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U.S. PAYMENTS POLICIES CONSISTENT WITH DOMESTIC OBJECTIVES OF MAXIMUM EMPLOYMENT AND GROWTH

REPORT

OF THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

TO THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

WITH

INDIVIDUAL VIEWS

Printed for the use of the Joint Economic Committee

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LETTERS OF TRANSMITTAL

DECEMBER 26, 1962.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the members of the committee and other Members of Congress is a report of the Subcommittee on International Exchange and Payments entitled "U.S. Payments Policies Consistent With Domestic Objectives of Maximum Employment and Growth."

The views expressed in this subcommittee report do not necessarily represent the views of other members of the committee who have not participated in hearings of the subcommittee and the drafting of its report.

Sincerely yours,

WRIGHT PATMAN,
Chairman, Joint Economic Committee.

DECEMBER 21, 1962.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is the report of the Subcommittee on International Exchange and Payments entitled "U.S. Payments Policies Consistent With Domestic Objectives of Maximum Employment and Growth."

As set out in the annual report of the Joint Economic Committee (H. Rept. 1410, p. 145) the subcommittee this year undertook "a broadly based study of the conditions past, present, and prospective, which have raised the balance-of-payments problem to its present position of concern. Such a study, which would deal with the feasibility and contributions of alternative measures to be taken, would in no way minimize the urgency of the general trade liberalization objectives, but would explain the desirability, possibility, and needs presented by these other, complementary, directions of attack."

A compendium containing 20 study papers by various experts was prepared and published, followed by hearings by the subcommittee on December 12, 13, and 14, 1962.

The subcommittee wishes to express its appreciation to the experts who prepared study papers, and especially to Prof. Don Humphrey of the Fletcher School of Law and Diplomacy, Tufts University, who, as consultant to the subcommittee, arranged for the preparation of the various study papers and contributed greatly to setting up and conducting the hearings. The subcommittee is grateful for the work done by Dr. William H. Moore of the committee staff in handling the publication of the study papers and setting up the hearings. Mrs. Edna Gass of my staff assisted in the organization of the study and in the preparation of this report.

Sincerely yours,

HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments.

U.S. PAYMENTS POLICIES CONSISTENT WITH DOMESTIC OBJECTIVES OF MAXIMUM EMPLOYMENT AND GROWTH [1]

I. The Problem

The United States has for some years faced the problem of bringing its balance of payments under control in a manner consistent with its objectives of maximum employment and a more rapid rate of growth of the domestic economy. With the passage of time, the problem has intensified. The payments deficit continues and the reform of domestic economic policies for maximum employment and growth has only just begun.

At least until 1957, modest U.S. payments deficits, amounting to an average of $1.3 billion per year from 1950 to 1957, were considered desirable since they provided dollars to supplement gold in the monetary reserves of other countries. However, in the 4-year period from 1958 through 1961, the annual deficits were large, and the total U.S. deficit came to $13.6 billion. In this period, foreign monetary authorities added $3.5 billion to their dollar holdings.

They also turned in dollars for gold at a more rapid rate. As a consequence, U.S. gold stocks fell from nearly $23 billion at the end of 1957 to about $17 billion at the end of 1961. In the current year, it is estimated that the deficit will be about $2 billion, an improvement over previous years but still uncomfortably large.

Both the previous and the present administrations have attempted to improve the U.S. payments position and to minimize gold outflow: foreign aid has been in large measure confined to the shipment of U.S. goods; advance repayments of debt have been obtained from surplus-payments countries; the European countries have been persuaded to purchase more military supplies in the United States to offset U.S. military expenditures in Europe; reductions have been made on duty-free purchases abroad by U.S. tourists; tax incentives for private capital investment in developed economies abroad have been reduced, special inducements have been provided U.S. firms to modernize and to add to capital facilities so that U.S. industries may gain strength in international competition; and, in order to encourage foreign central banks and governments to hold dollars, interest rate ceilings on their time deposits have been removed.

Besides these actions directed to reducing the deficit in the balance of payments and to stemming the gold outflow, the administration has negotiated a supplementary standby credit agreement with nine

[1] Senator Jacob K. Javits: Because of other Senate business, Senator Javits was unable to participate in the drafting of this report and, therefore, the findings and conclusions herein are neither approved nor disapproved by him.

leading countries. This could add substantially to U.S. credit resources at the International Monetary Fund in case of need.

In order to prevent large speculative outflows of short-term capital, the Treasury and the Federal Reserve have, since early 1961, actively bought and sold dollars in foreign exchange markets. The foreign currencies needed for these operations have been borrowed under bilateral short-term currency "swap" agreements with a number of leading central banks.

Despite these efforts, the progress of the United States toward solving its payments problems has been unsatisfactory. Since 1960, the annual trade surplus has been maintained at around $5 billion, compared to an average of less than $2 billion in the early 1950's. (The volume of aid-financed exports was of the same order in both periods, i.e., about $2 billion.) Yet this improvement in the balance of trade has been insufficient to finance increased outflows, in particular a greatly increased volume of private capital investment and a substantial excess of military expenditures abroad not offset by foreign purchases in the United States.

The subcommittee believes that unilateral and cooperative efforts of the kind undertaken to date will not suffice to eliminate the payments deficit. A very substantially increased share of mutual defense and economic development costs will have to be borne by the other leading industrial countries, particularly those of the European Economic Community. The discriminatory effects of the Common Market external tariff and other restrictions on trade must be prevented from aggravating the present world payments imbalance, not only by worsening the U.S. payments position but by diminishing the export earnings of other free world countries. If multilateral cooperative action is not promptly forthcoming, the United States should be prepared to undertake more thoroughgoing unilateral action to restrict payments outflow.

The subcommittee is of the conviction—shared by responsible authorities in Europe—that the United States must move rapidly toward maximum employment, production, and more rapid growth. Indeed, the subcommittee believes that the strength of the dollar ultimately depends on the strength and growth of the underlying U.S. economy. It rejects the notion that the United States must raise domestic interest rates [2] or follow restrictive fiscal policies—causing a low growth rate and high domestic unemployment—in order to solve the U.S. balance-of-payments problem.

II. Subcommittee Studies and Hearings

The subcommittee believed that intensive study of some aspects of the related problems of world payments imbalance and the adequacy of the present system of international monetary reserves was required. Accordingly, the following studies were prepared for publication prior to subcommittee hearings:

Oscar L. Altman, International Monetary Fund, "Recent Developments in Foreign Markets for Dollars and Other Currencies," and "Canadian Markets for U.S. Dollars."

[2] See additional views of Senator Bush, p. 11.

Bela Balassa, Yale University, "Recent Developments in the Competitiveness of American Industry and Prospects for the Future."
Robert E. Baldwin, University of California, "Implication of Structural Changes in Commodity Trade."
Philip W. Bell, Haverford College, "Private Capital Movements and the U.S. Balance-of-Payments Position."
Edward M. Bernstein, research economist, Washington, D.C., "The Long-Run Prospects for the U.S. Balance of Payments."
Charles A. Coombs, vice president in charge of the foreign department of the New York Federal Reserve Bank, "Treasury and Federal Reserve Foreign Exchange Operations."
George N. Halm, the Fletcher School of Law and Diplomacy, Tufts University, "Fixed or Flexible Exchange Rates?" and "Special Problems of a Key Currency in Balance-of-Payments Deficit."
Seymour E. Harris, Littauer Professor of Political Economy, Harvard University, "The U.S. Balance of Payments: The Problem and Its Solution."
H. S. Houthakker, Harvard University, "Exchange Rate Adjustment."
James C. Ingram, University of North Carolina, "A Proposal for Financial Integration in the Atlantic Community."
Charles P. Kindleberger, Massachusetts Institute of Technology, "Protected Markets and Economic Growth."
Lawrence B. Krause, Yale University, "The European Economic Community and American Agriculture."
Irving B. Kravis, University of Pennsylvania, "The U.S. Trade Position and the Common Market."
Walther Lederer, Chief, Balance of Payments Division, U.S. Department of Commerce, "Measuring the Balance of Payments."
Fritz Machlup, Princeton University, "Proposals for Reform of the International Monetary System."
Jesse W. Markham, Princeton University, "Competition in the European Common Market."
James E. Meade, Cambridge University, "The Future of International Payments."
Howard Piquet, Legislative Reference Service, the Library of Congress, "Some Consequences of Dollar Speculation in Gold."
Robert V. Roosa, Under Secretary of the Treasury for Monetary Affairs, "The Beginning of a New Policy," "Banking and the Balance of Payments," and "Assuring the Free World's Liquidity."
Jaroslav Vanek, Harvard University, "Overvaluation of the Dollar: Causes, Effects, and Remedies."

The subcommittee also held hearings on various aspects of the outlook for the U.S. balance of payments on December 12, 13, and 14, 1962. The questions discussed and the experts testifying were:

1. HOW TO IMPROVE OUR BALANCE OF PAYMENTS

(*a*) U.S. competitive position and the challenge of Common Market to U.S. exports.
George W. Ball, Under Secretary of State.
Charles S. Murphy, Under Secretary, U.S. Department of Agriculture.
Bela Balassa, Yale University.
Lawrence B. Krause, Yale University.
Irving B. Kravis, University of Pennsylvania.
Stanley Ruttenberg, AFL–CIO.
(*b*) Free world defense—sharing the burden with our allies and alleviation through military purchases in the United States.
Charles J. Hitch, Assistant Secretary of Defense (Comptroller).
(*c*) Foreign aid—sharing the burden by our friends and tying purchases to U.S. sources.
Frank M. Coffin, Deputy Administrator, Agency for International Development.
(*d*) Expanding tourism to increase dollar receipts.
Voit Gilmore, Director, U.S. Travel Service, U.S. Department of Commerce.

2. HOW TO IMPROVE THE BALANCE OF PAYMENTS BY IMPROVING THE MECHANISMS

Robert V. Roosa, Under Secretary of Treasury for Monetary Affairs.

3. HOW TO IMPROVE OUR BALANCE OF PAYMENTS: CAPITAL MOVEMENTS

Philip W. Bell, Haverford College.
Peter B. Kenen, Columbia University.
Frederick H. Klopstock, manager, research department, Federal Reserve Bank of New York.

4. THE INTERNATIONAL MONETARY SYSTEM—DEFECTS AND REMEDIES

(a) Costs of having a key currency.
Alan R. Holmes, Vice President, Federal Reserve Bank of New York.
Hendrik S. Houthakker, Harvard University.
Theodore Geiger, National Planning Association.
(b) Exchange rates—are the old ones outdated? Integration versus flexibility.
James C. Ingram, University of North Carolina.
Richard Caves, Harvard University.
Jaroslav Vanek, Harvard University.
George N. Halm, the Fletcher School of Law and Diplomacy, Tufts University.
Charles P. Kindleberger, Massachusetts Institute of Technology.
(c) Proposed reforms in the International Monetary System.
Fritz Machlup, Princeton University.
Edward M. Bernstein, research economist, Washington, D.C.
Harry Johnson, University of Chicago.

III. Recommendations

1. The United States must secure from our Western European allies a larger contribution toward the costs of mutual defense of the free world and economic aid to the developing countries.

The subcommittee is not satisfied with the contributions being made toward mutual defense and economic aid by our Western European allies. If the rapidly growing, highly prosperous countries of Western Europe assumed a fair share of both these common obligations to the free world, a substantial part of the present imbalance in payments between the United States and Western Europe would be eliminated. The administration must, therefore, press more vigorously to secure such increased contributions from these allies.

2. The United States should promptly and vigorously bargain for the reduction of the Common Market external tariffs, and the Common Market should be requested to make an immediate, unilateral reduction in its tariffs on a most-favored-nation basis pending completion of the negotiations.

Together with the reallocation of defense and economic aid costs recommended above, expanding our trade surplus offers a constructive solution to the persistent U.S. payments deficit. Our best hope to increase the overall surplus further is to sell more to the prosperous European countries. Fortunately, this should be feasible since these are among the most rapidly expanding countries in the world, and they will be experiencing rapidly rising imports.

At the same time, many countries of Western Europe, and particularly those in the Common Market, need to import more because they face inflationary pressures. The tendency for countries like Germany, France, and Italy to continue accumulating gold and dollars rather than to spend more of their rising export income on imports, on capital investment in other countries, and on foreign aid, has been responsible for a large part of the free world's payments imbalance. If such surplus payments countries would buy United States and other foreign goods more freely, their present fully employed resources of capital and manpower could be devoted to the most productive activities, including further domestic capital investment essential for their future growth.

This adjustment, desirable both from the standpoint of the United States and in the interest of a fundamental correction in the free world payments balance, depends in part on a further improvement in the United States ability to compete in international trade. However, a much greater obstacle to adjustment is being erected by the rising trade discrimination of the Common Market and by its agricultural policy which poses special threats to our leading agricultural exports.

An immediate and substantial reduction of these restrictions to trade is necessary if the U.S. payments position is to be prevented from worsening—much less improved. The subcommittee believes that a policy of deferring trade negotiations until Britain enters the Common Market would have the gravest consequences. Negotiations should be started as early in 1963 as possible. In addition, the Common Market should be urged to make an immediate, unilateral reduction in advance of later reciprocal concessions by the United States. Moreover, Congress should promptly amend the Trade Expansion Act so that the "80-percent authority" will be available in bargaining with the Common Market—whether or not Britain is a member of the Common Market at the time of the negotiations.

3. The United States should promptly seek a payments agreement among the leading industrial countries to neutralize destabilizing short-term capital movements and to finance temporarily deficits arising from more basic factors.

The subcommittee believes it unwise to attempt to reverse capital outflows by a policy of high interests rates.[3] These simply increase unemployment and retard growth, thus compounding the balance of payments problem. To propose paying $30 to $40 billion per year in reduced incomes to American workers and investors to obtain a $2 to $3 billion per year reduction in the payments deficit is to reduce economic calculus to absurdity.

Aside from the lack of proportion in the argument, there is no reason to expect the policy to yield long-run success. The payments deficit and accompanying capital movements have not been cured by several years of high unemployment and slow growth, nor have analysts been able to produce reasonable proof of significant response of capital movements to moderate interest rate differentials.[4] Other factors, such as speculation, tax considerations, trade requirements, and rising direct investment abroad, appear to outweigh any possible interest rates effects.

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[3] See additional views of Senator Bush, p. 11.

[4] Contrary to widespread impressions, U.S. interest rates do not appear low compared to those in the other highly industrialized countries. Recently, for example, short-term rates in Switzerland, Belgium, Germany, and the Netherlands have tended to remain below the U.S. rates. Only in the United Kingdom, France, and Canada have rates been higher than in the United States. If forward cover is taken into account, the United Kingdom rate would be roughly the same as the U.S. rate.

But even if it were incontrovertibly proved that a measurable capital outflow would result from low U.S. interest rates, the United States should not damage its domestic employment and growth by raising them. Instead of adopting a policy of domestic high interest rates for "balance of payments" reasons, the subcommittee repeats its recommendations of August 1961 for a payments agreement which will prevent international capital movements from interfering with domestic growth. Neither the IMF standby credit agreement negotiated in 1961 nor the variety of bilateral short-term currency support arrangements of the Treasury and the Federal Reserve meet the conditions for an adequate payments agreement.

Those conditions are:

> * * * The amount should be adequate, particularly in currencies other than the dollar and the pound. * * * Credits should be made promptly as needed. The size of the credit in relation to the deficit should, by agreement, be governed by the nature of the deficit: if the deficit is caused by "hot money," the bulk of the outflow should be financed by the credit; if the deficit is "structural" (i.e., of the type which requires correction through accelerated industrial modernization), credit might be granted to cover a significant fraction of the deficit over a period of several years; if, however, the deficit is caused by inflationary policies on the part of the deficit country, credit should be given for only a short period and only if the deficit country agrees to take adequate remedial measures. ("International Payments Imbalances and Need for Strengthening International Financial Arrangements," Report of the Subcommittee on International Exchange and Payments, Joint Economic Committee, 87th Cong., 1st sess., 1961, p. 22.)

The chief weakness of the IMF standby credit agreement is that credit may not be available when it is needed, since there is no firm advance commitment to lend. The bilateral support agreements are extremely limited in amount and are for very short periods, though renewable by mutual consent. Moreover, the latter are primarily for the purpose of moderating disorderly conditions in the foreign exchange markets.

4. The United States must not devalue the dollar, nor offer a general gold guarantee on dollars held as monetary reserves.

The subcommittee dismisses devaluation as a practical possibility and rejects reliance on general gold guarantees as a way of incurring additional deficits safely.

A devaluation by the United States could be followed by similar action by other countries, so that we would probably derive no competitive advantage in world markets. Holders of gold and large producers of gold, like South Africa and the Soviet Union, would gain, but those holding dollars would suffer losses. Moreover, devaluation of the dollar would stimulate speculation about further devaluation, and the resulting flight from the dollar could create intense pressures for still more devaluation. In the process, dollars would lose their usefulness as a reserve currency, and world monetary reserves would fall.

A gold guarantee would enable the foreign owners of dollars to receive interest payments while also enjoying the risklessness of holding gold. This would make the dollar much better than gold, and the subcommittee rejects this proposal.

The subcommittee believes that the only occasion for the United States to consider extension of gold or exchange value guarantees would be as part of a general multilateral payments agreement wherein similar guarantees would be offered by all participants.

5. The United States should take the leadership in establishing a mechanism which can add to international reserves.

As world trade and payments expand, more reserves will be needed. Yet a surplus in U.S. payments would diminish reserves by canceling that amount of dollar liabilities. This, of course, could be averted by our agreeing to hold other currencies as part of our monetary reserves. Other countries in settling their accounts could also agree to hold strong currencies. In this way, reserves could be increased, and a multiple key currency system could begin to take the place of the present system.

This appears to be the objective of present U.S. policy, but it should be regarded as an interim step rather than a permanent system. A system of multiple reserve currencies which consists of a series of bilateral agreements to hold each other's currencies would not provide for the contingency of payments deficits of both parties to an agreement. The creditor country whose payments deficit had developed after granting credit to another country would not find the debtor country's currency usable as reserves for meeting its debt. This event would mean the cancellation of the debtor country's currency as part of world reserves.

The subcommittee believes, therefore, that the United States should give a higher priority and increased drive to discussions with other countries on a plan for a multilateral arrangement to use strong currencies in addition to the dollar and the pound sterling in a manner which will strengthen the world monetary system, add to world reserves, as needed, and lessen dependence on gold as an international monetary reserve.

This might be accomplished by any of several plans that have been proposed, such as that recommended by this subcommittee in its August 1961 report. Under the subcommittee's plan, a country with a payments deficit would have received credit from a number of countries whose payments position was strong. In exchange, creditor countries would have received IMF certificates which could be used at any time along with their gold and exchange reserves in international payments. The subcommittee's 1961 report said:

> Each member should enter into an agreement with the IMF under which the member stands ready to purchase up to a specified amount of IMF interest-bearing obligations, denominated in its own currency, carrying the maintenance of value provisions of the articles of agreement and having maturities up to 4 or 5 years. The amount should be adequate, particularly in currencies other than the dollar and the pound. Funds would be borrowed by the IMF from participating countries having adequate or redundant reserves and strong balances of payments and lent to other participants experiencing payments deficits. Countries owning these IMF obligations should be permitted to use them in international payments, along with their gold and foreign exchange reserves. ("International Payments Imbalances and Need for Strengthening International Financial Arrangements," Report of the Subcommittee on International Exchange and Payments, op. cit., p. 22.)

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The subcommittee believes that steps along the lines recommended above will bring about a solution of our balance-of-payments problems in a manner consistent both with our domestic economic goals, and with our long-continued commitments to move in the direction of an integrated free world economy. It must be recognized, however, that if the more desirable multilateral avenues toward solution of the payments problems are closed to the United States, or if they should prove inadequate, serious consideration will have to be given to moves backward toward the older restrictive policies such as:

(*a*) Prohibit access by new foreign issues to the U.S. capital market except where they are found not to add to the U.S. payments deficit.

(*b*) Screen applications for direct U.S. investment abroad in surplus-payments countries, with special emphasis on those investments which have long-term adverse effects on U.S. payments.

(*c*) Limit the amount of funds permissible for U.S. tourist travel.

(*d*) Impose an import tax on selected categories of U.S. imports.

Such measures, if taken, should be for the express purpose of correcting the U.S. payments imbalance. They should be rescinded promptly when the condition has been corrected.

ADDITIONAL VIEWS OF SENATOR BUSH

Stronger measures than have been adopted by the administration or are now recommended by this subcommittee are required to eliminate the persistent and dangerous deficit in the U.S. balance of payments.

Other free world nations, which enjoy a payments surplus, should bear a greater share of the burden of the common defense against Communist imperialism and of economic aid to the less developed nations. The administration must exert greater efforts to impress upon our allies the urgent need for a more equitable sharing of these costs. A reduction of approximately $1 billion in annual U.S. dollar outflow for these items appears necessary.

Additionally, we approach the point at which restrictions upon U.S. capital investment abroad, another large item among the factors contributing to the payments deficit, should be considered. Action to correct the imbalance between low interest rates in the United States and the higher rates prevailing in other free industrial nations also may be needed to prevent outflow of capital. Large increases in U.S. rates are not required. An increase of one-quarter to one-half percent in the general rate structure might suffice to keep mobile capital at home and attract investment funds from abroad.

These are unpopular measures to discuss publicly, but it seems clear, as the subcommittee has stated, that actions of the kind undertaken to date "will not suffice to eliminate the payments deficit." We have been relying, for the most part, on palliatives in an effort to solve the problem in an easy way. The blunt fact is that the problem appears to be beyond solution short of measures which will cause some discomfort both at home and abroad.

The subcommittee report pins its greatest hope for eliminating the deficit upon an expansion of our trade surplus. So does the administration. Such an expansion is desirable, of course. I agree with the subcommittee that the Common Market countries should give us an immediate, unilateral reduction in their tariffs, but even if this were done I question whether our trade surplus would expand sufficiently—or in time—to close the payments gap before a crisis is upon us.

While I agree with much that is contained in the subcommittee's report, my strong feeling about the urgency of the balance-of-payments situation has compelled the submission of these additional views.

PRESCOTT BUSH.

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