreign investment was minus $2.3 billion in 1959, while it was plus $2.4 billion in 1961. If the outflow of U.S. capital had been no greater in 1961 than in 1959, then the overall 1961 payments deficit would have been about $1 billion.

This simple, hypothetical comparison places the focus on whether the 1961 net foreign investment or the 1961 net capital outflow, or both, are likely to prevail in the future. The payments imbalance of the last several years—especially the payments surpluses of some countries in Europe—indirectly have set in motion various pressures for adjustment, in the form of the more rapid increases in prices in many European countries than in the United States. The upward pressure on prices may continue as labor shortages in Europe grow more acute, as wages of women are made equal to those of men in the Common Market countries, and as the Common Market coun-

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amount equal to foreign currencies or debts denominated in foreign currencies acquired by the U.S. Government.

Adjustment of U.S. net foreign investment to reflect foreign currency claims

[Millions of dollars, current prices]

	1951-55 averages	1956	1957	1958	1959	1960	1961	1962 [a]
Net foreign investment	−571	1,478	3,492	−66	−2,290	1,319	2,414	2,000
Less acquisition of foreign currency claims	111	618	726	410	629	970	[a] 800	800
Adjusted net foreign investment	−682	850	2,766	−476	−2,919	349	1,614	1,200

[a] Estimated.

Source: Survey of Current Business, Report of the Commission on Money and Credit.

[12] To simplify the discussion, it is assumed that the amount that foreigners wish to invest in the United States, at long term, is negligible. When it is positive, it should be offset against the amount that U.S. residents and the U.S. Government wish to invest abroad.

tries adjust their social security policies to a more uniform standard. In some cases, part of the increases in labor costs can be absorbed from the productivity gains, but prices are apt to rise and profits are apt to diminish as productivity gains prove inadequate. There is very little evidence that the rate of price increase has abated. Continued more rapid increases in prices in Europe than in the United States should help improve the U.S. trade position.

In the last several years, U.S. direct investment in Western Europe has been very large, and reflects a bunching of factors. These included the formation of the European Common Market and the European Free Trade Area, the abnormally low level of U.S. investment in Europe during most of the 1950's, until after the restoration of external convertibility at the end of 1958, and the sluggish growth in the U.S. economy. In the future, the attraction for new U.S. direct investments in Europe may be smaller than they have been in the last several years; hopefully, the incentives to make larger investments in the U.S. economy will be greater. The decline in profits in European industry has already been reflected in a reduced outflow of U.S. funds for direct investment in Western Europe, and this factor may be accentuated by changes in U.S. tax legislation in 1962—both the tax credit for new investment and the tightening of the regulations on foreign tax havens. Moreover, many U.S. firms, recently established in Europe through an outflow of U.S. funds, have shown considerable propensity for financing new investment from depreciation, retained earnings, and borrowings in the countries in which they are producing. And it is to be expected that the large investments in the last several years will result in an increased inflow of dividends and profits to the parent U.S. firms.

These are the favorable factors now in motion. One cloud in the outlook for the U.S. balance of payments is a possible major recession in Europe, which might tend to reduce the growth of demand for U.S. commodities in Europe, at the same time European producers might compete more actively in foreign markets. Most European countries, however, have very large international reserves of gold and foreign exchange and are likely to counter any recessionary developments vigorously with expansive monetary and fiscal policies so that the likelihood of a severe recession seems small.

At this juncture the factors favorable to the reduction of the U.S. deficit dominate the unfavorable factors, indeed by a considerable margin. Current U.S. policies for adjustment should reflect these trends. Despite the hopeful omens, it would be ill considered to count on market forces to restore a satisfactory payments balance. Deliberate policies are needed, and choices must be made among various possible policies; these choices must reflect both the costs of these policies and their impact in reducing the payments deficit.

Almost every policy for restoring payments equilibrium operates at some cost. Some of these costs are financial, like subsidies and government expenditures; others involve the costs of unemployment or of the less efficient use of resources; and others involve psychological costs—the pressure on a foreign country to increase its foreign-aid expenditures, or the changes in personnel in U.S. Government agencies as new individuals are chosen to further export promotion policies.

The costs of policies for adjustment should be compared before adopting particular policies. Evaluation of the costs suggests that there is no easy, one-shot, cost-free solution for moving to a position where the U.S. payments balance is satisfactory; some policies, however, may appear too costly to be adopted. An appropriate strategy is to continue to push on many fronts without deviating from established principles of U.S. domestic and foreign financial policy; in the long run, persistent and tenacious nibbling on the edges of the problem should be more successful and prove less costly than a frontal assault.

The appropriate target for U.S. balance-of-payments policy remains unclear because national balance-of-payments data are incomplete and inconsistent. Since a U.S. payment abroad is the receipt of some other country, while a U.S. receipt from abroad is a payment of some other country, it would be expected that the U.S. payments deficits would have a counterpart in the payments surpluses of other countries.[13] And this would hold for each type of international transaction—commodity imports, transportation, investment income, etc. If the data collecting system were perfect and the data presentation system were uniform, then the payments surpluses of some countries would be equal to the payments surpluses of other countries.

In 1960, however, reported deficits in the "basic accounts" alone exceeded reported surpluses by more than $1.5 billion; in 1961, by more than $1.2 billion.[14] (The basic balance of payments covers goods, services, transfer payments, and long-term capital transactions.) If short-term capital movements were included, the discrepancies between reported deficits and reported surpluses would be considerably larger. These discrepancies strongly suggest that if more complete data were available and presented in a more uniform manner, countries in deficit would show smaller deficits, and countries in surplus would show larger surpluses. Relative to the data-reporting practices of other countries, the U.S. payments deficits have been overstated.

The problem of measurement presents continual difficulties, and continuing effort should be devoted to reducing the gap in the data. Even if the data collection problem could be surmounted, there remain problems of formulating the country data in a more consistent manner. Especially important is the need to secure uniform treatment among countries in deficit and countries in surplus with regard to the treatment of short-term capital flows.

The U.S. payments balance is now calculated on the basis of changes in U.S. official holdings of gold and convertible foreign currencies, and changes in the holdings of liquid dollar assets by foreign official institutions, banks, and foreign private parties. Thus an increase in U.S. official holdings of sterling or marks would tend to increase the U.S. surplus (or reduce the U.S. deficit), and an increase in U.S. private holdings of convertible foreign currencies would not; while an increase in both foreign official and foreign private holdings of dollars reduce the U.S. surplus (or increase the U.S. deficit). The treatment of private holdings is asymmetrical, and is one cause of the large dis-

[13] Actually the sum of the payments surpluses should exceed the sum of the payments deficits by the increase in monetary gold stocks. This is because the exports of the gold-producing countries are adjusted upward to reflect new gold production. This increases the payments surplus of these countries; there is no change in the payments balance of any other country.

[14] See the 1960 Annual Report of the International Monetary Fund, p. 113.

crepancy on the short-term accounts. If the acquisition of short-term foreign financial assets by U.S. private parties were treated like the acquisition of these assets by the U.S. financial authorities, the U.S. payments deficit in 1961 would have been smaller by $1.2 billion. Altogether $1.9 billion of the deficit of $2.5 billion in 1961 was due to these short-term capital flows; only $600 million of the deficit was in the basic accounts.

Revising the payments statistics, while it would not change the fundamental situation, has two advantages—the first is that a more consistent presentation of the data would reduce what has been reported as the U.S. deficit, and minimizes the unnecessary and avoidable alarms that have contributed both to apprehensions about the dollars and gold and currency speculation. The second advantage is that a better awareness of which countries have the payments surpluses and which countries have the payments deficits, and in what amounts, would put more pressure on the countries in surplus to help bear some of the costs of adjustment to payments imbalance. This problem of statistical discrepancies has not gone unnoticed in the U.S. Government, but the results of interagency disputes has been to deluge the outsider with a basketful of new statistics rather than to reform the basic presentation.

4. CHANGES IN THE EXCHANGE RATE STRUCTURE

One policy sometimes suggested as a means of both quickly reducing the payments constraint and stimulating U.S. income and employment through larger U.S. net exports is a devaluation of the dollar in terms of other currencies. It is not evident that the United States could devalue successfully—that a devaluation of the dollar in terms of gold and every other currency would not be offset by a proportionate devaluation of most other currencies in terms of gold and the dollar. But even if a U.S. devaluation of 10 or 15 percent were successful in that it was not countered by equal devaluations by most other countries a U.S. devaluation is an inappropriate remedy for the U.S. payments problem. It is inappropriate because it is a quite costly way to improve the U.S. payments balance, and because it would reduce the pressure to adopt a number of desirable policies. The cost of a successful U.S. devaluation is too high, and the risk of an unsuccessful one too great, to warrant a U.S. devaluation.

Devaluation may be an appropriate instrument of economic policy at a time when a country's prices and costs are so hopelessly above those in most other countries that it suffers the dual handicaps of a large payments deficit and a large import surplus. In such cases the payments deficit will be a constraint on expansive income and employment policies, while the import surplus will have a contractive impact on domestic income and employment. In these circumstances devaluation removes or extends the payments constraint, and the contractive impact may become less severe or even be converted into an expansive impact.

If a U.S. devaluation were successful in achieving a satisfactory payments balance, it would probably be largely because of an increase in U.S. exports relative to U.S. imports; U.S. foreign investment would change only slightly.[15] (Because some U.S. payments for military expenditures abroad and foreign aid are not sensitive to changes in the price of foreign goods relative to U.S. goods, dollar payments for these expenditures might increase rather than decline.) The foreign counterpart of the larger expansive impact on the U.S. economy from an increase in U.S. net exports would be a larger contractive impact on other countries.

Devaluing the dollar to stimulate U.S. income and employment, at a time when the foreign trade sector already has a large expansive impact on the U.S. economy, would cause considerable concern in other countries; indeed, it would be one factor which might induce them to counter a U.S. devaluation. While it is true that other policies which succeed in increasing U.S. net exports also have a contractive impact on foreign countries, they are likely to object much more vigorously to a U.S. devaluation.

The likelihood that foreign countries might not counter a U.S. devaluation with their own devaluations cannot be ignored. Industrial producers in many of these countries are already concerned that their competitive position may be slipping even further behind that of U.S. producers; they could be expected to put tremendous pressures on their own authorities to devalue proportionately. Certainly if the United States devalued, several other industrial countries—Great Britain, and probably Canada and Japan—would follow almost immediately. The competitive pressures on producers in the continental Europe would become intense.[16]

Moreover, a U.S. devaluation would not be cheap even if it were successful. U.S. imports of goods and services would decline relative to U.S. exports of goods and services. Imports of foreign goods and services would cost more in terms of dollars than they now do, while exports of U.S. goods and services would yield less in terms of dollars; there would be deterioration in the U.S. terms of trade—the relation between export prices and import prices. Altogether the annual cost of a devaluation of 10 percent in terms of the decline in export prices relative to import prices might be in the range from $2 billion to $3 billion yearly.[17] This is quite expensive in view of the need to improve the U.S. payments position by $1.5 or $2 billion yearly.

And there are other costs to devaluation which cannot be calculated. Devaluing now would remove the discipline of the U.S. balance of

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[15] Some observers suggest that a major reason for U.S. direct investments abroad is an attempt to avoid higher costs of production in the United States. This view, however, was denied in a study of the experience of U.S. manufacturers operating abroad. "The data show that while foreign unit costs are more frequently lower than comparable U.S. costs, on the whole the difference by most criteria is small. Taking all the 192 product cost comparisons, total unit costs are lower abroad in 15 more instances than they are higher." Theodore R. Gates, "Production Costs Here and Abroad," National Industrial Conference Board, 1958, p. 15. It should be noted that the sample may be biased, because it focuses on those firms which, after analysis of the cost data, have chosen to produce abroad.

The inference from the results of this survey is that direct U.S. investment abroad would not be greatly affected by a U.S. devaluation.

[16] That the articles of agreement of the International Monetary Fund would stand in the way of these offsetting devaluations is highly unlikely. The Europeans believe that because of weighted voting the Fund closely reflects the U.S. viewpoint. It is extremely unlikely that they will accept a U.S. veto on their proposed changes in exchange rates, even if it means ignoring the Fund. This is what France did in the late 1940's when American supremacy was less readily questioned.

[17] This estimate was made in the following way—it was assumed that a 10-percent devaluation would result in an increase in import prices of 5 percent, and a decline in export prices of 5 percent. U.S. imports and exports of goods and services were multiplied by these assumed changes in import and export prices, which provided one estimate of the cost. A convenient, wide range around this estimate was selected.

payments, and weaken the pressures for the correctives to long-established policies and practices that in the absence of the payments problem, would probably continue in their own inefficient way. Domestically, the pressure of U.S. payments deficit has greatly emphasized the need for long-overdue changes in U.S. tax and depreciation policies and the importance of price stability. Internationally the U.S. payments balance has focused attention on the need for the other industrial countries in Western Europe to carry a larger share of the burdens of economic development and of mutual military defense. Without the pressure of the deficit, the incentives to make these changes would have been considerably less, and many of these changes might not have taken place.

The consequences of a U.S. devaluation for growing economic integration must not be ignored. The U.S. authorities now are extensively committed to maintaining the present exchange rate for the dollar. Many positions have been taken on the basis of these commitments. If the U.S. authorities were to renege on this commitment, the blow to greater economic integration would be a sharp one.

Even though a U.S. devaluation at this juncture is clearly inappropriate this does not rule out the possibility of a change in the structure of exchange rates, which clearly was envisioned in the establishment of the Bretton Woods system. Unfortunately this system contains a bias which operates to the disadvantage of the United States. Many countries have not hesitated to devalue their currencies against gold and the dollar at a time when they have had large payments deficits. In 1949 nearly all the European currencies were devalued against the dollar and some countries which devalued in 1949 have since devalued again—France in 1957 and 1958; Spain in 1957 and 1959. Many of these countries now have payments surpluses, and some of them have done relatively little to reduce their surpluses.

Thus most of the burden of adjusting policies to the current imbalance in international payments has been transferred to the United States. If the United States devalued to achieve a surplus, other countries might again devalue when they came under payments pressure. Such a ratchetlike downward system of adjustment in exchange parities is clearly untenable, for countries in deficit would almost immediately fall prey to tremendous speculative assaults. This would destroy the Bretton Woods system and the system of reserve currencies.

The problem of mutual responsibility for maintaining payments equilibrium, and the possibility that some countries with payments surpluses should appreciate their currencies, was recognized by the Commission on Money and Credit.

> * * * If large U.S. payments deficits appear persistent, the need for a change in the exchange rate structure must be recognized, and the change can be either a U.S. devaluation or an appreciation of some other currencies.
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> Changes in the structure of exchange rates should not be looked upon as obviating the need for other measures needed to achieve payments balance, such as those promoting effective selling and more adequate credit to increase the competitiveness of U.S. goods abroad. Adjustment by countries in surplus is not advocated as a means of avoiding domestic measures in the United States or in other deficit countries. But surplus countries as well as deficit countries have a responsibility for the world payments system and should take appropriate steps, as the United States did during the early postwar period.

If a change in the structure of the exchange rates is necessary, it should be worked out through international negotiations with major industrial countries, perhaps through the IMF. Decisions to alter the value of a country's currency by more than 10 percent require approval by the IMF. The Commission believes that instead of maintaining only a passive attitude, the IMF should be encouraged to take more initiative in recommending and effecting changes in the exchange rate structure. Such changes, or discussions of them will generally cause disturbances in exchange markets. Speculative capital flows will also certainly occur, and the IMF could take an aggressive role to minimize the impact of these shifts and their effects on reserves through supplying standby credits to countries subject to the speculative attack.

The Commission believes that the present dollar price of gold should be retained as a central pivot in the exchange rates structure among IMF member countries and that any needed realinement of the structure should be around this pivot.

A stable exchange rate structure policed aggressively by the IMF should prove workable, provided appropriate domestic policies are pursued. It is likely that the structure of exchange rates will require only occasional changes. But if changes in exchange rates are necessary, they are preferable to the development of a system of restrictive controls that would stifle world trade, or to the sacrifice of major domestic objectives to secure external balance.[18]

If the IMF system is to work successfully, some of the European countries which now have both reserves and payments surpluses large relative to their economic size bear responsibility for adjusting their payments position. Some of these countries are clearly out of balance, and are throwing an undue share of the burden of adjustment on other countries. If these countries which now have excessively large surpluses do not wish to revalue their currencies upward, they must adopt other measures to bring their payments position more nearly into balance. Achieving this objective either through a change in the exchange rate or alternatively through increases in foreign aid, reduced reliance on the United States for military support, reductions in tariffs and quotas, involves many delicate issues, but these countries ought not to be exempt from sharing in the burden.

5. U.S. Policies for Securing a Satisfactory Payments Balance

In the last several years, considerable attention has been given to a variety of policies which might be adopted to achieve and maintain a satisfactory payments balance. Rather than discuss this list exhaustively, this section emphasizes two considerations important in discriminating among these policies. The first is that policies should be evaluated in terms of their impact on the U.S. technological lead, for it is the technological lead which enables the United States to achieve such a large trade surplus despite its apparent higher prices and costs. Categorically, policies which help increase the lead are desirable.

The second consideration concerns economic efficiency. Economic efficiency—obtaining an objective through least possible economic cost—is an important goal. At times the goal of efficiency may conflict with other objectives of policy. When it conflicts with the objective of securing a satisfactory payments balance, then the goal of efficiency should receive secondary importance. For example, it might be possible to secure an improvement in the U.S. payments position of $100 million annually by substituting U.S. sources of supply for foreign sources in meeting some of the needs of U.S. troops stationed

[18] Report of the Commission on Money and Credit, pp. 230–231.

abroad. The switch in supply sources, however, might raise the cost of the materials by $25 million, which would be an additional cost to the U.S. Treasury.[19] Securing an improvement in the payments balance of $100 million extends the payments constraint, and permits greater reliance on expansive policies to more fully achieve high-level employment. If each increase in income of $1 billion results in an increase in U.S. payments for commodity imports and foreign services of $30 million before offsets, and of about $20 million with offsets, then having an "additional" $100 million of foreign exchange to spend would permit an increase in U.S. income of $5 billion.

These numbers must be considered as estimates rather than as exact calculations. Despite the approximate character of the estimates, they indicate that at a relatively small cost the payments constraint can be extended to permit expansive income and employment policies. Ideally, it is desirable to achieve satisfactory payments balance at high level employment without the need for such inefficient policies. But if high level employment and a satisfactory payments balance do not prove fully compatible at all times, there should be no hesitation to adopt some policies which may seem less than fully efficient.

U.S. domestic financial policy

A most important domestic policy for achieving a satisfactory payments balance in the long run is adherence to high-level employment policies in the context of relative price stability. In the short run, pursuit of high-level employment policies may result in a larger U.S. payments deficit. Over a more extended period, high-level employment provides one of the best spurs to technological innovation and development and to rapid productivity gains which are so important for the growth of U.S. exports.

The strength of U.S. position in world trade depends on its technological leadership. This leadership is increasingly threatened by the greater speed with which new techniques, once developed in the United States, become available in foreign countries. A balance-of-payments policy which retards the growth of U.S. income below its high-employment potential in an attempt to reduce the U.S. payments deficit cuts into the U.S. technological lead, and this weakens the U.S. balance-of-payments position in the long run. It is preferable to pursue high employment, even if new arrangements are necessary to finance a somewhat larger deficit in the short run, than deliberately to sacrifice part of this lead.

Maintaining the U.S. technological lead

U.S. expenditures for research and development are now over $15 billion yearly, more than several times larger than the total in other industrial countries in the free world. The Federal Government provides two-thirds of the funds for U.S. research and development, with major emphasis on military and space-related activities. Many of these new techniques and processes developed under these pro-

[19] This is an example of the additional direct cost to the U.S. Treasury. The purpose of the change in procurement policies is to extend the payments constraint and permit adoption of more expansive income and employment policies. Increases in U.S. national income of $100 million tend to result in an increase in Federal tax revenues of nearly $20 million. There can be no doubt that the additional tax revenues resulting from the higher incomes made possible by extending the payments constraint will greatly exceed the cost to the Treasury of the policies undertaken to extend the payments constraint.

grams have commercial applications, which if developed would assist in maintaining the U.S. technological lead. Quickening the pace with which the commercial applications of governmentally sponsored research can be developed is so important for the U.S. balance of payments that it would not be out of order to devote an additional $20 or $30 million annually to this task.

There are a number of different measures which might be adopted. For example, an industrial extension service might be operated in conjunction with the State university system, much like the agricultural extension service. This industrial extension service would engage in making U.S. producers much more aware of new products and techniques; it would be especially valuable for smaller and medium size firms. Another approach is to set up 20 or 25 research centers, each concerned with the needs of a major U.S. industry, to focus on bridging the gap between the new techniques, products, and processes becoming available in Government research, and the needs and uses of particular industries.

Other domestic policies

A major consideration in the choice of specific domestic policies to reduce the U.S. payments deficits is whether these policies tend to reduce economic efficiency. A good example is the reduced effectiveness of U.S. foreign aid when the worldwide procurement policies of the aid agencies were replaced, hopefully, for a temporary period only, by procurement in the United States. This means that the aid recipients obtain less real benefit from a given dollar amount of aid since they will be obliged to rely on higher cost dollar sources of supply, or, alternatively, that a larger amount of dollar aid would be necessary to extend the same amount of real benefit. Tying U.S. aid will probably affect about $400 or $500 million of aid which was formerly untied, and should improve the U.S. balance-of-payments position by a somewhat smaller amount, perhaps at a cost of a loss in efficiency of $100 million—the additional burden on the U.S. Treasury so that the shift to dollar procurement does not result in a reduced real benefit to the aid recipient. And this estimate overstates the real costs to the U.S. economy of tying aid, since there is considerable surplus capacity in the U.S. economy.

Similarly, the foreign exchange cost of U.S. military expenditures abroad can be reduced by supplying a larger proportion of needs from U.S. sources. This will be somewhat more costly than using procurement from foreign sources. The relevant comparison, however, is not with the before-and-after costs of U.S. military procurement, but whether this additional cost is one of the least expensive ways of securing an improvement in the U.S. payments balance of $500 million or $1 billion.

Direct subsidies and indirect subsidies in the form of tied procurement have very high leverage in removing or extending the constraint that an adverse payments position may have on domestic high-level employment policies. While the number of these measures which can be adopted is limited by various international arrangements, there remain a considerable number of measures which the United States can use with much greater effectiveness.

Much more attention should be given to U.S. export promotion policies. The strong international competitive power of U.S. commodities has been amply demonstrated—now more effort should be given to translating this competitive power into additional exports. The Government expenditures for trade fairs, for more effective promotion of exports through better information, and for the promotion of foreign tourism in the United States are paltry, and should be greatly increased. And that the new programs of the Export-Import Bank, intended to increase U.S. exports by more effective credit financing arrangements, cover considerably less than $500 million of U.S. exports in their third year of operation is not impressive testimony that the Bank's longstanding reluctance to promote U.S. exports through aggressive use of export credit and export credit guarantees has changed significantly.

Financing the interim deficit

The effective progress that can be made in reducing the size of the deficit during any short-time period through measures which are consistent with U.S. high employment policies is limited. A choice has to be made between temporarily having the deficit that occurs at high employment even if it requires new financing arrangements, or having a somewhat smaller deficit and a somewhat lower level of income and employment and a deficit that appears consistent with established financing arrangements. This distinction between measures taken to reduce the deficit, and measures taken to finance the deficit, while clear in the particulars, is not always clear conceptually. Thus, if the United States wishes to obtain foreign currencies by borrowing abroad at long term, the U.S. deficit will decline; if it borrows at short term, the deficit remains unchanged.

The advance repayment of debts owed by foreign governments to the United States in 1961 and 1962 was exceedingly helpful since it reduced the deficit, as have the sale of U.S. Treasury notes to several European countries, and the sale of participations in the obligations due the Export-Import Bank. Much more attention should be given to the direct sale of nonmarketable long-term U.S. Treasury obligations to various foreign countries. Depending on the preferences of foreign countries, some of these obligations might be denominated in the currency of the purchasing country. Special provisions could be made for encashment on short notice.

6. CONCLUSION

A number of different policies can be adopted to reduce the U.S. payments deficit. Each policy has a cost, and the costs of most policies can be estimated. An appropriate strategy in reducing the deficit is to adopt the combination of policies which will yield a satisfactory payments balance at least total cost.

The costs of various policies designed to attain this objective can be measured in terms of the loss in economic welfare or the decline in real GNP. Some policies to improve the balance of payments place an additional burden on the U.S. Treasury, but in most cases this added cost is more than offset because the measures adopted relieve the payments constraint. By permitting more expansive policies which result in higher incomes, these measures facilitate an increase in tax revenues which is almost certain to exceed the cost of these measures to the Treasury.

The target objective should be to reduce the U.S. payments deficit, as now calculated, perhaps $500 or $700 million at high-level employment, which means securing an improvement in the overall U.S. payments balance of about $2 billion over 1961. It is difficult to pinpoint an exact target, partly because the situation is dynamic and changing and partly because there are two important subtargets—one for the basic accounts, and one for short-term capital movements. An improvement in the basic accounts is more important than an equivalent improvement in the short-term capital accounts, because the former reflect on the international competitive position of the United States and the latter do not. Thus an improvement of $1.5 billion in the basic accounts at high-level empolyment (which might mean a surplus in the basic accounts of $300 million) would be an even more important objective than a somewhat larger overall improvement which partly reflected a considerable improvement in the short-term accounts.

The most costly balance-of-payments measure is a nonexpansive income policy—this policy is extremely expensive because the decline in national income below the high-level employment potential may be as much as 30 or 40 times the resulting improvement in the payment balance, because a decline in U.S. national income of $1 billion may improve the payments balance by little more than $20 or $30 million. Moreover, a nonexpansive income and employment policy is extremely expensive for the U.S. Treasury, since a shortfall of $5 billion between the high employment income level and actual income level costs the Treasury about $1 billion in tax revenues.

Devaluation of the dollar, although less costly than domestic deflation, is also a costly policy for adjustment. The direct financial cost of a 10-percent devaluation from the deterioration in the U.S. terms of trade would probably exceed the desired improvement in the U.S. payments balance. In addition to this high direct cost, there are a number of indirect costs, since devaluation would greatly reduce the pressure on other industrial countries to take on their appropriate share of the burden for development aid and military defense. But the likelihood that a U.S. devaluation would be successful and not followed by proportional devaluation of other countries seems small. The high risk that a devaluation will not succeed, and the high cost if it does succeed, rule out this policy for adjustment.

The least costly means to secure a satisfactory payments balance at high-level employment is to adopt a series of selective measures which would both increase U.S. receipts and reduce U.S. payments, and to reduce the foreign exchange cost of U.S. foreign aid and U.S. military expenditures abroad. Shifting procurement from foreign sources to U.S. sources may increase the cost of some U.S. programs; nevertheless this remains one of the least costly ways to reduce the deficit. It is clear from the excess of U.S. commercial exports over commercial imports that U.S. jroducts are extremely competitive internationally; much more attention should be given to export stimulants in the form of more effective export credit, new trade promotion devices, etc. Maintaining the U.S. technological lead is also extremely important; and programs designed to quicken the rapidity of the development of commercial applications from Government sponsored research and development are needed. Indeed because of the pressing nature of the balance-of-payments problem, it would not be out of order over the next several years for the U.S. Government to allocate $100 million or even $150 million to be distributed among the most promising measures for reducing the payments deficit.

Through time the balance-of-payments situation will change. It may be necessary to adopt new policies or reduce reliance on established policies, and the best strategy may change as the costs of various policies change. What the most appropriate policies are at any time can only be determined after an analysis of the cost of each policy; few policies, unfortunately, are free.

Further Remarks by Jaroslav Vanek

* * * we have made a mistake in the step-by-step reconstruction of the balance-of-payments effect. On the export side, there would effectively be an improvement of about 4.5 billion, as we have estimated. On the import side, however, an effect of one-half of the size of the export-effect (this we have taken as a reasonable approximation) would represent a 2.25 billion reduction in the *volume* of imports, while the *value* of imports (with 15 percent devaluation) would increase, in terms of dollars, by about 2.25 billion.

Thus the total *initial* effect on the balance of payments would be 4.5 billion minus 2.25 billion, rather than 4.5 billion plus 2.25 billion. And this is just about the correction in our balance of payments you have deemed necessary. The total *final* effect of a 15 percent devaluation would then be even somewhat lower, because of the impact of increased GNP on imports.

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