244

THE UNITED STATES BALANCE OF PAYMENTS

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

EIGHTY-EIGHTH CONGRESS

FIRST SESSION

PURSUANT TO

Sec. 5(a) of Public Law 304

(79th CONGRESS)

PART 1

Current Problems and Policies

JULY 8 AND 9, 1963

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

21-415 WASHINGTON : 1963

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C., 20402 - Price 55 cents

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THE U.S. BALANCE OF PAYMENTS

MONDAY, JULY 8, 1963

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The joint committee met at 10 a.m., pursuant to call, in room 318, Old Senate Office Building, Representative Henry S. Reuss presiding.

Present: Senators Fulbright, Proxmire, Javits, Miller; Representatives Patman, Reuss, Griffiths, Curtis, and Widnall.

Also present: Senate Banking and Currency Subcommittee on International Finance: Senators McIntyre and Dominick; House Banking and Currency Committee on International Finance: Representatives Moorhead, Pepper, Wilson, and Halpern.

Staff members present: James W. Knowles, executive director; Gerald A. Pollack, economist; Donald A. Webster, minority economist; and Hamilton D. Gewehr, administrative clerk.

Representative REUSS. Good morning. The Joint Economic Committee will be in order. Chairman Douglas has asked me to chair this session of the Joint Economic Committee's continuing inquiry into the problem presented by our balance of payments and the international monetary and exchange position of the United States.

The Joint Economic Committee and its subcommittees have in the last 2 years spent a good deal of time on this subject and have issued specialized reports on the balance of payments and related problems in August 1961 and in December 1962.

This morning we are pleased to have with us Representatives of the House and Senate Banking and Currency Committees, specifically the International Finance Subcommittees of those two committees.

The reason for that is the obvious one that the Joint Economic Committee has no legislative jurisdiction. The legislative jurisdiction is lodged in the respective Banking and Currency Committees, and, because it is not entirely unlikely that the total study of the balance of payments in the future will include some attention to legislation, we thought it desirable to invite the members of the House and Senate Banking and Currency Committees here this morning and tomorrow morning and at successive sessions of the Joint Economic Committee's study of the U.S. balance of payments.

We have with us this morning the Honorable Douglas Dillon, Secretary of the Treasury. There will be with us later on Under Secretary of the Treasury Robert Roosa. We will proceed with the presentation of Mr. Dillon's very compendious statement which is at least partly in answer to a series of questions put to the Treasury some time ago by the Joint Economic Committee and its staff.

It is hoped that we can conclude our examination of Secretary Dillon today. If necessary, the Chair is prepared to go over into the afternoon session if all members haven't had a chance to present their questions. Under Secretary Roosa will be with us tomorrow. I understand that he has to leave for Europe sometime tomorrow afternoon. So, we will try to accommodate our questions to his schedule.

There is on the future docket of the Joint Economic Committee a session later this month at which we will hear representatives of the Brookings Institution who have just completed a 2-year-long study of our balance-of-payments problem.

Under the rule, after the presentation of Mr. Dillon's statement members of the Joint Economic Committee will be recognized for 10 minutes each, varying between the majority and minority side, and after that members of the respective House and Senate Banking and Currency Committees will be recognized for 10 minutes each.

If there are further questions after the first go-round, each member will be given additional time.

Mr. Curtis?

Representative CURTIS. I would simply like to state at the opening of the hearings that we on the minority side of the Joint Economic Committee are going into this subject with great interest. I would like to have inserted in the record correspondence that I have conducted on this subject with Secretary of the Treasury Dillon, which I have previously put in the Congressional Record. I think it will be useful material.

Representative REUSS. Would you identify the material?

Representative CURTIS. Yes. I have it here. It is the correspondence that I have had with Secretary Dillon on the subject of the balance of payments which has appeared in the Congressional Record.

Representative REUSS. Consisting of letters dated April 2, 1963, April 11, 1963, April 29, 1963, May 15, 1963, and May 21, 1963?

Representative CURTIS. Yes.

Representative REUSS. Without objection, the material offered by Mr. Curtis will be received into the record.

(The material referred to follows:)

HOUSE OF REPRESENTATIVES,
Washington, D.C., April 2, 1963.

Hon. C. DOUGLAS DILLON,
Secretary, Treasury Department,
Washington, D.C.

DEAR MR. SECRETARY: Part of the reason for the apparent improvement in the U.S. balance of payments over the past 2 years has been advance debt repayments by foreign governments of about $700 million in both 1961 and 1962. To the extent that advance repayments improve our current payments position, they eliminate a source of balance-of-payments credits in future years when the debts normally would have been paid. In this sense, foreign debt prepayments represent borrowing from the future.

It is my understanding that in 1962 the administration began using a number of additional techniques based upon the same principle of borrowing from the future in order to improve the current balance-of-payments position. Without the use of these new techniques, excluding debt prepayments, it is my impression that the balance-of-payments deficit in 1962 would have been as much as $3 billion, instead of the $2.2 billion reported. If debt prepayments also are considered, the deficit would have been over $3.6 billion or about as much as the average in the 1958-60 period.

Since these techniques have received little or no public attention, there is a widespread impression that our balance-of-payments position is steadily improving. In order that the Congress and the public have a clear idea of what progress actually is being made, I wish to set forth my understanding of these techniques and to ask for your comment.

One of the new techniques being employed is the sale to foreign governments of nonmarketable U.S. Government obligations denominated in foreign currencies. This technique accounted for an improvement in the balance of payments last year of $250 million. In 1963, an additional $279 million of these obligations have been sold. When these obligations are finally paid off, there will be an equivalent debit item in our balance of payments.

Another new technique which temporarily improved the balance of payments in 1962 by as much as $460 million, was the firm commitment of foreign funds for military purchases in the United States. This was achieved when the German Government, on January 1, 1962, deposited this amount to the credit of the U.S. Government. These funds, which were set aside for the eventual purchase of military supplies and equipment, thus showed up as a credit in the U.S. balance of payments in advance of firm orders for the equipment and supplies. Normally the German payments would have appeared as a credit only after the equipment and supplies had been actually ordered or delivered. To the extent that this is the case, any improvement in the balance of payments in 1962 from this source was at the expense of the balance of payments in a later year.

Finally, the balance of payments appears improved by about $100 million because the United States has paid its subscriptions to certain international organizations as they came due, not in dollars, but in non-interest-bearing, nonmarketable securities. Sometime in the future, the international organizations will exchange these for dollars. In other words, the debit in our international payments represented by these subscriptions has been postponed from 1962 until a subsequent year.

I will appreciate having your comments on these observations.

Respectfully yours,

THOMAS B. CURTIS.

THE SECRETARY OF THE TREASURY,
Washington, D.C., April 11, 1963.

Hon. THOMAS B. CURTIS,
House of Representatives,
Washington, D.C.

DEAR TOM: I am happy to reply to your letter of April 2.

The data on special transactions as given in your letter are of course correct. As you may know, the March 1963 issue of the Commerce Department's Survey of Current Business, published in the past few days, notes these various factors and discusses their effect on our balance of payments. Through this and other means we would hope that such information is receiving wide circulation, and thus helping to bring to the public generally a full appreciation of our balance-of-payments problem.

The receipt items you mentioned in your letter reduced our liquid liabilities to foreigners. The overall balance of payments deficit, measuring our gold losses and the changes in our liquid liabilities to foreigners, reflected this situation accordingly. The $100 million outpayments item, representing certain subscriptions to international organization in the form of non-interest-bearing notes, appears as a capital outflow in the balance of payments but will affect the deficit or change our liquid liabilities only when and as it is converted to dollars and spent abroad rather than in the United States.

There are, of course, special factors of this or other kinds almost every year. Very often, as you know, the comments that accompany publication of the balance-of-payments schedule call special attention to these items affecting individual categories or the payments schedule as a whole. You will recall the large amount of sales of jet aircraft and cotton sales in 1960 which was noted, at that time, as giving exports an unusual boost over the previous year. In 1959, a number of special factors were noted and included in the $435 million of debt prepayments which helped reduce the deficit that year.

In my view, these special transactions should not be considered as borrowing from the future. There are a number of contingent items which, in some sense, relate to the future both on the assets and on the liabilities side. For example,

our balance-of-payments deficit does not take into account the claims we are accumulating from the large outflows of U.S. capital, and such claims on the asset side are not stressed. Insofar as military offset arrangements are concerned, including advanced military payments, they do reduce the liquid liabilities of the United States since the funds are earmarked mainly against firm orders and are solely for military purchases in the United States. They represent, of course, the result of our efforts to offset our military expenditures abroad by specific arrangements for increased sales to those countries of U.S. military equipment.

But, in my view, the important and significant question deserving particular attention involves the amount of our payments balance that must be financed in one way or another over a given period. This question of financing seems to me to focus attention on the present problem and to center concern properly on the need to effect those correctives which alone can provide real and lasting improvement.

As you are aware, we are pressing forward on all fronts to gain those correctives; we shall, indeed we must, gain them. But the process will take time and the objective of a balanced payments position cannot be predated in any precise sense. This is so because we rely on the operation of free markets. The program we follow includes such fundamental factors as responsible public and private effort to restrain wage and price levels, the appropriate influence of interest rate levels, export expansion, and the fostering of an increasingly favorable investment climate at home.

While these forces continue to work to correct the situation, we have taken various measures both to curb Government spending of dollars abroad and to meet financing needs. In bridging the gap before balance is attained in ways consistent with a free trade and payments system, a whole complex of arrangements has been devised to assure that confidence in the payments system and in the United States dollar are maintained. I think that our efforts along this line have been quite successful in preventing speculative outbursts and in avoiding any disorderly exchange markets. This was the experience at the time of the stock market disturbances last spring, during the Canadian exchange crisis, and again during the Cuban showdown last year. In the process, the payments system has been buttressed by a series of financial arrangements designed to forestall or cope with any such pressures.

We must, of course, continue every urgent effort to overcome our balance-of-payments problem and thus to bring to a halt the presistent deficits that have characterized our payments position for too many years. With this thought that your letter conveys, I most heartily agree.

With best wishes.

Sincerely yours,

DOUGLAS DILLON.

HOUSE OF REPRESENTATIVES,
Washington, D.C., April 29, 1963.

Hon. C. DOUGLAS DILLON,
Secretary, Treasury Department,
Washington, D.C.

DEAR MR. SECRETARY: Thank you for your letter of April 11 in which you comment on questions about certain special transactions in our balance of payments which I raised in a letter to you of April 2.

I have noted the article in the March issue of the Survey of Current Business to which you referred. While passing reference was made to the special transactions in which I am interested, both the article and your letter do little more than arouse in me a desire to know much more about them.

I am, of course, pleased to know that my general understanding of these transactions is correct, but I would appreciate it if you could send me detailed information about them and the underlying circumstances. The specific transactions in which I am interested include—

(1) The sale to foreign governments of nonmarketable U.S. Government obligations denominated in foreign currencies;

(2) The advance commitment of foreign funds for military purchases in the United States; and

(3) The net transfer of non-interest-bearing, nonmarketable securities to certain international organizations as part of our capital subscriptions pending their need for cash.

Besides detailed information on these transactions, I would like the Treasury's estimate of what the balance-of-payments deficit would have been in 1962 without the use of these techniques as well as without the use of foreign debt prepayments.

In addition, I would like to know how the use of each of these techniques in 1962 will affect our balance of payments in later years.

Finally, with regard to (1) above, I would appreciate knowing the authority under which the Treasury is incurring nondollar debt and how this nondollar debt relates to the debt ceiling.

You make the point in your letter that "a whole complex of arrangements has been devised to assure that confidence in the payments system and in the U.S. dollar are maintained." It is precisely this "complex of arrangements" that interests me and that prompted my earlier letter.

It strikes me that unlike other special factors which affect the balance of payments almost every year, to which you referred, the special transactions about which I asked were devised by the administration in order to create an apparent improvement in the balance of payments in 1962 as well as to ease the immediate problem of the outflow of gold.

It is my impression therefore, that the conscious use by the administration of these special transactions reduced our balance-of-payments deficit significantly below what it would have otherwise been. Because of the nature of these transactions, it is also my impression that—like foreign debt prepayments—they represent a form of borrowing from the future.

I do not say that these transactions are undesirable. But I do believe that much more needs to be known about them before a judgment can be made and before it is clear what real improvement, if any, has been made in solving our balance-of-payments problem.

In view of the national interest in maintaining confidence in the dollar, I understand that this may be a sensitive area. At the same time, however, I believe that a clearer understanding of these transactions and their effects is important for the development of sound public policy.

As you know, the Joint Economic Committee is scheduling full committee hearings on the balance of payments next month or early in June. Your response to this letter and the testimony which will be given at these hearings should serve the highly useful function of shedding some needed light on these subjects.

With best wishes.

Respectfully yours,

THOMAS B. CURTIS.

THE SECRETARY OF THE TREASURY,
Washington, D.C., May 15, 1963.

HON. THOMAS B. CURTIS,
House of Representatives,
Washington, D.C.

DEAR TOM: In response to your further letter of April 29, I am happy to provide the more detailed information you requested regarding certain transactions which affected our balance of payments last year.

Our sales to foreign monetary authorities during 1962 of long-term nonmarketable U.S. Government obligations denominated in foreign currencies consisted of $200 million of 15-month lira bonds which were issued to the Bank of Italy and $51 milion of Swiss franc bonds with maturities of 15 to 16 months issued to the Swiss National Bank. Further details as to the terms and conditions of these transactions and the background and circumstances from which they evolved are contained in the enclosed press release and fact sheets, issued by the Treasury on October 23, November 5, and December 5, 1962, and on pages 10 to 16 of the enclosed report by Mr. Charles A. Coombs on "Treasury and Federal Reserve Foreign Exchange Operations" which was published in the March 1963 Monthly Review of the Federal Reserve Bank of New York.

Statutory authority for the issuance of these foreign currency series obligations is contained in section 16 of the Second Liberty Bond Act, as amended (31 U.S.C. 766). Moreover, such foreign currency series obligations bear the same relationship to the debt ceiling as any other public debt obligations.

The net increase during 1962 in funds committed by foreign governments for military purchases in the United States and counted in our balance-of-payments statistics as Government nonliquid liabilities to foreigners was about $450

million. As I indicated in my letter of April 11, these commitments of funds were a result of our efforts to offset U.S. military expenditures abroad by negotiating agreements with major allied countries for increased sales of U.S. military equipment and services and had been earmarked, mainly against firm orders, for use solely for military purchases in the United States.

A third type of transaction during 1962 reflected in our balance of payments as an addition to Government nonliquid liabilities to foreigners was a net increase of about $135 million in the funds held by certain international organizations as reserves in the form of non-interest-bearing nonmarketable U.S. Government obligations. The procedure of our paying capital subscriptions to these organizations, and their holding reserves, in this form until such funds are needed for actual disbursements to member countries is believed to be more realistic, and also more closely in line with the traditional balance-of-payments treatment of our bilateral foreign-lending programs, than the alternative course of treating all commitments of funds to these institutions as liquid liabilities which immediately add to our payments deficit.

While it might be of possible interest, for purposes of some particular analysis, to adjust the published amount of our overall payments deficit to exclude one or another of the above transactions or the $666 million of advance payments on Government loans which we received during 1962, I do not believe that any such calculation would really provide the most meaningful measure of our overall deficit. While each of these transactions did of course have a somewhat special character, this does not by itself appear to warrant our treating them differently from a great variety of other transactions of a more or less temporary or unusual character which from time to time also affect our international accounts.

As I indicated in my letter of April 11, our overall program for dealing with the balance-of-payments problem necessarily involves both a longer term program to bring about a lasting correction of our payments deficits, consistent with our traditional reliance on free market forces and encouragement of free international payments arrangements, and also a variety of shorter term measures to bridge the gap before this balance is fully attained. Moreover, it is essential that we meet the gross financing needs associated with our international payments in a way that will assure continued confidence in the U.S. dollar and the international payments system.

In carrying out this program, we fully recognize—as I know you do—that transactions of the kinds you have inquired about, however helpful their immediate effects on our payments position and on the international strength of the dollar, cannot of course be regarded as any substitute for the more fundamental and lasting correctives which I noted in my previous letter.

With best wishes,

Sincerely,

DOUGLAS DILLON.

HOUSE OF REPRESENTATIVES,
Washington, D.C., May 21, 1963.

Hon. C. DOUGLAS DILLON,
Secretary, Treasury Department,
Washington, D.C.

DEAR MR. SECRETARY: Thank you for your prompt and courteous reply to my letter of April 29, 1963, which posed certain questions dealing with three specific types of transactions affecting our balance of payments.

I feel that our correspondence has served a useful purpose in advancing public understanding of a complex and delicate subject matter, by casting light on some of the techniques devised by the administration to show an improvement in the balance of payments and to ease the immediate problem of the outflow of gold.

However, I believe that the Congress and the public would benefit from a further discussion and clarification of these special techniques and their present and future effects upon the balance of payments. It is my own belief that confidence in the dollar can best be maintained by full and frank disclosure of the facts.

We will have a further opportunity to consider the implications of the special transactions discussed in our correspondence when the Joint Economic Committee conducts its study of the balance of payments sometime this summer. I look forward to examining these subjects with you or other Treasury officials at that time.

Thank you again for your assistance in this matter and with very best wishes,

Sincerely yours,

THOMAS B. CURTIS.

Representative CURTIS. I have one other request which pertains to these hearings. On Friday, I introduced Concurrent Resolution 192 in the House of Representatives, which advocates that one of our national goals be the maintaining of a balance-of-payments equilibrium. I would like to have this resolution inserted in the record of these hearings, together with the statement which I issued at that time.

I understand Senator Javits is going to introduce a similar resolution in the Senate. If I may, I would like to have that also put into the record.

Representative REUSS. Without objection this material is received.

(The material referred to follows:)

[H. Con. Res. 192, 88th Cong., 1st sess.]

CONCURRENT RESOLUTION

Stating the sense of the Congress that achievement of balance of payments equilibrium is essential and that the United States should take the initiative in fostering an international balance of payments

Whereas the United States has had a deficit in its international balance of payments every year, except one, since 1950; and

Whereas largely as a result of these deficits, United States short-term dollar liabilities to foreigners totaled $25,300,000,000 at the end of April 1963; and

Whereas these liabilities constitute a potential claim against the United States gold stock of $15,700,000,000, of which less than $4,000,000,000 is "free gold" not required to serve as backing for our currency; and

Whereas the health of our domestic economy and strength of the dollar and its ability to serve as a key international reserve currency depends upon the early elimination of the balance-of-payments deficit and the creation of improved arrangements to serve the liquidity needs of an expanding international trade and payments system: Now, therefore, be it

Resolved by the House of Representatives (the Senate concurring), That it is the sense of the Congress of the United States that achievement of balance-of-payments equilibrium in a manner consistent with the dollar's role as a key international reserve currency should receive the highest priority in the formation of national economic policy; and be it further

Resolved, That the maintenance of equilibrium in its international accounts should be a continuing and major goal of United States international economic policy; and be it further

Resolved, That the United States take the initiative within the International Monetary Fund to devise new and improved methods of permanently strengthening the international monetary and credit mechanism in order to provide (a) improved means of financing balance-of-payments deficits until basic corrective forces restore equilibrium, and (b) sufficient liquidity to finance increases in world trade and payments once United States balance-of-payments equilibrium is achieved.

[S. Con. Res. 53, 88th Cong., 1st sess.]

CONCURRENT RESOLUTION

Whereas the United States has had a deficit in its international balance of payments every year, except one, since 1950; and

Whereas, largely as a result of these deficits, United States short-term dollar liabilities to foreigners totaled $25,300,000,000 at the end of April 1963; and

Whereas these liabilities constitute a potential claim against the United States gold stock of $15,700,000,000, of which less than $4,000,000,000,000 is "free gold" not required to serve as backing for our currency; and

Whereas the health of our domestic economy and strength of the dollar and its ability to serve as a key international reserve currency depends upon the early elimination of the balance-of-payments deficit and the creation of improved arrangements to serve the liquidity needs of an expanding international trade and payments system: Now, therefore, be it

Resolved by the Senate (the House of Representatives concurring), That it is the sense of the Congress of the United States that achievement of balance-of-payments equilibrium in a manner consistent with the dollar's role as a key international reserve currency should receive the highest priority in the formation of national economic policy; and be it further

Resolved, That the maintenance of equilibrium in its international accounts should be a continuing and major goal of United States international economic policy; and be it further

Resolved, That the United States take the initiative within the International Monetary Fund to devise new and improved methods of permanently strengthening the international monetary and credit mechanism in order to provide (a) improved means of financing balance-of-payments deficits until basic corrective forces restore equilibrium, and (b) sufficient liquidity to finance increases in world trade and payments once United States balance-of-payments equilibrium is achieved; and be it further

Resolved, That the President be requested to consider calling for an International Economic Conference to review the long-term adequacy of international credit; to recommend needed changes in existing financial institutions; to consider increased sharing of economic aid for development and military assistance; and to consider other pressing international economic problems placed before it by a prepreparatory committee for such Conference.

Representative REUSS. Secretary Dillon, we are delighted to have you with us. You have a comprehensive prepared statement and we would like now to have you proceed as you have in the past in your own way.

STATEMENT OF HON. C. DOUGLAS DILLON, SECRETARY OF THE TREASURY

Secretary DILLON. I welcome this opportunity to discuss with your committee the policies and programs of the United States aimed at restoring balance in our international accounts. The searching questions you have submitted to the Treasury focus on many of the key issues with which we must deal. I should like to touch upon each of them in my testimony today, although a number of them can be more fully covered by Under Secretary Roosa.

Your inquiry is particularly timely, for the data now becoming available for the first half of 1963 emphasize again that the path toward balance is not an easy one—that past progress can be no substitute for renewed effort—and that, while we have been able to buy time, there is no time to waste. In recognition of these facts, the Cabinet Committee on the Balance of Payments, established last summer by the President under my chairmanship, has for some months been conducting an intensive review of all aspects of our progress and programs. That review is nearly completed. The administration is now preparing a new detailed action program for the fiscal year that began this month—a program that will build upon and reinforce the policies introduced shortly after President Kennedy took office.

This discussion, by providing an opportunity to explore with you the varied aspects of our problem—a problem that cuts across so many vital national interests—will greatly assist us in making final decisions on appropriate and effective measures to meet our needs. After these decisions are approved by the President and announced, we will, of course, be glad to return and discuss them with you should you so desire.

In evaluating our progress over the past 2 years, a number of encouraging developments are evident. Our overall payments deficit has been reduced moderately from a peak of $3.9 billion in 1960, and an average of $3.7 billion in the period 1958–60, to $2.4 billion in 1961 and to $2.2 billion in 1962. This was achieved despite the higher level of imports associated with substantial gains in the domestic economy. Labor costs and prices have held steady throughout this period of rising activity, in sharp contrast to the pattern of developments within some other leading industrialized nations. And, there is reason for confidence that these emerging market forces—if supported and reinforced by well-conceived tax reduction and concerted effort by Government, industry, and labor—will in time restore solid balance-of-payments equilibrium.

But, the hard fact is that progress toward our goal of balance has been disappointingly slow and uneven over the past 12 months. When all special Government transactions are excluded, the deficit during the first quarter of this year was no smaller than the average quarterly figure for 1962.

We have been able to finance this continuing deficit successfully. But that task will rapidly become more difficult unless we can point to concrete evidence that we are making further significant inroads into the hard core of our deficit. And to achieve that necessary progress, our efforts directed toward improvement in every major sector of the balance of payments must be sustained and intensified.

DEVELOPMENTS IN OUR BALANCE-OF-PAYMENTS ACCOUNTS SINCE 1960

The nature of our problem is illustrated in the tables accompanying my statement, which summarize developments in the various sectors of our balance of payments since 1960.

As indicated by table 1, our overall surplus on goods and services—excluding those exports of both goods and services directly financed by our foreign aid programs—was about the same in 1962 as in 1960, at $4.3 billion. If allowance is made for the impact of the dock strike last winter, the results for the first quarter of this year were in line with 1962 experience. In 1961, however, this "commercial" surplus had temporarily moved considerably higher, to $5.3 billion.

The year 1961 was favorably influenced by a decline in imports, associated with the delayed effects of the 1960 recession. Subsequent recovery brought a sharp rebound in imports last year, and, as a result, our surplus on commercial merchandise trade alone was some $800 million smaller in 1962 than it had been in 1960, despite a growth of roughly $600 million in our commercial exports. This would indeed be discouraging, had we not foreseen the sharp increase in import requirements from recession levels which was quite consistent with past cyclical behavior. Even so, these data suggest the critical impor-

tance of further efforts to lift our export performance and widen our trade surplus.

Department of Commerce analysts have recently reported some tentative, but suggestive, indications that our competitive position in world markets is beginning to improve. Imports over recent months are running a bit below expected relationships to GNP, and exports are slightly above a level that might have been anticipated on the basis of trends in foreign business activity. But this evidence, welcome as it is, provides no ground for concluding that improvement in this area can be decisive in terms of our overall problem for the period immediately ahead. In this highly competitive world economy, that result can only be assured over a period of years by improved industrial efficiency, and by hard and imaginative effort by American business enterprise. And, industry must be supported by all the assistance in trade promotion and export credit facilities that Government can appropriately render, consistent with our firm commitments to the principles of freer trade and fair competition embodied in the General Agreement on Tariffs and Trade.

Meanwhile our surplus on commercial services has improved appreciably since 1960, fully offsetting the decline in our merchandise trade balance. This has been achieved despite a sizable increase in our tourist expenditures abroad, largely because of a rise of nearly $1 billion in 2 years in our annual income from private foreign investments. This flow of earnings exceeded $1 billion during the first quarter of 1963 alone, one reflection of the basic strength of our international investment position.

The outflow of dollars stemming from net Government payments abroad, plus net private long-term capital movements, as shown on table 2, declined in both 1961 and 1962, dropping from slightly over $6 billion in 1960 to $4¾ billion last year. However, this improvement was largely due to some special Government receipts. During the first quarter of 1963, this favorable trend was sharply reversed, as private long-term capital outflows rose sharply and the special Government receipts included in these figures ran at a much lower rate than during 1962.

Net military expenditures abroad declined by nearly $850 million between 1960 and 1962, largely because of a sharp rise in military payments to us by our allies. This rise in military receipts reflected agreements with certain of our allies providing for procurement of more of their equipment and supplies from the United States, helping to offset the balance-of-payments impact of the costs of maintaining our forces in their countries. However, a large portion of these military receipts during 1962 represented advance payments for military hardware to be delivered at a later date; similar advances were small during the first quarter of this year.

Meanwhile, the Defense Department has successfully held its gross spending abroad below 1960 levels. Vigorous economy efforts and increased emphasis on American procurement have been required to achieve this result in the face of the added costs related to the Berlin buildup in the fall of 1961 and to the substantial increases in local prices in areas where our troops are stationed.

At the same time, dollar outlays overseas for economic assistance have been held essentially level, while an increased total amount of aid

has been provided in the form of American goods and services. Roughly half of the gross Government grants and capital expenditures that appear in the balance of payments is inherently tied to exports of U.S. goods and services, under Public Law 480 programs and Export-Import Bank credits. Most of the remaining half is disbursed by the Agency for International Development. About 50 percent of the disbursements by AID (and under related small programs) in the calendar year 1962 is now estimated to have been provided in the form of U.S. goods and services, as compared with approximately one-third that took this form in 1960. This percentage will rise sharply in coming years. The Agency for International Development estimates that the proportion of its new commitments that will directly be reflected over a period of time in shipments of American goods and services reached a figure of more than 80 percent during the fiscal year 1963. This means that, in time, more than 90 percent of total Government grants and capital will finance U.S. exports.

The significant upward shift in the proportion of tied aid is probably the least known aspect of our entire balance-of-payments program. Many people who have suddenly recognized the grave significance of our balance-of-payments problem are urging that the way to stop the dollar drain is to cut out foreign aid. What we are doing instead is to see to it that, so long as we remain in balance-of-payments deficit, this country gives as much as possible of its aid in kind. When we can make our aid available this way, there is no shift of dollars to others, but instead shipment of goods produced here.

Your committee has inquired as to the actual net effect on the balance of payments of tying aid to American procurement, apparently having in mind that some of this aid (or other funds available to the recipient nation) may have been spent in the United States in any event. No one can pretend to answer that question with precision. But it appears to us, on the basis of our evaluations of the specific development programs financed by American aid, the types of goods involved, and the availability of alternative sources of supply, that a very large proportion of this aid, if not tied, would find its way into the reserves of other industrialized countries rather than result in exports from the United States. That is why we think it appropriate, in analyzing our export figures, to include only those shipments that are commercially financed. We recognize that some fraction of the aid-financed shipments might also have been sold on fully competitive terms, although virtually all recipients would have had to curtail imports sharply in the absence of assistance. Furthermore, it is important to note that some of the funds shown as dollar payments under economic aid in our balance-of-payments statistics—including the payments we make to international organizations—result in purchases of U.S. goods and services, and not in building up foreign reserves of dollars.

Taking these various qualifications into account, it is the best judgment of the AID agency that the figures I cited earlier about the amount of tied U.S. economic aid do not overstate the degree to which our economic aid in fact represents U.S. goods and services sent abroad, adding to what we would otherwise have sold commercially. Tied aid may be rightly viewed as an expedient to be abandoned when our international accounts return to equilibrium and other aid do-

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nors are prepared to follow similar policies. But, we believe it to be an essential tool for reconciling, during this difficult period, the imperatives of our balance of payments with an effective aid program directed toward vital foreign policy objectives.

Long-term capital outflows, also shown on table 2, moved somewhat higher in both 1961 and 1962, and then jumped sharply during the first quarter of this year, reaching a total of over $1 billion in only 3 months. This upturn, primarily due to an exceptionally large volume of Canadian borrowing in the New York market, is the largest single factor responsible for the lack of improvement in our overall accounts during the first quarter.

Moreover, the flow of foreign direct and long-term portfolio investment into the United States declined sharply in 1962 from levels already disproportionately low relative to similar U.S. investment abroad. There was a still further decline during the first 3 months of 1963.

Short-term capital, on the other hand, flowed toward the United States on balance during the first quarter. However, this was to some extent a statistical illusion. Definite signs of renewed outflow have been apparent each month since January, when a single large loan repayment combined with the usual reversal of year-end window dressing by European banks to cause a sharp, but temporary, improvement of some $200 million. This January inflow has been more than offset in succeeding months. For the first 5 months of 1963, the net recorded short-term outflow appears to have been about $200 million.

As shown on table 3, net recorded short-term capital movements were substantially smaller last year than during 1960, when funds flowed out in record volume, but were still uncomfortably large. Moreover, the interpretation of this downward trend in recorded outflows since 1960 is somewhat clouded by a rise over the same period in unrecorded outflows, which usually are thought to include a substantial element of short-term capital. Looking at the picture as a whole, it is evident that movements of short-term capital will continue to require very close attention in our efforts to move toward sustainable equilibrium.

Consistent with our objective of presenting these data to interested analysts as clearly and meaningfully as possible, certain revisions have recently been introduced in the official presentation of balance-of-payments data by the Department of Commerce. Accordingly, table 3, in summarizing the data, distinguishes between "regular" and "special government" transactions.

Broadly speaking, "regular transactions" are those public and private transactions responding to usual market forces and to well-established governmental policies here and abroad. The "special transactions" are those resulting from intergovernmental negotiations specifically arranged to ease the balance-of-payments situation of the United States. This category is comprised of foreign debt prepayments, advance payments on military exports, and sales of nonmarketable, medium-term Treasury securities to foreigners.

As table 3 shows, our balance on "regular transactions" showed considerable improvement in 1961, but approximately 60 percent of this improvement was lost in 1962 when the deficit on these transactions increased by over $500 million. During the first quarter of

1963, this balance remained at approximately the 1962 level. It is this pattern which points so clearly to the need for an intensification of our efforts to achieve a more competitive economy and to reduce the burdens on our international accounts from aid and defense to the maximum extent consistent with the vital national objectives toward which these programs are directed.

Meanwhile, we have had considerable success in arranging "special transactions" to narrow the gap in our payments, helping to carry us through this difficult period. These transactions totaled nearly $1.4 billion in 1962. But arrangements of this character, dependent as they are on the cooperation and confidence of our friends and trading partners and representing a charge on our future earnings, cannot be viewed as a substitute for substantial and early improvement in our trade, capital, and regular Government accounts.

Table 4 shows the manner in which our residual deficit has been financed—through the acquisition of additional dollars by foreign countries and international institutions, through net repayments by foreign countries to the International Monetary Fund in dollars, and ultimately through net sales of gold or convertible currencies. While the composition of this financing depends importantly on the position and policies of the countries whose surpluses happen, at any given time, to be the counterpart of our deficit, it is clear that each of these means of financing has played an important role over the past 3 years.

I should point out that the decline indicated in our net position vis-a-vis the IMF—that is, the increase in the Fund's dollar holdings—does not reflect any drawing on the Fund by the United States. Rather, it reflects the extent to which other countries, which in the past have borrowed dollars in large volume from the IMF in time of difficulty, have now repaid those drawings.

When a foreign country draws dollars from the IMF, it may use these dollars to finance its own deficit; as these funds pass from country to country, they may become a claim on our gold or must be absorbed in other ways. Conversely, as dollars are repaid to the Fund—as they were in a net amount of almost $1 billion over the 3 years 1960–62—these dollars, until drawn by other countries at some later date, are immobilized in the IMF. An equivalent portion of our deficit is thus financed without loss of gold or a buildup in dollar holdings of foreign countries. At the same time, under the rules of the Fund, our potential drawing rights are increased or reduced as Fund holdings of dollars decline and rise. As of last April 30, Fund holdings of dollars reached the amount of our dollar subscription—equal to 75 percent of our quota. Repayments cannot be accepted by the Fund in dollars beyond this limit. In other words, with minor technical exceptions, countries presently indebted to the Fund cannot now make repayments in dollars but must repay either in gold or other convertible currencies of which the Fund holds less than 75 percent of quota.

The final line of table 4 shows that our gold payments in both 1961 and 1962 were little more than half as large as in 1960. Our gold loss in the first 6 months of the current year has been running at a rate substantially below the 1961–62 level, and during this period the Treasury gold stock declined by $245 million. However, since

the volume of gold transactions customarily fluctuates substantially during the course of any 1 year, it is difficult to draw conclusions from the results over any few months.

One other fact deserves mention before leaving these tables. Transactions with Canada swung markedly against the United States during the first quarter of 1963, as compared with a year ago, when our position vis-a-vis Canada was unusually favorable. Between these two quarters, the swing against us was $360 million. This was largely due to the unusually heavy Canadian borrowings in the United States to which I referred earlier. This rate of borrowing is not likely to continue.

Meanwhile, our "regular transactions" with all other countries showed an improvement during the first quarter as compared to the same period in 1962.

TABLE 1.—*U.S. balance of payments, commercial surplus on goods and services, 1960 – 1st quarter 1963*

[In millions of dollars]

	1960	1961	1962	Change 1960-62 (improvement +)	1st quarter 1963 seasonally adjusted
1. Nonmilitary merchandise exports	+19,459	+19,913	+20,479	+1,020	+4,998
2. Less exports financed by Government grants and capital	+1,919	+2,237	+2,345	+426	+613
3. Commercial merchandise exports (1−2)	+17,540	+17,676	+18,134	+594	+4,385
4. Nonmilitary merchandise imports	−14,723	−14,497	−16,145	−1,422	−3,985
5. Commercial trade balance	+2,817	+3,179	+1,989	−828	+400
6. Private investment income	+2,873	+3,464	+3,850	+977	+1,005
7. Other nonmilitary service receipts	+4,307	+4,532	+4,801	+494	+1,180
8. Less services financed by Government grants and capital	+288	+430	+538	+250	+160
9. Commercial service exports (6+7−8)	+6,892	+7,566	+8,113	+1,221	+2,025
10. Nonmilitary service imports	−5,434	−5,436	−5,791	−357	−1,447
11. Commercial services balance	+1,458	+2,130	+2,322	+864	+578
12. Commercial surplus	+4,275	+5,309	+4,311	+36	+978

TABLE 2.—*U.S. balance of payments—Balance on Government assistance and long-term capital accounts, 1960 – 1st quarter 1963*

[In millions of dollars]

	1960	1961	1962	Change 1960–62 (improvement +)	1st quarter 1963 seasonally adjusted
1. Military expenditures	−3,048	−2,934	−3,028	+20	−741
2. Military cash receipts	+320	+398	+1,143	+823	+204
(of which advances on military exports)	(−16)	(+5)	(+470)	(+486)	(+23)
3. Government grants and capital outflows, gross	(−3,405)	(−4,056)	(−4,281)	(−876)	(−1,082)
a. Less transactions involving no immediate dollar outflow [1]	(−2,298)	(−2,940)	(−3,211)	(−913)	(−856)
b. Dollar payments abroad (3 −3*a*)	−1,107	−1,116	−1,070	+37	−226
4. Repayments on U.S. Government loans, excluding fundings by new loans	+585	+1,201	+1,182	+597	+128
(of which nonscheduled repayments)	(+48)	(+668)	(+666)	(+618)	(+25)
5. U.S. direct and long-term portfolio investments abroad	−2,544	−2,609	−2,766	−222	−1,013
6. Foreign direct and long-term portfolio investments in the United States	+430	+466	+271	−159	+28
7. Remittances and pensions	−672	−705	−736	−64	−217
8. Changes in Government liabilities [2, 3]	+1	(*)	+248	+247	+63
(of which sales of nonmarketable, medium-term nonconvertible securities)	(−)	(−)	(+251)	(+251)	(+63)
9. Balance, including special Government transactions [3]	−6,035	−5,299	−4,756	+1,279	−1,774
10. Balance, excluding special Government transactions [3]	−6,067	−5,972	−6,143	−76	−1,885

*Less than $500,000.

[1] Comprises principally U.S. merchandise and service exports, refundings of loans of U.S. Government and private U.S. lenders, and subscriptions to international institutions in the form of non-interest-bearing notes.

[2] Excludes liabilities associated with military transactions and with Government assistance operations.

[3] Excludes sales of nonmarketable, medium-term, convertible Government securities.

TABLE 3.—*U.S. balance of payments—Selected balances, 1960 – 1st quarter 1963*

[In millions of dollars]

	1960	1961	1962	Change 1960–62 (improvement +)	1st quarter 1963 seasonally adjusted
A. Regular transactions:					
1. Regular recorded transactions, excluding private short-term capital outflow [1]	−1,792	−774	−1,925	−133	−915
2. Recorded domestic and foreign private short-term capital	−1,438	−1,364	−623	+815	+42
3. Unrecorded transactions	−683	−905	−1,025	−342	−44
4. Balance on regular transactions	−3,913	−3,043	−3,573	+340	−917
B. Special Government transactions:					
1. Nonscheduled receipts on Government loans	+48	+668	+666	+618	+25
2. Advances on military exports	−16	+5	+470	+486	+23
3. Sales of nonmarketable, medium-term nonconvertible securities			+251	+251	+63
4. Sales of nonmarketable, medium-term convertible securities					+350
5. Balance A+B, excluding B.4	−3,881	−2,370	−2,186	+1,695	−806
6. Balance A+B	−3,881	−2,370	−2,186	+1,695	−456

[1] Differs from sum of line 12 of table 1 and line 10 of table 2 by the amount of Export-Import Bank fundings of U.S. private short-term credits. Though not a payment abroad and therefore not included in line 10 of table 2, these fundings are already reflected as receipts of private short-term capital in line A.2 of this table and must, therefore, also be included as Government outpayments in line A.1. During the periods in question they were: 1960, 0; 1961, 111; 1962, 93; 1963 1st quarter, 8.

TABLE 4.—*U.S. balance of payments—Residual financing of the deficit, 1960—1st quarter 1963*

[In millions of dollars]

	1960	1961	1962	Change 1960–62 (reductions in financing +)	1st quarter 1963 not seasonally adjusted
1. Residual financing of the deficit	−3,881	−2,370	−2,186	+1,695	−319
2. Increase in short-term official and banking liabilities and in foreign holdings of marketable U.S. Government bonds and notes (decrease −)	+1,737	+1,764	+653	+1,084	+287
3. Foreign private holders including banks and international and regional organizations (excluding IMF)	+289	+1,083	+200	+89	+376
4. Foreign official holders	[1] +1,448	+681	+453	+995	−89
5. Decrease in U.S. monetary reserve assets (increase −)	+2,144	+606	+1,533	+611	+32
6. IMF position	[1] +442	−135	+626	−184	−46
7. Convertible currencies		−116	+17	−17	−33
8. Gold	+1,702	+857	+890	+812	+111

[1] Revised.

THE OVERALL STRENGTH OF THE U.S. FINANCIAL POSITION

In appraising these recent flows, and the evident need for further action to reduce the deficit, I want to emphasize that the overall strength of our financial position is enormous, despite the decline in our gold stock and the increase in our liquid liabilities to foreigners. Today, the aggregate value of private investment holdings abroad by Americans totals over $60 billion. Nearly two-thirds represents direct investment in foreign enterprises—the kind of investment which can be expected to yield a steady increase in earnings over the years ahead. The increase in these private assets since the end of 1949, when our long series of deficits began, has roughly matched our loss of gold and the rise in foreign claims on the United States. At the end of 1962, investments by our private citizens in other countries, plus our gold stock, exceeded holdings of foreign countries and international institutions here—most of which are in relatively low-yielding money market instruments—by an estimated $25 billion, or about the same as in 1949. In 1957, before the recent period of larger deficits, the margin was only slightly larger. Moreover, these calculations do not take any account of the steady accumulation of the U.S. Government loans and investments abroad, which now total about $18 billion. Some of these Government funds, to be sure, may not be fully realizable in useful currencies, but in toto they do represent much of real value, and they serve to further bolster our long-run position.

THE BASIC APPROACH OF OUR BALANCE-OF-PAYMENTS PROGRAM

The basic philosophy and general approach which will continue to underlie our program for closing the deficit were first set down in the President's message to Congress on the balance of payments of February 1961. As he has made clear, our firm intent is to attain a satisfactory and durable balance in our overall payments by means

consistent with other basic national interests. We cannot seek solutions at odds with our traditional reliance on a decentralized free enterprise economy.

We must recognize the clear need for reducing unemployment and for more rapid economic growth at home. In our own interests, and those of other nations, international trade must be expanded rather than restricted. And we cannot abandon our central responsibilities of world leadership—for maintaining secure defenses, for contributing to the development of less favored nations, and for conducting our affairs in a way that will maintain freedom of capital movements and strengthen the fabric of the international monetary system.

These basic requirements, combined with the simple fact of our dominant role in world trade and finance, have meant that we could not either prudently or effectively utilize many of the simpler and more direct types of action by which other countries have sometimes dealt with their payments deficits. Currency devaluation, import restrictions, exchange controls, substantial restriction of credit designed to raise interest rates and reduce domestic consumption, or abandonment of our commitments for the protection of the free world are all out of the question. Instead, we have recognized that—

First, a satisfactory and lasting balance in our payments can be achieved only as substantial adjustments are made in countless transactions by our private citizens and business firms, each responding freely and vigorously to new market incentives and opportunities;

Second, these necessary market adjustments must be supported and encouraged by an appropriate fiscal and monetary environment, by effective Government trade promotion programs, and by firm discipline in the maintenance of price and cost stability;

Third, because the full benefits of these market adjustments will become evident only over a period of years, there is a continuing need to seek additional and more immediately effective reductions in, or offsets to, those large foreign payments that can be subjected to direct administrative action, particularly in the areas of defense and aid; and

Fourth, as a further means of assuring our capacity to deal with the immediate situation while our longer-term program is taking hold, we must pursue vigorously a wide variety of measures to assure adequate financing of our remaining deficits in a manner consistent with an improved payments system and the role of the U.S. dollar as an international reserve currency.

In its particulars, our program has encompassed a broad range of actions and policies, of widely varying character and timing. Its most important components have been, and will continue to be, measures that will improve the competitive position of our economy, not only in terms of efficient production at reasonable prices of the goods and services in demand in world markets, but also in terms of its attraction to capital, both foreign and domestic. Basically, this means a rapidly growing economy attractive to new investment—an economy in which our industry provides clear leadership to the world in product design and development, as well as in production methods. And it also must mean stability or reductions in costs and prices.

THE LONG-RANGE PROGRAM—TAX POLICY, COST AND PRICE STABILITY, EXPORT PROMOTION

The primary opportunity today for action of major and lasting importance to support these goals lies in the area of taxation. The investment credit enacted last year and our thoroughgoing administrative liberalization and modernization of the regulations governing depreciation have given a strong boost to the international competitive position of American industry. But more is needed. We must strike from our economy the shackles of wartime tax rates which were originally designed to curb excess demand and combat the strong inflationary pressures of the war and early postwar years. The 10 billion net reduction in personal and corporate income taxes recommended by the President will do just this. Not only is this tax reduction program the keystone of our effort to lift the growth of our domestic output and employment, but it has a direct bearing on our prospects for eliminating our balance-of-payments deficit.

Of course, one of the effects of any stimulus to domestic growth, whether induced by tax reduction or otherwise, will be some increase in imports to feed the production process and to meet the demand generated by higher incomes. But added investment in new plant and equipment, responding to the stimulus of tax reduction should help us to reduce costs through the installation of new and up-to-date machinery. And a rapidly growing economy will offer a favorable environment for the introduction of new products and for pioneering in new production processes. This will help make American businessmen more competitive not only in foreign markets, but also in our own home market, where we face substantial and aggressive foreign competition.

Even more important in terms of the balance of payments, tax reduction will greatly improve the investment climate in the United States. Incentives for the American businessman to utilize his funds in expanding facilities at home rather than abroad will increase. Foreigners are likely to respond to the increased opportunities as well, and securities of U.S. firms, attracting the increasing funds of foreign savers, could become one of our very best selling exports. At the same time, the huge flow of savings generated by American citizens will more readily find employment within our own borders, reducing the present spillover of surplus savings to other markets.

The ability to employ our savings fully, and to attract investment from abroad, fundamentally rests on the growth and profitability of our economy. There are indications that profit margins are now shrinking in Europe, under the pressure of rising costs. If we can improve the growth prospects and profitability of our economy, this should be a powerful factor favorably influencing the long-term capital account in our balance of payments.

The past year has seen important progress in reducing the tax incentives for direct investments abroad by American business. One of the substantial tax advantages of foreign investment has been the more favorable treatment of new investment through special tax credits and accelerated depreciation. The investment credit enacted last fall, which was limited to domestic investment, and our accompanying administrative reform of depreciation have gone a long way to remove this differential. Enactment of the corporate tax reduc-

tion recommended by the President will be a substantial further step in equalizing the tax status of investment at home and abroad—in fact, with a reduction of the corporate income tax to 47 percent, the tax incentive to foreign investment in most industrial countries as compared to domestic investment will have been so reduced as to be only a very minor element in business decisions to invest abroad.

The Revenue Act of 1962 also revised our laws so as to strike hard at the use of tax havens for purposes of tax avoidance. While it is still much too soon to be able to qualify the results of this action in balance-of-payments or revenue terms, there is evidence of declining interest in the establishment of new subsidiaries in tax haven countries.

In considering the relationship of our current tax program to the balance of payments, it is also important to point out that tax reduction will accomplish a needed redistribution, between fiscal and monetary policy, of the responsibilities for encouraging business expansion. Readily available credit is of little avail if the incentives are weak for using that credit to make new investment. But, when incentives to invest are strong, minor changes in interest rates may go relatively unnoticed, and the monetary authorities can have more freedom to influence those rates that are significant in terms of international capital flows.

You have inquired specifically as to whether a tax cut would require a tighter monetary policy to prevent a deterioration in our international accounts. To this in my view the answer is clearly "No." Under present circumstances, with our economy operating well below its capacity, and with high unemployment, the stimulus of the substantial tax cut we have recommended would not be inflationary. Consequently a tight credit policy designed to slow consumption and counter inflation would appear to be most inappropriate in the present setting. The relation of a tax cut to monetary policy is quite different.

As I will point out in detail later, there is strong evidence that a substantial portion of short-term capital flows are markedly sensitive to interest rate differentials. Because of this fact, and in the light of the size of our continuing overall balance-of-payments deficit, we must recognize the possibility that the monetary authorities may at some point feel obliged to take further action designed to influence those rates that are particularly significant for our balanced of payments. A tax cut would be most helpful in offsetting any possible adverse effect of such action on our domestic economy. To put it in a nutshell, my view is that a tighter monetary policy will not be required by the results of a tax cut, but that a tax cut would prove most helpful should the monetary authorities feel obliged to take further action for balance-of-payments reasons.

Tax reduction to improve our industrial efficiency and our balance of international investment flows must be paralleled by vigilant maintenance of wage and price stability. Our success in holding costs and prices steady during the current expansion has been gratifying. Over recent years, the annual rate of wage increase in manufacturing has dropped steadily, and for the past 2 years has been slightly below the yearly gains in productivity. That in turn has made possible a small decline in wholesale prices since 1960. Nevertheless, the major

test still lies ahead, as our economy returns closer to its full potential. That is why we have placed so much emphasis on the wage-price guideposts developed by the Council of Economic Advisers as an appropriate benchmark for evaluating the longer-run behavior of wages and prices—recognizing at the same time that any tendency for productivity to exceed wage gains, when accompanied by a parallel fall in prices, would help speed the needed process of adjustment.

Finally, to be sure that our improving competitive position is translated as quickly and fully as possible into growth in our trade surplus, we must also provide all appropriate governmental stimulus and assistance to the actual process of exporting. Many more American businessmen must be made aware of the large and profitable opportunities offered by foreign markets. They should be assisted with all the market information that government can provide, and with intensive official promotion of American products abroad. And they must continue to be provided with ample facilities for export financing, fully comparable to those available in the other industrialized countries.

Our programs aimed at these objectives have already been greatly expanded, and we anticipate that the results will be cumulatively favorable as more and more American firms are brought into contact with export markets. However, I might note at this time that the House of Representatives just last month failed to approve the appropriations requested by the Department of Commerce to strengthen these efforts to stimulate our exports. I earnestly hope that the comparatively small amount of funds involved, less than $6 million in all, will be restored by the Senate and included in the final appropriation bill—for it surely will be returned to us many times over in additional earnings from exports. Failure to approve these funds can only insure a smaller trade surplus and a larger deficit in our balance of payments.

Effective action in these three areas—tax reduction, price and cost stability, and an intensified export effort—provides the core of our longer-run program to restore balance in our international payments. In addition, in view of the trenchant analysis in the March report of your committee, I need not emphasize here the importance of successful trade negotiations to assure that foreign markets are open to our products and I will not discuss this problem further today.

But these measures will necessarily require time to take effect through the working of market forces; their impact on our international payments is as yet insufficient; and it would not be possible or prudent to rest on these actions alone.

MORE DIRECT GOVERNMENT ACTION TO REDUCE AND FINANCE THE DEFICIT

This is why we have undertaken a great variety of more direct actions that promise prompt results. While some of these measures will be of value for years ahead, others provide only temporary benefits, or would not be desirable as permanent programs. But all of them are urgently necessary today to achieve a reduction in foreign expenditures, to provide additional foreign receipts, or to facilitate the financing of our deficits in a manner which will strengthen rather than disturb the world payments system.

As I suggested earlier, methods of reducing foreign exchange costs in the two largest areas of governmental foreign expenditures—military spending and foreign aid—have been pursued vigorously. But further progress must and will be made. As we review these programs intensively, opportunities for additional savings are being found, without jeopardizing essential national security objectives. In addition, we are subjecting the foreign transactions of every other Federal agency to a periodic screening and justification procedure centered in the Bureau of the Budget.

While the total of these expenditures is not nearly so large as those for defense and aid, moderate further balance-of-payments savings will be possible in this area. New international marketing procedures by the Department of Agriculture—as, for example, the new cotton auction program—can also be expected to make a significant contribution.

No less significant are satisfactory arrangements for the residual financing of the deficit, and ample protection for the dollar against speculative pressures or other emergencies. In developing facilities for these purposes, we have also been alert to their implications for longer-range strengthening of the international monetary and payments system. I shall touch only briefly on our actual operations in this area, but Under Secretary Roosa will be prepared to discuss them extensively.

Prepayment of debt has reduced the deficit by about two-thirds of a billion dollars in each of the years 1961 and 1962. These payments have been mutually beneficial. They provide a capital inflow into the United States that is definite and final. From the point of view of the surplus country, these repayments, eliminating holdings of dollars that at the time are excessive, avoid a future stream of payments that might fall due at less opportune times. When there are traditional or other pressures to maintain a particular ratio of gold to dollar holdings in official reserves of some countries, these debt prepayments also serve to avoid unnecessary movements of gold. The sale of medium-term Treasury securities to foreign monetary authorities can serve somewhat similar purposes, although these transactions do not have the permanence of debt prepayment. A special feature of these securities is that they can, where both countries consider this appropriate, be denominated in the currency of the lending country. These securities thus provide surplus countries a third alternative to gold or dollar-denominated securities in making use of their dollar accruals. The foreign currency issues must still be considered experimental, and their future depends in large measure upon the response which they evoke from the leading official holders of dollars. But, there are $630 million of these special foreign currency medium-term issues outstanding at the present time. Without the introduction of this instrument, transfers of gold into foreign reserves would probably have been substantially higher.

In addition to these arrangements, the Federal Reserve has further developed its network of reciprocal currency agreements, providing foreign exchange facilities to either party if needed to meet temporary strains. The aggregate of these "swap" facilities now totals $1,550 million.

THE ROLE OF BILATERAL AND MULTILATERAL ARRANGEMENTS

All of these bilateral arrangements are further buttressed by the resources of the International Monetary Fund, which can provide credit in case of need on terms of 3 to 5 years. The resources of the Fund were supplemented during 1962, when the necessary ratifications were completed to establish the special borrowing arrangement agreed to by 10 of the leading industrialized countries. This arrangement makes up to $6 billion of supplementary resources available to be used, if needed by any of the participating countries, to meet threats to the stability of the international payments system. Of these resources, $4 billion are available in currencies other than U.S. dollars, importantly bolstering the ability of the Fund to meet sizable drawings without exhausting its supply of usable currencies.

Thus, bilateral and multilateral facilities are playing complementary roles in meeting our needs—and the needs of other nations—for liquidity and credit resources. Because of the particular nature of the problem facing us, our main effort over the past year has been to strengthen these facilities through bilateral arrangements that could be selectively tailored to meet immediate needs.

Our deficits have a counterpart in surpluses in other countries, but these surpluses have not been evenly distributed, nor are their size and location predictable. With one or two exceptions, the surpluses have tended to concentrate first in one country and then another. The countries which happen to be experiencing these surpluses at a given time are also those which are accumulating dollars, often beyond their immediate needs, thus creating pressure to turn these surplus dollars into gold. The flexibility of bilateral arrangements makes them particularly appropriate and useful in reducing these pressures, inasmuch as they can be directed more precisely to the point of need. Moreover, certain techniques—repayment of debts, for instance—can only be arranged on a bilateral basis.

Multilateral arrangements, on the other hand, are more useful—I should say essential—whenever it becomes desirable or necessary to strengthen the international payments system as a whole by adding to international liquidity generally. As the President stated in addressing the annual meeting of the International Monetary Fund and the World Bank in Washington last year, and as he confirmed last month in Europe, the United States welcomes continuing study of methods to improve further the functioning and stability of the international monetary system. The financial ministers of the 10 countries participating in the special IMF borrowing arrangement also stated last September that they were ready to contribute to such studies.

Clearly, it is important, even while the pressures of our own imbalance are still upon us, to examine carefully all manner of proposals that may be useful to us, and to the world, once the current imbalance has been corrected and new problems emerge. But these global plans cannot and should not be regarded as specific correctives for our present problems. I should also point out that there is widespread agreement that no general shortage of international liquidity is evident at the moment. That is partly because of the special resources arrangements in the IMF, in the establishment of which the United States took the lead during 1961 and early 1962. But it also

seems clear that the time will come when new facilities or arrangements will be required to insure for the future an adequate overall growth in monetary reserves and credit availability.

This problem has already been studied very carefully by your own subcommittee and I hope that your studies continue. Similar studies are in process, of course, within the administration, as well as in most of the other leading countries and international organizations.

The path ahead is not clear and much further work will be required, but experience with the even more difficult problems following World War II gives one confidence that as the nature and magnitude of future needs become clearer to most of us, ways to cope with those needs can and will be developed. The international payments system has evolved remarkably well since the days of Bretton Woods, and this process of evolution toward a stronger system has certainly not been completed.

But as I have already noted, in considering the long-run need for improvements in the international payments mechanism we must avoid the error of thinking that the solution to our present balance-of-payments difficulties can be found in such improvements. No international payments system will relieve countries of their individual responsibilities to achieve balance in their international payments over a reasonable period of time. It is, of course, most important that there be an adequate amount of reserves, suitably distributed, to allow a reasonable period of time during which the adjustments needed by any particular country can be made. The United States is prepared to work with other countries to strengthen and improve the international payments mechanism in this direction. But such efforts will be doomed to failure if other countries feel that we look upon them as a means of avoiding the steps we ourselves must take now to bring our payments into balance.

Nor can we afford to delay in the illusion that some system of flexible exchange rates may somehow offer a painless and acceptable method of adjustment. Visionary proposals of this kind, which I know have been brought to your attention from time to time, ignore the basic fact that the world payments system today—and with it the prospects for expanding trade—rests upon the interchangeability of gold and the dollar at a fixed price, and confidence in the stability of other leading currencies. A regime of flexible rates among the major trading nations has never, through the years, successfully met the test of use and experience. The cost in greater uncertainty, disruption of the highly integrated world trading community, and a lessened flow of trade and investment would be far too high a price to pay. The United States, together with every other leading nation, is for that reason fully committed to preservation of the system of fixed exchange rates as the essential underpinning for freely flowing and expanding trade. That commitment is embodied in the Bretton Woods Agreements.

CAPITAL FLOWS AND INTEREST DIFFERENTIALS

In addition to developing facilities for financing our deficit and working toward a stronger payments system, the United States has over the past 2 years participated to an unprecedented degree in

active and extensive debate, discussion, and consultation with the other industrial countries on national economic policies affecting mutual international objectives. This has been particularly true with respect to factors affecting the international movement of long-term and short-term capital.

It is evident in these discussions that European financial circles feel that the differentials between the higher interest rates prevailing in many West European countries and those in the United States are contributing importantly to the outward flow of capital from this country, and that these differentials should be narrowed. For our part, we have recognized that there is a considerable sensitivity of movements of short-term capital to interest rate levels in the various leading countries—a sensitivity that has repeatedly been confirmed by those in close touch with the market, and is often observable in reported data, despite the variety of other influences at work at any time.

I would like at this point to address myself in some detail to your question relating to the degree of sensitivity of short-term capital movements to interest rate differentials. Our conclusion, after studying this matter intensively, is that there are substantial sums of liquid funds that are potentially sensitive to differentials between interest rates here and interest rates in the Euro-dollar market, and also between rates here and those on British and Canadian Treasury bills and on other short-term paper in those, as well as in continental European, money markets. This is particularly true when the forward exchange rates fail to offset most of the actual interest rate differential. Financing of third country trade through acceptances also appears rather sensitive, while bank loans to official borrowers or preferred customers and financing of American exports appear much less so.

Despite much that has already been accomplished through cooperative action, both in keeping our short-term rates at somewhat higher levels and in keeping foreign money market rates as low as practicable, existing differentials are still causing substantial outflows of the more sensitive types of capital. Much of the outflow in April and May, for instance, appears to reflect increased deposits of American firms in Canadian banks and a sharp increase in American acceptance financing of trade between foreign countries. To illustrate the problem, the pull of the Euro-dollar market—with 3-month money returning just under 4 percent in London—is apparent; prevailing yields for roughly comparable types of money market instruments in New York are around 3¼ percent. While existing differentials with respect to most of the important foreign markets are not large, it is important that we continue to do all that is reasonable to narrow them further in order to reduce significant outflows, and perhaps in time reverse the direction of some of these flows.

I am aware of the fact that the only detailed study heretofore submitted to you—that made last summer by Professor Bell—has been interpreted as indicating a lack of interest rate sensitivity in overall short-term capital movements. This is an area that has until recently received comparatively little study. This is perfectly understandable since the free and large-scale movement of short-term capital dates

only from the end of 1958, when the currencies of most of the major industralized countries became convertible.

The Treasury has, of course, had a close interest in this matter for some time. In order to increase the availability of information regarding capital movements, and thus facilitate improved understanding and knowledge, the regular reporting forms for banks and nonfinancial institutions have been modified and improved. A supplementary form for nonfinancial institutions was introduced last fall and revised forms for banks were introduced about a month ago. We expect much new and hitherto unavailable information from these new forms.

In a further effort to broaden the content and coverage of our balance-of-payments statistics and to improve their presentation, the Director of the Bureau of the Budget has recently appointed an eminent committee of business and academic economists to study all aspects of our balance-of-payments statistics. This committee is chaired by Dr. Edward M. Bernstein and is due to file its report next spring after a full year of study.

Paralleling our work on the new reporting forms, we also undertook early last summer a staff study to examine short-term capital movements as fully as possible with the available data. We engaged an outside consultant to assist us—Prof. Peter B. Kenen, of Columbia University. This study was completed last fall, and indicates a clear sensitivity of certain short-term capital movements to interest rate differentials. We will be glad to make this technical study available to the committee if you so desire.[1]

Representative REUSS. May I interrupt at this point, Mr. Secretary. Yes, we would so desire. Do you have it handy?

Secretary DILLON. Not right here, but we will bring it in by tomorrow. I do not have it with me.

Representative REUSS. Since it is close to being the meat in the coconut, we might like to have it this noon, if possible.

Secretary DILLON. We will try, Mr. Chairman.

Representative CURTIS. Will you have enough copies?

Secretary DILLON. Yes; we will have enough copies.

Since the completion of this staff study, the sensitivity of short-term capital flows has been confirmed by a detailed investigation which has just been completed by Benjamin J. Cohen, of the Balance of Payments Division of the Research Department of the Federal Reserve Bank of New York. This report, which the bank has authorized us to furnish to your committee, attempts—successfully, in my opinion—to reconcile the apparent divergencies in the Treasury-sponsored and Bell studies.[1]

Representative REUSS. Mr. Secretary, can you furnish us with that, too?

Secretary DILLON. Yes, sir.

Representative REUSS. The same basis?

Secretary DILLON. The same basis.

Representative REUSS. Thank you.

Secretary DILLON. It points out that short-term capital movements include a wide variety of capital flows, some of which are sensitive to interest considerations and others not. It further shows that those types of flows in which our study found a close correlation with interest rate differentials are precisely the same flows for

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[1] These two reports have been reproduced at the end of the record of these hearings. See Kenen report, p. 153, and Cohen report, p. 192.

which Professor Bell was unable to find any correlation with trade movements.

The types of short-term flows which these studies indicate are sensitive to interest rate differentials include the following:

1. Dollar claims of nonfinancial concerns on Canada and Europe;
2. Foreign currency claims of banks and nonfinancial concerns on Canada and Europe;
3. "Other" bank-reported short-term claims on Canada and Europe; and
4. Errors and omissions for all areas combined.

These four items accounted for between $1.2 billion and $1.4 billion of our overall balance-of-payments deficit during each of the 3 years 1960–62 when interest rate differentials favored Canada and Europe. In 1959, on the contrary, when interest rate differentials were favorable to the United States, these same four items accounted for an inflow of funds that reduced our overall deficit by some $500 million. A sizable part of this difference may be attributed to the interest rate factor.

The New York Federal Reserve Bank study suggests that a reasonable reduction of the current differential in short-term rates would be likely to improve our annual balance of payments by $500 million or more. In addition, this study shows that private foreign holders of dollars are strongly influenced by interest rate differentials. This would not affect our balance of payments figures but would substantially reduce the gold drain, since private foreign holders would retain their dollars in larger amounts rather than turn them over to official holders who alone have the right to convert them into gold.

One more piece of confirming evidence is available. Since last fall a few large banks have reported to the Federal Reserve on a confidential basis the totals of their short-term transactions involving transfers to Canada and the United Kingdom on a fully covered basis. Such transfers are clearly interest induced and have continued at a substantial pace throughout the first 6 months of this year. The sample, which makes no pretense of being complete, shows over $220 million of such transfers so far this year.

For all these reasons, we are convinced that substantial amounts of short-term flows are sensitive to interest rate differentials. This opinion is also fully supported by the unanimous views of those here and abroad who actively deal in foreign exchange on a daily basis. Mr. Roosa will be glad to answer in full any questions you may have on this highly important, but rather technical, subject.

In the case of long-term portfolio investment, on the other hand, the effects of interest rates are much less clear. Such studies as have been made, mostly by various Federal Reserve banks, fail to show any consistent correlation between the volume of U.S. purchases of foreign long-term securities and existing long-term interest rate differentials. However, these studies do show that whenever long-term rates in the United States are relatively high, as in 1959, portfolio purchases tend to decrease. In spite of these inconclusive findings, European authorities are categoric in their views that our present long-term rates, which are substantially below those in Europe—except only for Switzerland and the Netherlands—are largely responsible for the increasing volume of foreign long-term

borrowing in our markets. Thus, while there is evidence on both sides regarding the sensitivity of long-term portfolio investment to interest rates, it seems clear that interest rates are not by any means the only factor involved.

The ready availability of American capital and our well-developed market facilities are also important. As I pointed out in Rome over a year ago, our balance-of-payments problem limits the amount of long-term portfolio capital which we can prudently supply to others. It is essential for other industrial countries to develop their own capital markets so that they can do a more complete job in meeting their own requirements. While the last year has seen some progress in this direction—most notably in Germany, Italy, and perhaps now in France—it has not been adequate and the demands on our markets are still much too heavy. Mr. Roosa will be glad to furnish you with fuller information on the state of the various European capital markets and on the progress that has been made during the past year.

Looking at our payments as a whole it is clear that if we are to achieve balance there must be a substantial reduction in the net outflow of long-term portfolio capital as well as a reduction in the outflow of short-term funds. One means of approaching this objective is to see to it that our capital market is utilized to mobilize foreign savings to the maximum extent possible—that is, we need to export securities as well as goods, and to take advantage of the interest of foreign investors in new dollar issues. We have noted that a large part of the extensive recent activity in new foreign issues has been carried out through private placements. These private placements, many of which are Canadian issues, normally foreclose the possibility of foreign participation that always exists in a public offering. We have urgently invited the financial community to explore this problem further in the hope that it will be feasible for them to make wider use of public offerings.

CAPITAL FLOWS AND OUR POSITION AS WORLD BANKER

On the subject of longer-term capital flows and interest rates, I would like to make two general points of basic importance. First, purchases of foreign securities are a very small fraction of the very large total of $50 to $60 billion that is annually placed in mortgages and other long-term securities in this country. With confidence in price stability restored, the willingness of savers to place money at savings institutions and to commit funds for longer-term investment is growing, and interest rates have been reflecting this increase in savings. Long-term interest rates in this country may well respond over time to growing investment demand in the normal market manner. However, the approach taken in some quarters abroad that a drastic effort should be made by public policy to raise the entire structure of long-term interest rates by a sizable amount in an effort to slow down the outflow of long-term capital does not seem to me to be realistic. It fails to recognize both the practical difficulties of reversing the current pressure of savings flows seeking investment outlets in this country, and the great hazards for the domestic economy implicit in any such attempt.

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My second point concerns our position as world banker, and your question concerning the applicability of exchange controls on capital flows to our situation. Exchange controls would directly violate one of the precepts upon which our whole effort is predicated—that, in our economy, we must rely primarily upon decentralized decision-making by millions of individuals and businesses responding to market forces. Government, to be sure, must accept the responsibility for influencing these market forces in ways consistent with national objectives, but always without attempting to direct individual transactions.

Moreover, a partial system of exchange controls would soon break down as funds flowed through uncontrolled channels—spurred by the fear of still further controls. In the end, a complete system of exchange controls would be required. This would seriously prejudice the position of the dollar as the world's chief reserve currency, would tend to shrink world liquidity and reduce the volume of world trade, thus bringing in its train grave dangers of a worldwide economic recession. For these reasons, the institution of exchange controls, even though supposedly applicable only to certain types of transactions, is not practicable or acceptable policy for the United States.

Instead, we must continue to meet our special responsibility as world banker. Essentially, this is to pursue policies that assure maintenance of the stability of the dollar free from exchange controls. In return, foreign countries have freely and willingly provided us with huge resources—aggregating some $21½ billion in liquid dollar balances alone. The rise in these balances of over $15 billion since 1949 has financed 58 percent of our cumulative deficits over the past 13 years. Had it not been for our position as banker to the world, this credit would not have been extended to us, and we would long ago have been faced with the hard necessity of curtailing imports, reducing foreign investment, and cutting into the substance of our defense and aid spending abroad.

THE SURPLUS COUNTRIES

In assessing the outlook for our balance of payments, we must also look at developments in the surplus countries. The surpluses that are the counterpart of our payments deficit have for the most part been accruing to the other industrial countries of continental Western Europe. Orderly and constructive elimination of payments imbalances requires that these surplus countries accept a responsibility for pursuing policies which will reduce their surpluses, thus paralleling U.S. efforts to eliminate our deficit. These countries should continue to eliminate trade barriers which discriminate against our exports. In addition, it would be appropriate for them to work toward lower interest rates, particularly long-term rates, offsetting the effects on domestic demand, if need be, by restrictive fiscal measures. And, finally, it would be helpful if these countries would continue to share more fully in the burdens of providing for our common defense and of assisting in the development of less fortunate areas of the world.

Balance-of-payments surpluses have very real advantages for Western European countries, but they create some problems as well. In particular, they contribute to inflation in these countries, and this

inflationary impact is not limited to the purely financial implications of the surplus. A balance-of-payments surplus is inherently inflationary, when in a time of general labor shortage and pressure on available resources, more goods and services are sold outside the economy than are imported.

As a result of pressures generated in part by these surpluses, combined with a general shortage of labor, wages and prices in Europe have been rising for the past few years far more rapidly than in the United States, unit costs have been increasing, and profit margins have declined. This offers us an opportunity to compete more effectively. But it would be foolhardy to expect European authorities to sit back and permit this inflation to proceed unchecked.

European governments are already exerting themselves to restrain wage increases through what has come to be known as "incomes" policy. However, the natural inflationary forces are so powerful that their efforts have only succeeded in somewhat moderating the tempo of the inflationary process. Should this process proceed to a point where European countries find their balance of payments to be endangered, we can expect them to take strong action irrespective of the domestic consequences. However, a general disappearance of European balance-of-payments surpluses would almost inevitably mean the simultaneous disappearance of our deficit. Meanwhile, the continuation of this moderate inflationary tendency in Europe gives us an opportunity to bring our own payments into balance, thus laying the essential groundwork for the strengthening of the whole international payments system. But this opportunity must be seized. And we must be prepared to take those further actions that our needs require. For it is clear that further action and renewed impetus are needed to improve each of the major sectors of our balance of payments—our trade balance, government expenditures abroad, and the capital account.

THE NEED FOR FURTHER ACTION

In view of the broad authority and influence of this committee on the economic policy of the Congress, I should like to take advantage of this opportunity to stress with all the conviction I can summon the indispensable importance of decisive action by the Congress to enact during this session a program of tax reduction and revision along the lines generally proposed by the President at the beginning of this year.

The continued progress in our economy since that time, as measured by the increase in gross national product and other indicators, serves to accentuate rather than diminish the desirability and feasibility of that forward step. This progress in some part is built on expectations by businessmen of the dynamic stimulus to investment and consumption inherent in the tax program. Should it fail of enactment, the frustrations of these expectations might well arrest the progress and invite a recession. Moreover, this progress, promising increased revenues for the fiscal year 1964 over those earlier estimated in the President's January budget, complemented by reductions in projected appropriations by the President and the Congress, should ease the concern of those who were troubled by the size of the deficit as originally projected for fiscal 1964.

The passage of the tax program, by adding to the momentum of an advancing economy, offers the greatest opportunity in years to move our economy to full employment. Despite our recent progress, the rate of unemployment has remained undiminished; last month it was slightly higher than in June a year ago. While our labor force increased over the year by 1,200,000 and only 800,000 new jobs were created. Yet, the Nation is a year closer to its responsibility to provide work for the floodtide of youth born in the aftermath of World War II. Twice as many jobs must be created in each of the remaining years of the sixties as have been created in the last 2 years of an expanding economy if we are to meet the mandate of the Employment Act of 1946.

The boiling over of racial tensions witnessed in recent months should not impair the priority of the tax program on the legislative agenda. For who can doubt that an overriding element in the quest for equal opportunity and in the frictions resulting thereform is the need for jobs and the chance to provide a better standard of living, housing, and education for Negro and white alike. Discrimination is not likely to be dissipated by pushing whites out of jobs for Negroes, but rather by creating adequate job opportunities for both.

And, finally, for reasons I have analyzed briefly in my statement, the enactment of the tax program is central to our basic objective of achieving balance in our international accounts and maintaining confidence in the dollar. A vigorous, dynamic, and growing American economy is the necessary backdrop for achieving the sharp competitive edge that will increase our trade surplus—for reaching demand and profit levels that will invite the increasing investment that will bring our two-way capital flows into better balance—for assuring our friends abroad that putting dollars to work earning interest and profits is preferable to exchanging them for gold.

To meet both of our national economic objectives—growth and full employment at home, and a balance in our international payments—and to meet them simultaneously, within the framework of a market economy, clearly requires further effort. We cannot expect our problems to yield easily, but a solution is within our grasp.

To those who urge that balance of payments be given the top priority, as well as to those who urge that domestic growth be an exclusive preoccupation, I can only reply—we cannot achieve one without the other—we must achieve both if we are to be true to our national purpose and our international obligations.

Secretary DILLON. Thank you, Mr. Chairman.

Representative REUSS. Thank you, Mr. Secretary.

We will now proceed under the 10-minute rule to explore the many points raised in your paper.

Mr. Secretary, the Joint Economic Committee has for 2 years now been urging that the United States, in order to get control of its international monetary situation, both during the time when it was rectifying its payments imbalance and after that was done, promptly seek a payments agreement with the leading industrial nations of the world which would have the effect of neutralizing destabilizing short-term capital movements and which would finance temporary deficits arising from more basic factors.

The administration has not agreed with the recommendation of the Joint Economic Committee, and, so far as I know, no steps in that direction have been taken. I was encouraged to see that President Kennedy said, in his notable speech in front of the Paulskirche in Frankfurt last week—and I am quoting—"The great free nations of the world must take control of our monetary problems if these problems are not to take control of us."

I am wondering, does this mean that the administration has now decided to embark upon a new initiative, along the general lines of the recommendation of the Joint Economic Committee, that the time has come to ask our leading industrial partners to shoulder on a multilateral basis the destabilizing effects of payments movements?

Secretary DILLON. I will be glad to answer that. It is an important question. Certainly we would not agree with the thought that nothing has been done to handle destabilizing movements of short-term funds. In fact, I think the arrangements that have been concluded in the last 2 years have very well taken care of that problem.

These arrangements include the large swap facilities that have been developed by the Federal Reserve System. They include the cooperation which has developed between the central banks with respect to foreign borrowings.

This has been evident in the way that speculative pressures on the pound sterling were handled rather rapidly and effectively. It was indicated by the way problems were handled with Canada last year. It was indicated by the fact that nothing much happened in connection with the U.S. dollar at the time of the Cuban crisis last fall.

The strengthening of the IMF and the special borrowing arrangements were an integral part of that.

The other part of your question is the one that I think has more immediate bearing on our situation, which is what can be done to insure that adequate time and amounts of funds—credit—can be available which will allow time to take care of the more fundamental difficulties.

Representative REUSS. If I may interrupt, that was my question. I don't mean to disparage the swaps, the foreign borrowings, the other things which have been done. But the proof of their less-than-full adequacy, it seems to me, is in the fact that we still are badly exposed in the international monetary field, and we find that this keeps us from doing things which we otherwise would like to do to restore the momentum in our domestic economy and cure the unemployment that you have so eloquently referred to.

So the question is: In addition to these things that have been done, what about an international monetary agreement, adequate in amount, something like automatic in its action, multilateral in its scope, which will enable us to have a higher degree of control over what we do in this country toward curing unemployment and accelerating growth?

Secretary DILLON. That is an important question. We have for the last 6 years run deficits which will amount, certainly by the end of this year, to $18 billion. It becomes a question as to what is adequate in time and in amount.

In this, of course, the views of the United States are not necessarily the only controlling ones because the views of those who have to make credit available also are of great importance. They have proved willing, these other countries, to continue to make credit available.

I am sure they will continue to do so provided they feel that we are taking the steps which seem to be indicated to bring our own payments into balance. I do not think that it is practicable or possible to reach an agreement on improvements in the international monetary system, which in the long run will be necessary to provide needed extra liquidity and extra reserves and credit availability for the world generally, if this is thought of by others as a means of allowing the United States to continue to avoid to take action to right its own balance of payments.

I think this is very clearly spelled out—and we have to take account of this—in the recent annual report of the Bank for International Settlements which devotes a number of pages to this subject.

Now, this report is approved by the financial authorities of all the countries in continental Europe, and by the United Kingdom authorities because they are a part of the Board, and it takes a very strong position against the need for any increase in international liquidity right at this time and says that the need is rather to rectify the imbalance, between the U.S. payments flows and those of other countries, particularly in continental Europe.

So, I think we have to take that into account and work with them to maintain credit availability, but we certainly do not find any general multilateral program that has been suggested by anyone that has any degree of acceptability or immediate practicability.

We are prepared to work at these things and we are working at them, both studying them ourselves and in conversations with other countries, both bilaterally and in international organizations.

You asked about what the President said in Bonn?

Representative REUSS. In Frankfurt.

Secretary DILLON. Excuse me, his speech in Frankfurt. What he did there was to repeat with considerable emphasis the same statement that he made to the International Monetary Fund last fall regarding our willingness to work for the improvement in the payments system. That statement was welcomed and was agreed to by the members of the 10 countries who were part of the Special Borrowing Arrangements in the communique which they issued at that time.

He did not intend to indicate that we had any new proposal or would have any new specific proposal to carry out at this time or to initiate at this time.

What he did intend also to do was to express his confidence in, and the importance of, these other nations of continental Europe, surplus countries, continuing to act in a responsible way in helping us to finance our balance-of-payments deficit as they have been doing while we take the moves that are necessary to bring it closer to balance.

These moves will take several more years. This is not a rapid process if we do it in the proper way, which we must do. I do not think that the type of thing that we will suggest be done at any time should be something that would involve any substantial interference with our domestic economy here at home. I do not think these things

are in conflict. I think it is vital that we do both of them at the same time.

Representative REUSS. I am sorry to hear that I apparently read too much into what the President said in Frankfurt. I was hopeful that something new was indicated.

I recognize that the report of the Bank for International Settlements which you have just mentioned did indeed poo-poo the idea of any new initiatives in international monetary cooperation. But I would want to throw out this thought. The BIS is made up of the central bankers and monetary authorities of the various countries, and I am wondering if the subject of the economic health of the free world is not too important to be left entirely to the central bankers. If it is in order for President Kennedy, for example, to publicly ask our friends and neighbors to buy the idea of nuclear armed merchant ships, would it not be equally in order for him to go over the heads of the central bankers and ask the democratically elected leaders of our friends and neighbors to all put their shoulders to the wheel and come up with the kind of international monetary arrangement which will end the present situation, where we can't put our own economic house in order?

What would you say to that?

Secretary DILLON. Well, I think we can put our own economic house in order while also doing the things that are necessary to move toward balance-of-payments equilibrium. As far as the central bankers of Europe are concerned, all of them work very closely with their elected governments, in some cases they are the national authority for carrying out foreign exchange policy rather than the finance ministry.

This happens to be the case of the Bundesbank in Germany. I think what they have had to say in the BIS report does represent in general the views of the finance ministers of the countries as well as the views of the central bankers.

There is no sharp difference between these central bankers and their finance ministers at this time as to what the proper procedures should be. What the President did was to make an appeal which I think is entirely proper. It was also an expression of confidence more than an appeal for something new, an expression of confidence that if we continue to cooperate with the European countries they will continue to cooperate with us and allow the financing of our deficit to continue without forcing drastic actions of the type that would be either bad for us domestically or bad for world trade or bad for the security of the world.

Representative REUSS. Representative Curtis?

Representative CURTIS. Thank you, Mr. Chairman.

First, let me express my appreciation to you, Mr. Secretary, for a very full discussion of this very serious problem. I am pleased that you have reaffirmed your deep concern about this problem and its impact not only in international affairs, but also on our domestic economy.

I am also pleased by the attendance of our committee which demonstrates that the Congress is very much concerned.

I am going to have to use my 10 minutes not to interrogate, but to point out certain things, because with this attendance there is not going to be much chance to get into this very lengthy 59-page document.

I am going to take the floor of the House this afternoon for an hour under special order to discuss this problem and I will pick up some of the points then that I stress here. I will send you a copy as I have in the past. I also have a list of some prepared questions that I would like to submit to you for reply.

(The following was later supplied for the record:)

QUESTIONS FOR SECRETARY DILLON FROM CONGRESSMAN THOMAS B. CURTIS

1. Although certain effects of the proposed tax cut might improve the U.S. balance-of-payments position over the long run, isn't it likely that over the short-run the payments deficit would worsen because of the increase in imports associated with stepped up economic activity as well as the pressure on prices which would result from a rapid economic expansion?

2. The Joint Economic Committee staff has estimated that a $10-billion tax cut might increase GNP by nearly $40 billion. What would be the likely increase in imports resulting from such a rise in GNP?

3. A continuation of the balance-of-payments problem could lead to a loss of confidence in the dollar, a large and sudden liquidation of foreign dollar balances and possible devaluation. What would be the domestic economic consequences of such a chain of events?

4. How would a restoration of fundamental balance-of-payments equilibrium benefit the domestic economy? Can it be said that the balance-of-payments problem is acting as a drag on the domestic economic health of the Nation?

5. In recent years, American business has been laboring under a profits squeeze, which has shrunk average return on stockholders' equity from about 14.1 percent in the 1947–51 period to about 9.4 percent in the 1957–61 period. How does this relate to the flow of U.S. investment capital to Europe and other oversea areas? While a reduction in the corporate tax rate would improve this situation somewhat, aren't trends in productivity and costs, particularly wage costs, even more important? What public policies are appropriate to assure that gains in productivity will be realized in the form of higher profits, lower prices, as well as in higher wages? Wouldn't this be likely to solve the capital outflow problem?

6. The idea has been advanced that the United States could ease speculative strains against the dollar by continuing to buy all the gold offered to it without, however, committing itself to paying $35 an ounce or any other predetermined price. This proposal would not alter the present U.S. policy of selling gold at the fixed price of $35 an ounce. What is the Treasury's view of this proposal or an alternative proposal that would remove any uncertainty about our buying price by specifying a price substantially below our $35 selling price?

7. European countries with extensive turnover tax structures grant substantial tax credits and rebates to encourage exports. Could you supply some information on these devices, how they operate, and which countries employ them? What have we done to get these countries to abandon these devices so as to equalize competitive conditions? Do we plan to do more? Could the GATT rules be changed to prohibit rebate of indirect taxes? Or could the GATT rules be modified to permit rebates of other types of taxes such as those more frequently employed in the United States? Is there any way we can now give tax credit for exports against corporation income taxes and still remain within the GATT rules? Can any modifications of our indirect tax structure be made that will place us on a fairer basis in granting tax credits to encourage exports?

8. We understand that the Commerce Department was at one time interested in a program of tax credits for costs incurred in the development of export markets above and beyond what can now be written off as legitimate business expenses. Australia and New Zealand now grant such credits. How large would such credits have to be in order to substantially stimulate U.S. exports? Would such credits violate the rules or "spirit" of GATT?

ANSWERS TO CONGRESSMAN THOMAS B. CURTIS FROM SECRETARY DILLON

Question 1. Although certain effects of the proposed tax cut might improve the U.S. balance-of-payments position over the longrun, isn't it likely that over the shortrun the payments deficit would worsen because of the increase in imports associated with stepped-up economic activity as well as the pressure on prices which would result from a rapid economic expansion?

Answer. The favorable effects of the tax program in terms of making our economy more competitive—both with respect to increased industrial efficiency and its attractiveness to capital—will indeed take some time to work themselves fully through the economy. But, this in no way should imply that the more immediate effects need be adverse.

As the question suggests, the more rapid rate of domestic expansion induced by tax reduction can be expected to generate some increased demands for merchandise imports, a large proportion of which consists of raw materials necessary to feed the productive process. Increases in domestic incomes might also be reflected in somewhat larger expenditures for certain services purchased from foreigners. Moreover, it is possible that this response of imports could develop with a relatively short lag as production is stimulated—certainly these effects are likely to be evident within 6 months, and significant within a year.

On the other hand, the expected favorable response of capital flows to the improved outlook to the domestic economy should also begin to make itself felt rather promptly, offsetting the effects of the increased flow of imports on our balance of payments. In fact, it is the capital accounts that are the most volatile element in our international payments, and perhaps the portion most clearly sensitive to developments in the domestic economy and to an improved outlook over the longer run. In that connection, it may be relevant to note that responsible foreign observers have frequently pointed to the desirability of tax reduction to stimulate the domestic economy and to create a more favorable environment within which to achieve balance in our international payments.

The precise balance of these favorable and unfavorable forces during the early period following enactment of the tax reduction program cannot be accurately forecast, but it is clearly possible that the net impact could be decidedly favorable. For instance, the rise in imports related to a tax reduction over the first 6 months or so would not exceed a few hundred million dollars, while the favorable change in capital flows could potentially be greater. Moreover, the stability of industrial prices in this country during the past 2 years of expansion, the ample availability of labor and material resources to meet expanded demands, and the evident upward cost and price pressures in a number of other industrialized countries strongly suggest that our balance of payments difficulties will not be complicated by adverse relative price movements during this period.

Clearly, the variety of shorter run measures that we have introduced to reduce the balance-of-payments deficit are necessary to assure adequate progress toward balance over the period before the tax program and other longer range measures become fully effective and the latter's favorable implications for the balance of payments are fully realized. One of the compelling reasons for choosing tax reductions as a means of stimulating the domestic economy is to assure that the policy actions that might be required to deal with the balance-of-payments problem in the shorter run will not inhibit progress toward our domestic objectives.

Industrial supplies and raw materials are still the largest component of our imports and respond with some sensitivity to production movements as measured, for example, by the gross national product (with services excluded), or by the index of industrial production. However, the relationship of demand for these imports to overall domestic industrial activity is not precise, and the response at any given time will depend upon numerous factors, including price trends and the prevailing pattern of production. There is reason to believe, however, that the sharp expansions in certain import categories that occurred in initial recovery stages from the recessions of 1957–58 and 1960–61 are not likely to occur under present conditions, since this response reflected in part a sharp swing from inventory liquidation to accumulation, and because the gains in business were heavily concentrated in some durable goods that require relatively large amounts of imported raw materials.

It also deserves mention that there is a steady historical change at work in the pattern of U.S. imports as the share of finished manufactured goods increases. Imports of crude materials and semimanufactures are still larger than imports of finished manufactured goods but not by a great margin. Because imports of finished manufactures are predominantly consumer goods, they are less sensitive to short swings in domestic business activity, and meet with far more competition from our own products. Consumer goods imports are governed essentially by consumer incomes and tastes, and by considerations of comparative price, quality, and availability. Tax reduction will, through its effect on incomes, tend to raise these imports, but the rise should be gradual so long as other factors—especially prices—do not move adversely.

It is, of course, extremely important, for many reasons, that stability be maintained in U.S. costs and prices. As suggested above, the initial stimulus from the tax cut should be absorbed without strong price pressure, but the danger of this kind of pressure will become greater as production more closely approaches the limits set by manpower and plant capacity. Recognition of this danger has been reflected in the emphasis by this administration on the wage and price guideposts set forth in the Report of the Council of Economic Advisers more than 18 months ago. These guideposts, which are designed to focus the attention of labor, business, and community leaders on both the necessity for overall price stability and the prerequisites for achieving it, suggest, as a general norm, that wage increases should not exceed long-term gains in productivity, and that prices in industries experiencing exceptionally large gains in productivity should reflect the lower costs made possible by this greater efficiency. On the average, wage increases have in fact dropped steadily over recent years, and last year were within the bounds set by rising productivity. In the shorter run, with the stimulus of tax reduction expected to reflect itself in faster than average gains in productivity generally, adherence to these guideposts in pattern-setting wage and price decisions offers the opportunity for reductions in costs that can be passed along in the form of lower prices. Moreover, the significant rise in after-tax income of both individuals and businesses implied by the tax program should help mitigate upward wage and price pressures.

Thus, while it seems clear that the stimulus from tax reduction will bring, in its train, some rise in imports, the rise need not be so large as to pose further problems in terms of the overall balance of payments. There are too many imponderables in the form of the exact speeds of response that may be expected from the different items that contribute to the total payments deficit or surplus to allow a definite and unqualified answer as to the balance of forces during the early months following a tax reduction, but it is our belief that if any deterioration did occur from the side of imports it would be small in amount and temporary in duration.

Question 2. The Joint Economic Committee staff has estimated that a $10 billion tax cut might increase GNP by nearly $40 billion. What would be the likely increase in imports resulting from such a rise in GNP?

Answer. As suggested in the previous answer, it is not possible to arrive at an exact quantitative prediction of the timing and amount of any increase in imports induced by domestic expansion. As a general guide, however, an increase, approximating 3 percent of the gain in GNP would be in line with average experience in the past. Applying this ratio to the figure you suggest for the increase in the GNP related to the tax program would imply a rise in the neighborhood of $1.2 billion in the annual rate of imports. The increase in imports related to the tax program would, of course, be spread over a number of years, probably not reaching the full amount until 1966 or beyond.

Maintenance of domestic cost-price stability, particularly in the light of the evident upward pressures on costs and prices in a number of countries supplying manufactured goods to our market, offers an opportunity for holding the rise in imports related to increased economic activity over coming years within smaller limits than suggested by this simple extrapolation of postwar experience. In that connection, there are some indications that imports, during the early part of this year, equivalent to 2.8 percent of GNP, were somewhat below levels that might have been expected on the basis of past relationships to domestic income and production. While it would clearly be premature to conclude from these recent data that our international competitive position has already improved significantly and that this ratio will drop further, the favorable implications of the tax program for industrial productivity, combined with responsible wage and price policies, should create a favorable environment for such competitive gains in the future. Taking into account, therefore, the assist to exports, the net balance-of-trade impact over time should prove favorable.

Question 3. A continuation of the balance-of-payments problem could lead to a loss of confidence in the dollar, a large and sudden liquidation of foreign dollar balances, and possible devaluation. What would be the domestic economic consequences of such a chain of events?

Answer. Our defenses against speculative disturbances and sudden flows of short-term funds of the kind apparently envisaged by this question have been strengthened greatly over the last few years by means of the cooperative efforts of the major trading and financial countries. The general arrange-

ments to borrow, supplementing IMF resources, the network of reciprocal currency agreements among the leading industrialized countries, the cooperative effort to deter speculation in the gold market, and willingness to undertake official intervention when needed in the markets for foreign exchange all provide absorptive capacity to meet any speculative onslaught. In addition, arrangements for financing our deficit in an orderly and constructive manner have been further developed, including, particularly, the use of intermediate-term borrowing in both dollars and foreign currencies from surplus countries. Taken together, these varied arrangements surround the dollar with defenses adequate to meet foreseeable contingencies under existing circumstances, and should permit this country to restore equilibrium in its international accounts without disturbing the stability of the international financial system.

However, the question posed apparently contemplates a continuation of the U.S. balance-of-payments deficit in such size and for so prolonged a period that even these strong defenses are overwhelmed. The most immediate and clearest threat implicit in such a sequence of events—a sequence we are determined to avoid through a continuing, vigorous effort to reduce and eliminate the deficit—would be a breakdown of the international monetary system, which today rests upon the assured interchangeability of gold, and the dollar at a fixed price. For a considerable period of time, after such a crisis, it is likely that one would observe internationally the phenomenon of dislocated exchange rates moving widely in response to shifts in confidence and huge flows of short-term funds as one currency after another fell under suspicion. Elaborate systems of exchange controls and restrictive trade policies would be likely to develop as individual nations tried to shield themselves from these influences as best they could. Ordinary risks of international business would be compounded as margins of operating profits were, in many cases, dwarfed by sudden and unexpected losses on foreign exchange transactions. Conventional facilities for financing trade could not be expected to cope adequately with the problems that would arise, and orderly business planning would be disrupted. The great damage done to the free flow of trade as a consequence of these developments need not be elaborated on at length.

It is not possible to draw a sharp and meaningful distinction in the world, as we know it, between these disturbances to international trade and the domestic economic consequences of a breakdown of the world financial system. Certainly, all trading nations would feel the consequences of a contraction of trade and a tendency toward bilateralism in the form of a loss of real income, and there would be a clear danger that strong worldwide recessionary tendencies would develop to further compound the difficulties. The depressing effects on domestic business would not result simply from the dislocation in foreign trade, but also (and perhaps more importantly in the case of the United States) from the severe shock to business confidence and the added uncertainties inherent in these monetary dislocations.

While no nation could be expected to be immune from these effects, it is, of course, possible that in this country vigorous domestic countermeasures could soften the blow to domestic confidence and business activity implicit in your question. However, even resolute and timely action could not be expected to prevent rising domestic unemployment, a constriction of the orderly flow of savings into productive domestic investment, and price instability.

While these strictly domestic effects conceivably might, with appropriate policies, be less serious in the United States than in other nations in which the economy is more closely geared to international trade, the broader and lasting consequences of a collapse of the international financial system for the strength, stability, and cohesion of the free world would be at least as dangerous for the United States, as the leader of the free world, as for any other nation.

Question 4. How would a restoration of fundamental balance-of-payments equilibrium benefit the domestic economy? Can it be said that the balance-of-payments problem is acting as a drag on the domestic economic health of the Nation?

Answer. Fundamental balance-of-payments equilibrium implies a sustainable external balance on trade, government, and private capital transactions with the rest of the world over a period of time long enough to average out random, cyclical, and other shorter-run disturbances, without fluctuations in exchange rates or resort to official controls over trade or capital movements. In addition, it implies the absence domestically of any substantial margin of unutilized resources, or persistent tendency for domestic costs and prices to stay out

of alinement with world costs and prices. Balance-of-payments equilibrium could not be regarded as fundamental if, for example, external balance were achieved internationally at the cost of widespread domestic unemployment; nor could one regard balance-of-payments equilibrium as fundamental if persistent tendency toward domestic inflation were masked by widespread controls over trade and payments.

In the present situation faced by this country, restoration of fundamental balance-of-payments equilibrium inescapably requires a more rapid rate of domestic economic activity, fuller employment of our human and material resources, and rapid strides in productivity. The improvement in our trade balance that can be expected as a result of increased efficiency and stable prices will, in turn, have direct benefits to the domestic economy in terms of higher production and added jobs, although it should be pointed out in that connection that fluctuations in imports and exports within the anticipated ranges would account for a relatively small proportion of our national output. At least as important, the relative improvement in the attractiveness of domestic over foreign investment that can be expected as domestic growth quickens will reinforce other actions taken to speed the modernization and productivity of the U.S. economy.

The second part of the question inquires as to whether the balance-of-payments problem is acting as a drag on the economic health of the Nation. The answer here is implied in the answer to the first part of the question—to the extent that our balance-of-payments problem reflects lost export opportunities and a flow of capital abroad that might otherwise have been employed in the United States, it has, of course, reduced job opportunities in the United States and hampered modernization of our own industry. This is why restoration of balance will imply benefits for the domestic economy.

More important, however, the U.S. balance-of-payments deficit has been a symptom rather than a cause of inadequate domestic economic performance, and a satisfactory solution to the balance-of-payments problem cannot be found in measures that would impair growth at home. Consequently, we have not, and will not, seek a solution in internal constriction. What we must do, however, is to adapt the tools of economic policy flexibly to our needs, so that we can continue to achieve a blend of policies that will support, at one and the same time, our domestic and external objectives.

That is why we attach so much importance to tax reduction, since it will provide a lasting stimulus to domestic economic growth and at the same time help to improve the international competitive position of our economy, stimulate investment at home while reducing the net outflow of capital, and supply a needed degree of freedom for the monetary authorities to deal with balance-of-payments contingencies without appreciable risk for the domestic economy. At the same time, the balance-of-payments problem lends special urgency to the need to maintain stable costs and prices in this country, but that objective is certainly consistent as well with our domestic aims.

I believe the record is clear that our efforts to restore external equilibrium have not served to restrain domestic activity. In particular, upward pressures on key long-term interest rates, typical of past expansion periods, have been avoided, and mortgage rates are actually substantially below levels prevailing during the past recession. Credit is freely available in all sectors of the market, providing further important support to the economy. While the potential for easing money further is indeed limited by balance-of-payments considerations, there is no clear evidence that this would be desirable or necessary on domestic grounds. Instead, tax reduction offers a much more suitable means of catalyzing investment and production, and, as suggested above, would be fully consistent with our external objectives as well.

Question 5. In recent years, American business has been laboring under a profits squeeze, which has shrunk average return on stockholders' equity from about 14.1 percent in the 1947–51 period to about 9.4 percent in the 1957–61 period. How does this relate to the flow of U.S. investment capital to Europe and other overseas areas? While a reduction in the corporate tax rate would improve this situation somewhat, aren't trends in productivity and costs, particularly wage costs, even more important? What public policies are appropriate to assure that gains in productivity will be realized in the form of higher profits, lower prices, as well as in higher wages? Wouldn't this be likely to solve the capital outflow problem?

Answer. While other influences have doubtless played a significant part in shaping the overall pattern and size of U.S. foreign investment, the suggestion

implicit in the question that relatively favorable opportunities for the profitable employment of capital abroad have been a basic inducement to an increased outflow of American capital is valid.

The question goes on to suggest that while a reduction in U.S. corporate tax rates would be directly helpful in this respect (as it surely would), the behavior of trends in productivity, wage costs, prices, and before tax profits will be a more important influence in the longer run. This is certainly true, not only with respect to capital flows, but with respect to our international competitive position as a whole. Over a period of time, the tax reduction program we have proposed will, by spurring domestic growth, increased investment, and industrial efficiency, support these objectives, and in combination with price stability offers an opportunity for supporting our goal of lasting external balance in a way fully consistent with the operation of natural market forces.

The question does not refer explicity to the indirect but very powerful effects of tax reduction upon corporate profits and investment opportunities as a result of an expansion in total economic activity. As GNP moves closer to its full potential, sizable gains in productivity can be expected, and past cyclical experience suggests that profits are likely to increase faster than activity as a whole as full employment is approached, helping to increase profit margins toward levels typical of some of the earlier postwar period and increasing the return on invested capital. The point may be put more concretely by considering the specific periods of time referred to in the question. Between 1947 and 1951, when the average after-tax rate of return on stockholders' equity was about 14 percent, GNP (in constant prices) rose by approximately $60 billion, or by some 21 percent during the 4-year period, and the economy was operating much closer to the limits of its capacity. Between 1957 and 1961, when the average aftertax rate of return on stockholders' equity fell to about 9.4 percent, GNP at constant prices rose by only about $39 billion, or by less than 10 percent during the entire 4-year period. Unemployment ranged from 5 percent to 7 percent for most of the period, and there was a sizable margin of unused capacity.

This is a striking contrast, with the earlier period of rapid growth in real GNP associated with a relatively high rate of aftertax return on stockholders' equity, and the later period of slower GNP growth associated with lower average rate of return. At the same time, growth in productivity tended to be lower after the mid-1950's than earlier in the postwar period, and business investment activity remained on a plateau.

The essential explanation lies in the fact that corporate profits are a sensitive indicator of the overall performance of the economy, and that slow growth discourages investment and tends to reduce opportunities for productivity gains. As a consequence, the beneficial effect of tax reduction upon corporate profits, and in terms of international capital flows, is seriously understated if reference is made only to the direct effect upon aftertax profits, without allowing also for the indirect stimulus to investment and profits as economic activity expands. This is true even though the data cited in the question may overstate the extent of the decline in the real return on capital in the United States over the postwar period, since rising prices prior to and during the 1947-51 period tended to be more promptly and fully reflected in current profits than in the net worth accounts to which they are compared.

As these comments imply, it is entirely appropriate and desirable that the productivity gains implied by economic expansion be realized in the form of higher profits as well as increased wages and, in some cases, lower prices. That is the essence of the wage-price guideposts set forth in the Annual Report of the Council of Economic Advisers for 1962. As indicated in the answer to the first question, those guideposts suggest, as a central feature, that average wage increases should be alined to long-term trends in national productivity. This would permit, over a period of time, other claims on national income, including profits, to rise proportionately if prices, on the average, remain steady, as the guidelines contemplate. These guideposts would also be consistent, in the shorter run, as productivity gains exceed the longer run average, with declines in prices and restoration of profit margins in cases where they might be abnormally depressed.

Clearly, our international competitive position could be improved still more rapidly if we were able to achieve a decided reduction in domestic prices over time. While any price declines made possible by rising productivity are to be welcomed for that reason, it must be recognized that as a practical matter it

may not be possible to achieve a decline in average prices without resort to an unacceptable degree of Government intervention in wage and pricing decisions, particularly during a period when there is a clear need to expand the overall volume of economic activity.

Question 6. The idea has been advanced that the United States could ease speculative strains against the dollar by continuing to buy all the gold offered to it without, however, committing itself to paying $35 an ounce or any other predetermined price. This proposal would not alter the present U.S. policy of selling gold at the fixed price of $35 an ounce. What is the Treasury's view of this proposal or an alternative proposal that would remove any uncertainty about our buying price by specifying a price substantially below our $35 selling price?

Answer. The question proposes that the fixed U.S. buying price for gold be abandoned, or a "substantially" lower price be specified, in order to ease speculative strains against the dollar. A similar suggestion was advanced in the minority views contained in the Annual Report of the Joint Economic Committee, 1962.

Wholly aside from any legal or technical barriers, a move of this kind—reversing long-established policy—would appear virtually certain to stimulate renewed speculation in gold, to introduce new uncertainties over the value of the dollar, and to accelerate rather than diminish the loss of gold by this country.

Presumably, those who have advanced this idea hope that foreigners who now purchase gold for speculative or monetary purposes would be deterred from doing so in the belief that the world price of gold might at some point fall to a lower U.S. Treasury buying price. However, such behavior would be quite unlikely to develop, since free world demand for gold for monetary, industrial, and speculative purposes has been fully ample for many years to absorb all gold available at $35 per ounce, even while the U.S. Treasury, as a result of our payments deficit, has been a large net seller of gold. Unilateral reduction of the U.S. buying price, particularly at a time of continued deficit, would not alter this desire to hold gold as a store of value and as international reserves—a desire deeply rooted in tradition and experience and embedded in our international monetary arrangements.

Instead, there would be grave risk that such a unilateral move by the United States would be interpreted as a sign of weakness and unwillingness to take measures necessary to reduce our balance-of-payments deficit and the gold drain. By undermining one of the basic obligations we have undertaken as a member of the IMF and a responsibility central to the role of the dollar as a reserve currency, doubts over the viability and stability of the present international payments mechanism would be aroused, without an effective, tested substitute available.

Finally, even apart from any repercussions on confidence, such action would place a wholly undesirable barrier on gold sales to this country by other countries for the purpose of ordinary monetary settlement of trade imbalances. With reduced opportunities for purchasing gold from time to time from other countries experiencing temporary deficits, the net gold outflow from this country would rise rather than decline.

Question 7(a). European countries with extensive turnover tax structures grant substantial tax credits and rebates to encourage exports. Could you supply some information on these devices, how they operate, and which countries employ them?

Answer. All major trading countries levy a charge on imports to compensate for the indirect tax burden on comparable domestic goods, and exempt exported products from indirect taxes, or rebate indirect taxes already paid.

A brief account of the German practice will indicate how the system operates. Germany has a turnover tax of 4 percent, levied at every stage of production when a genuine sale takes place. Products that are exported are exempt from the final stage turnover tax, and the exporter receives a lump-sum rebate to compensate for the tax accumulated during earlier stages of production. In addition to exemption from the 4-percent tax at the final stage, exporters thus receive rebates ranging from 0.5 to 3 percent of the price of the exported product, depending upon the estimated tax accumulated during the production process. The rebate may be less than 4 percent of the export price because the base value for the turnover tax at earlier stages of production is less than the export price and because of integration in some industries which reduces the number of taxable turnovers.

Germany also imposes a turnover equalization tax on imports which ranges from 4 to 8 percent, depending upon the estimated tax borne by similar domestically produced goods. Certain important raw materials are exempt from the equalization tax, and lower rates apply to some agricultural products.

Austria and all Common Market countries except France have cumulative turnover taxes similar to Germany's. France has a value added tax that permits a more precise calculation of the tax previously paid on exported goods. Great Britain has a single-stage purchase tax (not unlike the sales taxes imposed by States and municipalities here) which is applied to imports but not to exports.

Question 7(b). What have we done to get these countries to abandon these devices so as to equalize competitive conditions? Do we plan to do more?

Answer. Because GATT and other international agreements (the Rome treaty creating the EEC, for instance) specifically permit countries to exempt exports from indirect taxes and to impose equalization taxes on imports, there is no legal basis for asking foreign trading countries to give up these practices.

With a cumulative turnover tax, it is generally not possible to determine precisely the amount of tax borne by domestic products, so there is room for disagreement with respect to the correct equalization duty on imports. Germany recently raised its equalization duty on a list of 95 imported products, arguing that the present levy did not impose as great a tax on imports as that borne by domestic goods. The United States and other countries protested this increase in the levy on imports, but the German Government insisted that its action was justified in the light of existing international agreements. The United States is continuing to study this situation to determine what further steps are appropriate.

Question 7(c). Could the GATT rules be changed to prohibit rebate of indirect taxes? Or could the GATT rules be modified to permit rebates of other types of taxes such as those more frequently employed in the United States?

Answer. There would probably be strong opposition to elimination of the provision in GATT that permits the exemption of exports from indirect taxes. Many countries have relied heavily on turnover taxes for a long time, long before the formation of GATT, and have followed the practice of exempting exports from such taxes. These countries would undoubtedly oppose strongly any attempt to prohibit their present practices with respect to exports and imports or to extend these practices to direct taxes. Nevertheless, the United States is pressing for a reexamination of the rationale for distinguishing between direct and indirect taxes in this context.

Question 7(d). Is there any way we can now give tax credit for exports against corporation income taxes and still remain within the GATT rules?

Answer. There is substantial question whether a tax credit based on exports would technically violate the letter of the GATT provisions, but other members can be expected to urge strongly that such a move would violate the spirit of GATT. It would also put the United States in an embarrassing position, because this country has long been the leader in urging the elimination of restrictions on trade. Furthermore, if we were to adopt an export tax credit on the ground that it did not technically violate the rules of GATT, other trading countries might retaliate by adopting similar measures so that any advantage obtained would be short lived.

Question 7(e). Can any modifications of our indirect tax structure be made that will place us on a fairer basis in granting tax credits to encourage exports?

Answer. The United States follows the general practice of the European countries in exempting export sales from indirect taxes and in imposing these taxes on imports. The United States, however, receives a much smaller proportion of total tax revenues from excise and sales taxes than most European countries. The U.S. tax structure would have to be altered drastically if it were to match most countries of Western Europe in reliance on indirect taxes.

Question 8. We understand that the Commerce Department was at one time interested in a program of tax credits for costs incurred in the development of export markets above and beyond what can now be written off as legitimate business expenses. Australia and New Zealand now grant such credits. How large would such credits have to be in order to substantially stimulate U.S. exports? Would such credits violate the rules or "spirit" of GATT?

Answer. Australia and New Zealand permit overexpensing of costs incurred in developing export markets. Australia permits firms to deduct double the actual amount of such expenditures, and New Zealand permits a deduction of 150 percent of such expenditures. At one time, the Department of Commerce suggested that the United States permit the deduction of 120 percent of export promotional expenditures.

It seems very doubtful that tax credit for export promotional costs is an effective way to strengthen the balance of payments. The concerted export promotional program described in the President's recent special message on the balance of payments is tangible evidence of the very great importance that we do attach to well designed efforts to expand foreign sales.

However, there are a number of considerations which argue against the use of this type of tax deduction for export promotion. First, it is very difficult to estimate just how large the deduction would have to be to cause a substantial increase in exports. Second, and related to the foregoing, if deductions do not through their own influence greatly increase promotional effort, an unnecessary and inequitable benefit is given individuals and businesses who would carry on the activity in the normal course of business. Third, there are some extremely difficult administrative problems, one of which would be to define precisely what expenditures are eligible for the extra deduction and what expenditures are not eligible. Fourth, tax concessions on exports do invite retaliation on the part of other countries.

The question inquires whether the overexpensing of promotional expenditures violates either the rules or the spirit of GATT. There would very probably be disagreement among GATT members on this point. Much would depend upon the circumstances which surrounded the granting of tax credit.

In conclusion, while export promotion is unquestionably of great importance at this time, as is evidenced by the scope and variety of the programs we have undertaken, many serious problems would arise in tax credit for export promotion of the kind suggested by the question.

Representative CURTIS. I would hope that the committee would set aside a day when we could come in and have a cross-examination, using this committee as a forum to really exchange viewpoints and to point out where there is agreement and where there is disagreement.

I suggested, and I thought that the committee had approved, a different format for going into this balance of payments matter. I suggested that the staff prepare a paper posing the problem. This paper would have been gone over by the minority so that we could point out the areas of agreement.

Since there is a good deal of agreement on analysis, we could point out where the disagreement exists.

Then, when the witnesses came before us, they could direct their attention to the document, thus pinpointing where the debate seems to lie.

I am still hopeful that we will proceed in that fashion. This is no criticism of you, Mr. Secretary, because, if I were you, I would have used this opportunity as a forum to try to promote the tax reform which you favor; however, this in my judgment is not what our committee should be doing in this area.

We are not the Ways and Means Committee. I would love to have an opportunity to go into detail and state the reasons for my disagreement.

Now the comments that I wanted to make are these: I think essentially your statement is fine in covering the topics and in being pertinent. It is in the nature of a confession and an avoidance.

You confess to many things with which I agree, although I think some of your statements are highly inconsistent. I will point out a couple of these inconsistencies.

The avoidance lies in the area of not discussing some of the basic points of disagreement. I will also try to point out a couple of those.

First, with regard to inconsistent statements. I was very pleased to see your emphasis on the policy of cutting expenditures in the area of foreign aid, but the President has an increase in his budget, an original increase from $3.9 billion to $4.9 billion.

After the Clay report, it was cut back, I was happy to see, to $4.5 billion, although the Clay report suggested that the cut should apply to the $3.9 billion, cutting it to $3.4 billion.

Further, the Clay report pointed out that this was only the first year and that they were suggesting a 3-year cut. I notice the press has failed to bring that point out and has directed attention solely to the first-year cut.

But here the policy you state, and which I certainly agree with, seems to me to be completely inconsistent with what the administration has actually requested and is still insisting upon, a $4.5 billion expenditure in this area.

I would point out what seems to me to be a basic inconsistency in the objectives of aid, vis-a-vis "Buy American."

Much of the argument for aid has been put in the context that it is "Buy American." I suggest that if the AID director were here, and I hope he will be here for interrogation, he would point out how completely inconsistent that is with the objectives of aid.

I happen to think that it is. I say this as one who has favored the theory of foreign aid and do to this day. I have always felt, though, that we had such loose budgets that we were probably causing more damage than good.

But there is an inconsistency that I think is very important.

You mentioned the effect of tax cuts on foreign investment and you also related this to our tax changes of last year concerning foreign investment. Yet, rightly so, your paper points out the fact that our investments have gone up.

That is, on page 12, you show the reverse of what you say happened on page 18. On page 12 you point out that:

> Long-term capital outflows, also shown in table 2, moved somewhat higher in both 1961 and 1962, and then jumped sharply during the first quarter of this year, reaching a total of over $1 billion in only 3 months.

Then you go on in the next paragraph:

> Moreover, the flow of foreign direct and long-term portfolio investment into the United States declined sharply in 1962 from levels already disproportionately low relative to similar U.S. investments abroad. There was a still further decline during the first 3 months of 1963.

I think it is about time that the administration reviewed some of its basic premises of both the tax cut and its economic theory. One of the theories, the basic theory of this so-called economic growth, is that it is the way to solve unemployment.

Although we have had this great increase in gross national product which the President is now hailing, we don't have any relief in the field of unemployment. The implication to me is that the basic theory is unsound. I have suggested that it has been unsound all along, that our real problem in unemployment is structural and frictional. I think that the administration should at least be willing to join in debate on the issue instead of avoiding it.

The basic theme, as I see it in here, is to improve the investment climate in our country. I could not agree with that more. That relates

to profits. There has been little discussion here on the problem of profits.

After all, tax cutting is dealing with only tenths of a percent when it relates to the return on the invested dollar. When the decline from 14 to 9 percent on the invested dollar, which occurred over the past 5 or 6 years, deals with economic factors, it deals with whole percentage points. We have to get, in my judgment, into that area.

The avoidance that I referred to is the failure to discuss the economic impact of deficit financing on the domestic economy and the fact that the proposed planned deficits of the Executive are not for just this year but will go on, under its own estimates, into fiscal 1967 and perhaps by more realistic estimates into 1972.

Now, if the administration believes in its theory, then let us start debating it instead of avoiding the debate.

The question of price stability, which is so basic, has been mentioned here. The administration, and I notice you repeat it, consistently refers to prices that have been relatively stable. But the price indicators, using the Consumer Price Index, show that is not so.

There have been increases averaging about 1.3 percent a year. Compare that to the period of January 1952 through December 1955 when the index moved up by slightly more than 1 point over the whole period. In fact, there was virtually no increase at all from 1953 to 1955.

So, price stability now does not happen to be the fact. Dr. Heller and the administration consistently talk about it and say that there is no danger in this area of inflation through deficit financing when, as a matter of fact, the so-called idle plant capacity that they speak of is obsolete. At least that should be a subject of debate.

Now, let us get into it instead of begging the question each time. In the same way, the unemployed are unskilled, semiskilled, and obsolete skilled, and so we have a problem in the area of unemployment.

I see my time is now up, but I wanted to point out some of the areas, at any rate, around which I think this debate should center. I hope that these hearings are going to clarify these things. Let us avoid as far as possible the areas in which we are in agreement.

Let us as well as we can pinpoint where honest men differ so that we can find out through examination of the facts and the arguments what our policy should be in this area.

Secretary DILLON. Could I have just a moment to state a few answers?

Representative REUSS. Certainly.

Secretary DILLON. I would like just as briefly as possible to answer a couple of these things. On the question of foreign aid our emphasis has been on the "Buy American" aspects so that it doesn't affect our balance of payments.

As I pointed out, in fiscal 1963 more than 80 percent of the AID commitments were commitments which will result in export of U.S. goods and services, which compares rather dramatically with the fact that in 1960 only one-third of our AID expenditures had that effect.

We feel that is a better way to cure the balance-of-payments aspect of aid than just by cutting it out. That does not mean that the aid program should not be carefully evaluated and studied by the Congress and by everyone else, but it means that our major effort so far as the

balance of payments is concerned is tying aid, which we agree is not the best permanent policy. But our only alternative under our present balance-of-payments situation would be to pretty well do away with foreign aid.

As to the question of investments, the fact is that the general competitive position of U.S. investment was improved by adopting depreciation practices that were roughly equivalent to European practices, and it will be further improved by a decrease in corporate income tax rates. I think the answer is that it is clear that there will be an improvement——

Representative CURTIS. In the face of the figures, that is what I want to ask you.

Secretary DILLON. That is what I was going to say. The reason this does not show in the figures is that it takes a certain amount of time. Direct investment which is the only one affected here—not portfolio which went up last year—the direct investment stayed level, did not go up.

Direct investment decisions are made one, two, and sometimes even more years ahead of the actual payment of the money, which is when it shows up in our balance-of-payments statistics.

I am sure that the fact that last summer and again last fall our depreciation practices and the tax treatment of investment were improved, and hopefully some time this year our corporate tax rates will also be reduced, this will certainly show up—probably not this year but beginning next year and certainly the year after—in direct investment.

This should have very little effect, however, on portfolio investment. The third thing was the question about the increase in gross national product not having affected employment.

I think the answer to that is clear because the increase in gross national product has not been adequate and that is one reason, the basic reason, why we feel we need the stimulus of a tax cut.

As far as relatively stable prices are concerned, I was really referring there largely to comparisons. If you look at what has been going on in Europe during the last few years, their consumer price indexes, wholesale price indexes, wage indexes, all of them have been rising very much more rapidly than the moderate increase in our Consumers Price Index.

Finally, as far as the budget deficit is concerned, that appears to be primarily a domestic question. It doesn't directly affect our balance of payments. This has been made very clear in our discussions with all of the foreign people who are interested in our balance of payments and in the reports of such institutions as the Bank for International Settlements and others, none of whom have taken exception to deficits of the size that we have had or that are in contemplation as far as the balance of payments is concerned.

Representative REUSS. Senator Fulbright?

Senator FULBRIGHT. Thank you, Mr. Chairman.

Mr. Secretary, could you refresh my memory on how much of our balance-of-payments deficit is attributable to our foreign military expenditures? Do you know that?

Secretary DILLON. Yes. That is shown rather clearly on Table 2 of my statement (p. 15). This indicates that in 1960, 1961, and 1962

there was a fairly level total outflow of about $3 billion. Military cash receipts went up substantially because of the offset agreements that we have negotiated.

In 1962, however, included in those offset agreements were advance payments which amounted to some $470 million. If you include that during 1962, our net military outflow was just under $1.9 billion.

If you do not include that as a permanent thing, it was about $2.3 billion.

Senator FULBRIGHT. Well, is it fair to say that we can anticipate in the neighborhood of, say, $2.3 billion as being recurrent if we maintain the same level?

Secretary DILLON. I think it would be lower than that because the offset agreements we have negotiated will have a larger impact in 1963, I think slightly, than they had in 1962—I mean the permanent ones, not the advance payments.

So, I think that the figure would be more nearly somewhere around $2 billion provided there are no further reductions in costs. But I think there will be further reductions in costs in our Defense Establishment.

There are also some things included in military expenditures which are decreasing and which will phase out completely, one of which is the contracts we have had for many years for the purchase abroad of uranium.

Senator FULBRIGHT. How much do you attribute to American tourists? What is our deficit on tourism?

Secretary DILLON. Last year it was close to $1.5 billion.

Senator FULBRIGHT. How much to foreign aid, the regular foreign aid program? Just roughly. I don't need the details.

Secretary DILLON. About $1 billion.

Senator FULBRIGHT. That is allowing for the 80-percent Buy American?

Secretary DILLON. That is allowing for the effect of that on disbursements as of last year. Since there is a leadtime, that effect will steadily improve and we would hope that that figure would drop over the next 2 or 3 years to about half, perhaps as low as $500 million.

Senator FULBRIGHT. If I understood you, you object to general or even partial exchange controls because if they are partial they must, you think, inevitably become general.

But does this same objection apply to any specific restrictions upon particular elements such as tourism, military expenditures, and foreign aid? Restrictions on these would not upset, in other words, the free trading area you mentioned.

Secretary DILLON. No. I think anything we do in the military area or the foreign aid area or in expenditures that are governmental expenditures we are free to do, as a government, without affecting general principles.

As to tourists, that would be, I think, a little different. We have reduced—and this has been continued by the Congress now—the allowance for duty-free purchases abroad by tourists, which has saved us about $125 million a year.

But that is small compared to the overall tourist deficit. I should think it would be in the interest of the United States to try to promote much greater "see America first," "travel in America" programs,

so as to get the thought clearly to our citizens that it would be helpful if they traveled in the United States rather than abroad in the next few years.

Senator FULBRIGHT. Haven't other countries successfully put limitations upon the amounts of exchange that their nationals may be allowed to take abroad?

Secretary DILLON. Yes. These are countries who have had complete exchange controls. This has been one part of those controls. As they have dismantled them they have taken off some quicker than others.

This is one that came off a little more slowly but it is coming off gradually and there is a strong movement in OECD to dismantle them completely now.

Senator FULBRIGHT. Do you see any probability of the European countries, surplus countries, removing their obstacles to our exports?

Secretary DILLON. I think that is a major problem which I didn't go into here. It is primarily within the jurisdiction of the State Department and the President's special negotiator, Mr. Herter, but I think it is a very grave problem and we do have to negotiate very hard.

Personally, I have always been sympathetic with the Joint Committee's position, which it has held for some time, that, because of their advantages and because of what has actually happened to trade with the adoption of the Common Market, the Common Market countries should certainly grant some unilateral reduction in tariffs.

Senator FULBRIGHT. Finally, to draw this together, isn't it quite evident that, unless these obstacles are removed, specific measures in these three fields in particular will have to be taken?

Secretary DILLON. That may be; yes.

Senator FULBRIGHT. It may be? Don't you think it is inevitable?

Secretary DILLON. I think it is very likely; yes.

Senator FULBRIGHT. If we cannot increase exports, particularly to that area, the military and the tourists and the foreign aid will have to be reduced?

Secretary DILLON. Yes.

Senator FULBRIGHT. Is that fair?

Secretary DILLON. I think that is fair.

Senator FULBRIGHT. Thank you, Mr. Chairman.

Representative REUSS. Senator Javits?

Senator JAVITS. Mr. Secretary, I would like to join Congressman Curtis in congratulating you on a very comprehensive statement. Though we may not agree with some major aspects of it, it certainly is a comprehensive presentation, I think, very worthy of your skill.

Mr. Secretary, I gather from your statement that you think that we are soundly based in the world's economic competition, except that a serious imbalance in our international payments is the penalty we pay for being the world leader. Is that a fair characterization of your statement?

Secretary DILLON. I think that is largely accurate. There is the fact that studies have shown that some very rapid increases in wages and costs in this country in the early 1950's did substantially reduce our competitiveness in certain areas such as steel which is the most obvious.

And therefore we have to work to reestablish the degree of competitiveness that will give us a larger trade surplus or maintain our trade surplus against the hard efforts of competitor countries.

But, I do think the primary problem is threefold. First, we have very large military expenditures overseas which no other country has in anywhere near the same amount.

Second, we have been carrying substantial foreign aid burdens on our balance of payments, although we are being quite successful in reducing those.

Third, there has been a very extensive private capital flow, both short term and long term, which is another major problem.

Senator JAVITS. And fourth, the tourists?

Secretary DILLON. Tourists are a very important element. That goes up every year.

Senator JAVITS. Now, in each of these items, military aid, economic aid, tourists, and capital outflow, our allies and associates could, if they would, lift a material part of the burden off our backs, could they not?

Secretary DILLON. Yes; I think they could do more, although some countries, particularly Germany with its offset agreement and Italy which has a similar one, have done a good deal to help our net military expenditures.

But I think in general still more should be done. Some of the tables which your staff has prepared show that military expenditures are smaller in proportion to the gross national product in most NATO countries than they are in the United States.

(The tables referred to follow:)

TABLE 1.—*Defense expenditures of NATO countries as percentages of GNP at current market prices, calendar year 1962*

	Percent		Percent
Belgium-Luxembourg	3.0	Norway	3.7
Denmark	3.0	Portugal	7.1
France	6.5	Turkey	5.4
Germany	5.1	United Kingdom	6.4
Greece	4.5		
Iceland	([1])	European NATO countries	5.4
Italy	3.5	Canada	4.5
Netherlands	4.5	United States	9.8

[1] Not available.

Source: Compiled by the staff of the Joint Economic Committee from data supplied by the Statistics and Reports Division, Agency for International Development.

TABLE 2.—*Economic assistance and defense expenditures of selected countries*[1] *as percentages of GNP*[2] *in calendar 1961*

Countries	Percentages of GNP[2]					Per capita aid and defense expenditures	Per capita GNP[2]
	Grants and grant-like contributions[3]	Official net lending[4]	Total official aid (1)+(2)	Defense expenditures	Total net official aid and defense expenditures (3)+(4)		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Belgium	0.93	−0.01	0.92	3.40	4.32	$54	$1,254
Canada	.20	−.01	.19	5.32	5.51	97	1,753
France	1.68	.14	1.82	7.41	9.53	108	1,138
Germany	.25	.61	.86	4.93	5.79	72	1,235
Italy	.16	.07	.23	4.04	4.27	26	599
Japan	.20	.38	.58	1.26	1.84	8	426
Netherlands	.63	−.01	.62	5.03	5.65	54	950
Portugal	.51	.92	1.44	7.84	9.28	22	237
United Kingdom	.38	.30	.67	7.60	8.27	104	1,252
Weighted average, above countries[5]	.54	.28	.81	5.42	6.23	56	904
United States	.60	.12	.72	10.36	11.08	288	2,597
Weighted average, all selected countries[5]	.57	.18	.75	8.41	9.16	137	1,493
U.S. expenditures as percentages of total expenditures of the selected countries	62.97	39.45	57.35	74.53	73.14		

[1] The selected countries comprised the membership of the OECD's Development Assistance Committee in 1961.
[2] GNP is measured at factor cost, and equals GNP at market prices less indirect taxes net of subsidies.
[3] Includes grants, reparations, transfers of resources for recipients' currencies, and grant and capital subscriptions to multilateral agencies.
[4] Includes bilateral loans, consolidation credits, and purchases of IBRD bonds, loans, and participations. Excludes official loans for 5 years and less.
[5] Weights are GNP for cols. (1) through (5), and population for cols. (6) and (7).

Sources: Compiled by the staff of the Joint Economic Committee from: "Outlook for U.S. Balance of Payments," hearings before Joint Economic Committee's Subcommittee on International Exchange and Payments, 87th Cong., 2d sess., December 1962, p. 71; and Statistics and Reports Division, Agency for International Development.

Secretary DILLON. We have continually urged that they carry a larger share of the aid burden now that they are better able to do so. There have been shown some increases which have been very welcome. I think it still has a good deal farther to go.

As you know, we have been urging them to improve their capital markets, which they recognize they should do. That is a difficult long-term problem. They are working at it, but they have not made anywhere near as much progress as I think could and should be done.

Senator JAVITS. Now, as the administration recognizes this and as it shows up most glaringly in the balance of payments, has any thought been given to holding a world economic or monetary conference, at least with 10 of the leading industrialized countries who have indicated a disposition to discuss these matters?

As I see from the reference in your statement, these 10 countries have made special arrangements with the IMF to supplement its lending capacity. Have we given any consideration to raising these issues in terms of the very clear framework of article I of the Articles of Agreement of the IMF at an international monetary conference at least with the 10?

Secretary DILLON. No; we have not thought that a public conference was very useful unless it was well prepared and we knew what was going to come out of it. The results of the London Economic

Conference in the early 30's are an example of what an ill-prepared conference can do.

However, we are working with the 10. We discussed these subjects with them and we have an agreement to meet from time to time to discuss these issues with the Finance Ministers of the 10. There will be such a meeting here at the time of the meeting of the International Monetary Fund this fall.

There was another one last winter at the time of the NATO meeting in Paris, and a couple of times a year I think we will continue to meet regularly to discuss these matters.

Senator JAVITS. Mr. Secretary, I don't want to reargue history with you but, as I recall it, the London Economic Conference of 1933 failed because of the irreconcilable conflict between the Roosevelt administration's inflationary economic policies necessitated by our depression and the stabilization measures advocated by leading members of the Conference. Isn't it a fact, Mr. Secretary, that, in order to get anything really done of a major character, the financial authorities of the respective countries have to be backed by their people, and that you are not going to rouse their people to our problems which may require us under extreme circumstances—as Senator Fulbright indicated in his questioning with you—to reduce these aspects of our world leadership? Aren't you going to fail to impress their people unless you do dramatize this on an international scale, at some public international conference?

Secretary DILLON. Of course we do have the benefit of that at the annual meetings of the Monetary Fund. I think this could perhaps be somewhat better done than it has been through the ministerial meetings of the OECD, if the ministers held some of their sessions in public.

The OECD meetings, ministerial meetings, so far have been entirely private. They have resulted in some communiques which have not been received with great interest. If they discussed these major questions publicly at the ministerial level, I think they would help a great deal to achieve the result you suggest. There is a point in educating the people as well as trying to reach an agreement with the technical experts.

Senator JAVITS. Mr. Secretary, is it fair to say, and I don't want to edge you into any position because this is much too important, that the administration has not considered this question which we are discussing, of enlisting the interest of the peoples of our principal allies, the industrialized countries of the world, in this problem which is so grave to us, especially in terms of the possible urgent necessity which we may face of diminishing the extent of our international leadership.

Is it fair to say that the administration has not considered that?

Secretary DILLON. I think it is not quite fair to say that. I don't think we have considered that it is advisable from the point of view of having an international monetary conference. But certainly the statements that the President made when he was in Frankfurt were designed generally to educate the European public to the fact that there is a very real problem and that this is something which has to be handled jointly and not merely by our taking actions which, as you say, might be unfortunate, either for ourselves or the world as a whole or both.

Senator JAVITS. Looking at the other side of the medallion, I would like to get this in before my time expires. I notice that the economic prescription of the administration for building up our own productivity and therefore our own capacity to deal with this international imbalance of payments continues to be a tax cut.

I notice that is very much emphasized. Are you in a position to tell us, Mr. Secretary, what are the administration's legislative priorities? Does civil rights legislation precede a tax cut, does it follow a tax cut, or is it an equal priority? Are they both No. 1?

Secretary DILLON. Certainly nothing has happened to displace the No. 1 priority of the tax reduction. As I mentioned briefly at the end of my statement, I can think of nothing that would probably do more to ease some of the current tensions than an economy that was functioning better, which would make it possible to give more jobs to both minority and majority groups at the same time.

So we think it is absolutely essential. The exact timing as to how it moves through the Senate is something which I don't know that the administration can completely control. Certainly it is our objective to have a tax reduction during the course of this year.

Senator JAVITS. This year? And is it also the administration's objective to have civil rights legislation this year?

Secretary DILLON. I think very clearly it is, to have both.

Senator JAVITS. So both are the main legislative objectives of the administration?

Secretary DILLON. I think that is correct.

Senator JAVITS. Thank you. Mr. Secretary, I have some questions on our gold purchase policy, et cetera. I hope we will have a chance to go into that with Mr. Roosa.

Secretary DILLON. Fine.

Representative REUSS. Representative Patman?

Representative PATMAN. Mr. Secretary, you mentioned that our unfavorable balance of payments was due to four things: foreign aid, military payments, tourists, and outflow of capital. How does the outflow of capital compare with any one or all of the other three? Is it more or is it less than any one of the others?

Secretary DILLON. The outflow of capital altogether is substantially more.

Representative PATMAN. Substantially more?

Secretary DILLON. Yes.

Representative PATMAN. Is it more than all three?

Secretary DILLON. I would say it is about the same as all three.

Representative PATMAN. I was surprised, a while ago, that, when someone asked you about cutting down or reducing certain items if certain things would happen, you only mentioned the first three. You mentioned foreign aid, military payments, and tourists. You didn't mention outflow of capital.

Secretary DILLON. That was in answer to a question. I, certainly on reflection, would have mentioned outflow of capital because, when you include short-term and long-term flow, it is the major outflow.

Representative PATMAN. If you want to deal with the outflow of capital, you would only deal with very few institutions, would you not, about 20 of the largest banks and a few of the industrial companies.

Secretary DILLON. No, I think this is very general in some areas. In all the private investments abroad by individual manufacturing concerns and individual businesses they make their decisions without thinking about the banks.

They also are largely responsible for these movements of short-term capital when they find they can put excess funds to work in the Euro-dollar market for more than they get by putting them on deposit or buying short-term Governments here in the United States.

So I think this is a general area that a few banks could not control, although the banks that do carry out exchange operations in the foreign exchange markets are relatively few in number.

Representative PATMAN. Now you know the principal banks that engage in these operations that result in the export of capital, don't you, and you know the amounts.

Secretary DILLON. I am not sure that we do. We do know that the banks so engaged do make reports but these reports are confidential and we are not furnished with anything except overall totals where they are lumped together. So we don't know what one bank does as against another.

Representative PATMAN. You get information from investment houses?

Secretary DILLON. We get full information regarding each sale of portfolio securities.

Representative PATMAN. That is not considered confidential, is it?

Secretary DILLON. No; usually they are registered and they are public, they are advertised in some form or another.

Representative PATMAN. Would 20 of the investment houses cover most of the investment of capital abroad?

Secretary DILLON. I think probably fewer.

Representative PATMAN. Would you be in a position to furnish information as to how much was exported last year by these 20 investment houses on loans or investments to the developed countries, we will say, not the underdeveloped countries, and then make an estimate of the total to the underdeveloped countries since they are not included?

And would you give the same information for the first quarter of this year? I understand that is available too.

Secretary DILLON. Yes.

Representative PATMAN. But not the second quarter. Is the second quarter available?

Secretary DILLON. The second quarter is not yet available. It will probably be in a month or a few weeks.

Representative PATMAN. Will you furnish the same information without identifying the banks, for the first 20 banks?

Secretary DILLON. That is a technical question, whether we can do it for 20 banks or more. We will do what we can.

Representative PATMAN. Do it the nearest to the 20 that you can.

Secretary DILLON. We will do the best we can on that.

Representative PATMAN. Thank you very much. With that I assume that we will have permission to insert this in the record.

Representative REUSS. Yes; without objection this material will be inserted in the record.

(The material referred to follows:)

U.S. portfolio capital outflows involving U.S. investment houses and banks in the United States

[Millions of dollars]

	Total	New issues of foreign securities [1]	U.S. bank loans and credits, net [2]	
			Long term	Short term
Calendar year 1962:				
Canada	−394	−457	−30	+93
Western Europe	−392	−195	−85	−112
Japan	−357	−101	−51	−205
Australia, New Zealand, South Africa [3]	−58	−60	+14	−12
Total developed countries	−1,201	−813	−152	−236
All other countries	−205	−179	+35	−61
International institutions [4]	−84	−84		
Total	−1,490	−1,076	−117	−297
1st quarter, 1963:				
Canada	−389	−368	+19	−40
Western Europe	−33	−60	−27	+54
Japan	−58	−47	−1	−10
Australia, New Zealand, South Africa [3]	−6			−6
Total developed countries	−486	−475	−9	−2
All other countries	+46	−37	+36	+47
International institutions [4]				
Total	−440	−512	+27	+45

[1] Amounts of U.S. funds involved, without taking account of refundings and other capital repayments.
[2] On own account and domestic customer account.
[3] In case of bank loans and credits, data for New Zealand are not separately available and are included under "All other countries."
[4] Represents International Bank for Reconstruction and Development only; regional institutions are included with areas they serve —the Inter-American Development Bank under "All other countries," and the European Coal and Steel Community under Western Europe.

LIST OF U.S. INVESTMENT HOUSES PARTICIPATING AS PRINCIPAL UNDERWRITERS IN PLACING NEW ISSUES OF FOREIGN SECURITIES IN THE UNITED STATES DURING 1962 AND THE FIRST QUARTER OF 1963

Arnhold & S. Bleichroeder, Inc.
Bell, Gouinlock & Co., Inc.
Burnham & Co.
Dillon, Read & Co., Inc.
Eastman Dillon, Union Securities & Co.
First Boston Co.
Glore, Forgan & Co.
Goldman, Sachs & Co.
Greenshields & Co., Inc.
Halsey, Stuart & Co., Inc.
Harriman, Ripley & Co., Inc.
Kidder, Peabody & Co., Inc.
Kuhn, Loeb & Co., Inc.
Lehman Bros.
Merrill Lynch, Pierce, Fenner & Smith, Inc.
Morgan, Stanley & Co.
Paribas Corp.
Smith, Barney & Co., Inc.

Representative PATMAN. Thank you sir.

Representative REUSS. Representative Widnall?

Representative WIDNALL. Mr. Secretary, I too would like to compliment you on your presentation today. I think it has been most helpful. You referred to the private placement of new foreign issues. What is the specific advantage in placing those issues privately over the public market?

Secretary DILLON. There are two advantages for the person who borrows the money that way. One advantage is that presumably it is a simpler and, just possibly, a quicker and maybe a more certain process because you can negotiate, you are sure you have made the sale, rather than having it done through a public issue.

The other, which applies to certain industrial companies, is that in private placement they do not register the securities with the Securities and Exchange Commission and therefore they do not make public or do not make available to the public all the facts that are required for a registered issue.

This has been important, particularly in the case of European borrowers. There have been not too many so far but there have been a few issues privately placed in the United States by large industrial concerns in Germany and France and I think a major reason why they wanted to place them privately is that they do not make public the full information even to their own stockholders that we regularly do and they just don't want to do it. Therefore they avoid that by making a private placement.

Representative WIDNALL. Is there any legislation that we could pass or any recommendations you could make to the Congress which will be helpful in trying to correct this situation and make possible more public placements rather than private placements?

Secretary DILLON. We certainly are working to that objective. We have not yet thought of any specific legislation in this connection but the difference is great; of the European issues that have been sold publicly here this year, more than 50 percent have been sold abroad.

So they have had only a 50-percent impact on our balance of payments. Whereas for those that are privately placed it is 100 percent. So it is a very important thing; we are continuing to work with the industry. I think they are becoming aware of this now and I hope this will have some result.

A great proportion of the private placements have been Canadian issues. I think there it has not been a question of trying to avoid publicity or anything. It has just been that it was simpler and quicker. The Government of Canada borrowed that way and the Province of Quebec, when they nationalized their electrical industry in Quebec, financed it by borrowing $300 million in the United States and they did it privately.

But that was just, I think, because of convenience. Just by talking we have found that there is an interest in Europe in buying Canadian securities. So we think if these were offered publicly some of them would be placed in Europe which would be very helpful to our balance of payments.

Representative WIDNALL. Mr. Secretary, you placed great emphasis on a tax cut and the incentives that that would provide the economy by way of employment and business opportunity. In view of that, would emphasis on the reduction in corporate income taxes to 47 percent be far more helpful if that reduction was immediately to 47 percent rather than graduated over a period of years as recommended by the administration?

Secretary DILLON. The recommendation by the administration was for a reduction to take effect in two steps, one on January 1, 1964, and the other on January 1, 1965. This was consistent with the recom-

mendation to reduce individual income taxes in two steps and certainly as far as the impact on our economy and making our investment climate better is concerned we would prefer to see this whole tax reduction put in in one step on the first of January.

However, this would have budgetary implications. It would not have much effect on the fiscal 1964 deficit but it would enlarge the fiscal 1965 prospective deficit over and above what would be the case by putting the cut into effect gradually over a 2-year period.

We just weighed those two things together and we came up with a recommendation to do it in two steps. So far as the impact on the economy is concerned there is no doubt it would be better to do it all at once.

Representative WIDNALL. I also had this in mind in asking you that question. Inherent in your statement is the projection that we probably are going to face a change in interest rates, since you imply that not only our officials feel that our situation is urgent, but foreign countries are worried about the disparity between the rates here and in their own countries overseas.

It seems to me that strong leadership at this point in emphasizing the need to do this immediately would have a very salutary effect as well as doing anything in the interest rate field.

Secretary DILLON. I did not intend to leave any particular implication there except the very public fact, again referring to this Bank for International Settlements report, that this is one of the clear-cut recommendations they make—one of the suggestions that is continually made to Mr. Roosa when he goes to these meetings in Europe, and it has been adverted to publicly in many and various statements by Europeans.

This is particularly in the short-term area, but they also feel it would be effective in the long-term area and we differ with them there. Any change, if there is to be one, is something which the monetary authorities here, the Federal Reserve, who also have a responsibility to protect the dollar, will have to make. It is not a decision we make.

I don't know what their decisions may be, when and whether they feel such a thing is necessary. All I pointed out was that under the pressures that we are under, the need to reduce outflows, certainly that possibility has to be taken into account.

Representative WIDNALL. When we recently visited the Federal Reserve in New York and explored the balance-of-payments situation at that time I believe there was one adverse figure of about $1.1 billion that was unexplained. They could not pin down where the $1.1 billion had gone. Is that hot money? What is the nature of that?

Secretary DILLON. That is probably the item which we refer to as either errors and omissions or unrecorded transactions which shows on table 3 as being $1,025 million in 1962; $900 million in 1961 and just under $700 million in 1960. This is the net difference in other words between the overall figures which we get from the banks and know, and those figures which can be identified through other information such as military expenditures, foreign aid, sale of bonds, things of that nature.

It is generally believed that this is largely transfers of short-term capital by corporations or individuals although some of it can well

be repatriation of capital by Europeans. Since the situation in Europe has stabilized and the prospects have been better there, a lot of the capital that fled from Europe at an earlier time has been willing either to go back or to make itself public.

Now one of the strange things about our balance-of-payments accounting is that if a European owns an interest in American stocks and has them in his name with an address in New York and then shifts that address, and says send me the report to Paris where I live, but keep the same stocks, they are then put down as being owned by a foreigner abroad whereas before they were assumed to be owned by a resident of the United States. And, because no money actually flowed in, unrecorded transactions will show an outflow equivalent to the value of the securities.

So, although it has no effect on our gold, that type of thing is in our balance of payments. That is one of the reasons we got this special committee under Dr. Bernstein to study this with great care because I think there are a number of instances like that that many people are not generally aware of, and that it would be well to have more fully explained.

Representative WIDNALL. Thank you.

Representative REUSS. Senator Javits has a unanimous consent request.

Senator JAVITS. I ask unanimous consent to introduce an exchange of correspondence with the Secretary based upon certain questions put to him by a distinguished banker in New York. That is, my request of May 15 and the Secretary's reply of May 28. A further reply pursuant to other questions which were added on July 5 and a special letter on tourism, which the Secretary discussed this morning, on June 18.

I understand the Treasury Department has no objection to making all of these part of the public record.

Representative REUSS. You so request?

Senator JAVITS. I so request.

Representative REUSS. Without objection, it is so ordered.

(The correspondence referred to follows:)

MAY 15, 1963.

Hon. DOUGLAS DILLON,
Secretary of the Treasury,
Department of the Treasury, Washington, D.C.

DEAR DOUG: At the Economic Club dinner on April 22, 1963, Mr. Armand Erpf, of Carl M. Loeb, Rhoades & Co., asked several questions on the U.S. balance-of-payments situation which he was good enough to send me as well.

I found his questions very interesting and I would very much appreciate having your comments to the following ones. In case Mr. Erpf's questions are not readily available I am repeating them below:

1. How high a priority does restoring the balance-of-payments deficit command on the list of major national issues?

2. What, in your view, is the proper allocation between private sector and public sector spending overseas? The payments balance of the private sector is already favorable, can anything further be done to reduce our public cash expenditures overseas without endangering our foreign economic and military programs?

3. Do the State Department and the Defense Department discuss what steps each or both could undertake to curb or restrict cash spending overseas which between the two tends to contribute heavily to the disequilibrium of the payments equation? What discipline do they discuss or invoke, or is it left to the financial agencies, the Federal Reserve, and the Treasury to cope with the problem? Is this matter just left to the inevitability of gradualness? Does the

Cabinet Committees on Balance of Payments have any say over the oversea spending policies of U.S. Government agencies?

4. The technical work of the Treasury and the Fed in the form of Roosa's arrangements, borrowing abroad, currency swaps, and whatnot is undoubtedly of current benefit in holding off gold outflow and discouraging short-term runs on currency. You have rejected the view that they are "coverups" that cause us to lose sight of the underlying need for payments equilibrium, or that the Treasury or the Federal Reserve might consider them substitutes for needed remedial action. Is it possible that beyond their short-term benefits they might be considered first tentative steps toward a truly international system of banking, painfully slow because of political resistance to the implied abandonment of anachronistic national prerogatives?

5. If we raise current interest rates here to make investment in the United States more attractive and counteract the tendency of funds to go abroad, would this (*a*) vitiate our growth plan, (*b*) trouble the position of England and thus unduly bring trouble to the second of the two currencies that finance virtually all world trade, or (*c*) hurt countries such as Germany and Japan where surpluses on current account disguise the continued thinness of capital formation and capital markets which has brought them into our capital markets to the tune of $1 billion a year?

6. If the problem is solved and we cease to have a significant or worrisome international payments deficit, do you think that the world can satisfactorily finance an expanding world trade, or will we face contraction and deflation? If so, what should be the basic approach: Roosa's deals, Bernstein's ideas, or the Triffen or Stamp plans? And do you think that the Fed and the Government will be prepared to cope with this new problem, or will we only get at it when crisis is upon us?

I will appreciate having your comments on these questions.

Sincerely,

JACOB K. JAVITS,
U.S. Senator.

THE SECRETARY OF THE TREASURY,
Washington, D.C., May 28, 1963.

HON. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR JACK: I welcome the opportunity to comment on the questions, raised at a recent economic club dinner in New York, which were cited in your letter of May 15.

The first of these questions relates to the priority being given to correction of our balance-of-payments deficit relative to other major national issues. I can assure you we are continuing to give this problem the very high priority which was clearly given to it in the President's February 6, 1961 message to the Congress on the "U.S. Balance of Payments and Gold Outflow From the United States." As you may recall, the President then referred to our balance of payments as "one of the key factors in our national economic life," stressing that we must "in the decades ahead, much more than at any time in the past" take our balance of payments into account when formulating our economic policies and conducting our economic affairs.

The second question asks about the proper roles of private and governmental expenditures abroad, respectively, in our program for correcting the payments deficit. Our overall deficit cannot logically be blamed on any particular category or form of expenditures, private or public, and any feasible and appropriate increase in earnings or reduction of expenditures in either sector will be equally useful in correcting this deficit. As indicated on page 4 of the enclosed copy of my report of March 1962 to the President on the balance of payments, our first line of attack on the payments deficit has consisted of a series of measures to curtail the outflow of dollars stemming from the activities of Government itself. This has included, notably, a vigorous and continuing effort by the Defense Department to economize on oversea military expenditures and to negotiate what have been termed "offset" agreements involving increased purchases of U.S. military equipment and services by major allied countries, and also a broad and determined effort to minimize the balance-of-payments impact of our foreign aid programs by maximum feasible emphasis under these programs on the procurement of U.S.-produced goods and services. We are continuing and intensifying

these efforts wherever it appears that this can be done without impairing the effectiveness of our programs for free world defense and economic development. In addition, it should also be noted that about $2.3 billion of our $20½ billion of nonmilitary merchandise exports in 1962 were directly financed by Government grants and capital; and that large additional private sector receipts are made possible by other Government expenditures abroad. It is our belief, moreover, that the private sector of the American economy certainly has the capability, and should be expected, to generate a surplus sufficient to support and finance this country's military and other responsibilities as the leader of the free world.

The third question you cited was concerned with the adequacy of the efforts being made by various individual agencies within the executive branch to minimize the balance-of-payments impact of their oversea programs or expenditures and the manner in which our detailed policies on this are developed and implemented within the executive branch. I have already referred above to the broad and vigorous programs which the Defense Department and the Agency for International Development have been carrying out to minimize the net international payments under their programs. In addition, we have also established within the last year a procedure for the reporting and control, through the Bureau of the Budget of the international payments and receipts of all Federal agencies. I might add that the President himself has, from the beginning of his administration, given close attention to the development and implementation of this aspect of our balance-of-payments program and that the interdepartmental coordination and continued improvement of these efforts is also one of the major functions of our Cabinet Committee on Balance of Payments. Through these efforts we have, for example, already reduced net military expenditures affecting the balance of payments from a level of $2.7 billion in 1960 to about $1.9 billion in 1962, and dollar payments to foreign countries and international institutions under our foreign aid and other grant and capital programs have been reduced despite a substantial increase in the size of the total aid program. Larger reductions in dollar outflows are expected as expenditures under old programs cease. Over four-fifths of fiscal year 1963 AID funds are expected to result in procurement of U.S. goods and services.

The fourth question, referring to the new techniques we have developed in the area of Treasury and Federal Reserve foreign exchange operations and sales of special Treasury securities to foreign monetary authorities, poses the subject of the possible longer term implication of these innovations for an improved international payments banking system. In the context of current world payments situation, we regard these new technical developments as significantly bolstering and improving the international payments system. While their longer term usefulness and importance under changing circumstances can only be tested and demonstrated as we go along, it is our belief that their long- as well as short-term usefulness as a practical means of improving the world payments system is much increased by the fact that they represent a practical, evolutionary approach which builds upon existing procedures and arrangements, and which has resulted in fuller participation of other countries in the operation of the international payments system.

The fifth question deals with the relation of interest rates and our monetary policy to international capital movements including possible adverse effects of action in this area either on our own domestic economic situation or on the payments position or rate of capital formation in major foreign countries. Our domestic objective, of course, is to bring about the sort of conditions in which the abundant supply of savings now seeking longrun investment abroad can be utilized more fully and productively at home. Under such conditions, increases in interest rates here would be a natural reflection of the improved productivity of investment at home. As measures to promote this general objective, the investment credit enacted into law by Congress last year and the new depreciation guidelines are already proving their effectiveness. A most important further step is the reduction in corporate income taxes and the improvement in the tax structure incorporated in the tax revision proposals now under consideration by the Congress.

I have long suggested the need for efficient, fully effective capital markets in Europe, freely open to potential foreign borrowers. The initial reexamination by some European countries of their capital market mechanisms is encouraging. As their capital markets develop, there should be some reduction in their long-term interest rates, narrowing the present gap between the level of rates in most other industrial countries and those here. Even if long-term rates here

rose above those in Europe and Japan, we would expect foreign governments and corporations, particularly those needing relatively large amounts of money, to resort to the highly developed U.S. market.

Some short-term capital movements appear to be more directly influenced by interest rate differentials. By and large, our present fiscal and monetary policies have been reasonably successful in raising short-term rates here—and hence reducing the differential between the United States and most foreign rates—without placing any upward pressure on long-term rates, so much more significant for our own domestic growth. In this area there is a clear need for continued and increased international monetary cooperation to insure that measures taken here and in the other principal financial centers all contribute to stability and do not, in the pursuit of perhaps conflicting domestic objectives, result in measures damaging to other countries.

The final question is concerned with the possibilities for expanded world trade and adequate liquidity in a world where the U.S. balance-of-payments problem has ceased. On these scores I believe that we have grounds for considerable optimism. The international cooperation which has been developed in the past several years has made it possible to weather successfully major strains on the international payments system, such as those involving Britain in 1961, and Canada in 1962. In addition, following the convertibility of the major European currencies, the European Monetary Authority has contributed effectively to international liquidity; the quotas in the International Monetary Fund have been sharply increased; and $6 billion in new resources have been provided for under the special borrowing arrangements of the IMF. We have said we would be willing to accumulate currencies of other leading countries, should this become desirable at some future time to maintain adequate world liquidity.

Much has been contributed to this question by international financial experts both inside and outside of the U.S. Government. We will continue to welcome discussion of these questions which are so important to the maintenance of a secure and strong free world economy.

With best wishes.

Sincerely,

DOUGLAS DILLON.

THE SECRETARY OF THE TREASURY,
Washington, July 5, 1963.

Hon. JACOB K. JAVITS,
U.S. Senate, Washington, D.C.

DEAR JACK: I am glad to take this opportunity to reply to the further questions on our balance of payments posed in your letter of June 19.

1. A better distribution of the burden of Western defense has been a U.S. objective for some years. In addition to our continuing efforts in NATO to get our European Allies to undertake a larger share of the common defense efforts, we have been successful in negotiating bilaterally with two of our principal Allies with strong payments positions—Germany and Italy—arrangements which offset most or all of the foreign exchange cost of maintaining our forces in their countries. We are further reducing the net balance-of-payments cost of maintaining our forces overseas through sales of military goods and services to other allies, and we are actively seeking to increase these sales further. These offsets and other sales are mutually beneficial in that they assist our NATO partners to meet their defense commitments and improve the military strength of the Alliance, and at the same time reduce the burden of defense on the U.S. balance of payments.

2. The U.S. Travel Service is actively at work in over 30 principal tourist markets seeking to promote travel to the United States. Both advertising in local magazines and newspapers and travel films in the local language are used in this effort. While it is impossible to demonstrate a direct relationship between such generalized advertising and tourist expenditures here, we believe this can pay off many times over in increased balance-of-payments receipts. In addition to these active promotional efforts, we believe that tourism to the United States is also being helped by our actions to simplify visa and entry requirements, and other efforts to make visits to the United States easier and more attractive.

3. The administration has placed export promotion high on the list of measures designed to help the balance of payments. The new financing and guaran-

tee facilities provided by the Export-Import Bank and the Foreign Credit Insurance Association have improved the ability of American exporters to meet the terms of their competitors abroad in this respect. Services provided to American businessmen by the Department of Commerce and American embassies and consulates abroad have been sharply increased, and direct promotional efforts have also been intensified through trade fairs, trade centers, and trade missions. Many new firms have been induced and assisted to enter the export market. The administration has considered the feasibility of granting specific tax incentives to exporters along with other possible incentive measures, but has not felt it advisable to propose the substantial modification in our tax system that would be required if an effective incentive were not to conflict with our international commitments under GATT. We are, therefore, taking a very firm stand against the proliferation of special tax export incentives used by our European competitors. The United States has, of course, consistently allowed a full exemption of excise (and other indirect) taxes imposed on goods destined for export, the rebate of which forms the basis for the incentive system of most European countries. But the effect is less than that abroad since such taxes play a relatively smaller role in our tax system.

4. The major savings which might be anticipated from further reviews of Government expenditures affecting the balance of payments would be in the two largest programs in this area—the expenditures necessary to maintain our forces in various oversea areas, and those expenditures under our foreign aid program which result in a dollar outflow. In these programs, considerable savings have been achieved already. I have already discussed the far-reaching program which has been developed by Secretary McNamara to reduce the net impact of defense expenditures abroad. In this connection, we have held gross expenditures down despite price rises abroad and the impact of the Berlin buildup. The substantial impact of offset agreements has been noted earlier.

The Agency for International Development and its predecessor agencies have taken a series of steps which will further reduce dollar outflows under its program—it is currently estimated that over 80 percent of AID commitments in fiscal year 1963 will be provided in the form of U.S. goods and services.

While the possible savings that can be brought about through the "gold budget" review of other agency programs will necessarily be relatively small, each agency is being required to justify the need for each oversea activity to the Budget Bureau, and any deviation from the approved expenditure targets must be thoroughly justified and approved.

5. Our attitude toward the various proposals for "broadening existing financial institutions into a truly international banking system" has been one, not of dogmatic opposition but rather one of willingness to undertake study and analysis. Many proposals which have been made have been of a far-reaching nature and all have involved great complexities and innumerable technicalities which would have to be satisfactorily resolved before even tentative support could be given. In the circumstances we have felt that we have a special responsibility that constrains us not to set off any premature hope or speculation concerning any of these proposals. We would, I think, be acting equally irresponsibly if we were either to reject proposals out of hand or to support them before they have been given rigorous analysis and been deemed reasonably practicable and useful. But this does not mean that we have been unwilling to study carefully suggestions which have been made; and, in fact, we do continue to study ways and means of improving the existing institutions.

You will recall that we actively participated in increasing the resources and utility of the International Monetary Fund in the negotiation in 1961 of the general arrangements to borrow. However, there is at present no consensus among major financial countries that the functions of the International Monetary Fund or other financial institutions need to be broadened particularly in the sense of creating a truly international banking system and none is likely in the near future. Even were such consensus to develop, the negotiations would be protracted, and there is no certainty that they would eventually develop a greater volume of credit than that now being obtained by the United States through bilateral arrangements. These have been effected speedily and selectively, and they have proved mutually advantageous. They have been designed to facilitate financing of our deficits on a short- and medium-term basis. They have entailed innovations and experiments in international finance. They have also increased international liquidity and induced greater international monetary stability. But they are not designed to shore up indefinitely the con-

sequences of a continuing deficit in the basic elements of our balance of payments. Adjustments to this end take time, and we conceive of the bilateral financial arrangements as the most practical and suitable ones available at the present time to bridge the gap.

With best wishes.

Sincerely,

DOUGLAS DILLON.

TREASURY DEPARTMENT,
ASSISTANT SECRETARY,
Washington, June 18, 1963.

Hon. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR JAVITS: I am pleased to furnish you information on several matters related to our net tourism balance, in accordance with the request of Mr. Szabo of your staff. These aspects are: (*a*) Public Law 480, section 104(s) sales of local currencies to American tourists; (*b*) estimated effect of the $100 limitation on duty-free imports by returning American tourists; (*c*) allowances of Western European countries, Canada, and Japan to their residents for tourist travel; and (*d*) data on foreign tourist expenditures abroad for 1960, 1961, 1962, and the first quarter of 1963.

The possibility of Public Law 480, section 104(s) sales of local currencies to American tourists is limited by the fact that there are relatively few countries whose currencies the U.S. Government holds in amounts excess to its needs. These countries and the amounts of excess as of December 31, 1962, are shown below:

[Thousands of dollars]

Country	Dollar equivalent of excess U.S. Government holdings	(Of which accruing from Public Law 480, title I sales)
Burma	4,754	(181)
India	154,165	(33,438)
Pakistan	56,308	(6,033)
Poland	375,297	(375,297)
United Arab Republic (Egypt)	18,039	(16,455)
Yugoslavia	32,979	(18,070)
Indonesia	4,928	(4,311)
Israel	12,812	(510)
Total	659,282	(454,295)

It would not benefit the U.S. balance of payments if we were to sell to American tourists local currencies which are needed for current operations of our Government abroad, because we would then have to use dollars to buy these currencies from foreign governments to cover U.S. Government needs. Hence, we have followed the policy of making available for sale to American tourists only those currencies which are in excess of U.S. Government needs. These are currencies of countries which do not get a very large share of American tourism and in the case of India and Pakistan particularly are recipients of large amounts of U.S. assistance extended in order to ameliorate difficulties caused by these countries' shortage of foreign exchange. Accordingly, these countries are reluctant to agree to U.S. Government sales of Public Law 480, title I local currency proceeds to American tourists since it would tend to reduce their own dollar income from American tourists. Only two of the above countries—United Arab Republic (Egypt) and Israel—have agreed to the sale of Public Law 480, title I proceeds to American tourists.

In the case of Egypt, the U.S. Government through April 30, 1963, had made available for sale to American tourists $12 million equivalent of Egyptian pounds, and through the same date had sold only $8,824.98. Egyptian pounds were announced as being available for sale to American tourists through a Treasury Department January 7, 1963, press release. Notice is also being given through the Commerce Department's foreign commerce weekly, "International Commerce." In the case of Israel, our excess holdings have been reserved for dollar

repayable loans to the Weizmann Foundation and none has been made available for sale to American tourists.

The $100 limitation on duty-free imports by U.S. residents returning from abroad is estimated to have resulted in a reduction of $123 million in their foreign purchases in 1962 as compared with 1960, the last full year before the reduced exemption.

Table I enclosed shows the travel allowances granted by other advanced countries to their residents, according to our latest information. You will notice that seven of the countries have unlimited allowances. Denmark and the Netherlands are close to being in that category. In the case of France and the United Kingdom, it is more difficult to judge the liberality of the allowance in view of the fact that amounts in addition to those shown may be granted upon justification to the authorities. In these cases as well as those of some of the smaller Western European countries, and in the case of Japan, there is room for further liberalization. The U.S. Government has pressed in the OECD and elsewhere for full liberalization.

Table II enclosed shows the U.S. tourism account for the years 1960–62 and the first quarter of 1963 (seasonally adjusted). The increase in our tourism deficit last year despite some increase in our tourism receipts is not encouraging, and it has led us to redouble our efforts to reduce the deficit in 1963.

Please let me know if you have need of further information on this subject.

Very truly yours,

JOHN C. BULLITT.

TABLE I.—*Foreign travel allowances granted to their residents by various countries*

	Amount of allowance that traveler can convert before departure from his country	Additional amount of allowance in form of bank notes which traveler can take abroad and convert
Austria	$577 per journey [1]	$385
Belgium	Unlimited	(2)
Denmark	Any reasonable amount	290
France	$700 per journey [1]	150
Germany	Unlimited	(2)
Ireland	$706 per journey [1]	[3] 140
Italy	Unlimited	80
Luxembourg	do	(2)
Netherlands	$1,194 per journey [4]	---
Norway	$500 per year	[3] 50
Portugal	Unlimited	(2)
Spain	$500 per journey [1]	50
Sweden	$1,160 per journey	---
Switzerland	Unlimited	(2)
United Kingdom	$706 per journey [1]	140
Canada	Unlimited	(2)
Japan	No automatic allowance [5]	---

[1] Additional amounts may be allowed upon justification.
[2] Unlimited.
[3] May be spent only on carriers of traveler's country.
[4] An additional amount of $40 is also granted automatically for each day of travel beyond 14 days, up to $3,781. Unlimited additional amounts are granted on request.
[5] Japanese declaring themselves as "business travelers" are allowed $500 per year plus fares.

NOTE.—For countries in the above table where the allowance is not "unlimited," the allowance is generally in addition to fares.

TABLE II.—*U.S. tourism account, 1960–62*

[In millions of dollars]

Year	Exports			Imports			Net tourism balance
	Trans-ocean fare receipts from foreigners	Travel by foreigners in United States	Total, tourism receipts	Trans-ocean fare payments to foreign carriers	Travel by U.S. tourists and businessmen abroad [1]	Total, tourism payments	
1960	+110	+887	+997	−490	−1, 744	−2, 234	−1, 237
1961	+112	+900	+1, 012	−515	−1, 747	−2, 262	−1, 250
1962	+117	+921	+1, 038	−563	−1, 905	−2, 468	−1, 430
1963 1st quarter (adjusted)	(2)	+231		(2)	−482		

[1] Roughly 80 percent pleasure, family, etc., and 20 percent business.
[2] Not available quarterly.

Representative REUSS. Before calling on Senator Proxmire for his long-delayed 10 minutes I would like to look ahead a bit. Mr. Secretary, you have been very helpful and patient. It is quite obvious now that not all members are going to be able to ask their questions before the inevitable adjournment for the lunch hour.

Would you be able to reappear here at 2:30 this afternoon to continue so that we may finish with our questions to you this afternoon? Then we would ask Mr. Roosa to come in in the morning as planned.

Secretary DILLON. I will be glad to return at 2:30. I would ask your indulgence in allowing me to leave at 12:45 because I have an engagement for lunch with the President and the Prime Minister of Australia at 1 o'clock.

Representative REUSS. Senator Proxmire I am sure has heard that.

Secretary DILLON. We have 18 minutes.

Senator PROXMIRE. I am only allowed 10. Mr. Secretary, I join my colleagues in commending you on the persuasiveness with which you have justified your viewpoint. I do wish we had a chance to talk about this Kenen report as well as the Cohen report but, as we have not seen them, of course we can't very well discuss them.

I understand there is considerable question about both of them.

It is quite unusual for any economist or any expert to argue that reducing taxes to expand the domestic economy will help the balance-of-payments situation. Normal economic analysis would suggest a precisely opposite effect. Of course, reduction in corporate income taxes is going to make investment opportunities more attractive. Certainly it will tend to expand our industrial opportunities by increasing demand and employment. But don't you leave out of account the other side, the fact that we are reducing taxes at a time when we have a big deficit—an $8 billion deficit? Reduction in taxes will at least temporarily increase that deficit, and the tendency will therefore be to increase aggregate demand. This, I presume, would at least tend to push prices up above what they would be otherwise. Now, in answer to a similar point made by Congressman Curtis earlier, you said that the various authorities had indicated that, in their judgment, this would not have an inflationary effect. Professor Duesenberry, an eminent Harvard monetary specialist, who appeared before us, argued

that you can't really reduce unemployment levels significantly without having some increase in the Consumer Price Index. Now isn't it likely that there is a great deal of truth in the position taken by Professor Duesenberry, that to be fair about this thing we must pay a price for expanding our economy at home, and that this price might be adverse, might be well worth paying, but adverse so far as our international balance of payments is concerned?

Secretary DILLON. I think the answer to that is that, with the present level of unused capacity and unemployment, there would not be an inflationary impact in the stimulus to the economy of the kind contained in the tax reduction process we are recommending. However, should we be successful, as I think we will be, and approach toward fuller employment, then there is no doubt that restraints which have been on wages and prices because of this excess capacity and excess unemployment will be lessened, and it will be more difficult for us to hold our prices and to maintain the type of relative price stability we have been maintaining. You are quite correct and I think it will become more and more important at that time to reach an understanding among labor, management, and the Government, realizing how important it is to hold our price levels with our balance-of-payments situation.

We will have to make a great effort. I don't think it is impossible.

Senator PROXMIRE. Your emphasis on the tax cut contradicts the classical economic analysis which suggests that you get international stability by the very fact that as your international trade falls off it has a depressing effect on your economy, wages drop, prices drop, and this gives you a competitive advantage. Of course the reverse happens if your economy is expanding. The reverse thrust of the tax cut would have somewhat of a tendency to be adverse to our balance of payments, but I think you have very persuasively emphasized the fact that there are some counteracting factors. I am inclined to think maybe the general effect would be somewhat adverse. It it a price that might be well worth paying. But it is a price adverse to our balance of payments.

Secretary DILLON. I think that is the question. I think you are quite right in saying that our present situation runs counter to the classical courses for the balance of payments for a number of reasons. First, because our international trade is such a small part of our overall economy that the type of restrictive action we would have to take to have effects on our international payments would have much bigger effects than would be desirable on our domestic economy and that these in turn would then cause—because of our size—problems throughout the world and make difficulties in world trade and commerce. So we can't do some of the things that smaller countries have been able to do.

The other situation is that classically balance-of-payments problems have been associated with inflation and excess demand within a particular country and in our case, probably for the first time, it is associated with just the opposite, with excess capacity, rather than excess demand, and with excess unemployment. So we have a situation that is different from anything foreseen by the classical economists.

Senator PROXMIRE. You advocate Operation Nudge with a vengeance. You emphasize, as I understand it, that we should not increase

long-term interest rates, but follow monetary policies that would keep long-term interest rates at the present level while tending to increase short-term interest rates.

You relied to some extent at least in one question on the recommendation by the Bank of International Settlements. It is my understanding that the latest BIS annual report states that short-term interest differentials have largely been eliminated and that a further increase in U.S. short-term rates would be undesirable.

This was in June, I believe. The staff gave me this quotation. It is directly out of the BIS report. Doesn't this contradict what you have been advocating to us this morning?

Secretary DILLON. There is such a quotation in the report. It is not quite in full context with the rest of the statements. We don't know quite what they had in mind. That is something we are discussing now with them. I think what they had in mind and what they maybe didn't make very clear is that it would not be desirable to increase our short-term interest rates to the extent that they would attract substantial funds from other weak or relatively weak currencies, in particular the London market.

In that quotation you just gave, they go on and specifically refer to the fact that funds should not be attracted from the United Kingdom. I agree with that. I don't think that would be helpful. I do think there is an area, particularly in narrowing the differential between our present interest rates and the Euro-dollar market, which would be helpful to our economy and would not adversely affect the United Kingdom. This means that if there is to be any change or any further change—of course we have shored up over the last 2 years our short-term rates—we have to be very careful about it.

Senator PROXMIRE. This seems to me to be a very modest prescription basically. You advocate, No. 1, a tax cut. I presume you acknowledge that this would not have a very great beneficial effect on our balance of payments. Then you advocate an increase in short-term interest rates. And you point out that we have to be careful about this because we don't want to lure money away from the London market and we have to work and cooperate with these people.

Furthermore, a point which has not been made yet, but I think is very compelling, is the fact that if we increase our short-term interest rates there is every reason why these countries in Europe would increase theirs, because they have a very persuasive domestic reason for increasing interest rates. They have inflation to cope with; we don't. They have a shortage of labor; we don't. They have a maximum utilization of their facilities, by and large, in many countries; we do not. If we increase our short-term interest rates by a half percent or 1 percent and they increase theirs, then there is an unfortunate effect in our domestic area and we perhaps don't benefit ourselves in the international area.

Secretary DILLON. You are correct on that. The essential element is that if there was to be any change here there would have to be an understanding and agreement as firm as one could get with the various monetary authorities abroad, certainly those on the continent of Europe where their balance-of-payments situation is strong, that they would not follow up any change in interest rates here by similar ones

over there which would vitiate the whole point of the operation. They have indicated informally that this is their objective. They could not ask us to try to have higher rates if they are going to follow them up immediately. I think Mr. Roosa who has talked to them regularly and at length would be able to answer you more fully on that tomorrow. You are perfectly right. The essential element of this is that if there is any change here it must not be matched by a similar change in Europe.

Senator PROXMIRE. Thank you very much, Mr. Secretary.

Representative REUSS. Thank you, Mr. Secretary and Under Secretary Roosa. We will stand adjourned then until 2:30 and we will look forward to continuing the discussion at that time.

(Whereupon, at 12:40 p.m., the committee recessed to reconvene at 2:30 p.m. of the same day.)

AFTER RECESS

(The committee reconvened at 2:30 p.m., Representative Henry Reuss presiding.)

STATEMENT OF HON. C. DOUGLAS DILLON, SECRETARY OF THE TREASURY; ACCOMPANIED BY HON. ROBERT V. ROOSA, UNDER SECRETARY FOR MONETARY AFFAIRS, DEPARTMENT OF THE TREASURY

Representative REUSS. The Joint Economic Committee will be in order. We again have the Secretary of the Treasury, Mr. Dillon, with us and Under Secretary Roosa. The next committee member to be recognized will be Senator Miller.

Senator MILLER. Thank you, Mr. Chairman. I too want to say that I appreciate the comprehensiveness of your statement to the committee, Mr. Secretary. While we all recognize that some of the areas are not agreed upon, I think nevertheless it is well to get them out so that we can discuss them. The first question I would like to ask is this: In your statement you refer to the impact of the dock strike last winter on our export trade and also infer, I presume, that this had an unfavorable impact on our balance-of-payments situation.

Would you care to give an estimate of what the impact would be if we had a, say, 30- or 60-day railroad strike, which as you know is imminent?

Secretary DILLON. I think it would be most serious. Certainly one of the problems is that while a great amount of our imports are raw materials, processed raw materials of one sort or another which are in stock in the United States—that we draw down at the time of a dock strike, or a shipping or transportation strike of one sort or another, they are then brought in and built up so that there is no loss in the long run—the imports stay level. Our exports are much more heavily concentrated in manufactured products for which there are alternative sources. If, because of any long-lived delay in deliveries, we lose certain orders, it may be that we not only lose those orders for good because they go somewhere else but we also may lose the business that flows from that sale for good or for a long time.

So, generally speaking from our situation, a transportation stoppage—I have been thinking particularly of the dock strike, but if it is a long railroad strike it would have the same general type of effect—would more heavily affect our exports than our imports. Therefore, it would be very serious.

Senator MILLER. Thank you. In your statement you noted that imports over recent months are again running a bit below expected relationships to GNP. I am not sure what you mean by "GNP." I would like to point out this fact to you: In "Economic Indicators" for June of 1963, which has been prepared by the President's Council of Economic Advisers, I note that gross national product during the first quarter of this year increased $8.3 billion; but at the same time I note that when this is converted into 1962 prices the increase was only $5.7 billion. So that leaves $2.6 billion in inflation. I am wondering if your statement relating imports to GNP measures GNP as adjusted for inflation or to just a gross GNP figure?

Secretary DILLON. It relates to a gross GNP figure, because imports are valued at whatever their current value may be and over the years there have developed certain relationships which are expected. What I was doing here was quoting from the latest Survey of Current Business of the Department of Commerce, which analyzed these trends and made these statements which I have picked up. They have found the current level of imports was somewhat, a very small amount but somewhat, less than might have been ordinarily expected in proportion to our GNP.

These figures are also based on current GNP, the past, the present, all the time.

Senator MILLER. Thank you. I think it is well to point that out because if, indeed, gross national product is reduced to take out the inflationary figure, then you might find that the imports are actually running higher than they should be.

Secretary DILLON. The same thing would have been true in the past because GNP has always increased somewhat faster than constant dollar GNP. The figures I was referring to have always been related to GNP. I think there is a similar relationship the other way.

Senator MILLER. You stated several times that currency devaluation is "out of the question." It appears that, as a matter of policy, you do not favor such action, but I suggest to you that it may very much be a matter of "question" because, as I understand the matter, our gold supply is down to around $14.8 billion; and we have been losing gold at a rate of $900 million a year. So if we continue with the same amount of loss of gold for this year we will be down to around $14 billion and then down to around $13 billion at the end of 1964 and down to below $12.5 billion sometime during the middle or latter part of 1965.

I understand further that we need $12.5 billion to back up our own currency. If this is so, then it looks to me as though within a matter of 2 or 3 years we will be at a point where we will not have any free gold to deliver when gold rather than dollars is demanded in payment of our debts to foreign creditors. If that is so, I suggest to you that we will have devaluation of the dollar in the world market, because we would not be able to deliver gold when it is demanded. I would appreciate your comment on that.

Secretary DILLON. Yes; I only have two comments. First, the figure of our gold stock is about a billion dollars higher than the figure you used. It is something over $15.7 billion rather than $14.8 billion now.

Senator MILLER. You are right and I stand corrected. So I would merely have to increase the projections by 1 year.

Secretary DILLON. Time scale.

The other point is important. While our laws do require a 25-percent-gold cover for Federal Reserve notes in circulation and Federal Reserve deposits, our laws also provide that the Board of Governors of the Federal Reserve System has the right, on their own recognizance, to waive that requirement and to allow the sale of gold to continue. The Chairman of the Board of Governors of the Federal Reserve System has stated that if that situation should arise it would be his intention to make use of this authority.

He has pointed out the existence of this authority. This is not to try to minimize the seriousness of such a situation but merely to point out that there is no particular single point at which suddenly we would not be able to give gold to foreign countries should they so desire. We would still be able to do it even though it would require this waiver. That is the reason that the President's statement in February of 1961 pointed out that our entire gold stock in effect is available to back up the dollar.

Senator MILLER. Do you think that if such an emergency were found by the Chairman of the Federal Reserve this would impair the value of the dollar in the world market?

Secretary DILLON. No; I don't think it would. What would impair the value of the dollar in the world market would be failure to deliver or live up to our commitment to deliver gold for dollars.

Senator MILLER. And the fact that there would be less gold backing up our currency, you do not think would impair the value of the dollar?

Secretary DILLON. No; I think the fact that our gold supply is smaller one year than it was the year before means that we are less strong. If we got down to that point we would be less strong and that would be a situation that would be not as good as it is now and unfortunate. But the mere fact of hitting that particular point would not, I think, have any particular effect internationally. It would probably have more effect here at home where people would be disturbed by having that waiver.

Senator MILLER. Thank you. I think I have time for one more question. In your statement, Mr. Secretary, you said that surplus countries should continue to eliminate trade barriers which discriminate against our exports. I would like to suggest to you that I find it difficult to follow your statement that surplus countries should "continue" to do this when it is my understanding that they are going in the opposite direction. I am referring particularly to the Common Market nations and to their discriminatory variable import duties against our agriculture exports, more particularly poultry, a situation which prompted this statement by Prof. Lawrence Krause of Yale University in a study prepared for the Subcommittee on International Exchange and Payments of this Joint Economic Committee in the last session of Congress. (Factors Affecting the U.S. Balance of Payments, 1962). He states:

> The near term prospect for wheat imports into the Six from the United States are very poor and the complete loss of the market must be contemplated (p. 126).

Again he said at page 128:

While in the very short run the value of U.S. exports of meat may increase to the EEC, the eventual loss of the entire market must be anticipated.

Now do you really believe that they are actually eliminating discriminatory actions against us or do you think they are in fact discriminating against us? I am just wondering about your statement which indicates that they have a different policy.

Secretary DILLON. I think this statement was written in a little longer term time context because, looking back over 4 or 5 years they have eliminated quotas on all industrial products which did slow up our imports considerably; in that way they did move to liberalize restrictions. They also in some of the countries did liberalize restrictions on agricultural products. Italy, for instance. But certainly in the last year or two there has not been any sign of that. In fact, this poultry thing you point out is a move quite in the opposite direction. So, in the case of the immediate time scale probably the word "continue" is inappropriate here.

Senator MILLER. What do you think we should do about that?

Secretary DILLON. I think we have to use every effort at our command through our negotiations—not just plain trade negotiating tactics but also political power—the overall fact of our balance-of-payments situation, to see that we get a fair deal in these negotiations that are now being prepared for next year.

Senator MILLER. Do you think the administration should use the retaliatory provisions which we wrote into the law last year in the trade bill?

Secretary DILLON. If we have continued discrimination against the United States I would assume that there is no alternative but to do that. I think in the request which was filed with the European Economic Community we said that we would require compensation if we could not work out a suitable arrangement on poultry. That could take two forms. They could either reduce other duties equivalently so that our whole trade would not be hurt or, in case that is not done, the other alternative is that they allow us to increase certain tariffs to offset the increase they have already put into effect for poultry.

Senator MILLER. Thank you.

Representative REUSS. Representative Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman. I should also like to express to the chairman my appreciation for your inviting the members of the House Banking and Currency Committee to participate in the significant work of the Joint Economic Committee.

Mr. Secretary, from the point of view of the financial and economic strength and stability of the United States, which deficit should give us the most concern, (*a*) the deficit in our international balance of payments or (*b*) the deficit present and projected in the Federal Government's budget?

Secretary DILLON. At the moment there is no doubt that the most serious one for the United States is the deficit in its international accounts. The deficit in our internal budget is something that we have to bring into balance and should as soon as we can, but the problem there is quite different from the international accounts because in the budgetary case it is entirely an internal and domestic problem and

the question is whether it produces inflation, whether it produces too heavy a debt burden on our people in the future.

It is not at the moment producing inflation and the debt burden as compared to GNP has actually been going down year after year. Even though the debt itself has been going up the GNP has been going up faster. So the debt burden has been relatively easier to carry.

Now the international deficit is quite a different thing because there our deficit is with foreigners and they have a call on our assets, namely our gold stock, which although very large in terms of the world supply, is finite, is limited. So that is a more critical thing at the moment and is something that ought to be brought into balance just as soon as we can.

Representative MOORHEAD. Would I be correct in saying, Mr. Secretary, that the stress which you lay on the international deficit as opposed to the domestic or Federal budget deficit would be one of the reasons why in your testimony you deplored the fact that the House had not appropriated the $6 million to the Department of Commerce for the purpose of expanding our export trade.

Secretary DILLON. Yes; I would say that that is a very small amount in relation to the overall expenditures of the Government, which run between $90 billion and $100 billion. Nevertheless, in comparison to our balance-of-payments deficit, it certainly would bring added exports of 20 or 30 or 50 times the amount of the expenditure requested, which would be a very significant contribution to the closing of the balance-of-payments gap.

Representative MOORHEAD. Mr. Secretary, in this morning's Washington Post there is a column by Mr. Harold B. Dorsey. In the course of the column he quotes from the London Financial Times where it says:

> One of the silliest aspects of the international financial scene at the moment is that the continental countries, with far larger external reserves than they know what to do with, are regularly going to the New York capital market for funds to finance their development activities.
>
> They are thereby adding to the stress on the U.S. balance of payments to such an extent that they are having to be asked to put normal dollar convertible arrangements in indefinite suspense, this so that the United States can borrow from them on short term the funds it needs to sustain its long-term capital exports to them.

I should like to ask you if you agree, No. 1, that this is a silly situation and, No. 2, what can be done about it, and No. 3, what is being done about it?

Secretary DILLON. It is a situation which we have long recognized and which we don't think is a sound one. I first adverted to it publicly in a speech in Rome a year ago last spring and pointed out that it was highly important for the European countries to modernize and improve their capital markets instead of looking for capital requirements to the United States, which just would not be able to provide capital in the amounts that would be required if Europe is to grow as fast as it desires to grow and seems to be able to grow.

This has been accepted in the OECD; the European countries have generally agreed that they should improve the functioning of their capital markets. But they have pointed out that this is a long and difficult process. They have made some progress but not enough progress.

I would hope that this progress would speed up. This is not a very sensible arrangement. One thing I would like to say on that subject, there was a question furnished by the Joint Committee regarding European capital markets. We are preparing a rather detailed report, a factual report on the status of the European capital markets as we see them, the cost of doing business in them, their size and so forth. It is not yet ready but we would like to hand it in for the record as soon as we can get it ready.

Representative MOORHEAD. During the course of your testimony you adverted to the necessity for us to export securities as well as goods. Is the investment banking and the stock brokerage business doing anything to export securities? Is there anything they can do? Is there any way we can encourage them to export securities?

Secretary DILLON. In the sale of these new borrowings by European countries recently they have begun to do a far more active job, a better job than in the past. As I said, about half of the European securities offered in New York this year have been purchased by foreign investors.

Where issues have been publicly placed in the New York market, up to 70 percent have been sold abroad because of the effort of our underwriters to place these abroad, which shows that the buying public, investment public, in Europe is perfectly ready and willing to buy these securities at the interest rates that are appropriate, long-term rates that are appropriate to our market.

That is one of the reasons why we don't feel that it is entirely an interest rate differential that makes long-term borrowers come to the United States. I think that more should be done, that there should be an effort, which has not yet been undertaken but which will be, to sell Canadian issues to some extent in Europe.

We also hope that there can be a greater selling of our common stocks. Now we are interested in that, ourselves. Our mutual companies, for instance mutual investment trusts, are interested in that. But there are certain laws and requirements that create problems in selling these securities in Europe that will have to be eliminated before they can really proceed effectively.

We are going to try to see what can be done to make it possible for them to do this. It would be very helpful if they could.

Representative MOORHEAD. Would this also include already issued securities?

Secretary DILLON. Yes.

Representative MOORHEAD. Are there also some problems in the laws relating to already issued securities?

Secretary DILLON. Yes, there are problems in Europe. In some countries one is free to purchase foreign securities. In other countries one is not. You need to have special filing permissions which in effect make it very difficult.

Representative MOORHEAD. So the changes in laws that are required are primarily the laws of the foreign countries rather than U.S. laws?

Secretary DILLON. Yes, sir.

Representative MOORHEAD. Thank you very much, Mr. Chairman.

Representative REUSS. Senator Dominick?

Senator DOMINICK. Thank you, Mr. Chairman. Mr. Secretary, at the beginning of your statement, you refer to the Cabinet Committee on the Balance of Payments. I wonder if you would give us for the record the names of the membership of that capital committee?

Secretary DILLON. I would be glad to do that. It is composed of myself as chairman, the Secretary of Defense, the Secretary of Commerce, the Undersecretary of State, the Administrator of AID, the President's Special Representative for Trade Negotiations, the Director of the Bureau of the Budget, and the Chairman of the Council of Economic Advisers.

Then we consult from time to time with other interested Cabinet officials or heads of various agencies such as the Chairman of the Export-Import Bank or, on occasion, the Secretary of Agriculture when we deal with an Agriculture matter.

Senator DOMINICK. In your prepared statement you draw quite a clear distinction between exports of goods and services and exports of U.S. capital. Obviously in the bill which we passed in the last session of Congress we have been trying to discourage exports of capital in terms of industries setting up subsidiaries in foreign countries.

Has any study been made by this Cabinet committee or by the Treasury Department of the relationship between the export of capital and the use of the funds which are derived by this for purposes of increasing exports from the United States?

Secretary DILLON. Yes. There were studies made of that last year, and while there are some export flows from the United States, studies showed that these were much larger in connection with investments in underdeveloped countries. That is quite natural because the underdeveloped countries have little to contribute in the way of industrial goods, machinery or even building materials, so much more always came from the United States.

In an industrial development in Europe, while there was some machinery that came from the United States, the amounts were far smaller and generally amounted to something in the neighborhood of 10 percent or less of the capital export, whereas in the underdeveloped areas it would run up to 40 or 50 percent.

I don't think that what we finally did last year discriminated against or restricted formation of subsidiaries abroad, except in "tax haven" countries, and there it very clearly did strike at an area which we felt represented an abuse of our tax laws and was bad for our balance of payments.

We did improve the competitiveness and attractiveness of investment in the United States through the investment credit and also through depreciation reform and we hope that passage of the current tax bill will further improve that status and in that way make investment more attractive here as compared to abroad. We think that will be of great help.

Senator DOMINICK. We seem to have some conflict in purposes it seems to me. We have been trying to improve the economies of other countries and we have talked in terms of doing a large part of it by private investment. Yet when we do we also seem to be increasing our balance-of-payments problem.

Then we do it by Government economic aid and we find that Government economic aid is one of the reasons that we have a loss of gold and an imbalance in our payments situation. This has always created a problem in my mind. Let me ask you one more question. In your testimony you say that the increase in the long-term capital outflow occurred largely in Canada during the first quarter of this year and the last portion of last year.

Didn't that follow almost immediately after Canada raised its interest rates and increased its tariffs?

Secretary DILLON. Yes, but I don't think the two were connected. The reason for the increase in the flow to Canada was that the Canadian Government for the 2 preceding years had discouraged the use of the American capital markets. They felt that they were becoming too dependent upon it.

When they had some currency difficulties last year, one of the things which they did was to reverse that concept and decide that to the extent that they could borrow money in the United States that would be very advantageous for Canada. So that whereas before they had more or less informally told their provincial governments that they would prefer that they not go to the New York market, they then withdrew this policy and they again came and there was a substantial volume of business.

In addition, the Canadian Government itself borrowed $250 million in the United States for the purpose of building up the reserves which had been depleted by this currency speculation against the Canadian dollar in the spring; $125 million of that went out in the fourth quarter last year and $125 million in the first quarter of this year.

Then we had one very big special borrowing which I mentioned this morning, totaling $300 million, which was borrowing by the Province of Quebec, designed to provide the funds needed to pay for the nationalization of their entire electric power system in Quebec.

Of that, $100 million went out in the first quarter of this year. So just those two issues totaled $225 million. There were others. What went to Canada was roughly $400 million in the first quarter.

Senator DOMINICK. Along the same line of discussion, in your statement you suggest certain things that it will be appropriate for the financial surplus countries to take action on: lowering interest rates particularly long-term rates, offsetting the effects on domestic demands, and a variety of others.

Yet these countries have gotten into the financial position that they are in by doing the opposite of this. So what incentive is it for them to take action?

Secretary DILLON. They have not done exactly the opposite. All of them agree that it would be better if they had lower long-term interest rates. These things are complex as you well know. In Germany, for instance, which is one example because they have done very well on their growth, they, because of wartime damage, have put great stress on rebuilding their housing.

They have subsidized their long-term interest rate for housing and facilitated long-term lending for that purpose so that mortgage borrowings in the Federal Republic of Germany are fully 1 percent below the rate in the United States. It is about 4½ percent.

As a result of that the bulk of the long-term money in Germany goes into this area. The demand is tremendous and there is very little long-term money available for other things. I think that is a type of situation which causes some of the problems and I think the Germans recognize this.

They talk quite a lot about the need to equalize their long-term rates better so that they can get lower rates for industrial borrowing and lower rates for government borrowing. They no longer need this full subsidy for housing as much as they did.

If they would only change this, it would be very helpful so far as we are concerned.

Senator DOMINICK. Within the context of your statement though, these countries and particularly Germany, France, Italy, England, Netherlands, Belgium, and so on, have in large part been charging more on short-term rates but on the long-term rates you say they have been lower than we are in housing.

In general they have been lower, and their trade barriers, the wall around the Common Market at least, have become as fixed as you can get at the present time and are fairly high. In view of the fact that they have done this and seem to have prospered I can't see that we have much to offer to try to change their minds.

Secretary DILLON. One of the most prosperous countries in the world as far as its balance of payments is concerned is Switzerland, which has far lower long-term interest rates than we do.

So, I don't think that any of these countries that prospered, prospered because they had high interest rates. I don't think any of them feel that that was the reason they have prospered. They would like to see, all of them, somewhat lower long-term interest rates. Their short-term interest rates, while higher generally than ours, have not been nearly as much higher as the long-term rates.

Senator DOMINICK. In answer to a previous question, you indicated that the capital outflow was equal to the deficit encountered from tourism, foreign aid, and military expenditures.

Secretary DILLON. I think it is probably a little more but I said at least that.

Senator DOMINICK. At least that, yes. Do you have any breakdown as to whether this reflects short-term capital outflow? It is my understanding that a great deal of this is short-term, meaning 3 to 5 months.

Secretary DILLON. That is right. I was asked for the total. The long-term outflow last year was about $2¾ billion. The short-term outflow was about $1¾ billion. So, you have a total outflow of about $4.5 billion for these capital flows.

Senator DOMINICK. Thank you, Mr. Chairman.

Representative REUSS. Representative Pepper?

Representative PEPPER. Thank you, Mr. Chairman.

I would like to join in the expression that is extended by Mr. Moorhead for including the members of the House Banking and Currency Committee in this hearing.

Mr. Secretary, in your statement, referring to American businessmen, you say:

> And they must continue to be provided with ample facilities for export financing fully comparable to those available in the other industrialized countries.

Now, before the House Banking and Currency Committee a while ago, we had representatives of the Export-Import Bank in respect to the President's request that we enlarge the insurance capacity or the capacity of the Export-Import Bank to insure against certain risk exports by American businessmen.

As I recall, in the testimony at that hearing, it was brought out that Western Germany insures about 30 percent of its exports and the United Kingdom about 20 percent of its exports, while the United States insures less than 1 percent of our exports.

While we have enlarged to an effective $1.5 million the insuring facility or power of the Export-Import Bank, I just wondered if even that will, as I think you so wisely recommend, provide to American businessmen the facilities for export financing fully comparable to those available in other industrialized countries?

Secretary DILLON. I think, Mr. Pepper, that the facilities that have now been made available by the Export-Import Bank, the rates, the type of insurance, the type of guarantees and credits, are now certainly comparable to those available abroad and I think they are generally recognized as such.

This took quite a period of time because it is a complex matter and we did set this up on a basis where we relied heavily on private industry and private insurance companies.

It took a while to get that organization set up. It is now functioning and I think that the bugs are all worked out of it so that it is comparable.

Now, in volume it is not comparable because this is a newer thing and people do not yet understand the need for it. They don't use it as much as they do abroad.

One reason for that possibly is that a lot of our exports are done by a few larger companies that more or less insure themselves and less are done by smaller companies than would be the case in the exports of practically any other major industrial country, where they make greater use in volume of this insurance.

But, I would think that if we did find the Export-Import Bank should by any chance run out of capital for this, this would be one thing that we would want to fix very rapidly.

Incidentally, I hope it will not be long before the Congress resolves the question about the Export-Import Bank and renews its charter because it is very disturbing to our exporters to find themselves without any organization to which to turn at the moment because it has not been renewed.

Representative PEPPER. Do you recommend that that provision be retained by the House, enlarging the capacity of the Export-Import Bank aid in this insurance program?

Secretary DILLON. Most certainly.

Representative PEPPER. Mr. Secretary, do you have the figures at hand to show the deficit in the amount of expenditures abroad and in this country by tourists?

Secretary DILLON. Yes, we do have them.

Representative PEPPER. Could you give me the substance of them please, sir?

Secretary DILLON. Yes. I will be glad to. As I said, overall the figure last year came to $1,400 million. I will give you the details in just a moment.

In 1962 our total receipts from tourism which includes travel by foreigners in the United States as well as the receipt of ocean fares from foreigners by American steamship and airlines, came to $1,038 million.

Our outpayments came to $2,468 million. And our net deficit on tourist account for 1962 was, therefore, $1,430 million. In the preceding year it was $1,250 million and in 1960 it was $1,237 million. Prior to that time it had never exceeded $1 billion.

Representative PEPPER. Our deficit then was greater in 1962?

Secretary DILLON. It has been increasing every year. It increased very little between 1961 and 1960 but it increased substantially between 1960 and 1959 and it increased substantially again in 1962 over 1961 and it gives every appearance of increasing again this year.

Representative PEPPER. Now, that deficit is about what percentage of our total deficit in foreign trade?

Secretary DILLON. As compared to our total deficit after we have used the various special methods of financing it, this would come to something pretty close to two thirds. Prior to that, if we took our gross deficit, before any of the methods of financing, it would be a little less than half.

Representative PEPPER. So, it is from a half to two-thirds, that is a very sizable part.

Secretary DILLON. I will say 40 percent to two-thirds.

Representative PEPPER. Yes. Therefore, it would appear to be in the national interest for us to do all we can to attract tourists to this country.

Secretary DILLON. Yes, and even more important maybe, to have our own people who are vacationing find all the wonderful spots there are to vacation in in the United States.

Representative PEPPER. I think the administration is to be commended for having initiated a tourist division, a bureau in our Department of Commerce.

I wonder if you recall offhand how much is being spent in furtherance of that program annually.

Secretary DILLON. I think last year the expenditure, there was appropriated something like $3 million. As I understand the situation, the Department of Commerce asked for something like $4.25 million this year and the House saw fit to only allow them about $2.5 million, which is less than last year. So, I guess we will have fewer foreign tourists coming to the United States.

Representative PEPPER. If the money is productive at all in bringing tourists over here it is rather a shortsighted policy to diminish the means of bringing them here which is so significant to us in the field of this balance of payments. Is it not?

Secretary DILLON. I would agree with you; yes, sir.

Representative PEPPER. Now, another thing if I may. You may have given it, I don't recall if you have. What is the total of foreign investments in the United States, or approximately?

Secretary DILLON. I can give you that figure. I have not given it. The total foreign investments in the United States as of now, counting all investments, Government as well as private, at the end of 1962 were estimated at about $51 billion, of which about $20.5 billion was long-term investments and $30.6 billion was shorter-term, more

liquid investments, U.S. Government securities and things of that nature. The bigger part of it is in the short-term investments which, in effect, represent in part the counterpart of our balance-of-payments deficits.

Representative PEPPER. About what is our approximate volume of investments abroad?

Secretary DILLON. At the end of the year our investment abroad was something close to $80 billion. We had about $60 billion of private investment and some $18 billion of Government investment of which, as I said, some is repayable in nonconvertible foreign currency and hence not readily usable. But it also includes a lot of good assets such as the Export-Import Bank loans and the loan to the United Kingdom and a number of others.

About two-thirds of it is dollar loans.

Representative PEPPER. There again, whatever Government or private enterprise can do to enlist more non-short-term, particularly foreign investments in the United States would aid in the reduction of this imbalance of payments?

Secretary DILLON. Yes, sir; very much so.

Representative PEPPER. Another question if I may. Since access is being had to our capital markets by some foreign borrowers, I wonder if it might be possible for foreign countries to meet their capital needs by having American capital share in some of these overseas investments with foreign capital, either at a public or private level, and thereby diminish somewhat the outflow of our own capital and the drain on our balance of payments.

Secretary DILLON. Of course, in the case of American direct investments abroad that is a question for a company that makes the investment to decide.

But, I think there has been a tendency by our companies investing abroad to increase their partnership operations. Certainly, when our investments grow to a great volume in various countries abroad, there is a danger, if they are entirely American-owned, that they will stir up some opposition.

This happened in Canada. We all know about that. The same thing is now a matter of public discussion in Australia, and there has been some discussion of it from time to time in various countries of Europe. So, for that reason I think our companies are inclined now to be more receptive to foreign partners than they used to be.

Representative PEPPER. Thank you, Mr. Secretary and thank you, Mr. Chairman.

Representative REUSS. Chairman Douglas has asked that the following question be presented you, Mr. Secretary.

What is the position of the Cabinet Committee on the Balance of Payments on ocean freight rate differentials affecting U.S. exports and imports and what course of action does the Cabinet Committee intend to recommend?

Secretary DILLON. This question first came to my attention and to the attention of the members of the Cabinet Committee last winter—in February or March I became aware of it. I can't remember the exact date, but sometime like that. We were quite surprised when we found out what the situation was. We did not know what it was in detail, but the fact is that apparently outgoing freight rates, ocean

freight rates, are very considerably higher than incoming freight rates. So we reported this to the President and he has directed the Department of Commerce to undertake rapidly a study of this matter, which they have underway, to find out which particular rates are the type of rates where a cut would help our exports. Then, once they have determined that, to see what can be done about improving those rates. Since that time you have had this investigation, I understand, in the situation regarding steel. This is one of the chief areas but there are many others and the Department of Commerce is looking at the whole situation. Certainly it is our feeling in the Treasury, and as Chairman of the Balance of Payments Committee, that this is something that needs to be substantially rectified.

I think that the committee as a whole feels the same. There are certain economic reasons why a certain amount of difference might be possible since generally the freight loads on ships outbound are heavier than on ships coming in and that might give some reason. But we think it has been substantially overdone and certainly in the areas where it could be helpful to our exports there should be modifications sought one way or the other.

Representative REUSS. Thank you. Representative Halpern.

Representative HALPERN. Thank you, Mr. Chairman.

Mr. Secretary, I would like to join in the sentiments expressed by my distinguished colleagues on the Banking and Currency Committee in welcoming this opportunity to sit in at these balance-of-payment hearings. I wish to thank the Joint Committee for giving us this opportunity. I am particularly concerned with this subject as the ranking minority member of both the International Finance and International Trade Subcommittees of the House Banking and Currency Committee.

Mr. Secretary, to get back to the Cabinet Committee. Has the committee a program containing a time target for eliminating the payments deficit and delineating specific areas of action? If so, what is the time target and what are the areas for present and proposed action? And if not, how does the committee believe balance will be attained and in what period?

Secretary DILLON. As I have said in my statement, we have been working on the whole problem, reviewing the matter again. We keep it under constant review but we have again had an intensive review in the last few months. We feel there should be additional efforts made to reduce our direct Government costs so that we will be making recommendations shortly, as I pointed out, to the President. We do feel that capital flows have somehow got to be reduced. We do feel that big efforts must be made in our exports, continuing ones. Those are the general fields in which we have operated. Now concerning the exact recommendations we are going to make, I don't know whether they will be approved or not and I think we will have to wait until these are finally formulated and approved. As I said, I would be glad, once this has been done, to come back and discuss them further with the committee.

As to a timetable, that we have found is most difficult because so many different things enter into the balance of payments. You get an improvement on your military accounts while your direct investment accounts and your trade accounts stay the same. You think you are

going to do better. Suddenly you find that you have had a tremendous increase that is unexpected in long-term borrowing by Canada, for instance, and you find that you are no better off than you were before.

A year ago the big borrowings were short-term borrowings by Japan and that stopped. It is very difficult to foresee an exact period of time. None of the people in international organizations with whom we deal—representatives of the surplus countries—attach any great importance to a particular period of time when we will reach balance.

What they do attach importance to is definite and continuing and steady signs of progress toward balance. That is what we think we have to do and that we think we have not done well enough during the last year. That is why we feel extra action is necessary.

Representative HALPERN. Mr. Secretary, as you well know, the U.S. foreign-aid programs have been criticized on the grounds that we give economic and balance-of-payments assistance to other countries when such assistance should be more appropriately provided by international institutions. Now I will combine two questions. To what extent do we provide such assistance and, if this assistance were provided by international organizations would the balance-of-payments consequence for the United States be substantially reduced?

Secretary DILLON. I would doubt the latter because of the way we have now been able to work our aid. We have got this so that last year only some 20 percent of the aid which was committed was untied. On the other hand, of the free funds that are contributed to an international organization by all countries, approximately 30 percent come back to us here in the United States. So it depends on what our contribution is. If our contribution is 40 percent of the international funds, then of those funds we will get back the equivalent of about three-quarters. That 40 percent happens to be about what we contribute to a number of United Nations special projects. It is also about our proportion in the International Development Association. So I don't think there is much difference there. We do see that there is a great advantage in using international organizations to the maximum for a different reason, and that is to maximize the contributions of other industrial countries. That seems to be one of the best ways to do it. We have been in the process ever since last fall of trying to negotiate an increase in the resources of the International Development Association from $150 million a year, which it has been, to a higher figure. We are very hopeful that we may be able shortly to complete negotiations on a $250 million annual base.

In this organization there is almost a dollar and a half of foreign assets, foreign money, put in for every dollar we put in. So we think that is very helpful that way.

Representative HALPERN. Isn't it a fact that some international agencies providing economic assistance have authority to raise funds directly by issuing and selling bonds? Can you tell us what are those agencies, where have they raised funds and how much of it has come from the United States?

Secretary DILLON. I can provide that for the record. The two agencies which do that are the Inter-American Bank, which is a relatively new agency, and the World Bank which has been doing that for many years. The World Bank originally raised the bulk of its

funds here in the United States. More recently it has been raising larger portions of them in Europe and it has been fairly successful at that. But I think the last loan was about 18 months ago, a year ago in February or the end of January. The Inter-American Bank has sold two issues. The first one was in Italy. I think that was for about $25 million as I recall. The second one was last December here in the United States when they raised $75 million. But I can give you a full list of that for the record.

Representative HALPERN. Well, that would be helpful for the record. But I would like to repeat, how much—what percentage of these funds come from the United States?

Secretary DILLON. That will show in the figures we submit. I don't know offhand.

Representative HALPERN. Thank you, Mr. Secretary.

(The information referred to follows:)

Outstanding IBRD securities, distribution of ownership

	Outstanding (in millions of dollars)			Distribution	
	Payable in U.S. dollars	Payable in other currencies	Total	Percent held by U.S. investors	Percent held by foreign investors
June 30:					
1950	250	11	261	(1)	(1)
1951	300	25	325	(1)	(1)
1952	450	50	500	80	20
1953	500	56	556	72	28
1954	665	112	777	64	36
1955	705	147	852	56	44
1956	695	155	850	55	45
1957	833	201	1,034	53	47
1958	1,458	200	1,658	53	47
1959	1,591	314	1,905	50	50
1960	1,689	384	2,073	47	53
1961	1,711	529	2,240	47	53
1962	1,907	621	2,528	44	56
As of Mar. 31, 1963	1,902	621	2,523		

[1] Not available.

Source: IBRD.

THE INTER-AMERICAN DEVELOPMENT BANK

The Inter-American Development Bank has up to the present had only two bond issues. The first one, issued in April 1962, was for 15 billion lire, the equivalent of $24.2 million. These bonds were issued to a consortium of Italian banks. In December 1962, the Bank issued a $75 million bond issue in the U.S. market. Of this issue $2,432,000 (3.2 percent) was taken by foreign purchasers.

Representative REUSS. Mr. Secretary, on the general question of our $3-billion-plus payments imbalance, my difficulty very frankly is that I can't quite see how the "extra action" you are talking about is going to produce, within the foreseeable future, an end to the imbalance. It was with that in mind that I and our subcommittee here have for some time been recommending a more direct approach to one important facet of the payments deficit; namely, new foreign security issues in this country, the sort that Representative Moorhead was talking about, more than a billion dollars last year, currently running at the rate of $2 billion a year, though it probably won't be quite that bad by the time we are through the year.

It seems to me that the principal reason we get into this muddle is that there are enormous sums of American long-term investment capital seeking investment in this country. Foreigners know that, and they come into our well-organized market and borrow and this causes us to bleed, as I say, at the current rate of around $2 billion a year. The Joint Economic Committee has in the past recommended that we make foreign access to our U.S. new issues market in Wall Street more difficult and more expensive either by screening or by taxation. The administration has rejected this recommendation. What are the reasons for this?

Secretary DILLON. I think I expressed the reasons rather fully regarding the difficulties of exchange controls. I don't think I can add much to that. We don't feel that a partial exchange control would work. We would almost immediately be driven to a full exchange control. This would actually have very damaging, immediately damaging, results on our balance of payments by frightening American capital, which would start to leave the country in every way possible. That would force the imposition of complete exchange controls which have all the difficulties which I mentioned in my statement, of reducing world liquidity, tending to reduce world trade, and tending to bring on a situation such as we had in the thirties, a worldwide recession. Therefore, I don't think that exchange controls for us are practicable. I know some of them are in effect in foreign countries, but these are countries that have all had complete systems of control and they have been dismantled and they are on the way to get rid of them. The vestiges that are left happen to be these capital controls.

We are quite different. We have preserved currency convertibility, we have had no controls. So if we try to put any of them in we are moving in the opposite direction, which is the wrong direction. Therefore, this is quite a different situation. I think that is the reason that we oppose that.

Representative REUSS. You are clear we are not talking about exchange controls on current transactions or any control on American foreign investment abroad. All we are talking about is the underwriting business done by a relative handful of New York underwriters who specialize in flotations from Europe and Canada in this country.

Secretary DILLON. We feel that it is difficult, if not impossible, to act in even a small or specific area without inevitably being drawn into comprehensive controls. And this, as you so wisely pointed out, we don't want to do.

Representative REUSS. Would it not be a good thing for this country if the half dozen or so large New York investment firms that specialize in foreign flotations in Wall Street would come in and say that they had heard President Kennedy say, "Ask not what your country can do for you, but ask what you can do for your country," and then announce that from now on, starting tomorrow, they were not going to underwrite any further foreign flotations, particularly from surplus payments countries, until our balance of payments was corrected—provided however that where the Treasury told them that a given proposed issue was in the public interest as either stimulating U.S. exports or as directing its benefits to underdeveloped areas, an exception from this general proposition could be made—would that not be a fine thing and a cause for cheers?

Secretary DILLON. As mentioned very clearly in my statement I think it would be a good thing if there was a smaller total outflow of long-term portfolio investment which something like this would accomplish. Certainly there are different areas as you fairly recognized. We have traditionally financed a portion of our substantial trade surplus with Canada through exports of capital to Canada and through their borrowing here. Recently it just got too big, but the fact that there should be some is part of the way our economics link together.

Representative REUSS. Even with Canada, which I love, why not make them go to the International Monetary Fund, for example, or would the world come to an end if they were required to focus their borrowings abroad?

Secretary DILLON. They are presently in debt to the International Monetary Fund for nearly $300 million from last year. I think there is a chance for them to raise money abroad and I think it would be helpful if they tried. As I said earlier it would be helpful, to the extent that they are in our markets, if our investment bankers made an effort to sell these issues abroad. I think they could sell a substantial or significant portion of them in Europe if they tried. They never have. This is something which has not been traditional. They have just not thought about it. I think that now they will.

Representative REUSS. Is it your considered view—I want to be sure of this because in these Wall Street new issues we are talking about large sums indeed in our balance of payments—that we could not have the Securities and Exchange Commission, for example, screen foreign requests for security flotations in the Wall Street market with a view to cutting down their number, without embarking upon a program of exchange controls? I have difficulty in seeing why we could not, because practically all the countries of Europe do this.

Secretary DILLON. As I say, they have them as a vestige of a complete system which they are working away from and they are continually modifying their capital controls and working away from it there. The Securities and Exchange Commission would have to speak for themselves but I have always understood that they wanted to rather jealously limit their activities to making sure that all information, proper information, was disclosed in security trading and thereby not to be pushed into any other activities such as judging specific securities.

Representative REUSS. Well, have the Treasury do it. I don't care who does it. Should the surplus countries have unlimited access to our domestic market, which is dripping with our long-term investment capital? Does this not cause us to bleed unnecessarily? Since I can't work out the arithmetic for curing our payments deficit any other way, I am attracted, frankly, by the current $2 billion possibility of annual savings if we checked these flotations.

Secretary DILLON. As I said it is an important area and it is an area where there will have to be progress made if we are to achieve balance. I don't know that I can add anything further to that, except that we just don't think that a system of exchange controls in that area would be effective. We hope by exhortation and one thing or another that there may be some progress there. The exchange control route does not seem to be a practical one.

Representative REUSS. Without in any way being uncharitable about the values of admonitionism, is it not a fact that, following your speech in Rome a year or so ago on this very problem, the incursions of foreign corporations and institutions seeking investment capital in Wall Street on a new-issue basis have increased?

Secretary DILLON. No.

Representative REUSS. Last year it was a billion. In the first quarter of this year it was a half billion dollars.

Secretary DILLON. Yes. I think I can explain that seeming inconsistency. When I was in Europe and Rome my speech was directed at that time to the surplus countries of Western Europe. During the first 6 months of last year they had made much larger drains on our capital market than they had previously. After that this fell off substantially and, while there has been some further increase or some revival of interest, if you want to call it that, during the last 6 months, it was still well below the rate of the first 6 months of last year. Now the big increase came from Canada and that was a situation I didn't have in mind in Rome because there just was not any problem at that time. The Canadians were not borrowing. It is all in that area.

Representative REUSS. I would just add to the interchange we are having my own observation, from talking to a great number of very responsible central banking authorities in Europe, that almost without exception those I have talked to have said they can't see any reason under the sun why the United States puts up with a balance-of-payments deficit on the order that we have been running the last 5 years, and at the same time invites foreign seekers of capital into Wall Street—an item which constitutes probably the biggest single nongovernmental element in our current deficit. For the life of me, I can't justify it. These underwritings do not aid underdeveloped countries; they do not aid our military defense. I am very skeptical about the philosophical point that controls would somehow depart from, as you put it in your statement, the "decentralized decisionmaking by millions of individuals and businesses responding to market forces." I am just not impressed with the philosophy there at all. I hope that this will be the subject of continuing review by the Cabinet Committee on the Balance of Payments because I think we are missing a good bet.

Senator Javits.

Senator JAVITS. Mr. Chairman, I gather we are under a 10-minute rule?

Representative REUSS. Yes.

Senator JAVITS. Mr. Secretary, the interchange we have had leads me to ask this question: What benefit does the United States obtain from being the world's banker?

Secretary DILLON. As I pointed out in my statement, we have a very real benefit in that we have been allowed, because we were in this situation, to finance our deficits through increased foreign holdings of dollars. If we had not been a reserve currency, if we had not been a world banker, this would not have happened. It would have been the same situation as other countries face; as soon as we got into deficit we would have had to balance our accounts one way or another even though it meant restricting imports, as Canada had to do last year, or cutting back our military expenditures much more drastically than

our security would warrant. So, for that reason we have had a very real benefit, and this benefit continues, in the big volume of credit which we are allowed and through which we have been financing our continuing deficits.

I would say that is the chief area of benefit although there is one other very important one and that is that somebody has to be a world banker and provide this extra international liquidity. It has been the United States, which is proper, because we are the most powerful financial country and we had the most powerful currency.

That is what has made possible the international payments system and the whole development of world trade since the war. So if we were not in that position there would not have been this sort of development. So I do think this has been both a direct and indirect benefit to the United States and still is.

Senator JAVITS. Of course, the first argument doubles back on itself. If we were not the world's banker we would not have this problem. We could play it very cozily as other nations do. But the second argument impresses me greatly.

We have the biggest stake. Somebody has to be the banker. It is logical that the one with the biggest stake is the banker. Now is it not a fact that the indication of our difficulties in the international balance of payments is the loss of gold?

Secretary DILLON. That is the key factor; yes.

Senator JAVITS. Now, according to your chart, we have $16 billion worth of gold on hand, and we are constantly being shown the boogieman of the $20 billion in callable indebtedness in gold by foreign bankers and told that they can crack down on us any day and destroy us.

The minute they want to pull the plug we are bankrupt. What do you say about that?

Secretary DILLON. I would say, like many banks, we have less gold than the possible calls on us. But under our present system the possible calls are not by any means limited to the holdings abroad—total liquid foreign holdings, which include unofficial as well as official.

The official holdings of foreign countries right now are only about $12 billion. The real danger to the United States, as to any country when it has a free exchange system, comes from its own citizens. If its own citizens lose confidence in its currency and start to try to transfer funds abroad, which they can do in very substantial volume, it is perfectly obvious that any amount of gold could be swamped very rapidly.

Therefore, and this is why it is so important to retain confidence in the dollar, the whole thing depends upon confidence in the way the United States is handling its payments, confidence in what it intends to do and can do. That is why it is so dangerous to get started down the path to exchange controls in even a minor way because it would damage that confidence and swing back on us with very much greater effect than any benefit we might get.

Senator JAVITS. As Secretary of the Treasury, are you satisfied that the gold reserve of the United States is adequate for the obligations which it faces, including those which may be called in gold?

Secretary DILLON. Yes. I think the present gold reserve is perfectly adequate for the obligations that we face. The thing that is

not satisfactory in our present situation is that we are continuing to run a deficit, continuing to lose some gold. If we were to be in balance we could get along very well with the present gold stock—even with a gold stock that was considerably smaller.

England got along as banker for the world for a long time with coverage of 30 percent or less of what she owed.

Senator JAVITS. Do you have any time in your mind, any swing period of years, in which we can go on as we are going without running up against the grave danger of national insolvency?

In other words, how much time do we have to reach this equilibrium which is the thrust of the policy which you have described to us today? How long can we go on? I am trying to phrase it in such a way as to get the best answer you can give us. How long can we go on running deficits of this magnitude?

Secretary DILLON. That makes it much fairer. I don't think we can go on running deficits of this order of magnitude much longer. Whether that is 1 year or 2 years, it is a relatively short period of time.

When we reach complete balance is another question entirely. But if we are progressing toward balance and substantially and significantly reducing our deficit as the years go on, it is perfectly conceivable that we could continue in a modest amount of deficit for some years to come, if the people were confident.

By a modest amount, I would say something well under a billion dollars. That is perfectly practical. So it is not necessary maybe, to reach absolute balance at some given date. On the other hand, that should be our objective and we should try to get there but you can't ever be exact on timing.

There are these swings that you can't foresee. But the thing that is perfectly clear is that we do not have, as I said in my opening statement, much more time to waste as far as the present size of our deficits is concerned.

Senator JAVITS. You would say then that we could take the present order of magnitude of deficits for 2 years but you don't think we could take it any more?

Secretary DILLON. I would not like to put any particular time period on this. All I am saying is that certainly if we continued without any improvement through next year over this year, I think the situation would be one that would not be very comfortable.

Senator JAVITS. Under those circumstances, Mr. Secretary, should we not try to do what many have counseled us to do; that is, to increase international liquidity by giving ourselves some other base rather than this relatively narrow gold stock?

Secretary DILLON. Well, the question of total international liquidity is not really necessarily germane here. The question is: How much credit do our creditors want to continue to give us?

If they are ready to give us unlimited amounts of credit that would be one thing. I think it is becoming clear that while they feel they have just as much interest as we do in preserving the dollar and preserving the international payments system on which it is based, and, therefore, they cooperate not just out of kindness but in their own interest, there is some sort of limit beyond which they are not prepared to go or they don't think they can go. It is hard to judge what these limits are exactly until you arrive at them.

Senator JAVITS. Mr. Secretary, taking these things together, the fact is that the very same nations that are not shouldering the burden appropriate to their economic and financial power in military aid and economic aid and sending us enough tourists and floating security issues, are also the very creditors who are saying, "Well, maybe we won't give you quite the line of credit that your position requires."

And in view of the fact, Mr. Secretary, that we have this narrow base of gold against which the attrition is very great, and in view of the fact that we are the buyers of gold, we guarantee every gold speculator in the world that no matter what happens he gets $35 an ounce, he can't possibly lose very much, and taking all those things together, is it not time that we had a confrontation with all these nations in the eyes of the world and say, "We are not going to wait for 2 years, we are going to have it out now, you are going to carry your burden, we will carry ours. If we are going to be the bankers we have to have better terms"?

Secretary DILLON. I think that that in general, without a confrontation, was what the President was indicating when he spoke about international monetary policy in Germany. I don't know about better terms but we have to continue to have the credit that is needed until we can put our own payments in order. We have to work on that ourselves.

We cannot just say that someday they are going to come in balance by natural force and the rest of the world meanwhile should carry the burden.

We have to make some real efforts ourselves. I think we should do that. I think it should be made clear and I think that these hearings, what you are saying now, what the committee is doing, is helpful to make this known to the rest of the world.

Senator JAVITS. Mr. Secretary, my time is up. More later. Thank you very much.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. Mr. Secretary, in fiscal 1962 U.S. defense expenditures entering the balance of payments in all NATO countries were $1,733 million. Taking defense receipts into account our net adverse balance of payments with NATO countries in defense expenditures was $969 million, nearly $1 billion.

Now, the question is: Should we continue our defense expenditures in the NATO countries whose economies are growing at a faster rate than ours, whose contribution to the free world is only half ours as a percentage of GNP?

Secretary DILLON. Should we continue the same volume of defense expenditures?

Senator PROXMIRE. Should we continue the policy of this particular kind of aid? What I am talking about is the proposal which has been made by one distinguished Senator, and some of the rest of us are very interested in it, which would provide that assistance would not be furnished on a grant basis unless the President shall determine that it would be an undue economic burden on a country to purchase the supplies or equipment or services proposed to be furnished.

We would not help the rich countries any more by grants. We would require them to buy from us. As I have said, at least in 1962, this was a significant part of our balance-of-payments problem.

Secretary DILLON. One problem we have in discussing this with the European countries—this is a highly complex matter—is that we have not yet been successful in having the discussion quite as simplified as the way you have put it.

In other words, they like to separate aid expenditures and military expenditures. In looking at their aid expenditures overall many of them will claim that on a per capita and GNP basis they are doing just as well as we are. On our own figures certainly we have to agree that that is true, at least with some of the countries. But when it comes to defense they are much less. That is a totally different thing.

Senator PROXMIRE. Yes; by and large the defense cost is far greater than the foreign aid assistance.

Secretary DILLON. Far greater; yes. That is the real problem, in the defense area.

Senator PROXMIRE. Why is it not a sensible policy for us to say that where these countries are doing well, where they obviously have recovered, which is certainly true in Europe, it is true perhaps in Japan, that if they are going to get assistance from us they have to pay it back or they should pay for the military assistance they get from us.

Secretary DILLON. I think that is certainly true. The countries that can afford to should pay for it. That should be our policy; I think it is.

Senator PROXMIRE. Well, the NATO countries certainly are in this category, are they not?

Secretary DILLON. I don't think they get any assistance. We do make contributions, proportionate contributions, to which they all contribute, to build NATO infrastructure but we don't send military aid any more except possibly some small amounts going to Denmark and countries of that nature and maybe minor training expenditures.

In the case of Germany what you have suggested is more or less exactly what we have discussed with them and what they have agreed to in our cooperative logistics arrangement. That led to the offset agreement that we have—that they should provide a balance-of-payments benefit to us from military purchases equivalent to any balance-of-payments gain they had from our forces being in Germany.

That is what they are now doing. We receive comparable benefits from sales to Italy. Although we have sold military equipment we have not been able to negotiate such an agreement with France or England.

Senator PROXMIRE. I am talking about the Church amendment. I read the crux of it here which proposes to do just this: He has 15 sponsors in the Senate. It would seem to me to have a lot of appeal.

From what you say there is very little objection, and it would seem that this might be a sensible amendment.

Secretary DILLON. I am not familiar with the particular amendment.

Senator PROXMIRE. I understand on the basis of your answer. Let me ask one final question. On the basis of your testimony and your very comprehensive statement this morning, it would seem that you are relying very heavily on the effectiveness of Operation Nudge.

We have had some experience with this, that is, with keeping short-term interest rates high and letting long-term interest rates remain not as high.

Do you think that our experience suggests that this can be carried on as an effective policy? As a matter of technical discussion, is it a practical policy to the extent that we can have this as a significant bulwark in our balance-of-payment difficulties?

Secretary DILLON. We felt very clearly 2 years ago when we started a move in this direction that it was very clear that there could be a substantial narrowing of the differential between short- and long-term rates.

Over history that differential has varied all over the place. At certain times short-term rates have been higher than long-term rates. Naturally, as they do get closer together it becomes more difficult to carry this out.

I would say the answer to your question is that we think there is room for some further advance in this area, some further progress in this area. I don't know how extensive it would be.

Short-term interest rates have increased by about three-quarters of 1 percent since the spring of 1961. Meanwhile the longer term rates have declined moderately, maybe about a quarter of 1 percent.

So, there has been about a 1-percent narrowing of that differential. I don't think there is that much give left. I think it might be something considerably less than that but still enough so that it may have some effect here.

Senator PROXMIRE. It seems to me it is critical. Otherwise we are moving in opposite directions. You properly stress the great importance of promoting expansion of the American economy.

Obviously, if long-term interest rates increase and we thereby put on economic brakes at the same time we are stepping on the gas, in effect, we are not making much progress.

Secretary DILLON. That is no good. I do think there is room for some further progress in narrowing the differential between our short- and long-term rates.

Senator PROXMIRE. Thank you very much.

Representative REUSS. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Secretary, you gave quite a bit of attention to the importance of price, wage, and cost stability during the course of your comments. I think we would agree that with the loss in purchasing power of our dollar due to inflation it is pretty difficult to have price, wage, and cost stability.

Now, gaining my information from the Economic Indicators published by the President's Council of Economic Advisers, I find that during 1961 and 1962 we had a deficit of not quite $14 billion and we had inflation or loss in purchasing power of our money of a little over $14 billion.

Of course, the way you arrive at this is to take the gross national product increase, and compare that as an absolute figure to the gross national product increase reduced to prices prevailing at the beginning of the period.

Already in this fiscal year starting with July 1, 1962, and running through the end of March of this year, I find that we have $4.4 billion of inflation and that during this same period of time we have had a deficit of $4.9 billion. So they have been going pretty closely together.

I recognize that economists will agree generally that just because you have a dollar of deficit spending you do not necessarily have a dollar of inflation, but it has worked out that way pretty well in the last 2 years and 3 months.

Now, it appears that if we put into effect the President's budget and tax cut we are going to have a $10 or $12 billion deficit for fiscal 1964.

Do you have any estimate of how much loss in purchasing power of our dollar we will have during that period of time?

Secretary DILLON. I don't think that it would have any particular effect in changing the trend that we have followed consistently, which has been a very moderate trend since about 1958. Of course, the GNP price deflater which you are using is one overall indication of the change in prices, but it is only one of a number.

There is a consumer price index, there is also the wholesale price index. From the point of view of the balance of payments and exports, our wholesale price index is probably the most important because that tends to be nearer the price of the things that we export.

That item has, of course, not moved at all since 1958. It is just exactly the same. We have had the longest period of price stability in wholesale prices that we have had in some time.

Senator MILLER. Of course, I can see where the wholesale price index would have a bearing on our exports and that this would affect the conversions of dollars into gold on the part of some foreign dollar holders. But if they see the purchasing price of our money slipping steadily they might be more inclined to cash in the dollars for the gold.

The point I am making is that it looks like we are on the same steady rise of inflation or the same steady decrease in the purchasing power of our dollar.

Certainly, in the first three quarters of this current fiscal year—that is of the fiscal year ending June 30, 1963—we have had $4.4 billion inflation. I don't know what the fourth quarter will bring in but if it continues at the same pace we will have about $7 billion of inflation, which is about what we have had the previous 2 years.

My point is this. A $10 or $12 billion deficit for fiscal 1964 is going to produce about the same amount of inflation as we have been having. In fact, it could produce a little more because that is a greater deficit than we have been incurring. Let us assume there is a $4 or $5 billion inflation for this fiscal year, $4 or $5 billion of reduction in purchasing power of our people's money. I am wondering about the stimulative effect on the economy of having only a $2.8 billion tax cut for the same period of time.

I find in talking to people around the country that there is some bewilderment as to how much stimulative effect the tax cut of only $2.8 billion for fiscal 1964, which you have argued very forcefully for in the course of your remarks, will have on the economy. It seems that with the right hand we would give the people $2.8 billion more in purchasing power, but with the left hand, due to this deficit, we take away that much purchasing power and probably a great deal more.

I am wondering how we are going to have a stimulative effect with this tax cut. Will it not, in fact, be offset by the inflation or loss of purchasing power of our money during this same period of time?

Let me add one more thing that bothers a great many people. We have been presented with the proposition that we should stimulate the economy by providing $2.8 billion more in consumer purchasing power through a tax cut, but during the same period of time it appears that State and local governments are going to increase their taxes about $2 billion.

So, there is most of the additional consumer purchasing power down the drain. I am wondering about the stimulative effect of the tax cut in the face of these correlative phenomena.

Secretary DILLON. I think that is readily answered. So far as prices in our consumer index for all commodities are concerned, in the past 4 years consumer commodities have only increased about 2½ percent. So it is about one-half of 1 percent, six-tenths of 1 percent a year, which has been very modest.

The increase has been in the service item which is also reflected in the GNP deflator to a large extent and this will continue because there is not as much productivity increase in services. So this is a problem. Even when you keep your wholesale prices, your manufactured prices level your cost of living is likely to rise modestly.

So far as the stimulus of the tax cut is concerned, there obviously would not be any very great stimulus in fiscal year 1964 from a tax cut that only took effect on January 1. It takes a little longer for the stimulus to work out.

The total tax cut recommended is $10 billion, which is meant to be fully in effect by the 1st of January, 1965. It is generally felt that as far as GNP is concerned this will lead, through multiplier effects, to an increase in GNP of probably closer to $40 billion than $30 billion.

Somewhere in that area. So that is a very substantial increase. Now a further immediate effect, which I think will be good and which is the effect that we have put a lot of weight on, is the incentive effect.

The fact that when taxes are cut business will know ahead of time that there will be more demand, they will know that business will be more profitable, and because of this there will be more ordering and business will begin to operate at a higher capacity even before the actual money comes out into the economy.

In fact it is likely that there is a certain amount of that going on now in expectation of the tax cut.

Senator MILLER. May I say, Mr. Secretary, we have heard from a number of economists and they have advanced pretty much the same thinking that you did about the multiplier theory, but yet when we pinned them down they did admit that the multiplier theory, to really produce the effect that we wish, must operate within the framework of a stable dollar.

If the dollar is cut in its purchasing power, what does it profit us to have more dollars if we have no additional purchasing power? We are on dead center. My point to you is that it looks to me, on the basis of the record for the last 2 years and 3 months, that we are going to have maybe $4, $5, $6, or $7 billion of reduction in purchasing power of our money due to this deficit which will far more than offset the $2.8 billion of tax cut for certainly the first fiscal year.

I am afraid that over the period of time during which the tax cut is supposed to take effect we are going to find ourselves going backward so much that the inflation or the reduction in purchasing power of our money will offset the effect of a tax cut.

Add to that the problem of increased State and local taxes. It looks to me as though instead of having a stimulative effect on the economy, we are going to go backward. I want to be perfectly fair about this. I can tell you that I haven't received a single letter from anyone asking me to support a tax cut without a cutback in spending to make room for it.

I have been saying this for the last 4 or 5 months. You would think that somebody would, as a matter of general principle, write me a letter or call me on it, but I haven't even had that happen. I suppose I will have a few letters now, but to me it is rather indicative that there is an apathy on the part of the general public because they fear that the tax cut with the right hand will be offset with the left hand through the deficit spending that we are engaging in.

While I recognize that the tax cut will not have, per se, as you put it, an inflationary result, I suggest to you that the deficit which is proposed to accompany it is going to have that very result and it is going to cause a frustration, if not a complete elimination, of the objectives which you are seeking.

Now I am only going by the figures that the President's Council of Economic Advisers has given us for the last 2 years and 3 months.

I wish they were otherwise. But I am not persuaded that unless we have this tax cut we are possibly going to have a recession.

If we have assurance of a stable dollar, if we have assurance of a reasonably balanced budget, then I can understand your position. But in the absence of that, I am not persuaded. It causes me a great amount of concern because I know that you are dedicated to stimulating the economy just like all of us are.

I think personally that a meaningful tax cut is what we need, but I don't think we can have a meaningful tax cut if it is going to be accompanied by a deficit that is going to produce more reduction in purchasing power of our money than the tax cut itself will increase.

Secretary DILLON. It depends largely on how the deficit is financed whether it is inflationary. So far I don't think our deficits have been inflationary. I think the figures show that our total change in the cost of living index was 1.2 percent last year.

That is the consumer price index. What we are talking about is an increase of gross national product of 7 or 8 percent coming from this stimulation of the tax cut. It will be far more than the increase in the consumer price index and that increase would take place anyway.

That increase is not tied directly either to our existing deficit or to the tax cut that we have proposed as you have said. As I am glad you pointed out again, though I forgot to answer it, this question about State and local taxes—I think the only answer to that is that State and local taxes have been going up very rapidly ever since the war.

There is no indication at the moment that that process has come to an end although there is an indication that our citizens generally are getting more resistant, particularly to State and local tax increases. I think this $2 billion of increase would take place anyway, tax cut or no tax cut.

One of the things that the chairman of the committee asked was that a study be made as to what effect the tax cut would have on State and local revenues. This showed that there would be a very real effect from stimulating the economy—the State and localities would get something like $2½ billion or more extra revenue without raising taxes.

Therefore, that will be one of the byproducts we will be able to get from a tax reduction—possibly some easing of this strong trend that we have had of increasing State and local taxes because they will be able to take advantage of the higher returns from their present rate schedules.

Senator MILLER. What prompts my concern, Mr. Secretary, is that I took the Treasury's computation of the amount of additional State and local revenue that my own State could expect to receive from this Federal tax cut.

Then I applied the same formula to the share of inflation of $14 billion for 1961 and 1962 which the people in my own State were subjected to, and I find there is an estimate of $26 million a year more revenue for State and local purposes which my people would enjoy but at the same time they have not enjoyed some $90 million inflation or reduction in purchasing power of their money. This is reflected among other things in the continuous increase in the price of farmland and in the costs of agricultural production.

So this, it seems to me, is the heart of the problem. How much of the enjoyment of a tax cut will be offset by inflation that we will not enjoy? I point out to you, Mr. Secretary, that during this first quarter of the year we have had an increase in gross national national product of a little more than $8 billion. But of that, $2.6 billion is inflation. So about a third of our gross national product increase is, for all purposes, nothing except window dressing. It is completely and utterly meaningless. It is inflation. I think we are going to have to concern ourselves with the true gross national product increase rate than just merely the unadjusted figures.

If I may just ask one more question. You referred to the "shackles" of the tax rates that were put on during World War II. I am wondering whether we should be concerned not only with the shackles of the income tax rates but also with the shackles of the excise tax rates, if we are indeed trying to provide consumers with more purchasing power.

Secretary DILLON. I think we should. There were just too many things to do at once. A number of those excises have been gradually done away with, such as the transportation tax, but there are lots of them that remain.

I certainly think that our excise tax structure, as we presently have it, is far from a perfect tax structure. But we felt that income tax rates were more important to the economy and should be tackled first.

Certainly at some appropriate time after this tax cut has been in effect and there is time to assess its effect on the economy and we see what our budgetary situation is, we ought to have a very thorough going over of all our excise taxes.

I think there are probably quite a few smaller ones that are almost in the category of nuisance taxes that could be done away with without any great loss of revenue, but it would require a good deal of study and work by the tax writing committees. I think you have put your finger on a very important point there.

Senator MILLER. Thank you, Mr. Secretary and thank you, Mr. Chairman.

Representative REUSS. Representative Pepper?

Representative PEPPER. Briefly, Mr. Secretary—you have been kind to us all—who are the nations or what is the category under which they would fall who are drawing principally upon our gold reserve?

Secretary DILLON. I think I have figures here of what the gold flow has been. In the first quarter of 1963 we lost $111 million—that is a net figure because we bought some too, some came in.

Our biggest loss was $101 million to France, our second biggest was $70 million to Spain and our third largest was $30 million to Austria. These are the only ones of any significant size. This was offset largely by an inflow of $107 million from the United Kingdom, a good part of which was the result of the operations in the London gold pool.

Representative PEPPER. I was wondering whether there was any relationship to speak of between the surplus nations who draw on our gold and the nations who are the beneficiaries of our economic and/or military aid.

Secretary DILLON. No, I don't think that that is a very close connection. Last year our biggest taker of gold was France with $456 million and they don't take aid. Next is Spain with $146 million. Now in Spain, there are some aid programs, although very few. They have been phased out recently, but up until just a year or two ago we did have assistance programs there but we don't have them anymore.

Austria was the third one with $143 million. I missed the United Kingdom. They were $387 million, they were the second largest. We have no aid programs there. So, looking down this list, which is published, I don't think there are any countries with which we have substantial aid programs although there were some small gold purchases earlier in 1962 by a number of Middle East countries some of which may receive some aid.

Representative PEPPER. Is that also true of those who receive military assistance?

Secretary DILLON. I think that is generally true, yes.

Representative PEPPER. So this drain is not coming then appreciably or substantially from the beneficiaries of our economic or military aid?

Secretary DILLON. No, I don't think that is so at all.

Representative PEPPER. It is free movement, it is in the free market.

Secretary DILLON. Yes.

Representative PEPPER. Thank you very much.

Representative REUSS. Thank you very much, Mr. Secretary for your indefatigable performance all day long. We will now excuse you and ask you, Mr. Roosa to be with us at 10 o'clock tomorrow morning. I understand that you are leaving for Europe later on.

Mr. ROOSA. In the late afternoon. I have all day.

Representative REUSS. I am very hopeful that we will be able to finish up with you in the morning, at least that will be our goal, so that you can go.

The Joint Economic Committee will now stand in recess until 10 o'clock tomorrow morning in this place.

(Whereupon, at 4:30 p.m., the joint committee recessed, to reconvene at 10 a.m., Tuesday, July 9, 1963.)

BALANCE OF PAYMENTS

TUESDAY, JULY 9, 1963

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The joint committee met at 10 a.m., pursuant to recess, in room 318, Old Senate Office Building, Representative Henry S. Reuss presiding.

Present: Senators Sparkman, Proxmire, Miller; Representatives Reuss, Griffiths, Curtis, and Widnall.

Also present: Senate Banking and Currency Subcommittee on Innational Finance: Senator McIntyre; House Banking and Currency Committee on International Finance: Representatives Multer, Ashley, Moorhead, Pepper, Hanna, and Halpern.

Staff members present: James W. Knowles, executive director; Gerald A. Pollack, economist; Donald A. Webster, minority economist; and Hamilton D. Gewehr, administrative clerk.

Representative REUSS. Good morning. The continued session of the Joint Economic Committee will be in order. We are engaged in a study of our balance-of-payments problems and the international monetary situation. Yesterday we heard extended testimony in the presentation of a paper by Secretary of the Treasury Dillon as Chairman of the Cabinet Committee on the Balance of Payments. This morning there is with us Under Secretary Robert Roosa, who was also with us yesterday.

Mr. Dillon, in his testimony, mentioned that Mr. Roosa would be able to respond to many of the detailed questions. As I understand it, he will not make an additional statement but has certain materials which he would like to present.

You are very welcome here this morning, Mr. Roosa. We appreciate your attendance. I think we might start out by your identifying the additional paper which, as I understand it, is a document entitled, "U.S. Borrowings of Foreign Currencies," 22 pages in length, dated July 1, 1963. Is that correct?

STATEMENT OF ROBERT V. ROOSA, UNDER SECRETARY FOR MONETARY AFFAIRS, TREASURY

Secretary ROOSA. Yes, Mr. Chairman. I had not been able to predict precisely the way in which you would wish to have the hearings proceed. We wanted to use the time as fully and fruitfully for all of us as possible, so have prepared that paper well in advance in order to be able to either submit it for the record or present it as a statement as you wish.

But I gather it would be preferable to introduce that as an item for you to consider and include in the record and then proceed with discussions here this morning.

Representative REUSS. I think that will be most economical of time. Without objection the July 1, 1963 document on U.S. Borrowings of Foreign Currencies will be received into the record and we will now proceed under the 10-minute rule.

(The statement of Robert V. Roosa follows:)

U.S. BORROWINGS OF FOREIGN CURRENCIES

On July 1, 1963, foreign central banks and governments held $630 million equivalent of U.S. bonds denominated in foreign currencies and with maturities of up to 2 years. The outstanding securities are denominated in Swiss francs, Italian lire, German marks, Austrian schillings, and Belgian francs. Detailed information on the terms of these securities is provided in the attached table.

These securities represent the introduction of a new instrument into the international payments system, and have attracted considerable interest. Although the U.S. Treasury has made a special announcement concerning each new issue, it seems desirable to discuss these obligations and the operations with which they are associated in some detail.

Three questions are commonly asked about these instruments; namely, first, what kind of obligations are they and how are they issued; second, what purposes have they served; and third, what is their longer run future.

These obligations are issued under the authority contained in the Second Liberty Bond Act, as amended. Issuance of the obligations is a public debt transaction. The first use of these instruments occurred during World War I when, in order to secure means of payment for war materials purchased in Spain, certificates of indebtedness were issued denominated in Spanish pesetas. However, the peseta obligations were retired by 1921 and there was no further use of the authority until late 1961.

Under the authority of the act, sales may involve either certificates of indebtedness or bonds. Although not legally restricted to particular purchasers abroad, all those issued since 1961 have involved nonmarketable obligations and have been available for purchase by foreign central banks or governments only. There are other differences among the issues outstanding, one of them being the fact that certain bonds have provisions regarding possible redemption prior to maturity. This special feature will be discussed later.

The issuance of foreign currency obligations serves a number of closely interrelated purposes associated directly or indirectly with the operation of the foreign exchange markets.

The dollar, as the principal reserve and trading currency of the world, plays a key role in the foreign exchange markets and in the international payments system. For many years after World War II it was possible to let the dollar operate itself, so to speak, in view of its position of complete predominance as the preferred currency. The value of the dollar in terms of other currencies came as the byproduct of market forces plus the management, insofar as management did occur, provided by foreign monetary authorities which had undertaken to protect and defend their own currencies. Under the rules of the International Monetary Fund foreign monetary authorities undertook to maintain the value of these currencies in the exchange market within a narrow range (1 percent) of an established parity. This they accomplished by buying or selling dollars against their own currency as the occasion required. The United States on the other hand, refrained from intervention in the exchange market, and alone fulfilled its IMF obligations by standing ready to buy or sell gold at a fixed price against dollars on demand. In those days demand for the dollar to add to reserve holdings was high and a flow of additional dollars into the markets and into official reserves, far from being viewed as troublesome, was considered to be a constructive contribution to world liquidity.

Under those conditions, continuing U.S. balance-of-payments deficits of modest size posed no real problem. But at the end of 1958, foreign dollar reserve positions had been heavily fortified and a number of major countries moved to currency convertibility. Convertibility, which permitted the free exchange of one currency for another as required in connection with private

and official dealings (though not necessarily all capital movements), represented a particularly significant step forward in the search for higher levels of world trade under conditions of increased competitive efficiency. However, it also widened the possibilities for large movements of funds between markets seeking the highest return from investment or seeking a safe haven.

With the upward valuation of the German mark and Dutch guilder in March 1961, the problems that could arise were posed vividly. Abrupt changes in the rates for the dollar and sharp, precautionary discounts on the dollar for future delivery (discounts that proved to be economically unjustified), served only to excite speculative excesses that further sapped confidence. The dollar threatened to become the victim of disruptive speculative pressures. Under these circumstances it was no longer possible for the United States to adopt a passive attitude toward the fate of the dollar in the exchange market. Official U.S. exchange market operations were required if our currency was to be defended—along with other currencies—and the integrity of the dollar was to be sustained.

At the same time it had to be recognized that what happens in the markets—the movements of exchange rates and the level of those rates—provides early signals, and on occasion highly important signals, of the state of health of the payments system. Although sometimes misleading over the short run, such developments over time reflect basic forces and it is important that the form and effect of any official operations be designed to assure that such basic forces will show through.

One other important symbol closely watched around the world is the U.S. gold stock. What happens to the U.S. gold stock in turn reflects, over time, developments in the exchange markets which equally reflect balance-of-payments positions.

Sustained deficits in the U.S. balance of payments over recent years have tended to generate supplies of dollars in the market in excess of demand. The dollar has thus tended to be weak. As the price of the dollar declines, official operations—by the United States or the foreign monetary authority—can serve to cushion the movements and help to avoid speculative outbursts; in the final analysis, such operations must be undertaken to hold exchange rates within the limits agreed to under the articles of agreement of the International Monetary Fund. If foreign official institutions find it necessary to intervene and buy dollars, the dollars flow into official reserves. As such reserves rise, foreign officials convert some portion into gold by purchase from the United States—the only authority in the world which stands prepared to buy and sell gold against U.S. dollars at the fixed price of $35 per ounce. Thus the loss of gold and the accrual of official reserves of dollars abroad which may precede such a loss, signals developments in the U.S. balance of payments that need attention, and may demand correction.

Custom or legal requirements vary of course among countries with respect to the proportion of overall reserves held in gold. Balances in excess of the gold proportions are largely held in U.S. dollars. These dollars are for the most part invested in marketable short-term U.S. dollar securities which provide interest earnings and a high degree of liquidity owing to the deep and broad money market in the United States which permits sales of such investments with a minimum of delay and difficulty. The introduction of new obligations denominated in foreign currencies provided, however, a third investment alternative to foreign monetary authorities.

The decision by the United States to enter the foreign exchange market in defense of the dollar meant that some source of foreign currencies had to be found. With the dollar tending toward its lowest permitted value and the U.S. balance-of-payments deficit leading to higher offerings of dollars in the market than private demand would absorb, foreign official holdings of dollars were already "too high." This eliminated the possibility of buying foreign currencies by offering more dollars in the market, since our purchases of foreign currencies would simply further aggravate the situation. In the initial instance, our operations took place in German marks and it was possible to gain some resources by accepting German marks in payments for some of the debt owed to us by the German Government. When operations were undertaken in Swiss francs, however, in July 1961, no such source of foreign currency balances was available. The alternative was, of course, to borrow the foreign currencies.

These borrowings thus served to provide foreign currency resources which are needed if official activity is effectively to influence short-term fluctuations

in rates, the flows of dollars into foreign reserves, and conversions of dollars into gold. Alternative methods may be used to achieve these ends, the choice between them being determined by the particular circumstances and situation prevailing at any given time. The overriding consideration in recent practice, however, has been to cushion effects that might otherwise have led to speculation against the dollar, and the disruption of orderly payments arrangements keyed to use of the dollar—but to accomplish that cushioning without concealing the implications of the basic pressure upon the dollar for needed correction in the basic balance of payments situation of the United States.

One possibility for action has been for the United States to enter the foreign exchange market and use its foreign exchange resources to purchase dollars being offered in the market, thus absorbing dollars which would otherwise flow into foreign official hands. Alternatively, dollars may already have accumulated in foreign official balances in amounts which exceed the customary level held by a particular country. In the latter event—and it is such conditions which have thus far in fact comprised the vast bulk of operations—the foreign currencies received in exchange for the Treasury obligation may be used to purchase directly from the foreign central bank or monetary authority an equivalent amount of its dollar holdings. In the first approach the United States makes its acquisitions in the foreign exchange market (though perhaps with a foreign central bank helping to execute the purchase) while in the latter case market operations are conducted more directly with the foreign central bank, though customarily at known current market quotations. In the final analysis, however, this becomes largely a strictly technical matter since close cooperation among the authorities responsible for the major currencies has been a key feature of developments throughout the last 18 months of experimental innovation.

Insofar as the foreign partner in the borrowing operation is concerned, the debts provide an alternative form of investment. With the availability of this new instrument, therefore, foreign countries gaining reserves (whose own currency is convertible, strong and of use to the United States) can choose between U.S. dollar investments, gold holdings, or U.S. obligations denominated in their own currency.

In addition to the fact that the amount of these obligations outstanding has grown significantly over the past year and a half, another significant development lies in stretching out the maturities of these obligations. The reason for extending maturities is perhaps best illustrated in the case of the Italian lire obligations. The initial issue of certificates of indebtedness denominated in lire took place early in 1962 and had a maturity of 3 months. The expectation that the pressures in the market and the accumulation of dollar reserves by Italian official institutions would be reversed following the heavy inflows from tourism during the summer proved to be unfounded. Accordingly, after the outstanding short-term obligations had been rolled over on maturity into new short-term obligations, it became clear that the sources of these particular flows were deeper and longer lasting. This recognition by responsible United States and Italian officials led logically to the issuance of longer term securities which were clearly more appropriate to the conditions prevailing.

Somewhat different circumstances have been involved in some of the Swiss transactions. For the Swiss, at least initially, the issuance of longer term securities denominated in Swiss francs provided an outlet for budget surpluses of the Swiss Confederation. Since it could dependably be contemplated that such surpluses would not be required for domestic use at an early time, the issuance of securities of longer maturity was appropriate.

In several cases, however, it became apparent that foreign central banks—the holders of a nation's exchange reserves—were the major potential source of funds for investment in these obligations. Inasmuch as central banks have long established procedures to assure the liquidity of their portfolios in order to meet reserve needs, it was clear that a special obligation tailored to the needs of lender and borrower alike would be necessary. In the circumstances a special type of instrument was developed in the form of a medium-term bond denominated in the local currency but convertible upon short notice into 3-month certificates of indebtedness also denominated in the foreign currency, the shorter term obligations could then also be turned in for payment after further short-term notice.

These obligations, having original maturities of 15 to 24 months, thus contain a technical provision which makes their holding by foreign central banks possible. Such bonds bear interest at rates that do not exceed the rate on U.S.

marketable bonds in the New York market having comparable maturities on the date of issue. Because such bonds carry the appropriate rate for other medium-term securities, it may be expected that they will in the normal course be held to maturity. Moreover, such bonds provide, in effect, an exchange guarantee in terms of the particular local currency. In the absence, therefore, of significant and unexpected changes in the balance-of-payments position of a country holding such bonds, the securities should remain outstanding until their original maturity date—and, in the absence of such changes, could be renewed for a further period. A practical means has thus been devised, as a supplement to holdings of dollars or purchases of gold, to provide foreign official holders with a medium-term investment in the United States, through mutually agreeable channels. It obviously thereby helps to meet a part of the gross financing needs associated with our balance-of-payments deficits while averting additional gold drains that could complicate the longer run maintenance of the dollar itself as a primary reserve currency.

If the unlikely were to occur—that is, if a bond were not only presented for conversion into a certificate, but also if the converted certificate should be presented for redemption—the United States would need to pay off the obligations by furnishing the appropriate amount of the other currency. Should the United States have an insufficient supply of that currency at the time, the existing balance would have to be supplemented by purchases of the currency for dollars, and dollars would thus flow into the foreign country's official reserves. The very fact that early redemption of the obligations was requested, however, would reflect, as noted earlier, a substantial adverse change in the balance-of-payments position of the country concerned and hence, its need for dollar reserves to cover its deficits.

In the circumstances there would, of course, be a remote likelihood that the dollars would cause exchange market complications or lead to some demand on the United States gold stock. But there is perhaps a less remote likelihood that the dollars might ultimately reach another central bank which would wish to purchase additional bonds denominated in its own currency. And, of course, if the United States should at the time be in balance-of-payments equilibrium, or surplus, the generation of additional dollars in this way would no doubt meet a general need and the question of issuing other bonds to other countries might not arise.

Thus, generally speaking, any abrupt or heavy shift from surplus to deficit in the balance-of-payments position of a particular foreign country having a convertible currency and holding the special U.S. securities would undoubtedly have its counterpart in improved payments positions of the United States or some other convertible currency country. Insofar, of course, as the balance-of-payments change reflected an improved U.S. position, it would be quickly reflected in the exchange market and the dollar would tend to be stronger against that currency. As a practical matter, long before any presentation for conversion or redemption, such market conditions would have provided the basis for U.S. purchases of the currency in the regular course of business. It would be likely that the United States would have accumulated an adequate balance in the required currency in anticipation of maturity of the bond; certainly any deficiency in holdings of the currency at the time of redemption could be covered rather easily. Over the longer run, this will be the expected pattern of developments: a stronger dollar and a reduction of such foreign currency debts, to the extent acceptable to the holders.

These operations in the broadest sense reflect the close cooperation among financial authorities responsible for those convertible currencies of the free world that are traded extensively in the market. By reinforcing the network of central bank swap arrangements, the new borrowing procedures have reinforced the payments system. A convenient and appropriate method of dealing with market pressures is provided, through arrangements that fall somewhere between the very short-term foreign central bank swap credits and the longer term assistance available at the International Monetary Fund.

Although the preceding discussion relates our borrowings quite closely to our balance-of-payments deficits, it does not mean to suggest that this is their only usefulness under current conditions, nor that their possible usefulness will be eliminated once the United States achieves equilibrium in its balance-of payments or records a surplus. Indeed, it is quite possible that these obligations can play a continuing useful role over the longer term future. Countries can, of course, look forward to using these investments at some point

to meet the deficits that they may run. In the meantime, by avoiding demands on the U.S. gold stock, the means of payments available for the smooth flow of international trade and finance will have been maintained. If purchases of gold from the United States would have been made, a shift of gold would have been substituted for the use of a credit instrument. The overall payments system would, in fact, tend to become less liquid, whereas the new instruments would have provided an underpinning for sustaining or increasing liquidity.

Finally, even when the United States is recording surpluses, it is not likely that all foreign countries will be running deficits. Indeed, it is quite probable that some would still be recording surpluses. These obligations, tailored to meet the needs of individual countries abroad and ourselves, could then well prove useful in maintaining a smooth payments flow by continuing to absorb some of the otherwise surplus dollars accumulating in specific countries abroad.

Does the use of these debt operations at a time when the United States is running a balance-of-payments deficit in any way reduce the pressure toward balance? Most certainly not. But neither can the balance-of-payments deficit of the United States be wiped out overnight. In fact, its termination cannot be scheduled with precision because the adjustment process does not work that way in a market economy. To a considerable extent, the lasting correctives we seek must work through the complex of free market forces and institutions. The correctives must also work out gradually and smoothly—if financial relationships among the free world's nations are not to be severely wrenched. Recourse to direct controls over the movements of people, goods, or capital have been deemed out of the question—and rightfully so. This makes the correction no less urgent. Clearly every effort in both the governmental and private sector must be made and reinforced to secure dependable progress, at the most rapid practicable rate, toward the balanced position that must be achieved. Nevertheless, solution through the markets does mean an interim period during which an acceptable handling of overall financing needs is required. The issuance of securities denominated in foreign currencies is an integral part of that interim program.

Thus the issuance of such securities does not reduce the important influence of balance-of-payments discipline. The investments require negotiation. There must be agreement between borrower and lender, not only on terms and rates, but also on the basic fact that issuance of the securities is both appropriate and useful. Given these basic factors, there is little likelihood indeed that normal balance-of-payments disciplines will vanish as a conscious restraint.

As a final note, it should be added that sales of the foreign currencies realized when the securities are issued provide dollar receipts to the Treasury. These dollars are then available to meet domestic financing needs—and at a cost not exceeding those that domestic sales of dollar securities would have involved. Thus the United States does not issue any larger total of debt than would be necessary in any event for domestic requirements, but the part of the debt denominated in foreign currency performs, in effect, a double duty—that of helping to meet both our external and our internal borrowing requirements. And the foreign currency securities, representing the unassailable credit standing of the United States, are issued only at market rates of interest, on terms acceptable to prudent investors.

To summarize: U.S. sales of securities denominated in foreign currencies:

1. Provide resources for official operations in the foreign exchange markets to protect and defend the U.S. dollar;
2. Help to cushion demands on U.S. gold stock;
3. Add a new investment medium for foreign governments and official institutions;
4. Assist the United States, over the reasonably near future, to meet the gross financing needs of its balance-of-payments position; and
5. Constitute a useful exploration of possibilities for sustaining and bolstering international liquidity as required and appropriate to cover needs arising from shifting balance-of-payments positions.

U.S. securities denominated in foreign currencies have thus become a part of an international payments system that, still evolving and developing, has changed strikingly over the past 2 years. The smooth functioning of the exchange markets, particularly over the past year dotted with crises, provides testimony to the growing effectiveness of the overall complex of arrangements and techniques developed. All of this both reflects and requires the close cooperation increasingly apparent among financial officials responsible for the major convertible

international currencies. Indeed, none of the innovations of the past few years would have occurred without the creative and constructive effort of the leading officials of these countries.

Treasury foreign currency security issues

Currency	Amount in (millions of units)		Interest rate (percent)	Date issued	Maturity (months)	Payment date
	Local currency	U.S.-dollar equivalent				
Swiss francs	100	23	2.75	Oct. 18, 1962	15	Jan. 20, 1964
	120	28	2.75	Nov. 8, 1962	16	Mar. 9, 1964
	130	30	2.82	Jan. 24, 1963	16	May 25, 1964
	97	22	2.82	Apr. 1, 1963[1]	15	July 1, 1964
	100	23	2.83	Apr. 4, 1963	17	Sept. 4, 1964
	100	23	2.82	May 16, 1963	18	Nov. 16, 1964
	110	25	2.89	July 1, 1963[1]	18	Jan. 1, 1965
Subtotal		175				
Italian lire	31,000	50	3.00	Nov. 30, 1962	15	Feb. 28, 1964
	31,000	50	3.00	Dec. 7, 1962	15	Mar. 9, 1964
	15,500	25	3.27	Mar. 29, 1963[1]	24	Mar. 29, 1965
	46,500	75	3.30	June 28, 1963[1]	24	June 28, 1965
Subtotal		200				
German marks	200	50	3.13	Jan. 24, 1963[1]	15	Apr. 24, 1964
	200	50	3.18	Jan. 24, 1963[1]	18	July 24, 1964
	200	50	3.09	Feb. 14, 1963[1]	21	Nov. 16, 1964
	200	50	3.14	Feb. 14, 1963[1]	24	Feb. 15, 1965
Subtotal		200				
Austrian schillings	650	25	3.23	Apr. 26, 1963[1]	18	Sept. 26, 1964
Belgian francs	1,000	20	3.26	May 16, 1963[1]	24	May 16, 1965
	500	10	3.22	May 20, 1963[1]	24	May 20, 1965
Subtotal		30				
Total		630				

[1] Indicates bond contains convertibility feature.

NOTE.—Figures may not add to total because of rounding.

Representative REUSS. I wish to point out again that there have been invited here members of the House and Senate Banking and Currency Committees, specifically the International Finance Subcommittees thereof.

We are pleased to welcome here Mr. Ashley of Ohio of the House Banking and Currency Committee.

Mr. Roosa, I must confess to being quite distressed at the Treasury program forwarded yesterday in the statement by Secretary Dillon, in that the principal element in it, as I read it, for rectifying our balance of payments seems to be an increase in short-term interest rates.

I am distressed at this because short-term interest rates are already at their highest since 1960. As the Joint Economic Committee majority has repeatedly pointed out, we think that short-term interest rates are as high as they ought to be in view of the unemployment rate and the lagging growth rate of this economy.

We also feel that further increases in short-term interest rates cannot but be communicated quite promptly to long-term interest rates, an increase which even the Treasury agrees would not be in the national interest.

More than that, even if there were no such communication to the long-term interest rate structure, if you raise short-term interest rates, you particularly disadvantage small business and particularly inventive small business which needs capital.

You raise the cost of doing business generally, because business inventories are traditionally financed by short-term loans. You raise the cost of consumer credit which is likewise a function of short-term bank loans. We, therefore, regret that the administration seems to be in favor of a further increase in short-term interest rates.

The moves taken toward that end are already lamentably obvious to some of us. The Federal Reserve appears to have squeezed its free reserves in the last 2 months down to around the $200 million level from the $500 million level that many of us thought desirable in the current state of the economy.

There is talk of an increase—God forbid—in their discount rate. I notice that yesterday, apparently largely on the basis of Secretary Dillon's testimony in favor of higher short-term interest rates, the New York market responded by lowering the price and increasing the yields not just on bills and other short-term U.S. securities but throughout the entire spectrum, including 20-year bonds.

All of this is justified on the basis of our balance of payments and particularly on the basis of the staff study made for the Treasury some months ago which is known as the Kenen report after its author Peter B. Kenen and also on the basis of a Federal Reserve Bank of New York report which was prepared by Benjamin J. Cohen.

The Kenen report is dated October 1, 1962, and the Federal Reserve Bank of New York report is dated July 5, 1963. We were handed the reports last night. We have had time to look at them in a cursory manner, and the proposition I put to you, Mr. Under Secretary, is that they don't support the Treasury position at all.

I find that Mr. Kenen's paper contains his summary conclusion. I wanted to read this to you. I quote:

I am loathe to recommend that the United States raise interest rates to discourage short-term capital movements, even that they be kept at present levels—

Those were the levels of last October—

if the domestic situation argues for reductions.

My conclusions as to interest sensitivity are not decisive. Even if they were the cost at home would be excessive. I would recommend systematic intervention in foreign exchange markets to keep foreign rates near their interest parities.

Representative REUSS. I suggest that blows the Treasury's position out of the water, that the Kenen paper does not come close to suggesting what was suggested yesterday.

I also note that Mr. Kenen, himself, admits that, because of time pressure, the statistical background of his paper is very questionable.

For instance, in appendix I in the Kenen report here is what he says—and I am quoting again:

* * * A flaw in the computer program gave wrong results for several of the constant terms, introducing a systematic error into the corresponding residuals. This led to bias in the Durbin-Watson coefficient. The error was not corrected in time to rerun all the residuals.

I find this a disturbing basis on which to bottom a national policy of raising short-term interest rates, at a time when we have higher unemployed than we had a year ago, at a time when our growth rate is lagging.

I find similar grounds for disquiet in the July 5, 1963, Federal Reserve report. In his statement Secretary Dillon said that the New York Federal Reserve study suggests that a "reasonable" increase in the interest rate would be likely to improve our balance of payments by $500 million or more.

I have looked at the New York Federal Reserve Bank report and I don't find that in it. I find instead, that the report concedes that—

> * * * on the basis of evidence currently available, we cannot yet estimate by how much interest rates must change to generate a sizable capital flow. At best, we can simply suggest the volume of capital flows that might be associated with "substantial" rate changes (p. 193).

Now substantial is a far different matter from "reasonable." Later on in the New York Federal Reserve report I find this statement:

> * * * In the absence of more precise econometric analysis, we can just assume that the average annual amplitude of fluctuations roughly approximates the amount by which these capital exports might normally vary in a year in response to interest rate changes (p. 202).

Now, in simpler language what this says to me is that what the Federal Reserve did was to look at the unexplained items and say that these are the interest sensitive capital outflow.

Again, I find this an incredible basis upon which to found a national policy of higher interest rates. As you can see, I could not disagree more violently with your position, even though I respect the frankness and candor with which the Treasury came up here yesterday and today to present its position.

I would invite your comment on what I have just said, that the Treasury's position is wrong and that it should change its position, and that the President should use his best persuasive powers with the Federal Reserve to change a course which I regard as a potentially disastrous one.

Thank you for listening to me.

Secretary ROOSA. Yes, indeed. Thank you for giving me this opportunity to explain the situation, Mr. Chairman.

First, I would like to make very clear that we were not yesterday outlining any forward projection of an administration program. Whatever that program in its future characteristics may be, no firm decisions have yet been made.

Consequently, we are hoping, as the Secretary wanted to stress, to use the unusual opportunity of this exchange of views at this time, both to review some of the thinking that we have been considering, to review the record as it has developed, and particularly to receive from the interchange with this committee the suggestions and the testing of ideas that will have a very large part to play in the evolution of further steps in any administration program.

It is important, therefore, to realize that, while the role of short-term interest rates has been significant and will continue to be significant, the discussion yesterday did not by any means intend to center upon that.

It may be, I like to think, Mr. Chairman, the one element of a very comprehensive program with which you disagree and that perhaps by implication you are implying that all of the rest has been perhaps thus far inadequate but nonetheless rightly conceived.

Representative REUSS. If I may interrupt, let me make my position clear. Yes, I do think that by and large what the administration and the Treasury have done so far are good things. They are in the right direction. But the whole gist of what I am saying is that I don't think they are adequate. We are still running a $3-plus billion deficit and it would have been vastly worse if you had not done what you have done.

Secretary ROOSA. Yes, indeed.

Representative REUSS. I find ourselves exposed, and I think it is high time for new and vigorous action. I am deeply grieved to find that the new and vigorous action suggested is the raising of short-term interest rates which, I believe, will have as its principal effect the furthering of unemployment and the retarding of growth within this country.

I know the dilemma, but I do not believe in solving it by increasing our own unemployment and decreasing our growth rate. I believe in solving it by the kind of international monetary arrangements which this committee has suggested in the past, by the kind of controls on new issue flotations in the market in Wall Street which I mentioned yesterday, but not by the raising of our own interest rate structure.

Secretary ROOSA. Yes, sir. Well, if I may, Mr. Chairman, just continue because I wanted to make clear, first, that we were not presenting the outlines of a new program yesterday but were taking a trial balance in terms of where we are and the forces currently at work.

Now, within that framework we do, as a matter of judgment, genuinely disagree with you, and I would not want to conceal that disagreement for a minute. But as to whether and when short-term interest rates ought to rise further, as with so many of the elements in the appraisal, the influence the Government appropriately can exert on the money and capital markets must, for the most part, be a matter of judging the state of the market and the degree of what can be accomplished. There the Secretary was very careful to point out something that I would like to reemphasize, perhaps even elaborate further today. There are clear and impelling forces at work in the capital markets themselves which prevent any significant change in the level of long-term interest rates and which will, we feel confident, assure the availability of long-term funds on a scale not only adequate but ample to finance and support the growth and expansion and the new investment that we are all anxious to have.

This is partly because we have entered a period where with relatively stable prices—with all respect to Senator Miller, they are relatively stable by historical standards—there has been a decisive change in the liquid savings patterns in this country.

The flow of liquid savings, as you know, into financial intermediaries and related forms of savings, that flow has been increasing at a rate of 20 percent or more a year.

These increases reflect themselves in the long-term market, a market which is dominated by the use of mortgage funds much more than corporate external borrowing—as you know, there the larger part is

internally generated. The performance during the last 3 years of rising short-term rates, has been one of mortgage rates that have continued to decline.

These dominant characteristics of the market are what the Secretary wanted to single out yesterday in indicating that there may still be room for increases in short-term rates at some time, tested out on the basis of the way market developments are going, room for some increase that will still not be transmitted into any of those important sectors affecting the availability of credit for the whole range of constructive investment in the economy.

We can't tell, it has yet to be tried. The beauty of this kind of technique is that it is also reversible so that we are not restricted in this kind of approach, if we should find it necessary at any stage. I would be prepared to argue that we have certainly not yet found that there has been any impairment of growth and employment opportunities as a result of the changes that have occurred thus far in short-term interest rates.

Representative REUSS. And in availability of bank credit?

Secretary ROOSA. Yes, I would say so.

As to the studies, themselves, they, of course, are only an incidental part. We would not base policy on studies of this kind. They help to illuminate some of the aspects of the statistical record. The personal view of Mr. Kenen which you read is taken from the complete report, prepared by him with staff assistance from the Treasury, which was made available to the committee in advance of the formal submission of relevant parts of that study which we are submitting for the record. Portions deleted, as you can readily see, are those dealing with the collection of data, the presentation of data, and Professor Kenen's personal views on policy as of last October. Whether or not those views have changed because the domestic situation has changed and the urgency of the payments problem has increased is for Professor Kenen himself to say. We consulted with Mr. Kenen as to the portions of the report which he believed it would be appropriate to make available to the committee and it was agreed that the relevent portions were those submitted formally. The particular expression of opinion which you read was provided for background information on the ground that we did not want to leave any impression that we were trying to influence the committee. Mr. Kenen's own views may or may not have changed but he certainly was most mindful, as mindful as any of us, that he had made a preliminary effort. One of his principal conclusions is that the work should continue and it has continued at the Federal Reserve Bank in New York where the bulk of these data is assembled.

I would like also, if I may, to report Professor Kenen's view as to the significance of the "flaw in the computer program" which the chairman mentioned. Mr. Kenen himself has stated, in subsequent correspondence with the Treasury, that:

The computational defect mentioned in the appendix to the study has no bearing on the basic findings or conclusions. The flaw caused an error in one coefficient of the multiple-regression equations. This error was corrected by hand; all of the equations in the report are perfectly accurate. The flaw, however, led to bias in the Durbin-Watson coefficients. These are secondary measures of statistical reliability. Because they were biased they could not always be used to perform this particular test. But this itself does not say that the equations could not pass this test. When, in fact, the Durbin-Watson coefficients were usable they gave satisfactory results.

So, the fundamental fact is that in any judgment to move forward with the testing—the trial and error reliance on anything further in increasing short-term rates as they affect international flows—the fundamental reliance is on judgment and appraisal of what is occurring at the time.

So we introduced these studies as an illustration of what can be done with the available data by statistical methods thus far. I think you will find in the case of the Federal Reserve study as well, that it is quite rightly surrounded with heavy layers of academic disclaimers as to the solidity of any conclusions based on statistical measures of this kind.

Now, let me explain one aspect of the Federal Reserve study that I think is relevant and this becomes a matter for analysis. The statistical possibilities for testing are completely inadequate because we have not had—your familiarity with statistics would make this abundantly clear to you—we simply have not had the observations which would permit a full and adequate test under the specified, verified conditions required for academic statistical exercises, because we have only had convertibility since the beginning of 1959 and the market itself has been quickly changing. The principal finding in the Kenen paper, and the one which has now been further tested in the work that is summarized in the Federal Reserve paper, is something that I knew as a man in the market. I did not have to look at any statistics at all to know that from 1959 onward the development of the Euro-dollar market was pulling money by the billions into Europe, and it is and it has been.

There are no data on that market at all. Most of the funds flowing into that market are not even recorded as they leave the United States. We have not yet found ways of measuring, since so many of them are flows from U.S. corporations placed not just with the Canadian agency banks in New York which we can measure, but with a host of European banks and many of them even in unidentified accounts.

This then must become a matter of the informed judgment of a professional and no statistics are going to, for the present, get close enough to make an adequate measure.

What we have given you is a sufficient cross section of what can be developed from the existing statistics to show you that there is a basis for indicating, in those particular sectors within the short-term market for which some data are available, that there are flows that are highly sensitive to interest rate changes.

There are many that aren't. That, of course, is the purpose of introducing these studies. I would never want to imply that any policy judgment in which we are involved rests upon these completely inadequate measures of the total picture.

These have to be the judgments of people who are in the markets and live in the markets and who know what moves. Eventually some day, a fast-changing market will settle down, reporting methods will catch up, and we will be able to have much more nearly adequate measures.

These now are merely fragmentary approaches toward a picture of what I just must assure you some of us know to be the facts.

Representative REUSS. Mr. Curtis?

Representative CURTIS. Would you call on Senator Miller first?

Representative REUSS. Senator Miller?

Senator MILLER. Mr. Roosa, I would like to say that I was impressed by the Secretary's testimony yesterday regarding the differential between 3-month money and the London market of 4 percent and the 3¼ percent in the New York market and if indeed your figures are borne out by the facts, I think you have made a good case.

I would like to comment further by saying that I am most unimpressed by those individuals who say that an increase in short-term interest rates, to make ourselves competitive, would certainly have an adverse effect on our business conditions and our employment situation. Here is why I reach that conclusion. Let us say a businessman or a business firm wanted to borrow a million dollars and that in order to make ourselves competitive we increased our 3-month money from 3¼ to 4 percent.

At 1 percent on a million dollars, that would amount to $10,000, and three quarters of that would be $7,500 a year more that they would have to pay.

But, by the time they take the deduction on their Federal income tax return of 52 percent, the net out-of-pocket cost to the businessman or business firm would only be $3,600 a year on $1 million of borrowing.

I am going to have to have pretty good statistics to be convinced to the contrary in my position that this would have an adverse effect on business expansion or unemployment.

So I think, unless we have some very persuasive evidence to the contrary, that your position, and the position taken by the Secretary of the Treasury, is very well taken.

Now, on the other hand, I would like to point this out to you. I appreciate your deferring to my position on the stable prices and increasing prices. What I can't understand is why do you people over in the Treasury constantly talk about stable prices and wholesale prices?

Frankly, I am not a bit interested in those. What I am really interested in is what is the value of our dollar—especially when I see our dollar steadily going down in its purchasing power. You can talk all you want to about stable prices and wholesale prices but that does not influence me at all and it does not influence my people who are concerned about inflation.

They are interested in what is the purchasing power of their dollar; and whether they have to buy services or wholesale goods or retail goods we don't care. What we care about is what is the value of our money.

It seems to me that we have been finding a decline in our dollar of about 1 percent a year. The value of the dollar at December 31, 1960, was 46.6 cents in purchasing power compared to a 1939 dollar of 100 cents and today it is down to 45.6 cents.

According to my calculations that is a drop of about 1 percent in the value of our dollar each year.

Now, my point is that if foreign creditors see the value of our dollar slipping steadily year after year, I can't blame them for asking for gold instead of dollars. It seems to me that one of the first things we have to do is to stop this slippage in purchasing power of our dollar if we want to stop the outflow of gold. Now, do you agree with that?

Secretary ROOSA. Yes.

Senator MILLER. Now, the next thing, what is the Treasury's position on the definition of short-term money? Where do you draw the line in terms of months or years?

Secretary ROOSA. This too has to change with the nature of the instrument and the changing market. For the most part, in our statistical records, we have drawn the line at 1 year. This is not always reliable. There are a number of instruments that are essentially short term used in the financing of international trade which cluster in the 2- to 3-year area.

These are among the problems of statistical gathering that will never be fully solved and you can solve them best sometimes by treating them both ways so that you know what the facts are without concealing either way. But, in general, the dividing line has been taken at 1 year.

Senator MILLER. Now, why do you people on the one hand advocate increasing our interest rates on short-term moneys, say money for up to 1 year, in order to make ourselves competitive and in order to stop or in order, at least, to put a dent in our balance-of-payments deficit, and at the same time, on the other hand, you indicate a reluctance to increase the long-term interest rates?

Aren't we in a matter of competition either way? Isn't it possible that we are losing more of our balance of payments as a result of long-term money rather than short-term money?

Secretary ROOSA. Yes; the total outflow of long-term funds, if you include direct investment and portfolio investment, was indeed, last year, larger than the combined total of recorded short-term flows and all unrecorded items, assuming all unrecorded were short term. So that the outflow of long-term funds is also very important.

I would like to make two key points there. The first is that so far as long-term interest rates are concerned we have, certainly speaking for the Treasury, no objection to any increase in long rates that may occur as a result of the working out of the supply-and-demand forces in the long-term capital market.

Senator MILLER. In the long-term capital market domestically or in the world long-term capital market?

Secretary ROOSA. So far as we are concerned we are the world capital market. The residual of demand from the entire world comes here. Therefore, whatever emerges from the forces of supply and demand we are prepared to accept as the necessary implication of maintaining a market, which means a capitalist economy.

But, we also recognize that it is extremely important to look at both sides, supply and demand. And as I have just indicated, the conditions of relative price stability and, looking historically over the last 20 years, the comparatively high interest rates now available to savings deposits, savings and loans shares, and so on, have combined to produce a flow of liquid savings in this country which, overall, exceed the existing potential of demand.

It seems, therefore, to us that the most important thing is to create conditions that expand investment and if we can get the kind of roaring boom we would all like some day to see, this may in the end bring some rise in long-term interest rates.

That depends on stimulating additional investment demand in this country and that is why we put first, both for balance-of-payments reasons and for growth at home, the absolute priority of getting the tax reduction accomplished this year. Now, that is the first part on the long-term rate, the supply-and-demand side.

Senator MILLER. Pardon me, but may I ask you a question at that point? You put first priority on a tax reduction to give this stimulative effect to create a demand for money resulting from new starts of business and expansion of business?

Secretary ROOSA. Yes.

Senator MILLER. Why don't you couple that with a complimentary demand to take action that will preserve the purchasing power of our dollar?

Secretary ROOSA. Well, we are doing that too, sir. Let me add now a third point, but let me give my second and I will deal with that one as well, if I may.

The second point that I would like to make is that in contrast with our market most foreign markets are not free. We are attempting to do all we can to encourage the steps that will bring them closer to freedom and much has happened in the last 2 years that is very encouraging in this direction, and I will spend the rest of the week in Europe on these same problems again.

The results come slowly. The negotiation is hard. You have to work through a good many details that are not always visible to either side when you begin. But this is not the sort of thing that you accomplish with a wave of the hand or just a declaration of good will.

It has to be worked at and evolved. Meanwhile this has meant, of course, that we are carrying more than any free market worldwide standard ought to impose on the United States.

So what we must do is find every approach consistent with the market price functioning of both the long and short markets, find everything that is consistent with the avoidance of governmental intrusion which would involve the control of individual transactions and the need to select one borrower over another, and use the force of the market in any way that can help us.

Now, recognizing the gigantic flow of savings, knowing that even the changes we are hoping to see emerge abroad are going to take time, knowing that the vast flow of savings is so great that even if we wanted to we could not raise that whole rate structure on our shoulders and bring it to a higher level, we concentrate on that part of the market where we know the interest rate response is rather quick and close and where we can expect to get some important response.

This is not perfect. The market economy imposes some limitations. It gives us on the other side such great gains that we must respect and accept them. So we are simply not in a position to, by an act of will, whatever any foreign observer tries to urge on us, to simply raise the entire structure of interest rates. So we exert that force of Government influence, and this combines the Federal Reserve and the administration, where it can produce the greatest effect on international flows with the least possible impairment to the home economy.

In a world of hard choices this is the one we have made in the capital flow area.

Now, as to your third point: Why aren't we worried about the price level? We are, indeed.

Senator MILLER. May I say not quite that. Why aren't you giving equal priority to maintaining a stable dollar so that at the end of December 31, 1963, the dollar will still be worth 45.6 cents? That is my point.

Secretary ROOSA. Yes. It is hard to array all these priorities. I see from the newspapers that some have already misinterpreted the Secretary's statement yesterday on the question of civil rights as compared with tax legislation.

I hope he made it explicit, as I believe everyone here would certainly recognize that he did, that we were not placing taxes on top. We were saying that these are matters that are so intermingled that they have joint, compelling, inextricably top priority as far as administration thinking is concerned.

So, I don't want to get into a third one of these . But I would like to make very clear that it has been a prime aim and one for which we have done some things that have not been done before.

First, there has been an explicit and courageous effort by this administration to urge the recognition of some standards by which voluntary action in wage and price determination can result in stable prices, if possible, in fact, with appropriate declining prices.

I am referring to the wage and price guidelines first described by the Council of Economic Advisers a year ago, January, and to which a great deal of attention has been given since.

Paralleling that, the President has appointed and used to the fullest extent practicable, his own Advisory Committee on Labor-Management Problems.

This goes to the root of that part of our cost-of-living index which has really been rising, the whole services sector, where there is a problem of how to get enough productivity gains to justify the spread into those sectors of wage increases that have occurred in some others. As you know, it is the services sector that is now producing the principal part of this price increase.

But on the other side, in terms of aggregate demand where there has also been some concern expressed, and you yesterday were stressing the risk involved in financing a deficit that might lead to inflation—there, too, we have followed a course which has met considerable resistance and some criticism, including some from others of your colleagues on this committee. In every instance in the financing of that deficit, we have resolved out on the side of absorbing some of this gigantic savings pool which is otherwise unused or available to flow abroad, rather than relying on the additional creation of Federal Reserve money to finance the deficit.

Now, up through the end of April this year—over the previous 12 months—we have had an increase in the outstanding public debt of approximately, for that 12-month period, $6 billion. The commercial banks which generate the money supply of this country have had a reduction of $1 billion in their holdings of Government securities. This is not inflationary financing.

Taking all these aspects, the administration's concern is to exercise influence, wherever it can do so appropriately, on the price determining process as it relates to prices and wages, and on the other side in the manner in which we handle the deficit that emerges. We have been doing, I like to think, more than has ever been done before toward this objective.

If you say that is not enough I would have to agree. Probably it will never be enough but we certainly are trying.

Senator MILLER. Thank you very much.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. I do think that you and this administration deserve a lot of credit for the fine record on price stability in the Kennedy administration. I notice that between 1952 and 1960 the consumer price level—and I stress the consumer price level now—rose about 12 percent, an average of about 1½ percent a year.

In the Kennedy administration the rise has been around 1 percent a year, which is a better showing and I think a remarkable showing under all the circumstances. But I would like to call your attention in connection with my questions on the Kenen report to what we promised, we Democrats, when we were running for office back in 1960:

> As the first step in speedy economic growth the Democratic Party will put an end to the present high interest, tight money policy. This policy has failed in its stated purpose to keep prices down. It has given us two recessions—

I am reading from the "Rights of Man," the Democratic platform—

> It has given us two recessions in 5 years, bankrupted many of our farmers, produced a record number of business failures, added billions of dollars, in unnecessary hire and discharge, to the Government budgets and the cost of living.
>
> The new Democratic administration will reject this philosophy of economic slowdown. We are committed to maximum employment at decent wages, fair profits and a far more productive expanding economy.

Then there is one other part of the platform I would like to mention. Under fiscal responsibilities we say:

> We believe except in periods of recession or national emergency our needs can be met with a balanced budget.

Now, both of these particular pledges in the platform, it seems to me, by the policies you are advocating here, and Secretary Dillon yesterday, are being flatly contradicted. Yesterday you proposed, and the Secretary proposed, and you have reinforced it this morning, the very great importance of a big tax cut, and with all the benefits it would bring it would seem to me it would at least temporarily increase the budget deficit.

It certainly would not help us balance the budget. The other side of this proposal is that we should increase short-term interest rates. That directly contradicts and explicitly contradicts the other part of our platform. I think this was a fine platform in these particular respects.

Many of the rest of us do in Congress. So in this dialog between the administration and this committee it seems to me we should get a very firm and convincing and authoritative explanation of why you are following this policy. I am inclined to agree with Mr. Reuss that certainly your documentation, the Cohen report and the Kenen report, doesn't measure up.

Let me ask you specifically about this Kenen report now. I understand that the Kenen study nowhere states how much of the total capital outflow in the years examined was interest rate sensitive although this information can be inferred from the detailed statistical tabulations.

We have not been able to do this in the time available, that is the staff has not been able to, but I understand the staff estimates that only about 15 percent of the capital outflow would be interest rate sensitive, and this seems to be fairly reasonable.

What is your answer to that?

Secretary ROOSA. If I may, sir, I will go backward and start with the latest. The most significant point about the Kenen report, I think, is the qualification that I made at the start, and which Chairman Reuss read and called attention to. This was an exploration which incidentally was done primarily in order to help us find out what are the things we are not getting, how we should revise our statistical reports to try to get more, what are the missing links.

So that for the purpose we are now discussing, while it has some tangential relevance, there was not, at the time this was done, this objective. What was then done was that, when he completed his study, he made a recommendation that new data be gathered. Enough more would become available, he hoped, so that this would be pursued more systematically and continually by the Federal Reserve Bank of New York people.

So the only real reason for introducing this Kenen paper at all at this stage is that it was the first in what will be a series of studies in this area. The second is the Cohen report which was prepared by using a number of methods that Mr. Kenen started, applying them to more recent data, data that were not there when Kenen started. It is in this way that the Cohen paper has been developed.

So I think it is the Cohen paper—as far as any appraisal or distinction between the sensitive and insensitive, so far as measurements now go—which would be the operational document to use. He very carefully indicates that there are eight categories of different kinds of short-term capital flows and only three of them appear, from present data, highly sensitive.

They happen to be more than 15 percent, I don't recall now exactly, but they are the basis for this $500 million figure.

Senator PROXMIRE. Will you give us the rough percentage this would represent?

Secretary ROOSA. The most sensitive items would represent, in terms of total recorded flows over the entire period covered, about one-third of the total.

Senator PROXMIRE. Yes; but how sensitive are these capital flows? You see, we have the Gemmill study, we have the Bell study, both of which seem to me to suggest that interest differentials are of secondary importance in international capital flows. Of importance, but of secondary importance. Much less important than speculation and other things.

Secretary ROOSA. If you want to get a chance for further review, and I realize there has not been time up to now—we should have realized there would have been this keen interest in the studies and tried to get them in your hands before these hearings—we can discuss them the next time around in more detail if you like. But the key thing to note in the Cohen effort is that he has pretty clearly shown that there is not any real inconsistency between the Bell findings and the Kenen findings, once you recognize what data they had to work with and what they had to exclude.

Kenen did not have enough yet to really focus on the differences in the same way. Bell was really saying that short-term capital flows followed trade. Of course, a lot of them do. Much of the outflow of a year ago of short-term capital was directly related to the financing of Japanese trade and much of that has been funded in the market and is out of those banks.

I would certainly be the first to deny that interest rates are the dominant influence on all kinds of short-term capital. The key is that there are important sectors of this total that are sensitive, and I stress again that the most important is one for which we don't have measures. We are only beginning to get partial measures.

Those important sectors are highly sensitive and the little reporting we have so far indicates that these have now reached a proportion of the recorded total of something like 40 percent. And that sensitivity again is not the sort of thing that can be related—I wish the world were this simple but it is not—to a particular change in our interest rates. The differentials are important, too. The point was made yesterday that the Europeans cannot run away from us by raising their rates if anything that happens here is to be effective.

Senator PROXMIRE. Altogether we have reports from Bell and Gemmill which suggest that interest rates are not of very great importance; then we have one from Kenen which suggests that in some areas, up to 40 percent or a little less than that, they may be of some significance.

This policy of low interest rates is one which we feel is important for economic growth and expansion domestically. Our party explicitly committed itself to it. It seems to me wrong for us to reverse that policy based on this kind of documentation when the author of the study, Mr. Kenen, himself, says:

> My conclusions as to interest sensitivity are not decisive and even if they were, the cost at home would be excessive.

In other words, he does not advocate this policy on which the Treasury seems to be basing at least to some extent, and you qualified it, an action which contradicts that which we have promised we would do.

Secretary ROOSA. May I deal with that part of it?

Senator PROXMIRE. Indeed.

Secretary ROOSA. Because I would deny that this contradicts what was promised. Certainly in self-defense I should say that at my own confirmation hearing I made very clear that I had no understanding that that promise related to the short-term interest rate action which we then subsequently undertook.

The difference is that what was there referred to was what was considered to be a kind of single-minded reliance on higher and higher interest rates to accomplish things that could be done in other ways and without adequate regard for the employment implications.

Now what we undertook then, to the disbelief of most and I think to the statistically clear contradiction of that skepticism now, was a program under which we would, to the limit that we could by trial and error find it feasible, influence the one sector of the market that affected short flows most sensitively—where we could really get some results and do so without affecting either the general availability of credit or the prevailing level of long-term rates.

This has involved a good many things—there were a good many parts of this rather technical exercise. But at least after 2½ years the results can be stated, as the Secretary did yesterday. Long-term rates, certainly for that largest segment of the whole capital market, mortgages, are lower now in many parts of the country by a half of 1 percent than they were at the time this administration began.

The increase in rates has been in the short area. Government security rates have, to be sure, bounced around a bit but they are still in the same area. The increases in rates, lowering of prices, that the chairman commented on in relation to this current flurry of wondering about discount rate action, have all fallen within the range that the rates have fluttered within during the last few years.

Nothing adverse has happened to the long-term rates at all. Corporate rates are slightly lower. So in terms of fulfilling this pledge as it related to the vast sector of construction and investment activity in the American economy, I would assert that it has been fulfilled.

The fulfillment of it in the face of other compelling problems has been extremely difficult. It has involved a great deal of what you might call financial engineering but, at any rate, thus far I think that effort has been successful. The same aim will continue to prevail.

Then as to the second point, the promise for the balanced budget except in emergency, I won't try to say we are in a state of perpetual emergency. But I will say that I believe underlying the view that the budget should be balanced is a basic conviction that the risk, the harm, from an unbalanced budget is in generating the kind of inflationary pressures on the demand side which have been so troublesome in earlier years. Finding, for reasons that the Congress and the administration found compelling, that we just can't accomplish at once all of our objectives, the approach we have followed is to say, given that there must now be some budget deficit, let us make absolutely certain that it does not in any way contribute to inflationary developments in the United States.

I would submit that that has been accomplished. So that while the letter of the point has not been fulfilled, I believe the spirit has.

Senator PROXMIRE. My time is up. Thank you.

Representative REUSS. Representative Curtis?

Representative CURTIS. That is a very interesting theory. Of course, your deficits are projected on out into 1967. Have you projected into 1967 how much in additional Government bonds you are going to have to market?

Secretary ROOSA. Yes, and we are absolutely sure that savings in this economy will continue so large that there is no necessity, provided we manage the job well—there is no necessary inflationary threat.

Representative CURTIS. That is the issue, Mr. Roosa. That is what you believe. That is what I want to examine. So let us first get to the figures. What are your projections?

Secretary ROOSA. I am not in a position to project the deficit at this time or to discuss that in detail except to say that of course this administration has an enviable record of always overestimating its deficits, and that will be true for this year too by a substantial figure.

Representative CURTIS. Is that true?

Secretary ROOSA. Yes.

Representative CURTIS. In fiscal 1963 it was estimated and presented to the Congress as a $500 million surplus.

Secretary ROOSA. No, sir.

Representative CURTIS. It was a balanced budget, Mr. Roosa.

Secretary ROOSA. As soon as the July emergency had developed——

Representative CURTIS. I am talking about the fact that it was presented as a balanced budget.

Secretary ROOSA. For at least 6 months before the end of that fiscal year the expectation was for a budget deficit substantially larger than the one that emerged.

Representative CURTIS. You mean that during one of your estimate periods it happened to be different. But the basic estimates in the beginning were just as I said. I would like to put into the record the various estimates because I am afraid they are not substantiated any more.

Representative REUSS. Will the gentleman put in the Eisenhower administration estimates too?

(The following was later received for the record:)

Original budget estimates and actuals

[In billions of dollars]

Fiscal year	Receipts		Expenditures	
	Original budget	Actual	Original budget	Actual
1946	38.2	39.6	80.0	60.3
1947	29.5	39.7	33.8	38.9
1948	34.9	41.4	34.7	33.0
1949	41.9	37.7	37.1	39.5
1950	40.2	36.4	41.1	39.5
1951	36.6	47.5	41.8	44.0
1952	54.4	61.3	70.4	65.3
1953	70.1	64.7	84.6	74.1
1954	67.8	64.4	77.6	67.5
1955	62.4	60.2	65.4	64.4
1956	59.7	67.8	62.1	66.2
1957	65.0	70.6	64.6	69.0
1958	73.1	68.6	71.2	71.4
1959	74.0	67.9	73.6	80.3
1960	76.4	77.8	76.3	76.5
1961	83.3	77.7	79.1	81.5
1962	82.3	81.4	80.9	87.7
1963	93.0	86.4	92.5	92.6

Representative CURTIS. If the gentleman wants to make political capital out of this I would have been wise to have allowed Senator Proxmire to continue with my time.

I might also make this observation to my good Democratic friend. I think it is about time that they quit blaming Republicans for everything. There has been a Democratic-controlled Congress since 1954, and we are about 2 to 1 in minority in this Congress.

Apparently nothing can be done without this poor feeble minority which I happen to represent. Now, please let me interrogate in order to find out what is going on in the future. I can talk about the past. I criticized the Eisenhower administration's fiscal policies in many instances.

But I might say this; It was in the climate of a Democratic-controlled Congress that had a similar philosophy to that of the present administration, with respect to deficit financing.

Mr. Roosa, I am pleased that you don't duck as often, for when I ask administration witnesses they don't want to get into the theory behind deficit financing. They do not want to extend it to the period in which the deficit is projected. It is not just a deficit for fiscal 1964. It is a deficit that goes on in the administration's estimate to 1967.

Others have looked at that and say it is very unrealistic. I do, too, because it is predicated on reduction in expenditures, particularly in the military. If we take the actual rate of expenditure increase in the past 3 years and project that rate of increase out, which is the only way we can evaluate it, the deficit will go on until 1972. So it becomes a question of whether or not you, under your theory, can handle this kind of deficit without creating inflation.

I respect you for advancing such a theory. But it is this theory with which I disagree, and I would like therefore to dig into it a little bit. The next point is that you predicate your ability to handle the deficit upon anticipated economic growth. Is that not the basic principle you are relying upon?

Secretary Roosa. Yes, but I stress particularly the growth in savings related to maintaining stable prices.

Representative Curtis. But here we have this picture, Mr. Roosa, in which the savings are not remaining in this economy. So we come to what I think is a very key point in all of this, the business climate. Secretary Dillon's statement yesterday revealed, and you have confirmed it, that our investment money is not staying here in large sums. It is continuing to go abroad. There also has been a tapering off of foreign investment in our economy, which clearly indicates that, by comparison, there is something that is better about the business climate abroad than it is here.

I suspect that a good deal of it has to do with the fiscal policies of this so-called planned deficit extending over a period of time. I now want to relate it to these two points. We do have increased consumer purchasing power that has continued to increase even during the recent recessions. Is that not true?

Secretary Roosa. Generally, yes.

Representative Curtis. There has also been increased consumer credit which is tied in with this. So there does not seem to be anything wrong with our domestic market as far as consumer purchasing power is concerned.

Corporate liquidity is likewise fairly healthy. In fact some argue that it is over liquid. Would you comment on that?

Secretary Roosa. Yes.

Representative Curtis. Isn't it true that we have quite a bit of liquidity?

Secretary Roosa. Yes, sir. I am capable of giving quite a long answer on that.

Representative Curtis. Well, I would appreciate your giving a short answer simply because I am trying to lay some groundwork here. The same thing becomes quite clear when we consider that investment money seems to be available. So there is some other factor obviously at play causing our investments to flow abroad.

The plus side of our balance of payments is the balance of trade which is quite good. We hope we can improve it. Interestingly enough, it seems that this is the area in which the administration has

decided to do a little restricting—for example, in tourism, by cutting down duty-free purchases from $500 to $100, in other areas through the cartel approach, in the tax field, and in oil.

So in the trade area, far from freeing up, we seem to be moving the other way. Regrettably so are the people in Europe. At any rate, that is still a plus item and we hope it can improve.

Our return on our investments abroad is excellent, is it not?

Secretary ROOSA. Yes, indeed.

Representative CURTIS. Yes. Yet here is another area that the administration has sought to cripple to some degree. The third one I was going to ask a question about because I am not familiar with the figures. Do we get any sort of return for our services as the world banker, or is that included in our balance-of-trade figures?

Secretary ROOSA. No, it is largely in the aggregate of our interest earnings. It is a little hard to sort out. But one way to appraise it, of course, is to carry a little further what the Secretary did yesterday. I think you could say—I have seen this constructed by other imaginative academic people in other kinds of studies—that if we had not been the world banker we would have lost $400 to $500 billion of gross national product over the past 15 years.

Representative CURTIS. I think it does point up a very significant factor, the importance to the United States of being the world banker and of following correct policies so that we retain that position.

Secretary ROOSA. Yes.

Representative CURTIS. The minus side of the ledger is the Government expenditures. I was very pleased that Secretary Dillon stressed that we needed to review much more strictly our military expenditures and our foreign aid. The tragedy is that the administration is not doing that. Apparently it doesn't agree with the Treasury Department. But I do feel that this is an area in which exactly what Secretary Dillon has recommended should be done. However, the one thing that the theorists of this administration will not do and won't even discuss really is expenditure reform.

The answer I get from the Director of the Bureau of the Budget, both the previous one and the present one, is that this is a tight budget. We are supposed to take their word for it. Some Republicans, myself included, proposed to the President that he establish a Commission on Federal Expenditure Policy.

We are in a business in which we have to establish priorities. These expenditures programs are attractive and certainly have their supporters, but if we are going to adhere to an expenditure reform approach, a balanced budget approach, we are going to have to establish expenditure priorities.

Here, I think, is the fundamental difference between the administration's economic approach and ours because they happen to feel that planned deficits, just as you have indicated——

Secretary ROOSA. I really would like to get back to that one.

Representative CURTIS. I think you should because this is the basic point—planned deficits are necessary and the administration witnesses, at least those who seem to make the administration policy, oppose any cut in Federal expenditure, even a cut from a $99 billion expenditure rate projected for fiscal 1964 back to the $94 billion which was the rate for fiscal 1963, which I would not call a cut. I would simply say

it is holding it the same. The administration even opposes that, let alone a cut. They say that any change will interfere with their basic economic theories.

Now is that correct? I am not misstating their theories, am I?

Secretary ROOSA. If I may, when you have finished, I will deal with this as a whole.

Representative CURTIS. Why don't you do that? Although my time has expired, if my colleagues will bear with the answer I would like it.

Representative REUSS. You finish your answer to Representative Curtis.

Secretary ROOSA. The first point I should make clear is that none of us, I think, is committed intellectually or any other way to some kind of insidious effort to insinuate planned deficits perpetually into the American system. Instead, as I think any business enterprise must do, we find that there are times in the life of our business performance as a government when it is appropriate to borrow to expand and others when all other conditions make it possible to retrench.

Now the determination—the recognition of the need—to reach a position of balance of course remains as it was from the beginning, but we learn as we go along that the combination between those sacred cows which somehow cannot be touched and the essentials which must not be touched produce a result which is often larger than anyone originally contemplated, certainly larger than would have been expected 2 or 3 years in advance.

There is also a recognition that deficits may at times have a most appropriate role to play in the whole functioning of government as the largest business enterprise in the economy, just as A.T. & T. borrows a billion dollars every year and probably will go on to infinity borrowing a billion dollars additionally every year.

We don't plan to do that, but we do recognize there is a proper place for Government borrowing and that it must then be interpreted in the light of all the priorities. Against that we certainly set the fact that there is an overriding need for expenditure control.

There are differences of emphasis within the administration arising out of the special responsibilities of a department, and certainly it is inherent in the Treasury's role within the Government that we should be particularly insistent on expenditure control, as we have been.

The same theme was running through the presentation of the Secretary yesterday.

There is a great difference between making full, and I would like to think businesslike, appraisals of combined expenditure commitments and requirements and then setting that against the revenues to determine a businesslike method of meeting any gap that may remain and assuring that it will not have harmful consequences to the economy—there are great differences between that and an approach which I think was implied by the general phrase, "planned deficits and no expenditure control," or very little.

Now, in terms of the point you made about expenditure control being identified with reduction, this has been a hard point for me to come to realize but I must say it is a personal conviction and that I fully see it.

I regard holding the nondefense and nonspace expenditures for the next fiscal year constant as a reduction because——

Representative CURTIS. That has not been done, Mr. Roosa.

Secretary ROOSA. I am not really competent to go through all of that, but in the aggregate I think we will find that it has. But this is certainly the objective—it is the agreed aim of the President and all members of the administration that, in the aggregate, these should not increase.

And in the face of an increasing population with the increasing costs of servicing that population, it is, I think, remarkable that we will have even contemplated holding the nondefense, nonspace costs constant when in the last 10 years the increase in nondefense and nonspace expenditures was 7½ percent a year.

In that period, I think they ran a bit ahead of what should have been necessary for the growth requirements of the economy. Here I mean growth just because we have more people, more services to extend. But along with that, the fact that we are holding all other expenditures constant is indeed a reduction. Now, to try to trim below that.

I know all of the very righteous protesting that has been made in connection with the tax cut. Many say it is a fine thing if you would only cut expenditures, just give them a chance and they would find a way. I could tell you that I have tried to find a way and I am persuaded that so far, within the limits of my competence, the maintenance of the limitation of total expenditure other than defense and space at a constant level is in fact, in a growing—rapidly growing—economy, one where the adult population is going to explode very soon, a remarkable achievement and has had to represent a tremendous amount of tight squeezing.

Now, there may be more than can come out. As you know, since the budget for fiscal 1964 was first announced, as we went along during the spring of 1963 the President has already, through the careful, energetic screening which has continued by the Bureau of the Budget, found additional savings that amount to nearly $1 billion.

He did not want to overpromise at the start, but the effort to squeeze has continued and those squeezes are still coming out.

So, the businesslike control of expenditures, in the way of eliminating waste or balancing lesser priority against the essential, is going on every day. Now, it may not be all that you like, I am sure it is not all that Budget Director Gordon would like, but the process is there.

So I would want to stress that there is no lack of respect for the dollar insofar as our budgetary procedures are concerned. The essential point, then, is that we do believe in and maintain expenditure control—that the directive the President has given us for fiscal 1964 to maintain nonspace and nondefense expenditures constant is in fact a vigorous cut in what has been through the previous 10 years the 7½-percent annual increase in that category of expenditure.

I realize how this must be a difference of judgments. But, the implication I want to be sure to counter is one that there is lack of financial discipline. That I think genuinely does prevail.

Representative REUSS. Representative Griffiths?

Representative GRIFFITHS. Thank you very much. For how long has the purchase price and the selling price of gold been constant?

Secretary ROOSA. Really since early 1934. The price is made by the United States and it is our price that prevails.

Representative GRIFFITHS. Why don't we divorce our own monetary system from the control of gold and put a sign up over Fort Knox, "Gold for sale"?

Secretary ROOSA. Well, the sign is there now. If there were ever to be an embargo on the sale of gold, the entire monetary structure with us as its center as world banker would, of course, be destroyed.

Representative GRIFFITHS. Why do we have control of gold in our own system? Why do we use the control of gold in our own system? Why do we care about gold?

Secretary ROOSA. Well, the mores that underlie the acceptance of money go back a ways in human history. I can't pretend to do more than read them, not fully to understand them.

But the basic requirement that gold serves is that of a means of settling ultimate differences, the residuals that have to be settled between countries, after all of the other payments and capital movements have occurred.

You need something to provide the final balancing item. Until recent years when the supply of gold was unable to keep pace, and fully supply in the monetary reserves of the world those balancing requirements, the pound sterling filled in for the additional needs.

With our reaching the position of the most powerful or at least the most productive industrial country in the world, the responsibility mainly shifted to us. The complex that this is a part of is the monetary system on which the world depends. While there are many suggestions for changing that system, even some for getting along without gold at all, the possibility of introducing such revolutionary change would have such violent implications for the normal, ordinary trading patterns of the world that I don't think we would want to contemplate it.

Representative GRIFFITHS. But the real truth is, and you are correct, we have used it for so long, for so many centuries that we are incapable of thinking without it. We have substituted really gold for thought.

Secretary ROOSA. I would like to think that it is not quite that bad.

Representative GRIFFITHS. It is almost that bad.

Secretary ROOSA. There is also now and always has been a search for some kind of ultimate security, something that will be good when everything else goes to pieces—when a promise of a man on his I O U or the promise of a Government on its I O U will be despoiled, there will be something else on which people will find value.

That is the appeal that gold has always had. Until we find human institutions that can replace that kind of faith, I suppose that gold will play that role in the money system.

Representative GRIFFITHS. I think it is the men who are afraid to give up gold as their own standard. They are afraid of their ability without the gold standard. Since we determine the buying and selling price of gold we really offer those speculating in American dollars a safe harbor. Why don't we move either the buying price down or the selling price up?

Secretary ROOSA. The reason that the price of gold has been kept at $35 is to assure the continued interchangeability of the dollar with gold in meeting the growing requirements of the world for these reserves that settle the residual differences among countries.

If the dollar is going to be accepted for that purpose—one could argue that it should not be, but so long as the dollar does serve that purpose—it must be available at a fixed price. Once the certainty of that fixed price is in any way impaired then the usefulness of dollars as a substitute for gold is gone.

Now, you suggest lowering the price. The effect of that would be that the capacity of the dollar to serve this function would soon be gone in the sense that we would not in the future acquire gold.

I don't know whether you were here yesterday when the Secretary pointed out the figures for the first quarter of this year, the gold flows. While we had some substantial sales, we also had some substantial purchases.

If we were to lower the buying price in a world already geared to the $35 as a fixed price we, of course, would never get any of that gold. We would have a one-way street. And since there is always going to be two-way traffic, we would do all the selling and other people would do all the buying and we would soon have no gold at all.

The consequences of that system would be grave.

Perhaps you can argue that we need a completely new system. This is something that needs rethinking, testing our premises all the time. Whether you have such an intellectual conviction or not you can't ignore the fact that the world at present is geared to work in its existing manner.

You must never take the chance—I doubt if you would ever want to take the chance—of having the world function for a considerable period without known and tested, workable, practicable payment arrangements because we were going through a phase of transition to something entirely new.

You have to be really certain that what you contemplate will work before you can substitute something for what is already a pretty complex mechanism.

Representative GRIFFITHS. What we have right now is working very badly for us. In his statement, the Secretary says:

> The natural inflationary forces are so powerful in Europe that their efforts have only succeeded in somewhat moderating the tempo of the inflationary process. But should this process proceed to a point where European countries find their balance of payments to be endangered we can expect them to take strong action irrespective of the domestic consequences.

Secretary ROOSA. Yes.

Representative GRIFFITHS. They are now financing their prosperity out of our deficits aren't they?

Secretary ROOSA. That can't quite be said. What I would like to really stress in the part that you read is this: There is no money substitute for the fact that there will always be differences in economic performance among countries, differences that produce for a while flows out, for a while flows in.

They have to be settled no matter what the money system, and the process of adjustment is going to require correction on one side and correction on the other side.

To try to throw a new money veil over that and imagine it is not there is wishful thinking and self-deception. It just is not workable.

Representative GRIFFITHS. All right, let us throw a veil that can work right now. Why don't we act strongly in this country, as they admit they would, to stop the outflow of gold?

Secretary ROOSA. That would be to confuse means and ends. The way to stop the outflow of gold is to correct the balance-of-payments deficit that we have.

Representative GRIFFITHS. You admit that Europe would do it. They would not hesitate a minute. They would take action, no matter what the domestic consequences. Why don't we do it?

Secretary ROOSA. Because we have a problem they have not yet experienced. We have large unemployment at the same time that we have a balance-of-payments deficit. No country in the world has ever had that combination of conditions in the way in which we have experienced it in the last few years.

No economic textbook has ever been written for that combination of conditions. We are writing it now. We have to do a good bit of creating on our own.

Representative GRIFFITHS. What do you think is new in our situation that creates that situation?

Secretary ROOSA. I think, without trying to pontificate in a way I certainly can't, this is a further stage in the evolution of highly industrialized economies.

We are facing the very hard job of working out the combination of relations between Government and business in which, in this new and higher developed industrialized society, we are going to be able to keep unemployment low and our external accounts generally in balance.

We are going through an extremely difficult transition period and that is the reason that we have developed a balance-of-payments program which has so many parts to it, some long run, some short run. Necessarily, when the problem is of this scope, the basic adjustments are going to take time and we have to use other shorter run methods to buy time while the more underlying corrections can actually occur.

Representative GRIFFITHS. Thank you. Thank you, Mr. Chairman.

Representative REUSS. Representative Widnall?

Representative WIDNALL. Mr. Roosa, in the June 1963 "Survey of Current Business," U.S. Department of Commerce, in an article entitled "The Balance of International Payments During the First Quarter 1963," there is this paragraph on the first page of that article:

> The $250 million of 15 and 16 months nonmarketable, medium-term securities denominated in foreign currencies, which were purchased last year by foreign governments, and $30 million purchased in the first quarter of 1963 cannot be sold or converted into cash assets before they mature. Consistency with established criteria would make the sale of these securities equivalent to an inflow of foreign capital for medium-term investment rather than for cash holdings, and thus result in a statistical improvement in the overall balance measuring changes in our net liquidity position. The $58 million 5-year note issued early this year is redeemable against foreign notes held by the Export-Import Bank. It cannot be sold for cash and consequently is not liquid (p. 17).

Now this is done to bolster immediately the balance-of-payments position but isn't this done at the expense of future exports from the United States to be made in the future?

Secretary ROOSA. No, sir. If anything it is a way of helping to assure that the financing capability will be there to pay for exports at a later time.

But those particular transactions that you mention are only a part of what is now a somewhat larger sequence and the important thing about them is to realize that these are another of the methods we have developed to help in this process I described of buying time. This is really jointly developed, because the foreign governments and central banks have put their imagination to work trying to help in the effort. I tried to bring this out in the statement I submitted for the record.

We have had a very useful exchange of correspondence with Representative Curtis on all of this. I just want to stress that the reason these transactions are being explained and described so fully, and the reason that we have gone out of our way in persuading the foreigners to agree to publish things they usually don't publish, is that we do not want anyone to misunderstand or misinterpret what we are doing.

We don't pretend that we are solving the balance of payments in this way. We do argue that in this cooperative approach we are able to provide means for financing our deficit with foreign governments and central banks, which have already acquired more dollars than their conventional practices would allow them to hold and stretched them beyond that.

But, they still get additional dollars, because our deficit continues despite our efforts. It should not continue but nonetheless, it does. Then, those further additional dollars are more likely to end up in gold purchases. Now, they, in the same spirit of the comment I was giving to Representative Griffiths, know that it is helpful to the system as a whole to keep gold here if it can be done.

Representative WIDNALL. Are more of these transactions taking place at the present time?

Secretary ROOSA. Yes, indeed. There is another feature in some of them which is not included in those described in your quotation, and it is going to make it confusing to read balance-of-payments statistics for a while for that reason.

We are going to have to concentrate on two measures of the ultimate deficit. This confusion is why every newspaper in the country says that the deficit has been $3.2 billion this year and $2.2 billion last year whereas, in fact, the underlying accounts are the same.

There is no change. There is a switch which has occurred. By the conventions of the balance-of-payments accounting, the items that you mentioned there would go above the line, because the transactions are more nearly like something which has always been done in the past.

Since no one has ever done it before, the kind of transactions that we are now doing would go below the line. In either case, they were specifically negotiated by us with the other government as a way of, in effect, financing or relieving part of the pressure of our gross deficit in our balance of payments.

You are going to find it very hard to follow this in the statistics until we have been through it a little longer.

We have now done a total of about $650 million, including those you mentioned.

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Representative WIDNALL. Mr. Roosa, another thing. A couple of months ago the Defense Department issued a directive in connection with procurement that would cover military procurement involving dollars going overseas for both materiel and personnel. That was done at the insistence of the Treasury Department, was it not?

Secretary ROOSA. It emerged out of discussions in the Cabinet Committee on Balance of Payments. The decisions, of course, were those of the Secretary of Defense.

Representative WIDNALL. In our military procurement policy, how high is the percentage that would be accepted by the Government of dollars going overseas for both personnel and materiel? Is there a definite percentage involved?

Secretary ROOSA. This is a matter I think, even at the moment, of further discussion between the Director of the Budget and the Secretary of Defense. I am not in a position to throw any extra light on it at this time.

Representative WIDNALL. This seems to be an area where millions of dollars could be saved, procurement could take place in the United States.

It certainly should be understood by all those who are bidding on military procurement exactly what the rules and regulations are along that line.

Secretary ROOSA. Yes, indeed. Of course, it is clear to you and to me, I am sure, the risks if the American supplier thinks that he can shoot fish in a barrel. You may tend to lose price discipline.

But, the other side is that you have to use the American supplier to minimize the balance-of-payments drain. So, the need is to encourage the widest possible competition among American suppliers.

I see Representative Curtis shaking his head. In terms of pure economic theory, I shake my head, too. I just face the inescapable fact that in the balance of payments—as you are urging on us in domestic expenditures—things have to be cut.

This is one of the essential parts of getting the cut, and eventually we will be able to look back on this as one of the regrettable aspects of an essential adjustment period.

Representative WIDNALL. Mr. Roosa, I have one other question. I note that one figure, unfavorable figure, in the balance of payments is the flow of pensions and remittances overseas to the extent of almost $1 billion.

Has any effort been made to see if those remittances and pensions could be payable in other currencies?

Secretary ROOSA. Yes, sir.

Representative WIDNALL. What has been done along that line?

Secretary ROOSA. We do pay some of them that way. By a nice coincidence we sent up to the Congress yesterday a request for a little broader authority in the use of the foreign currencies that we now own to permit us wider latitude in just this kind of transaction.

We have made a pretty full appraisal of what could be done. We started out with certain things, thinking we could do them, but discovered the General Accounting Office said that we couldn't.

So, there has been difficulty just because of various strings attached to the way the original arrangements were written under which the foreign currencies flowed into our hands. So we have

now sent to the Congress, just yesterday, a request for legislation which will authorize us in a sense to commingle foreign funds and not keep them earmarked for just one single purpose. So long as that purpose is going to be satisfied out of funds available in that particular currency, we don't need to get them so immobilized awaiting us 5 years from now that we have to buy local currency now to pay pensions, or give the dollars to someone else to buy local currency, in settling these accounts.

So we are at this stage requesting the additonal legal authority to do more along this line. We have done everything that present law allows in the use of counterpart funds now, and with the new legislation we hope we will do more.

Representative WIDNALL. Thank you, Mr. Roosa. My time is up.

Representative CURTIS. The only point I would like to make is I don't believe two economic wrongs make a right. We had better get into the problems that are really there and start to solve them instead of this latching-up proposition.

Secretary ROOSA. Yes, I agree with you.

Representative REUSS. Representative Multer?

Representative MULTER. Thank you, Mr. Chairman. I appreciate your invitation to be present at these hearings. I do not have any questions to ask.

Representative REUSS. Senator McIntyre?

Senator McINTYRE. Thank you, Mr. Chairman. I, too, appreciate this opportunity to attend these hearings. However, I have no questions.

Representative REUSS. Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman. I would like to ask a question. Mr. Roosa, I think this problem of the balance of payments is one of the most difficult and complex facing this country. I think your testimony has certainly helped in the understanding of the problem.

I want to see if I can reduce this to a more meaningful situation to our people.

Can we analogize our whole situation to a business situation? Can we look at our balance of payments as we look at a potential business borrower and say that we have to look at both the income sheet and the balance sheet? The income sheet it seems to me is stressed, possibly overstressed. The income sheet is shown on page 25 of the publication, Economic Indicators for June 1963.

It is clear there that on a profit and loss basis we have been running a loss since 1957. But we are including in this loss investments which we are making abroad which make our situation somewhat different from true profit and loss situations.

We are more like A.T. & T.: borrowing money to make further investments. Now, what portion of the loss is represented by investments abroad, let us say last year?

Secretary ROOSA. We don't have full figures for 1962, I am sorry to say. But going back, the estimate for last year, the estimated increase last year in our assets abroad was about $5.5 billion. That is, in our total U.S. assets abroad, governmental and private.

Of that total, I think the Secretary mentioned yesterday the private part is in the neighborhood of $60 billion or a little over. On the other side, foreigners own a great deal here.

The aggregate of that, as of last year, is estimated now at around $50 billion or $51 billion. These figures are still being proved out. In 1961, foreigners had then pretty close to $50 billion.

Representative MOORHEAD. That would be on the balance sheet side?

Secretary ROOSA. Yes.

Representative MOORHEAD. I was thinking of what we call the income sheet. What would it be for the most recent year for which you have the figures?

Secretary ROOSA. How much did we add?

Representative MOORHEAD. How much did we add as compared to how much they added?

Secretary ROOSA. It looks as though in terms of investment position we added a little over $5 billion, they added around $1 billion.

Representative MOORHEAD. So if we could treat those as true investments as opposed to expenditures we would not be in balance-of-payments difficulty?

Secretary ROOSA. No. This is the point that the President has often made in these discussions. It is a sad fact that we don't use balance sheet accounting in appraising the position of a country in international affairs.

Representative MOORHEAD. However, again assuming we are looking at this as a business transaction, the income sheet accounting would not disturb us too much?

Secretary ROOSA. No.

Representative MOORHEAD. But then we would look at the balance sheet and, if we look at the totals on the balance sheet, we would not be disturbed because we have assets, as I recall it, foreign assets of something like $80 billion whereas our liabilities to foreigners are in the neighborhood of $51 billion.

Secretary ROOSA. Yes.

Representative MOORHEAD. Our assets might be reduced in the sense that some of our assets are in soft currencies?

Secretary ROOSA. Yes.

Representative MOORHEAD. Still at the foot of the balance sheet we would be in a very favorable or surplus position?

Secretary ROOSA. Yes, indeed.

Representative MOORHEAD. However, again speaking of this as a business situation, A.T. & T. borrows money to make long-term investments but it borrows in the long-term market. Does it not?

Secretary ROOSA. Yes.

Representative MOORHEAD. So that its current ratio remains favorable and in a liquid condition?

Secretary ROOSA. Yes, indeed.

Representative MOORHEAD. However, when we look at our current ratio this, it seems to me, is where we are in difficulty because, as I recall it, of the foreign claims against us of some $50 billion or $51 billion, short-term claims total about $30 billion.

Secretary ROOSA. That is right.

Representative MOORHEAD. Looking at our assets or our claims against the foreigners of $80 billion, how much of that is short-term?

Secretary ROOSA. About $7 billion excluding the Government holdings of counterpart funds which would add, depending on how you count them, you could even make it as high as $10 billion.

Representative MOORHEAD. So that our gross international liquidity is measured by adding our liquid claims against foreigners and gold?

Secretary ROOSA. Yes.

Representative MOORHEAD. And recognizing that the counterpart funds are legally restricted and cannot be considered short-term assets——

Secretary ROOSA. Yes.

Representative MOORHEAD. We would have $15 billion in gold and $7 billion in short-term claims?

Secretary ROOSA. Yes.

Representative MOORHEAD. So, that our current ratio as a business situation is adverse?

Secretary ROOSA. Yes.

Representative MOORHEAD. We are in a bad position with respect to liquidity, as a business corporation.

Secretary ROOSA. But not as a bank.

Representative MOORHEAD. But not as a bank?

Secretary ROOSA. Yes.

Representative MOORHEAD. However, even thinking of our position as a bank, would we not be in a stronger position or would we not do better, again considering the investments abroad as being bankable, if we could extend our liabilities abroad? Isn't one of our difficulties that we are financing our long-term investments by issuing short-term obligations which is, at least in a business sense, a dangerous thing to do?

Secretary ROOSA. You make money that way sometimes, but I agree. On that, we, of course, agree. The problem from a governmental point of view is to find a way in which to accomplish a kind of funding which corresponds with that which we provided in making all the loan credit available to Europe on long term.

What we have been doing so far, which has that effect, is to encourage and invite prepayment of their debt. So, we are reducing their long-term obligation to us, which is perhaps turning it upside down.

Now, what we have to find is a way, of course, ultimately of placing more of the American indebtedness in long-term form abroad. This is not a matter that moves from discussion to practice very readily, but this has been exactly the pattern that we have followed in this very limited way with our own borrowing operations.

I am not predicting that we are going to try to go beyond the 2- or maybe 3-year area with our present Government borrowings. But for foreigners this is a long step already, because we first interested them in shorter issues and then moved out somewhat, with most of them now 24 months. The ones I will be negotiating the rest of this week will be 24 or 27 months.

Representative MOORHEAD. It is a policy to extend that to as much as we can possibly sell in the foreign market?

Secretary ROOSA. Yes, and within the requirements of others. So far we are selling them largely to central banks and central banks can't go beyond certain limits. We can sell to governments, as, in effect, we have done with Italy, with which we have a 5-year obligation.

So, in principle we agree with you. In practice this is not always the easiest thing to do. But we are chipping away.

Representative MOORHEAD. Thank you, Mr. Roosa, my time has expired.

Representative REUSS. Representative Hanna?

Representative HANNA. I have no questions.

Representative REUSS. Representative Pepper?

Representative PEPPER. No questions.

Representative REUSS. One subject that we have not explored much this morning I would like to take a turn at with you—the question of an international monetary agreement, the sort of thing which the Joint Economic Committee has recommended, which, according to the press, the Treasury is against, and some other people in the administration are supposed to be for.

I want to clear up what we are talking about. The Joint Economic Committee's recommendation has been for a multilateral arrangement, sufficient in amount, largely automatic in operation, which will take the United States and other strong countries in temporary deficit out of their misery and by some sort of credit arrangement allow them to conduct their domestic economies with more attention to full employment and maximum growth than they otherwise could.

The Treasury's answer to this in Secretary Dillon's statement of yesterday, if I read it right, seems to be directed at a different proposal, a more Triffinesque proposal, if I may say so. The Treasury seems to be saying that the question of free world liquidity generally is one that we will have to explore in the future, but at the moment there are enough reserves in the free world—that is, if you take all the gold and all the enormous amounts of dollar and sterling balances. This is God's plenty.

Indeed, it is. The Joint Economic Committee does not claim that the free world is in an immediate bind on insufficiency of reserve assets.

What we are concerned with is something quite different—namely, are the present U.S. reserves, in view of our current liabilities, the present U.S. drawing powers under both the IMF and the supplementary agreement, and the assets that we come by as a result of your swaps, foreign borrowings and so on, are these adequate to protect the dollar in the immediate future?

My conclusion is that they are in no way adequate. I can chalk up some $5 or $6 billion that we can get our hands on, with some clogs on automaticity, but if we continue to run the same deficits in the next 5 years that we have run in the past, $3 billion a year, give or take a few hundred million, that adds up to $15 billion of exposure and we have only got $5 billion showing to counter it.

I am not about to cry havoc, but this does give me arithmetical pause. The Joint Economic Committee suggests, let us get out of this terrible muddle and bind by putting it squarely to our 10 or 11 free world industrial trading partners that they should join in an agreement which is adequate in amount, not the present chickenfeed amounts that we have got but something two or three times that amount; as automatic as possible in operation—something like the first tranche of the IMF—with perhaps different arrangements for different kinds of deficits; and most important of all, multilateral, because only if a creditor can obtain reassurance from a whole group of countries is it likely to buy such a thing.

It does not answer that kind of suggestion to say, "Well, the free world has plenty of reserves now." The reason that the free world has plenty of reserves now is because of the quite unintentional deficits we have been running in our balance of payments for the last 5 or 6 years.

So what about that? Should we not get the debate on a more common footing?

Secretary ROOSA. Yes, I agree with you. What you have described is a very helpful clarification for all of us. There are I think three layers of concern. Each one of them has significance but the difficulty is that some are shouting on different levels and they don't even hear the echoes of each other.

It is not contributing in that way to helpful development of ideas. Also, I think the feeling sometimes arises, just speaking of the Treasury parochially, that we are just willfully standing in a door, which if opened could provide a solution to our present situation. Apparently we just love to work hard because it would otherwise be so easy.

The problem is—suppose I start with the first level—we have to be sure in a responsible financial manner that our existing deficit, try as we may to get it down, whatever that deficit is, will be financed. And any possible deficit we are likely to see over the next year or two if it should run that long—at least we must work against the worst possibility, what those are likely to be—how can they be financed, what are the conditions of it, what must we do now to prepare for it?

Therefore, in a sense of maintaining current operating solvency, so to speak, we have to give that question priority, which very often means that we must be very careful in dealing with those who must make decisions on the other side of this process, that we don't convey the impression that we are trying to mesmerize them by some scheme whereby they will provide automatic financing that in their own mind they would not willingly provide.

The real problem, as the Secretary said yesterday, of our current deficits is that we have to see our way through the financing of them, and do so without disrupting the whole monetary system of the world and in a way that will not leave us with a residue that is harmful for future development.

We have to be sure that that can be done. This does not mean that you go out to some vague nowhere and get financing. The financing in the end always comes from the country which has the surplus. Whether you hide it behind an international organization or whether you go direct, the financing comes from the surplus country.

In the present setting, the only way adequately to handle our present problem is to deal directly with those countries that have the surpluses, and to so arrange the handling of the deficit that we don't impair the prospects for the future, whichever way anyone wants to choose to go. I think, regrettably, there has been a great deal of comment on the part of the people who just wish and hope, as urgently as we do, that there was some way of just opening a door on a new scheme and it would be over—a great deal of feeling that somehow or other that could be done, that the creditors would not know what was happening to them, and we would get financed and have freedom from adjustment without internal pain for a much longer period. On that level, this is not possible.

This is the sort of thing where it is not central bankers, it is treasuries, who are involved. I guess I probably negotiated every one of these transactions or was involved in it and I know pretty well what

is consistent with their own thinking and their own sense of responsibility about the way the payments system ought to work.

I also know that, in the current period of strain, there is no way of getting a large group of countries together to make additional automatic credits available on a large scale on the conscious premise that the United States just ought to have freedom from paying for 3, 4, or 5 more years.

I think on the other side of this, if we look back, we have had already more credit because of our role as world banker. We have had an aggregate credit from the rest of the world during our period of deficits of about $15 billion in addition to other ways in which it has been settled.

This is probably more than we will ever get automatically from any multilateral organization, so don't think we are not getting financing and don't think we are not being continually made aware of the fact that we have been given this financing. That is the first level.

It is one that I think must be understood in operating terms against the inescapable necessity of balancing your own books in the current setup.

Now the second level is the one that I think relates to the point you were making about the status of liquidity in the world as a whole.

Is there or is there not even now adequate liquidity for the world today? On that the general view is that it is adequate but, of course, there may be a case made that even now, certainly the case is made in terms of distribution, that some do not have enough. This is also a level on which good argument ought to occur.

Then there is the third level. That is the longer run future, the staggering mathematics that you are impressed by, and I am impressed by, and which I think we must all study carefully, certainly within the Government; and to the limit of our capacity, among our other duties, we have been studying this for at least the last 2 years.

The first result of it was something we now take for granted but this was a long and hard negotiation—getting the special resources of $6 billion for the Fund. This was exactly the limit of what was negotiable in the way of increasing the aggregate at that time. We regarded it as a major addition to the resources available for the present for whatever might occur and at least promising an avenue of development in the future.

But in relating this third level of interest to the longer-run future, I know of no one in the Treasury who would not agree with you that the arithmetic 5, 10, 15 years from now is a pretty impressive thing, however you do it, whether you think in terms of the reserve needs or the credit needs or whatever.

We know that much has been done in reserves and credit since Bretton Woods, much that was not foreseen at that time, and much more will have to be done. So we are with you in working on this problem and not to lose time to move forward on it now, as we have been within our own group over particularly the past year and in discussion with other countries as well.

But it is important, we believe, to the success of any study on the third level that it shall not be confused with the first. That is, the present position of the United States is going to have to be met by correcting our own balance-of-payments deficit, and meanwhile it is

going to have to be financed on a temporary basis with the countries which have the credit and who know what they are doing when they give us the additional credit—the additional time to get through this adjustment.

The third layer—the development of plans for the longer-run future—as you rightly say, should be going on now and is. But the prospect of having some fully agreed and well-conceived plan to introduce for approval now is virtually nil. There is enough difference of view so that it is going to take a long while to have this emerge into fully coherent thinking on which there is enough consensus to make sure others will agree.

You will see that this is the clear pattern in the future on which we are centering our hopes. But I think it is regrettable that somehow or other we in the Treasury, particularly, have not made clear—any more effectively than I have here today—the basic difference between these three levels that are relevant in this field. By placing a priority in terms of immediate action on everything that will get us through the first layer, because that is our pressing problem, we don't mean to deny the relevance of the second and the third, but we can't let any impression get around that we are relying on the second or third to get us through the first.

That has to be faced on its merits.

Representative REUSS. I have nothing but praise for the day-to-day first level operations conducted by the administration and the Treasury in the last 2 years or so. I agree with you on that. Where we disagree is in this. You point out that the finance ministers and central bankers that you deal with are not in a psychological frame of mind where they are likely to buy a program like that recommended by the Joint Economic Committee which we have discussed before.

I would not disagree with this. I know these fellows, too, and they are never going to buy it. What I ask you to take away with you is this thought. Suppose President Kennedy in the last 2 weeks, when he was over in Germany, Ireland, and Italy, had made as the great central point of his speeches the point that the free world ought to pull itself together and arrange for some sort of cooperative monetary program like this. Don't you think, as I do, that the people of those democratic countries would then have brought some democratic pressures upon their cabinets and finance ministers and central bankers so that they did get off their dime, and make the kind of agreement which the naked arithmetic shows us is long past due?

Secretary ROOSA. I don't want to ever underestimate the power of the prestige, influence, and great personal ability of the President of the United States. Therefore, I would think probably anything is possible. But in gaging the probabilities I would say that the greatest probability in an effort of this kind, which is going over the heads of established governments and responsible financial officials, to appeal to individual countries on terms which they are not quite prepared to accept in the way in which we see them—I would be inclined to think that I would not be able to be sitting here today; we would have had an exchange crisis before this time.

Representative REUSS. Thank you. Mr. Widnall?

Representative WIDNALL. Senator Miller wanted to ask a question.

Representative REUSS. Senator Miller?

Senator MILLER. Mr. Roosa, do you have a copy of the June issue of the Economic Indicators there?

Secretary ROOSA. I think so.

Senator MILLER. I hope you won't mind if I lead you through a couple of figures, but I feel compelled to do so in order that you will know exactly what my question is. I do not want to try to confuse you at all. You will note on page 35 of Economic Indicators in the last column that the public debt at the end of fiscal year 1961 was $289.2 billion. At the end of this last May it was $305.8 billion. So we have a difference or an increase in the national debt of $16.6 billion. Are you with me?

Secretary ROOSA. Yes.

Senator MILLER. What I want to do is to find out where the financing of that debt came from. What I do is go back to page 31 of Economic Indicators, under bank loans and investments, and I find that from the end of 1960—although I might say that to be on a perfect "T" with public debt figures we should start with the end of fiscal 1961, but we will have a margin of error on the plus side here.

So at the end of 1960 the investments in U.S. Government securities by banks was $59.6 billion and that had increased to $64.1 billion at the end of May 31. So we have $4.5 billion that we can say was financed by the purchase by banks of Federal Government securities during that period of time.

Now on page 30 we have the individual contributions to financing this deficit. Over there in the next to last column we have U.S. Government savings bonds, and the holdings of individuals increased from $47 billion at the end of 1960 to $48.2 billion at the end of May 30, 1963, or a $1.2 billion contribution there.

Then in the last column, U.S. Government securities maturing within 1 year, we find an increase from $41.9 billion at the end of 1960 to $48.6 billion at the end of this last May, or $6.7 billion contribution. Now totaling the $4.5 billion of banks and $1.2 billion of individuals in Government bonds and $6.7 billion of individuals in Government securities maturing in 1 year, I come up with $12.4 billion.

What I am trying to find out is where did the $4.2 billion come from in financing this $6 billion increase in the national debt?

Can you give us some idea?

Secretary ROOSA. Yes, I will be glad to provide this for you. I can tell you exactly what has happened. An increase in bank holdings of debt did occur in 1961. It was at that time and largely in the last half of the year, during the period of initial recovery from the recession. From the point of view of monetary policy, there was no reason to discourage that within the same framework that I mentioned here earlier.

As a matter of fact, since 1961, I think we have overdone it and borrowed too much outside of the banks thus far, but you can't pinpoint these things.

Senator MILLER. You say you borrowed it outside of the banks?

Secretary ROOSA. Yes, and I am coming to that. Now when you point to the increase you will notice that the increase had all occurred in these figures for banks by the end of 1961. If you go from the end of 1961 to May of 1963, over that entire period, we are still down by six-tenths of a billion dollars on these seasonally adjusted figures.

So the banks—at any rate since the end of 1961, as these figures

show, to the present—have not acquired any of the Government securities added to the debt. Now second——

Senator MILLER. May I interject this observation, that the individual contributions in purchasing Government securities maturing in 1 year increased substantially during that subsequent period, did they not?

Secretary ROOSA. Well, a large part even of these were held by banks. But changes occurred within the bank portfolio. So, while some banks held more 1-year Governments, they had fewer of the longer term governments. The longer term ones which they sold went to other institutional investors. You have to think of the changing composition of the debt as the result of a series of transactions between groups of holders and then look at the net which emerges at the end.

Senator MILLER. I recognize that. I am looking at the net. The net that I get is $12.4 billion as against the $16.6 billion increase in debt to be financed.

So I am $4.2 billion short.

Secretary ROOSA. No, sir, if I may respectfully, those figures don't add. You are adding columns that can't be added because a part of that increase in Government securities that you see on the left is in part reflected in the very same Government securities that you see in the column on the right for commercial banks.

It has been displaced by the transactions in longer term Governments of banks with other holders. So that those are just simply not columns you can add. I will be glad to give you the detailed record and then to summarize the essence of it. I did not come prepared to do this morning. (See p. 135.)

Senator MILLER. I appreciate that. I apologize for asking a question like this, realizing that you probably didn't come prepared to answer that. If you could provide the answer specifically I would appreciate it but I would like to raise this point with you.

When you furnish these data will we be able to account for the financing of this $16.6 billion?

Secretary ROOSA. Yes.

Senator MILLER. Entirely by the purchase of Government securities, short term or long term, by individuals or by our banking firms or by corporations?

Secretary ROOSA. Yes.

Senator MILLER. There is no printing press money involved in here.

Secretary ROOSA. No.

Senator MILLER. There is no monetizing the Federal debt involved, is that so?

Secretary ROOSA. Not quite. Because for the increase that occurred in 1961 there was a fairly substantial bank participation.

Senator MILLER. You mean commercial bank participation?

Secretary ROOSA. I am not talking about commercial banks, no. So far as commercial banks are concerned really for that period I don't regard this as printing press money but they did acquire Government securities while we were in recession and the early stages of recovery.

Beginning toward the end of 1961, really in September of 1961, we were able to begin redesigning our debt management program in such a way that the balance, once all these interacting transactions had worked through, would end up outside the commercial banking system.

Now there has been, and this is a second point, an increase in holdings in the Federal Reserve. Now that increase would have occurred whether the debt were growing or not because the Federal Reserve has made its decisions on how to increase the supply of bank reserves on its proper ground and it has broadly only two ways to do that.

Either it could lower reserve requirements or it could increase the reserve base. Increasing the reserve base it does always by buying Government securities. So whether or not there had been a deficit they would have been buying exactly the same amount of governments which they acquired.

So when we get this reconciliation that I have promised, you will see an increase in Federal Reserve holdings because this accounts for some net part of the increase in the debt.

Senator MILLER. Is that increase what we call monetization of the national debt?

Secretary ROOSA. No. It is what happens in every country. It is part of the process of the proper administration of the central bank.

Senator MILLER. I am not worried about whether we call it proper administration or improper. I am trying to get at where the dollar bills come from. Are they run off the printing press or are they actually taken out of someone's savings accounts? How do we get that increase you are referring to?

Secretary ROOSA. The increase that occurred in currency in circulation is the mechanical byproduct of the total increase in money supply permitted by Federal Reserve action.

The judgments they make they can describe and I should not pretend to, but I am sure they would not mind my saying that their judgments are made on the basis of their own appraisal of the domestic business and international situation. And, they have made those judgments, and have been since I have been here, have been able to make those judgments without a second consideration as whether it would help in managing the public debt.

It is the byproduct of mechanical arrangements that they do this by purchase of Government securities. If by tradition we should have it that they should buy oats, they could buy oats and do it. But they have to have some assets for providing increases in the bank reserves.

The part I think you are concerned with, and the usual problem of monetizing debt, is the acquisition of Government debt by the commercial banks, and there again is another pitfall. Commercial banks are not really monetizing if they put savings deposits into Government bonds.

As it happens we have not even had to worry about that quibble because they have not put anything in any Government bonds anyway since 1961. I think it would be perfectly appropriate if they did and I want to try to sell them some. The other problem is the other part of their balance sheet. If they add to their demand deposits, and in that way create new money because they are in some sense influenced to acquire Government securities, then we are monetizing debt.

Senator MILLER. And that has not occurred?

Secretary ROOSA. No.

Senator MILLER. Thank you very much.

(The information requested is as follows:)

Change in ownership of the public debt, June 1961 to May 1963

[In billions of dollars]

	June 30, 1961	May 31, 1963	Change
Government investment accounts	$56.1	$57.1	+$1.0
Federal Reserve banks	27.3	31.3	+4.0
Commercial banks	62.5	63.0	+.5
Private nonbank investors:			
Individuals:			
Savings bonds	46.0	47.4	+1.4
Other securities	17.1	19.0	+1.9
Total	63.1	66.4	+3.3
Insurance companies	11.4	11.0	-.5
Nonfinancial corporations	20.0	21.9	+1.9
State and local governments	19.3	20.6	+1.3
Foreign and international	12.7	15.9	+3.2
Mutual savings banks	6.3	6.1	-.2
Savings and loan associations	5.0	6.1	+1.1
Other private nonbank investors	5.5	6.4	+.9
Total	143.3	154.4	+11.1
Total debt	289.2	305.8	+16.6

NOTE.—Details may not add to totals due to rounding.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. I have two very brief questions. I want to see if I can get this picture that you have painted so expertly this morning and see if I can understand it. If we had no domestic considerations, if we were not also burdened with world leadership as the world banker, the classic, ideal and still effective way to bring about balance in our international payments would be an austerity program I presume?

Secretary ROOSA. Yes.

Senator PROXMIRE. In other words, a program that would be deflationary?

Secretary ROOSA. Yes.

Senator PROXMIRE. Drive our prices down so that we can sell abroad, drive our wages down, reduce Federal spending sharply?

Secretary ROOSA. Yes.

Senator PROXMIRE. Increase taxes, hike interest rates, and so forth?

Secretary ROOSA. Yes.

Senator PROXMIRE. Obviously we can do none of these things because that would be disastrous domestically and that would also contribute to an international depression?

Secretary ROOSA. Yes.

Senator PROXMIRE. This is what really puts us in a position where we have to look for other approaches. Now you have suggested a very moderate increase in short-term interest rates.

Let me ask you if it is not true that you are primarily relying on your judgment, not on the Kenen report but your judgment and experience, that it would be possible to discourage capital outflow or encourage capital inflow by reliance on what you would call a reasonable increase in short-term interest rates. Is that correct?

Secretary ROOSA. Well, if we want to distinguish between the long-run and the immediate part of the program, in the long run of course

the whole thing rests on the tax bill and I would never want to imply that I don't think that is crucial.

Senator PROXMIRE. Long-run, the whole solution to our international balance of payments?

Secretary ROOSA. No; that was a little exuberant. I was so shocked that you had forgotten the tax bill that I had hoped——

Senator PROXMIRE. I had not forgotten it. I said a tax increase, not a tax cut but a tax increase, would be a way of solving our international balance-of-payments problem although it would be disastrous domestically. You agreed.

Secretary ROOSA. The real center of our effort, I think, has to be the tax bill and the possibility for this kind of interest rate action having very little, if any, visible effect on the economy is hinged on the much greater impetus that we will get from the tax bill.

Senator PROXMIRE. You feel that with a $580 billion economy, that a $10 billion cut in taxes with perhaps a $12 billion deficit is going to be sufficient to give us that kind of stimulation in view of the experience we had in the 1930's when a deficit of 4 percent of the gross national product gave us no answer to our recession, depression, stagnation.

Secretary ROOSA. There have to be more parts to it than this but I think starting with the base of the tax bill is crucial. It is the sine qua non whether it is sufficient or not.

Senator PROXMIRE. Let us take the short run which is certainly a prime consideration this morning. How much do we have to increase our short-term rate in order to get a reasonable improvement in our flow of capital.

Secretary ROOSA. I don't know.

Senator PROXMIRE. Isn't this pretty crucial? This is a matter of judgment. You are the outstanding expert in the Nation on this. You are the responsible official.

Secretary ROOSA. I want to give you the answer that indicates most clearly the nature of the problem and that is that no one—I am sure no one—can presume to say precisely what the pattern will be. We know enough about the relationship to know that there will be a response.

We also know enough about the risks to realize that you can't stake out a particular rate movement as certain to succeed on the balance of payments and also certain to have no effect on the home economy.

The nature of this kind of influence—I am sure you have heard this often in other connections from Chairman Martin—is that it permits us to test the market to see what the response is and to learn from it. When we know that there is a reasonable presumption that things will move that way, we test and find out.

We can also reverse. This is something that does not wait for the convening again of Congress or the sending of a message and the meeting of a committee. It can be reversed if necessary within hours.

Senator PROXMIRE. Would it be unreasonable to presume that you would have to have a 1-percent increase in the short-term rate in order to have an effective action?

Secretary ROOSA. I would put it the other way around. One percent would in my judgment have quite a substantial effect—it would be so great that I doubt whether it would be consistent with other parts of our worries. We have to worry about what this will do to other money markets around the world.

We want to gain. We don't want to wreck them. I don't think a rise of 1 percent——

Senator PROXMIRE. Now we are getting around to a pretty feeble reed in view of the drastic situation that we have, the continuous loss of gold, the fact that you and the Secretary of Treasury have said this is a very serious matter. We are relying then on a change in short-term interest rates, an increase of less than 1 percent to be our principal bulwark against the situation for the next year or two.

Hopefully, over 3, 4, or 5 years the tax cut may be helpful in your judgment, although a tax increase would be a clear prescription if the balance of payments were the only consideration.

Secretary ROOSA. Yes. There are a number of other things that the Secretary mentioned. I don't mind repeating them, each one of them comparatively small, but this is the nature of working out a program where there has never been this kind of problem faced before. We have to rely on getting a little bit from every part.

This concerns a whole variety of things we are doing in the capital market, where we want to encourage foreign purchases of foreign issues placed here. That is beginning to improve. We are gaining a bit. We want to try to shift out of private placement into market issues, and that is beginning to gain a bit. We are putting more steam behind it.

We are in the whole export field—it is only since February we have had fully operational new facilities for export credit insurance—most people who are potential users of it don't even know about it yet. This has to spread so far as exports are concerned. So far as the impact on exporters of the new effort of Commerce and State in the tracing of markets and the finding of producing capabilities here to meet them—that is hung up partly because we don't have the full staff to do it. A comparatively small sum is needed to implement it.

That has been in the Congress now since January and we are hopeful that can be approved but we are going ahead with what we can do, improvising. A number of businessmen have come back and told me that the first signs they see are encouraging although the dollar amounts are small.

Senator PROXMIRE. All of these things add up to a small package, don't they, including the change in interest rate? Let me ask you, do you know of any country which has been able to rely primarily on an increase in interest rates to stem capital outflows and has been able to do so with an increase as small as less than one percent?

Secretary ROOSA. There has never been a country which has had our banking responsibility.

Senator PROXMIRE. I am not saying that you could go higher than this. In fact, I am inclined to also feel that an increase of 1 percent would now, on the basis of the testimony yesterday of Secretary Dillon, have probably an effect on our long-term rate.

He seemed to feel that we are pretty much at the limit of Operation Nudge, that further increases of a half percent or three-quarters

percent, 1 percent perhaps, would tend to increase the long-term interest rate too.

Secretary ROOSA. My best answer is to repeat the same. I think we don't have to be committed to any particular increase. You try to see. You wait until the time is appropriate. By appropriate I don't mean that our need is not apparent, but reading in terms of the way flows are going in the market you have to seize the right time to get the right impact.

Senator PROXMIRE. I very much appreciate your position as administrator and tactician. You have a great reputation, a deserved reputation in this regard. For us as Members of the Congress we want to have some idea of where you are going and what your objectives are.

I understand your position is very difficult.

Secretary ROOSA. Yes. The best I can do is to indicate the aim and the overriding principle that will pervade whatever action is taken. I think that in a true sense should be more responsive than a superficial attempt to say, yes, at a quarter of 1 percent we will get $200 million from it. It is just not that precise.

Senator PROXMIRE. Thank you very much.

Representative REUSS. We are grateful to you, Mr. Roosa for bringing your wisdom and your good humor to our meeting this morning. We will probably have several supplementary questions. For one thing, all the minority members were not able to be here.

In accordance with practice developed in other days, I take it, if we submit those to you rather promptly, you will be able, consistently with your travel patterns to Europe, to give us an answer in time that we may include it in the record of this hearing?

Secretary ROOSA. Yes, surely.

Representative REUSS. Thank you very much. So the Joint Economic Committee will now stand adjourned.

(The questions submitted and the answers provided follow.)

SUPPLEMENTARY QUESTIONS SUBMITTED TO HON. ROBERT V. ROOSA BY COMMITTEE MEMBERS AND SUBSEQUENT REPLIES

Question 1. To what extent does foreign borrowing in the United States occur because foreign governments limit access to their domestic capital and money markets, and because such markets are relatively underdeveloped and inadequately organized?

Answer. There follows a table showing in summary form the controls over capital movements exercised by major industrial countries. Following the table are brief descriptions of the most important capital markets of Europe. These sketches suggest the scope of the markets and the basic objectives of the authorities in exercising controls over them. There is in preparation a more comprehensive study which will be furnished to the committee in accordance with the Secretary's agreement to do so.

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Summary of controls over capital movements exercised by major industrial countries

Country	Type of capital movement				
	Convertibility of currency on capital account	Direct investments abroad	Portfolio investment abroad	Commercial credits—5 years and under	Financial loans
Belgium-Luxembourg	External	Control via free market	Control via free market	Control via free market	Control via free market.
France	do	Liberalized	Free	Liberalized	Individual licensing and banking laws.
Germany	Full	Free	do	Free	Free.
Italy	External	Largely liberalized	Generally permitted, with some exceptions.	Credits up to 5 years liberalized, all other credits under 1 year liberalized.	Loans within the EEC under 5 years less than $80,000, and with interest less than 6 percent are free. Loans over 1 year liberalized.
Netherlands	do	Liberalized	Control via free market	Liberalized	Individual licensing.
Switzerland	Full	Large credits controlled under bank laws.	Large credits controlled under banking laws.	Large credits controlled under banking laws.	Large loans controlled under banking laws.
United Kingdom	External	Individual licensing and control via free market.	Control via free market	Controlled over 6 months	Controlled under both banking and exchange control laws.

Country	Type of capital movement				
	Deposits in foreign banks	Flotation of securities issues by nonresidents	Repatriation of direct investments by nonresidents	Repatriation of portfolio investments by nonresidents	Areas where special regulations apply [1]
Belgium-Luxembourg	Control via free market.	Banking laws and free market exchange rate.	Control via free market	Control via free market	None.
France	Generally not permitted.	Controlled under both banking and exchange control laws.	Liberalized	Free	French franc area.
Germany	Free	Free	Free	do	None.
Italy	Generally not permitted.	Controlled under both banking and exchange control laws.	Liberalized	Liberalized	OECD; EEC.
Netherlands	do	do	do	Control via free market	Guilder area.
Switzerland	Free	Controlled under banking laws.	Free	Free	None.
United Kingdom	Generally not permitted.	Controlled under both banking and exchange control laws.	Free on approved investments.	Control via free market	Sterling area Uniscan.

[1] Payments to bilateral account countries not listed here are also under special controls.

NOTE.—The notation "liberalized" indicates that prior authorization is required, but is freely given. The notation "control via free market" indicates that transactions are permitted, but that the call on foreign exchange to finance them is restricted by channeling them through a free market, the supply of foreign exchange to which is limited. Tendencies for outflow to increase result in changes in the free market exchange rate rather than in an increased outflow of foreign exchange.

LONDON CAPITAL MARKET

The United Kingdom capital market is one of the oldest and best developed in the world. Before World War II it was a major supplier of capital for the world, and the pound sterling was the most widely held reserve currency. During most of the postwar period there was not a sufficient volume of capital generated within the United Kingdom economy to meet domestic requirements plus the amounts which all oversea borrowers would have wished to obtain. Consequently, access to the market has been limited to resident and Commonwealth borrowers, and even these have been regulated in an attempt to prevent excessive demand.

Transactions in foreign currency denominated securities are controlled by exchange regulations administered by the Bank of England for the United Kingdom Treasury. Residents who acquire certain foreign currencies (including U.S. dollars) as a result of capital transactions may, with permission, use them for the purchase abroad of marketable foreign currency securities. Otherwise they must offer them for sale to an authorized bank. Thus there is only a limited supply of foreign currencies available to British residents for foreign investment and the amount is controlled by the authorities. Individual residents, who wish to invest abroad in the specified currencies, may bid for them in this restricted market where the rate is generally above the commercial sterling-dollar rate.

This year there have been several developments which may lead to increased use of the London capital market by foreigners. A 5 percent 3-year loan for $20 million was made to Belgium; this was the first foreign currency loan in London since the war. In later actions, a British investment trust was allowed to borrow $10 million in New York, and the market was opened to all EFTA countries.

GERMAN CAPITAL MARKET

The German Government does not impose exchange restrictions on movements of capital into and out of Germany and occasionally a foreign issue is floated on the German market. On a net basis, however, Germany tends to be a borrower rather than a lender because of the high bond rate which currently averages roughly 6 percent. One of the prime causes of the relative scarcity of funds for industrial investment, which is reflected in the high bond rate, is a housing boom which, spurred by government concessions and subsidies, drains off into housing a large part of the savings available. Mortgage and communal bonds comprise as much as 70 percent of the total bonds issued in the German market.

The thinness of the market impedes the development of efficient institutions, limits competition, and contributes to high issue costs. The small volume of securities in circulation which contributes to this thinness is the result of several factors. The outstanding debt of the Federal, State and municipal governments is relatively small and therefore the large refunding operations which are undertaken in countries like the United States are unnecessary in Germany. A 2½ percent tax on the issue of debt certificates as well as administrative obstacles to the placing of shares through the German stock exchanges, such as listing requirements, are additional factors which reduce the volume of securities in circulation.

FRENCH CAPITAL MARKET

Foreign companies wishing to issue securities in France must comply with the regulations governing all issues of securities and also with the exchange regulations.

Canvassing in connection with operations on securities issued by foreign companies without the guarantee of the governments concerned is prohibited under a decree of August 8, 1935. The latter limits possibilities of selling foreign shares and bonds, whether new or old issues.

No foreign securties from outside the franc zone have been offered in France since World War II.

The French capital market is underdeveloped in relation to other European capital markets. It is characterized by controls and timetables for issuing new flotations. Interest rates and issuing expenses are high. The supply of funds does not normally meet the existing demand, although in recent years the volume of total savings has been increasing.

In June 1963, the committee of experts which had been set up by the French Government in June 1962, to examine the functioning of the capital market in France and to suggest possible methods to improve it, submitted its report. The main improvements advocated by the committee were: the introduction in France of open end investment trusts and the issue of so-called participating bonds, the yield of which would be in part fixed, in part fluctuating with turnover or profits. It proposed also that measures should be taken to facilitate the issue of convertible bonds. In recent years a number of French enterprises have been rather reluctant to make new issues on the share market, as large shareholders have been afraid of diluting their control. For this reason the committee also suggested issues of preferred shares, which until now have been forbidden in France. In commenting on the report, the Minister of Finance declared that the Government had not yet decided which of the various suggestions it would accept.

Since February 1962, French residents may freely acquire foreign securities listed on a recognized stock exchange, but the portfolio must be deposited with an authorized French bank. Direct foreign investment is subject to Finance Ministry approval, but such approval is considered only a formality.

The total absence of foreign securities issues in France since World War II, in addition to the unfavorable factors mentioned above, may also be due to the desire to insure that the market will meet French domestic requirements. Whether the French market is opened to foreign issues will depend primarily on an improvement in borrowing conditions on the market and also on a change in the attitude of the authorities. If the French balance of payments continues in a surplus condition, there may be some possibility of liberalization of the French capital market.

ITALIAN CAPITAL MARKET

In July 1961, the Italian authorities permitted the first flotation on the Italian market by a non-Italian issuer in more than 25 years. Since that time a total of four issues have been allowed, each for $24 million, to the International Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, and the European Coal and Steel Community. Actually these issues were not too well received in the market since they offered only 5 percent when the rate on Italian Government securities was 5½ percent.

All loans to foreigners, as well as the issue of foreign securities on the Italian market, are still subject to official approval. Two April 1963 exchange office rulings now permit Italian residents to grant loans freely (within the EEC), providing that the repayment period does not exceed 5 years, nor the amount 5 million lire ($80,000), and to buy foreign securities issued or payable abroad and listed on foreign exchanges. These decisions will help to bring the Italian capital market into closer contact with those of other countries.

In July the city of Milan offered a $20 million bond issue in New York. This action on the part of a leading Italian city is probably due to a combination of two factors: the thinness and high cost of borrowing in the Italian capital market, and the lower cost and readier availability of the funds in New York.

Furthermore, Government tax policies have tended to make it worthwhile for investors to try to export capital. This has been done by smuggling banknotes into neighboring countries thus making the Italian capital market a much smaller one than basic Italian resources would otherwise support. Recent reports indicate greater attempts on the part of the authorities to halt the smuggling traffic so that future trends on this are uncertain.

SWISS CAPITAL MARKET

The Swiss capital market is second only to New York in the amount of new foreign bond issues floated since World War II. Although the Swiss market has been and will continue to be a good source of capital for international borrowers, the volume of funds available has varied and will vary from year to year depending mainly on the Swiss balance of payments and domestic needs for capital.

The large increase in capital issues in the last 2 years has been in part a response to the large volume of capital inflow in that period which was related to various political and economic crises around the world. The national bank, as part of its anti-inflationary policy, opened the market to foreign borrowers, particularly in 1961, to relieve the pressure on the domestic economy. As a matter of policy the bank carefully controls the volume of new foreign bond issues with

a view to preserving the major share of available funds for Swiss borrowers and to prevent a rise in the traditionally low interest rates which for political reasons must be kept low. Approval of the national bank is required, under Swiss banking law for all foreign loans, purchases of shares of foreign companies, and investments abroad amounting to Swiss francs 10 million ($2.3 million) or more that have terms of 1 year or longer.

As a matter of policy the national bank is in principle prepared, under normal circumstances, to export any balance-of-payments surplus accruing to Switzerland. As long as the balance of payments is in substantial surplus it can be expected that the Swiss National Bank will take a liberal attitude toward capital exports. The current account in the balance of payments is presently in deficit but the continued large inflow of capital which more than offsets that deficit has permitted the national bank to continue its liberal attitude toward capital exports. The bank feels that the capital market should be kept as free as possible subject to domestic needs for capital and the balance-of-payments situation.

NETHERLANDS CAPITAL MARKET

Issues on the Dutch capital market offered by Dutch and foreign enterprises must be cleared with the Netherlands Bank. The Netherlands market was closed to foreign flotations from 1955 until May 1, 1961, primarily because of the domestic need for capital and the tightness of money. In April 1961 the Netherlands Bank announced it would begin to grant licenses for foreign issues, at least for foreign bonds, on the Dutch capital market. The bank's announcement emphasized that licenses would be granted only on a limited and gradual scale. The foreign issues in 1961 totaled $149 million and $63 million in 1962. This foreign borrowing largely took the place of Netherlands Government issues which would have absorbed excess domestic liquidity. The primary purpose of the authorities in granting permission for these foreign issues appears to have been the maintenance of a given level of Dutch international reserves. Thus the availability of the Dutch capital market to foreigners appears to depend upon trends in the Netherlands international balance of payments.

Question 2. To what extend do tax inducements here and abroad encourage capital exports? What have been the balance-of-payments effects of the Revenue Act of 1962?

Answer. Unfortunately these questions cannot be answered in quantitative terms. Taxation here and abroad can affect capital movements in a multitude of ways, both directly and indirectly. The most important tax influence on capital flows probably is by way of its impact on the general profitability of investments within individual economies. To the extent the tax program in the United States stimulates a more rapid rate of growth, a rising level of employment and an increase in disposable consumer income, it will greatly stimulate new investment in this country. Business estimates have indicated that last year's 7-percent tax credit for new investment, the revised guidelines for depreciation of capital equipment and the proposed reduction in corporate tax rates included in this year's tax bill will increase the profitability of new investment by something like 30 percent. Such an increase in the profitability of investment will constitute not only a strong magnet for the employment of U.S. savings but will also tend to attract investment capital from foreign countries.

Taxation policy may affect international capital movements directly in many ways. This problem is presently being explored by the Organization for Economic Cooperation and Development in Paris. Their preliminary studies show that the problem is very complex, involving an analysis of the following elements of the various national tax systems:

(*a*) the taxation of dividend income received by individuals owning stock in domestic companies and foreign companies;

(*b*) the taxation of dividend income received by corporations owning such stock;

(*c*) the taxation of stock dividends;

(*d*) the taxation of income from investments in bonds and debentures;

(*e*) capital gains taxes;

(*f*) taxes on capital;

(*g*) taxes on issue and transfer of securities;

(*h*) death duties.

The study indicates, for example, that among the members of OECD, only in the United States,[1] the United Kingdom, Germany, and Denmark is there no

[1] This statement was made before July 18, 1963, when the President proposed the interest equalization tax.

tax disadvantage (or a disadvantage of 10 percent or less which is treated as "no tax disadvantage" in the study) for the individual investor from investing in foreign securities rather than in domestic securities. The investor in Sweden suffers no tax disadvantage from investing in U.S. shares but does suffer a disadvantage if he invests in the United Kingdom or in a number of other OECD countries.

The tax effects vary, depending upon whether portfolio investment is made by an individual or by a corporation. A U.S. corporation, for example, receives a "dividend-received" credit of 85 percent on dividends received from another U.S. corporation. Since this credit is not given for dividends received from a foreign corporation, the U.S. corporate investor would suffer a tax disadvantage from investment in foreign rather than domestic shares. There is reported to be no such tax disadvantage for corporations resident in Denmark or Germany but there are various degrees of disadvantage for companies resident in any of the other OECD countries.

The situation is different again if the investment is of such a size as to constitute a participation in the foreign corporation. The definition of "participation" may vary from country to country; the European standard is generally 25 percent, the U.S. standard 10 percent. U.S. companies with participation in foreign companies suffer tax disadvantages ranging from 8 to 34 percent in half a dozen of the OECD countries.

Taxes on the issue and on the transfer of bonds and debentures and on the issue of shares differ from country to country. The following list shows in decreasing order of magnitude the duties levied on the issue of securities in the 14 member states:

Stocks and shares

United Kingdom	0.5 percent on authorized capital, whether issued or not; 6 percent on bearer shares.[1]
Germany	2.5 percent.
Netherlands	Do.
Austria	2 percent.
Switzerland	Do.
Spain	1 percent issue duty; 0.5 percent incorporation duty.
Italy	1 percent registration duty; 0.2 percent variable stamp duty.
Denmark	1 percent.
Norway	Do.
Belgium	0.7 percent.
United States	0.1 percent Federal; 0.1 percent State (e.g., Florida, South Carolina, nil in New York and Texas).
Sweden	0.1 percent.
Canada	0.02 percent incorporation duty.
France	Nil.

[1] After Aug. 1, 1963, this rate will be halved.

The problem is a very complex one and it is now being examined by an international group (the OECD) in an attempt to find out where the major problem areas are and with the aim of bringing about a freer international flow of capital.

Another area in which tax policy may affect capital flows directly involves the granting by the underdeveloped countries of tax exemption or tax reductions for a specific number of years in order to encourage new investment. It is a common practice among developing countries to offer such tax inducements. Obviously, if the political or economic outlook in a country is one of pronounced instability and is such as to endanger the safety of capital invested in a venture, tax incentives are likely to be of little significance in attracting investment, except possibly in cases where the payout period is very short. If, however, political and economic conditions afford investors a reasonable measure of safety, and if the prospect of profit is reasonably good, then a tax incentive granted by a developing country may promise a marginal increment to the disposable profits of a venture that would result in a capital commitment abroad that might otherwise not take place. This is so because despite the general approach in our tax system of taxing income as earned, we do not tax a foreign corporation even though it is wholly owned and controlled in the United States.

We tax the parent company only on dividends it receives from the foreign corporation. Consequently, to the extent that a U.S. enterprise is prepared not to withdraw profits from a foreign subsidiary in the form of dividends during the period when a tax incentive is granted, any tax reductions or exemptions which a foreign country may give to a foreign venture will inure to the benefit of the company.

The committee asks what have been the balance-of-payments effects of the Revenue Act of 1962. The Revenue Act of 1962 provided that a U.S. person owning a substantial interest in any foreign corporation controlled by Americans must include in his taxable income for U.S. tax purposes his pro rata share of certain categories of income realized by the foreign corporation. The categories of income are such that only the profits of so-called tax haven companies are affected. Income from active business operations of foreign corporations owned by Americans is left untouched which means that that income is not subject to current U.S. tax until it is distributed to the United States. (The administration proposal for the Revenue Act of 1962 was that all of the income of foreign corporations controlled by Americans should be subject to immediate tax whether distributed or not. This proposal was not accepted by the Congress.) The Revenue Act of 1962 provided also for the grossing-up of dividends received from foreign subsidiaries operating in developed countries, a technical change, the effect of which is that the combined foreign and U.S. tax paid on income distributed by foreign subsidiaries will amount to the 52-percent rate applicable to the U.S. corporate income regardless of the foreign tax rate. Previously, the effective tax rate might have been considerably below 52 percent (as it continues to be for the underdeveloped countries). The act also placed upper limits ($20,000 per year for the first 3 years, $35,000 per year thereafter) on the earned income exempt from U.S. tax for U.S. citizens residing abroad. These and other changes are estimated to increase U.S. tax revenue by $140 million. Some part of this will represent earlier distribution of earnings than would have occurred under previous legislation but a precise estimate is not available. Last year's tax program did, in our opinion, significantly reduce the attraction of tax havens as a channel for U.S. foreign investment. It is reported that there has been a definite slowdown, for example, in the rate of establishment of corporations in Switzerland as affiliates of American companies and that some corporations have been liquidated.

Prior to the 1962 Revenue Act, the income from foreign investment companies enjoyed preferential treatment as compared with income from domestic investment companies. These foreign investment companies provided a means whereby American shareholders could accumulate investment income indefinitely without paying American taxes thereon at either the corporate or shareholder level. On redemption, the American shareholder received capital gains treatment on his income. The 1962 Revenue Act made a basic change in this situation: Gain on the sale of shares in such companies, to the extent of the shareholders' undistributed portion of the companies' earnings, is taxed as ordinary income rather than as income entitled to capital gains treatment. The revision, however, allowed an exception if a company should elect to distribute 90 percent of its ordinary income annually, and if in addition, the shareholders report their portion of the companies' realized capital gains, whether or not these are distributed.

It now appears that the vast majority of SEC registered foreign investment companies have exercised the election under the code, which means they have elected to distribute 90 percent of ordinary income annually. In other words, they have chosen tax treatment substantially identical with the tax treatment of U.S. regulated investment companies, providing for current tax on the dividends and "pass through" treatment for the capital gains on a current basis.

Further, a number of these companies have taken a more fundamental step through corporate reorganization (sec. 367) and have thereby become full-fledged domestic investment companies.

We interpret these results as favorable from a balance-of-payments standpoint. They mean that a number of foreign investment companies which are essentialy American owned no longer find it profitable to operate as such now that their income no longer enjoys a special advantage over the income of domestic investment companies. In connection with those companies which have chosen to reorganize and those which have elected to be treated on essentially the same footing as domestic investment companies, a favorable result in our balance of payments may be expected to flow from their new commitment to distribute ordinary income annually. The magnitude of the balance-of-payments impact is not precisely ascertainable.

Question 3. What benefits accrue to the United States from permitting free access for foreign borrowers to our capital markets, and from freedom for U.S. financial institutions to transfer funds abroad? Why doesn't the United States impose direct controls on capital outflows as do other countries? What special responsibilities and benefits accrue to the United States in its role of world banker?

Answers. I. The benefits to the United States of free access by foreigners to our capital market:

Freedom of access to the U.S. capital market has both tangible and intangible benefits for the United States. The intangible benefits are perhaps the more important although they are difficult to define with any precision since they are inextricably linked with the whole function of the dollar as a key currency and as the cornerstone of the international payments system. The existence of broad capital and money markets in the United States freely available to foreign borrowers (and lenders) within the constraints set by the cost and availability of credit has set a pattern for the gradual dismantling of foreign controls on trade and payments in the postwar period. Without U.S. leadership as a free financial center we would not have had the rise of world trade—and its attendant beneficial effects on domestic growth both here and abroad—that we have experienced in recent years.

More specific benefits to the United States spring from the use of our capital markets by such countries as Canada and Japan to finance their large current account deficits with the United States—thus maintaining and promoting our exports of goods and services. As the largest capital-creating nation in the world it is only natural that the United States should be an exporter of long-term capital, both in the form of direct investment abroad and of long-term borrowing in our capital markets by foreigners. Both types of outflow add to productive capacity abroad—just as our own early period of rapid economic growth was stimulated by the import of capital from abroad. And although various timelags are involved and the process of adjustment cannot always be smooth, this growth of the world economy inevitably will add to our own economic well-being.

Still more specifically our foreign investment, both past and present, results in substantial current foreign earnings. Annual earnings of U.S. investors on foreign securities issued in our capital market probably exceed $400 million per annum, or about two-fifths of total purchases of new and seasoned foreign issues by Americans last year.

II. Benefits for the United States stemming from freedom for U.S. financial institutions to transfer funds abroad: In broad terms, the ability of U.S. financial institutions to engage freely in foreign financing has been of immense importance for the growth of U.S. foreign trade and of international trade generally. In the absence of the ample credit facilities for the financing of the dollar needs of foreign financial institutions and traders, the rapid growth of our export trade during the past decade could not have occurred. Our foreign financing has aided the economic development of the free world, and assisted in the emergence of more stable economic and political conditions abroad. Active commercial participation of our banks in international financing has enabled industry and commerce in many parts of the world to seek materials and foodstuffs wherever they are available at the lowest cost and has facilitated the growth of manufacturing and other production facilities to meet world demands for a broad variety of products.

International banking in the United States has yielded foreign exchange earnings that have benefited the income account of our balance of payments and has given employment to a large staff of people handling these transactions. Aggregate interest earnings from abroad accruing to our banks are about $300 million annually. These activities have also drawn to the United States a great variety of other types of international financial transactions such as insurance of foreign risks, and participation by foreigners in trading in our stock and commodity exchanges. These operations have also added to the financial earning power of this country.

III. Why doesn't the United States impose direct controls on capital outflows? While the freedom of access to our money and capital markets and the freedom of Americans to transfer funds abroad has on the whole been beneficial to the United States, the size of the outflows in recent years—together with our other spending abroad on imports of goods and services, defense, and foreign aid—has contributed to our balance-of-payments deficit. This is of course why the ad-

ministration has placed such emphasis on the encouragement of higher domestic growth rates and improving the attractiveness of domestic investment relative to investment abroad, why the Treasury and the Federal Reserve have been so concerned with the relative levels of U.S. short-term interest rates compared with those abroad, and why the Treasury has emphasized the need to remove restrictions abroad and improve capital market structures in foreign financial centers. These lines of approach are fully consistent with the sort of expanding and competitive world economy that we all are seeking.

The imposition of direct controls on capital outflows would be completely inconsistent with these fruitful lines of development and would deal a severe blow to the international position of the dollar and indeed to the status and prestige of the United States in its role of world leader. Moreover, it would be completely ineffective as even a partial solution of our balance-of-payments problem.

Some other developed countries, it is true, have various direct controls on capital outflows although they have been substantially relaxed or eliminated in many of them. Their effectiveness, particularly with respect to short-term capital movements, has not always been conspicuous, as the speculative attack on the pound and the French franc in the earlier era of widespread controls testify. Nonetheless, it is true that highly selective controls on capital issues work with a fair amount of success in a few countries.

But the United States is not just any country, nor is the dollar like any other currency. We must always be mindful of the fact that while our direct investment abroad exceeds such foreign investment here, foreign holdings of American stocks and bonds, and, especially, short-term liquid assets greatly exceed similar holdings of Americans abroad. The imposition of controls on capital flows, even of the most modest sort, would inevitably be interpreted by foreigners—based on their own experience—as the forerunner of more comprehensive controls. The dollars we might save by restricting foreign access to our markets through direct controls might be only a small fraction of what we could lose through the withdrawal of foreign funds from this country. Considering the size of foreign private dollar balances and dollar investments, this could mark the beginning of a collapse of the international dollar exchange standard and the present international payments system. The imposition of direct controls on capital outflows of the kind imposed in other countries is simply not a realistic approach to the problem of reducing flows from the United States.

The risks outlined above make direct controls an unthinkable approach for the United States. There would also be administrative problems of a serious nature, related to the difference in traditions and institutions in Europe and in the United States. In many foreign countries exchange controls have been a fact of life for decades. They have gradually been relaxed and the capital controls that still exist are only remnants of a broader system imposed during periods when financial freedom was an understandable sacrifice to wartime needs. The United States, on the other hand, would be setting out on uncharted seas, without an administrative apparatus such as has existed abroad for years. Moreover, supervising authorities abroad have to cope with only a handful of financial institutions compared with the infinitely larger number of more diverse institutions in this country. The very complexity of our highly developed financial markets and institutions, in addition, creates widespread opportunities for avoidance, if not outright evasion, of controls.

IV. What special responsibilities and benefits accrue to the United States in the role of world banker? The special responsibilities of the United States as world banker stem from the fact that the dollar is the cornerstone of the world's exchange rate and payments system and is the principal reserve currency. This unique position of the dollar has been the result of a natural evolutionary process and does not stem from a conscious decision of the United States to have the dollar perform a role in international finance that would be consonant with its position as a political, economic, and military power. It nonetheless carries with it the responsibility of assuring that the strength of the dollar permits it to perform its functions that are essential for the viability of the free world's payment system and for the maintenance of a high level of trade which is essential for economic growth at home and abroad. This necessarily involves an obligation to pursue policies that contribute to domestic economic growth and avoid persistent balance-of-payments deficits.

The major benefit that has accrued to the United States as world banker relates to the broad economic and political advantages that have arisen from the

successful evolution of a payments system in the postwar period—a system based on the dollar—that has contributed to the growth of trade and economic activity throughout the world. More specifically, the use of the dollar as a reserve currency by foreign monetary authorities has permitted the United States a greater flexibility in financing its balance-of-payments deficits and, until recently, gave the United States greater freedom to follow desired domestic and foreign economic policies than would otherwise have been the case.

Had the dollar not been a reserve currency, the shape of postwar economic developments would have differed vastly from the pattern we have experienced. Had foreigners not been willing—indeed anxious until the last few years—to add to their dollar reserves we would have been forced long ago to face the disciplines imposed by the need to maintain reasonable equilibrium in our internationl accounts. It is of course impossible to detail what "might have been," but if we had not been a world banker, we might well have been forced long ago to cut down our imports (perhaps through deflation of our domestic economy), reduce materially our foreign investments, income from which make a substantial contribution to our current balance of payments, and curtail, perhaps sharply, our military and economic assistance to our friends and allies. Had we taken these steps, our customers abroad would have sharply reduced their purchases in this country and we would now be confronted with discriminatory policies against the dollar in most countries of the world. Instead of the rapid growth of world trade, we would have witnessed stagnation that would have been harmful to our own prosperity and to that of the whole free world.

Question 4. Why would new issues controls imply comprehensive exchange controls? Don't some European countries have capital market controls without exchange controls?

Answer. I have said that a partial exchange control is not likely to work and that if we attempted one we might be driven to a full exchange control. The reason why a partial exchange control is extremely difficult to operate is, I believe, more a matter of psychology than of techniques. Traditionally, the imposition of exchange control has been a sign of extreme balance-of-payments weakness or a part of the preparation made in order to face wartime conditions or other highly critical situations. Under such circumstances any partial exchange control tends to frighten rather than reassure the holders of capital. The closure of any particular door, accordingly, is likely to be followed by a rush of capital through adjoining channels, so that the exchange controls must be rapidly broadened to protect the national currency. I have said that for these reasons the institution of exchange controls even though applicable only to a certain type of transaction is not a practical or acceptable policy for the United States.

I have pointed out, also, that the adoption of exchange controls would violate one of the precepts upon which our whole economic system is predicated, that in our economy we must rely primarily upon decentralized decisionmaking by individuals and businesses responding to market forces. I added that Government must accept the responsibility for influencing market forces in ways consistent with national objectives but without attempting to direct individual transactions.

During and immediately after World War II most European countries built up and maintained comprehensive systems of exchange controls. As their financial and economic strength increased they began gradually to dismantle the controls while maintaining most of the authority for reinstitution. Liberalization was extended first to current (i.e. noncapital) transactions, and later in some cases to certain capital transactions. The point is that the level of restrictions on capital transactions which remain (and in many countries it is still fairly comprehensive) was reached through gradual step-by-step relaxation, so that the effect of each successive step could be observed before the next was taken and with the threat of reimposition of controls in the background. It would be an entirely different and more difficult problem to begin with no controls whatsoever and attempt to erect a partial system of controls.

While several European countries (e.g. Switzerland and Germany) maintain control of foreign security issues without comprehensive exchange control systems, their experience is not relevant to the imposition of capital controls by the United States at the present time.

The continental European capital markets are small and centralized—both geographically and in terms of the small number of major participants—as compared with the U.S. market. Thus, the authorities in Switzerland and

Germany find it a relatively easy matter to secure compliance with their capital control regulations through their intimate association with their respective money and capital markets. Such an informal control mechanism would be much less effective in the United States, however, owing to the size and complexity of the capital market. Evasion or circumvention of capital controls by a significant minority of the market participants would not be difficult, and could lead to the collapse of the controls in the absence of an elaborate exchange control system.

Question 5. What are the underlying supply-and-demand conditions which suggest that costs and prices will continue to rise more rapidly abroad than at home? Can the United States move toward full employment without generating inflationary pressures that would place us at a competitive disadvantage relative to suppliers abroad? Haven't European governments already taken steps to curb rising costs and prices abroad?

Answer. The six Common Market countries (which account for most of the current payments surpluses and reserve accruals within Europe) expect as large an advance in GNP in 1963 as in 1962. During 1962, prices and wages advanced much more rapidly in these six countries than they did in the United States. However, these advances in general levels of prices and wages had only limited effects upon the prices within Europe of industrial goods, and upon the unit values of exports. The fact that the deterioration in the competitive position of European exports during 1962 was only very moderate helps to explain the continuing payments surplus of these countries, taken as a group. Any advances in U.S. industrial costs and prices of manufactured goods growing out of domestic business expansion in this country would threaten the minor improvement in our international competitive position which has occurred recently.

For 1963, even with comparable advances in GNP, prices and costs in the Common Market countries (perhaps with the important exception of Italy) are expected to advance much more slowly than they did in 1962. In fact, the pace of wage and price advances has already slackened in Germany and the Netherlands and, to a much lesser extent, in France. Among this group of countries, Italy is experiencing the greatest continuing wage and price pressures, and its external payments position has already shifted from surplus to substantial deficit as a result of capital outflows and an enlarged trade deficit.

The slackening of the rate of price and cost rises in Europe over the past 12 months has, in part, reflected some shifts in governmental policies to contain further advances. However, much stronger restrictive measures have been advocated by some European observers critical of the deterioration in Europe's competitive position. In its recent report, for example, the Bank for International Settlements expressed the view that, because "a dangerous point has been reached"[1], "some dampening of inflationary attitudes by policy measures may become neccesary"[2] if monetary stability is not soon regained. Further price and wage advances in Europe in 1963 are likely, therefore, to produce further shifts in European policies in the direction of restraint.

In the United States, average prices and wage costs have changed little since 1959. The current degree of capacity use would seem to permit considerable further expansion in production without leading to widespread increases in prices and costs. In the past, such increases tended to develop whenever output of major materials reached 90 percent of capacity; in May 1963, when steel output reached a peak because of the possibility of a strike, capacity use was in the neighborhood of 85 percent.

Underlying supply and demand conditions in the six Common Market countries: Even though they are experiencing in 1963 the 6th year of virtually uninterrupted business expansion, the six Common Market countries expect to achieve this year about the same rate of growth that they attained in 1962. Official estimates of GNP for 1962 and official forecasts for 1963 for these coun-

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[1] Bank for International Settlements, 33d Annual Report, 1962–63, p. 10
[2] Ibid., p. 3.

tries, which are reproduced in table 1, show a larger advance in the Netherlands, little change in France and Italy, and minor reductions in the rate of growth in Belgium and West Germany. (See table 1.) All the components[3] of GNP shown in table 1 are contributing to the 1963 advances in output, but private and public consumption have perhaps been the mainstays of the expansion since mid-1961. Over the past few months, export demand has shown renewed vigor, especially in Germany and the Netherlands, and press reports suggest a tendency in these countries for the rate of growth in private investment, which has been diminishing, to stabilize.

But the continued business expansion in Europe in 1963 is not expected to be accompanied by price and cost advances on a scale comparable to the marked rises during 1962. Equally important, even the substantial price advances in 1962 had only moderate effects on Europe's competitive position because the prices of manufactured goods and the unit values of exports were affected only to a limited extent by the general rise in consumer and wholesale prices and wage costs.

TABLE 1.—*Common Market countries: Changes in supply and use of resources, 1962 and estimated 1963*

[Percent change in volume from previous year]

	Belgium		France [1]		West Germany		Italy		Netherlands	
	1962	1963	1962	1963	1962	1963	1962	1963	1962	1963
Private consumption	2.5	3.5	6.7	6.0	5.7	4–5	5.5	5	4.5	4
Public consumption	5.0	2.5	5.6	6.0	11.2	6	5.5	7–8	4	2
Gross fixed investment	4	3	7.5	6.2	4.5	4–5	7	8	5	2.5
Exports	7.5	4.5	1.3	6.3	4.9	2.5–3	13	7	5.5	7
Less imports	5.5	4.5	11.4	5.6	10.9	5	13	9.5	6	6
Total, GNP [2]	3.5	3	6.3	6.1	4.1	3.5	5.5–6	5.5	3	4.5

[1] Excludes civil servants, financial institutions and domestic servants. 1962 change amounts to 5.8 percent after inclusion of these categories.
[2] Includes inventory change not shown separately.

Source: United Nations, Economic Commission for Europe, mimeographed draft of "Economic Survey of Europe in 1962," Part I, Ch. 2.

European price developments during 1962: Last year, prices and costs rose much more rapidly in the Common Market countries than in the United States; at the consumer level by 2.7 to 7.8 percent (1.1 percent in the United States); at the wholesale level by 1.3 to 4.7 percent (—0.8 percent in the United States); and in terms of wage costs per unit of output 2.7 to 4.8 percent (—0.7 percent in the United States). (See table 2.) However, about half the rise in European consumer prices was due to higher food prices which rose in these countries by 3.2 to 9.5 percent between March 1962 and 1963.[4] At the same time, the average level of industrial wages on the Continent was generally "more than 8 percent higher over the past 12 months than a year earlier."[5] As a result, wage costs per unit of output advanced from 2.7 to 4.8 percent last year in the Common Market countries while they declined by 0.7 percent in the United States. (See table 2.)

[3] Separate estimates are not available on private investment (which has shown a slower rate of increase for most European countries) and for inventories. Private investment is combined with public investment in table 1.

[4] Bad spring weather in the early part of 1962 was followed by summer drought in parts of France and Italy and by the exceptionally severe winter of 1962–63. In addition, food prices were pushed up by Government measures to raise farm income. A rise of 6 to 7 percent in the food index "means by itself 1 of about 2½ percent in the index of consumer prices" (BIS, op. cit., p. 7.)

[5] Ibid., p. 9.

TABLE 2.—*Selected price and wage trends in the United States, United Kingdom, and the Common Market countries, annual changes, 1961–62 and 1962–63*

[In percent per annum]

Common Market countries	Consumer prices	Wholesale prices	Hourly earnings	Wage cost per unit of output	Export unit value [1]	Prices of manufactured goods [2]
Belgium:						
1961 or 1961–62	1.0	0.8	4.7	2.5	(3)	(3)
1962 or 1962–63	2.7	1.3	7.6	4.8	(3)	(3)
France:						
1961 or 1961–62	5.0	3.6	7.6	3.1	1.8	.8
1962 or 1962–63	5.1	2.2	8.6	4.1	1.0	3.1
Germany:						
1961 or 1961–62	3.8	[4] 1.0	10.3	5.0	[5] −1.0	1.0
1962 or 1962–63	4.4	[4] .9	11.5	4.0	0	.9
Italy:						
1961 or 1961–62	3.9	2.3	7.1	.5	−1.1	(3)
1962 or 1962–63	7.8	4.7	14.7	2.7	3.0	(3)
Netherlands:						
1961 or 1961–62	4.1	1.5	6.3	3.4	[5] −2.0	0
1962 or 1962–63	5.6	2.2	9.2	4.5	(3)	1.9
United Kingdom:						
1961 or 1961–62	4.8	[4] 2.6	5.9	5.0	1.0	2.6
1962 or 1962–63	3.2	[4] 1.7	3.5	2.5	1.9	1.7
United States:						
1961 or 1961–62	1.1	−.3	2.7	−1.1	2.9	0
1962 or 1962–63	1.1	−.8	3.0	−.7	−1.0	0

[1] Derived from indexes of total export value and volume.
[2] Wholesale or producers' prices for manufactured goods where available; for France, an index of semimanufactured products is used and for the United States the index excludes food and farm products.
[3] Not available.
[4] The wholesale price index is the same as the index prices for manufactured goods for Germany and the United Kingdom.
[5] The revaluation of these currencies by 5 percent in March 1961 raised the foreign-currency costs of exports by 5 percent relative to domestic-currency values.

Sources: "Thirty-Third Annual Report, 1962–63," Bank for International Settlements, for columns (1) to (4); "International Financial Statistics," International Monetary Fund for column (5); and national statistics for (6).
Time periods covered are as follows: Consumer and wholesale prices, changes from March to March; hourly earnings and wage costs, changes in average for the year from preceding calendar year; export unit value and prices of manufactured goods, change first quarter to first quarter.
All data in table are in terms of domestic currencies.

But the European experience reveals a remarkable degree of slippage between advances in consumer prices and wage rates, on the one hand, and the prices of the manufactured goods (which largely determine the relative competitive position in world exports for industrial countries such as the Common Market Six and the United States), on the other. Wholesale prices generally rose only "about half as fast as retail prices" or about 2½ percent in Europe last year. Even within the consumer price indexes, prices of goods in Europe went up only about 2 to 3 percent compared with a 4 to 5 percent rise in services.[6]

But this slippage becomes even more marked when the recent behavior of price indexes of manufactured goods and export unit values is considered: these indexes show only limited rises when compared with trends in consumer prices, hourly earnings or estimated wage costs per unit of output. (See table 2.) Over the past 12 months, France had a 4.1 percent rise in wage costs, a 1 percent rise in export unit value and a 3.1 percent rise in an index of semimanufactured goods; Germany reported a comparable rise in wage costs but no rise in average export unit value and a less than 1 percent rise in the price of manufactured goods.

Why have industrial price rises been limited? Four special factors help to explain why Europe's competitive position—measured by trends in manufactured goods prices and export unit values—has been affected only to a limited extent by increases in general retail prices and in wage costs.

(*a*) International competition has helped to keep down price rises of manufactured goods. The larger portion of the price and wage rises reported in

[6] BIS, op. cit., pp. 74 and 77. For the United States, prices of goods rose not more than 1 percent and costs of services by 1½ to 2 percent.

Europe have been in sectors where international competition is limited (services and construction) or is restrained by governmental policies (food stuffs). In this connection, the reduction of intra-Common Market tariffs and elimination of quantitative restrictions have provided an ideal set of incentives for European manufacturers: the more efficient firm has the carrot of a broadening market and the less efficient firm the stick of gradually reduced protection from other member countries.

(*b*) European firms may have geared their pricing policies more directly to maintaining exports than have U.S. firms. Thus, the Netherlands central bank reported that, although wage costs rose considerably, export prices of manufactures declined by 2 percent in 1962.[7] In addition, the BIS has estimated that "export quotations for key steel products" from the European Coal and Steel community "have fallen by 30 percent or more from their 1960 peaks."[8] Steel prices are of course a key item influencing the cost of finished manufactured goods over a wide range of final products.

(*c*) European producers, perhaps because of the international competitive position, have been willing to accept reduced profit margins in the face of rising wage costs so as to maintain output and sales.

(*d*) Finally, wage and productivity increases quoted are generally national averages; in many cases, the export industries may achieve above-average productivity increases and, thereby, be able to absorb higher wage rates more easily than can firms which are less favorably placed in this respect.

Effects of economic expansion on U.S. competitive position: Whether a movement toward full employment now would generate inflationary pressures in the United States would depend primarily on the speed of the movement. Other major considerations would be how such a movement is generated, how well balanced demands are in relation to available resources, and what expectations are created by such developments. Whether a general advance in prices would place this country at a competitive disadvantage would, needless to say, also depend on price trends abroad.

In the United States, average prices of industrial commodities—finished products as well as materials—have changed little since early 1959. Labor costs (including fringe benefits) per unit of output in manufacturing similarly have changed little, apart from moderate fluctuations associated with the impact of recessions on productivity. Output per man-hour in manufacturing has advanced at, or above, the postwar rate of 3¼ percent per year while wage rates have increased less rapidly than earlier in the postwar period. Hourly earnings in manufacturing rose at an annual rate of nearly 10 percent in 1947–48, a rate of about 5 percent in 1955–57, and a rate of less than 3 percent in 1959–62. The hourly costs of the latest labor contract in the steel industry has been estimated at an annual rate of about 2 percent, and the contract runs until at least May 1, 1965.

The current degree of capacity use apparently would permit a considerable further expansion in production. For major materials, capacity use rose from about 80 percent in the first quarter of this year to slightly more than 85 percent in May when steel output reached a peak because of the possibility of a strike. Now that a new labor contract has been negotiated inventories of steel are larger than desired and steel production is declining. Of all the industrial materials, production of steel shows the widest swings in response to fluctuations in overall demands. Production of some other materials is higher in relation to capacity than is output of steel or major materials as a group. Previously in the postwar period widespread increases in prices and costs developed when overall output of major materials reached about 90 percent of capacity. But current conditions are in some respects different from those in earlier postwar periods of expanding activity and previous experience is no infallible guide for the future.

Government measures to restrain wage and cost advances: European governments took steps during late 1962 and early 1963 to check the continuing advances

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[7] See Annual Report, 1962, National Bank of the Netherlands, p. 55. "As a consequence of the sharp foreign competition, average export prices of manufactures did not rise in 1962 although wage costs rose considerably. Each of the categories of exports of manufactures showed some price reductions. On the average, this price reduction in 1962 amounted to 2 percent (preliminary data)."

[8] BIS, op. cit., p. 78. Thus, the price for steel bars is reported to have declined from a high of $100 per metric ton in the first half of 1960 to approximately $71 per metric ton during the first quarter of 1963 and the price for cold-rolled sheet from a 1960 high of $185 per metric ton to $112 in 1963.

in wages and costs. It is clear that European officials are determined to bring under control what they regard as excessive wage and cost advances in 1962 and will take whatever further steps seem to be required over the course of 1963.

Within the Common Market group, Italy has perhaps done least thus far on this front. In August and October 1962, and again in early 1963, Italy reduced tariffs or liberalized import restrictions to help stabilize domestic prices. At the moment, the financial press is speculating about a shift to a restrictive credit policy but no steps have yet been announced by the Italian authorities.

In Germany, the authorities have taken active steps to bring inflationary trends under control. Major speeches by top government officials have repeatedly warned of these dangers. In April 1962, several measures were announced by Chancellor Adenauer to slow down the building boom. During the course of 1962, the rapid pace of wage increases moderated. In April 1963, a major strike in the metal-using industry was settled only after Economics Minister Erhard personally intervened to work out a compromise on the wage question which represents a much-reduced rate of increase this year: the flat 5-percent increase granted may be compared with the 8.5-percent rise in wages in 1962.

In France, wage trends, especially in the private sector, were sharply upward in 1962. Partly because more urgent questions had to be met, the French authorities allowed a wide gap to appear between wage rises in the public and private sectors. This gap largely explains the labor difficulties in several public sector industries, including the widely reported coal miners strike, earlier this year. It is clear that the inflation problem is now a major concern of the De Gaulle government. The authorities have already taken steps in the field of credit control and are likely to take whatever further steps are required to bring French cost and price trends more in line with those in Germany and in major industrial countries outside Europe.

In the Netherlands, wage advances have moderated in recent months. Wage settlements reached so far in 1963 have all remained within the recommended 2.7 percent estimated growth this year under the economic plan.

SHORT-TERM CAPITAL MOVEMENTS AND THE U.S. BALANCE OF PAYMENTS

INTRODUCTION

This study of short-term capital movements and the U.S. balance of payments was undertaken as an exploratory analysis of the determinants of short-term capital movements and of the relationships between movements of various types of short-term capital. The study was carried out during the summer of 1962, and was based on data for 1958–61.

The Treasury Department obtained the services of Prof. Peter B. Kenen, associate professor of economics at Columbia University, as a consultant in the preparation of this study.

I. RECENT SHORT-TERM CAPITAL FLOWS

An overall view

Private short-term capital has played an active part in recent American payments experience. In 1960, the overall U.S. deficit totaled $3,925 million; the recorded outflow of private U.S. funds accounted for $1,338 million. In 1961, the deficit was $2,461 million; private short-term funds accounted for $1,472 million. In the fourth quarter of 1960 and fourth quarter of 1961, the recorded short-term capital flow and the unusual negative net error accounted for most of the deficit; and in the first quarter of 1961, the recorded outflow, taken by itself, was larger than the deficit (see table 1).

TABLE 1.—*Short-term capital movements and the U.S. payments deficit, 1959–61*

[Millions of dollars]

Period	Overall deficit	U.S. private short-term capital	Errors and omissions	Deficit less short-term capital and net errors [1]
1959:				
1st quarter	−880	157	100	−1,137
2d quarter	−1,244	−62	290	−1,472
3d quarter	−1,276	59	−8	−1,327
4th quarter	−497	−231	146	−412
1960:				
1st quarter	−641	−92	74	−623
2d quarter	−891	−181	−100	−610
3d quarter	−1,191	−467	−90	−634
4th quarter	−1,202	−598	−476	−128
1961:				
1st quarter	−308	−461	16	137
2d quarter	89	−355	−296	740
3d quarter	−909	−117	243	−1,035
4th quarter	−1,333	−539	−565	−229

[1] Approximately equal to the "basic balance."

Source: Survey of Current Business, various issues.

Clearly, U.S. short-term capital is not to blame for as much of the deficit as these figures indicate. Part of the short-term capital outflow was export financing, and U.S. exports might have been smaller if net lending had been smaller. But most of the flow was probably autonomous—the consequence of international interest-rate differences, disparities in the availability of credit, and outright speculation.

The details, 1960–61

The large short-term capital flows of 1960 and 1961 had had certain things in common. In both years, bank lending (acceptance credits and short-term loans)

were prominent. In both cases, Americans acquired large amounts of foreign currency and made other cash placements abroad. But a breakdown of the recorded flows (table 2a) shows a major difference between the 2 years.[1] The increase in foreign currency claims was much larger in 1960; the increase in bank loans was much larger in 1961. A close look at the fourth quarter flows broken down by region (table 2b) reveals a further difference. In both quarters, the increase in foreign currency claims was near $100 million. But claims on the United Kingdom and Canada accounted for most of the 1960 increase, while much of the 1961 flow went to continental Europe. There was also a difference in the destination of dollar credits, with Japan receiving fully half of 1961 lending but a very little of 1960 lending.

TABLE 2a.—*U.S. private short-term capital, 1960 and 1961*

[Millions of dollars]

Item	1960	1961
Increase (+) in all U.S. claims (balance-of-payments basis)	1,338	1,472
Increase (+) in all U.S. claims (Treasury foreign exchange forms)	1,341	1,455
Bank loans to foreigners [1]	−12	335
Acceptance credits and miscellaneous dollar claims reported by U.S. banks	651	556
Dollar items in collection and dollar claims of U.S. nonfinancial concerns	301	454
All foreign currency claims	401	110

[1] Includes loans to foreign official institutions, not studied separately in this report.

Sources: Survey of Current Business, June 1962, and Treasury foreign exchange forms.

TABLE 2b.—*U.S. private short-term capital, 4th quarter 1960 and 4th quarter 1961*

[Millions of dollars]

Item	All countries	United Kingdom	Canada	Europe	Latin America	Japan
1960						
Increase in all U.S. claims (balance-of-payments basis)	598					
Increase in all U.S. claims (Treasury foreign exchange forms)	595	96	46	85	215	155
Bank loans to foreigners (net) [1]	190	1	15	31	158	9
Acceptance credits and miscellaneous dollar claims reported by U.S. banks	175	−27	5	12	31	140
Dollar items in collection and dollar claims of U.S. nonfinancial concerns	129	76	−15	27	28	10
All foreign currency claims	101	47	41	14	−2	−4
1961						
Increase in all U.S. claims (balance-of-payments basis)	539					
Increase in all U.S. claims (Treasury foreign exchange forms)	522	6	3	167	96	173
Bank loans to foreigners (net) [1]	290		3	13	78	131
Acceptance credits and miscellaneous dollar claims reported by U.S. banks	118	−13	−13	31	74	37
Dollar items in collection and dollar claims of U.S. nonfinancial concerns	5	1	11	46	−52	−12
All foreign currency claims	109	18	1	76	−5	17

[1] Includes bank loans to foreign official institutions, not studied separately in this report.

The heterogeneity of short-term flows was confirmed in our first attempt at formal statistical analysis. Working with the net flows in the second half of 1960 and second half of 1961, we ran rank correlations on the data for 18 major countries.[2] First, we ranked the countries by the (algebraic) size of the half-year change in each type of claim and liability reported on Treasury Foreign Exchange Forms B–2 and C–1/2. Then we ran rank correlations between the

[1] There are small discrepancies between the increase in U.S. claims as recorded in the balance-of-payments statistics and the increase as recorded in the Treasury foreign exchange forms. These differences are chiefly due to statistical adjustments made by the Commerce Department.

[2] Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland, United Kingdom, Argentina, Brazil, Chile, Mexico, Venezuela, India, Japan, Austria, South Africa, and Canada.

1960 and 1961 lists, taking each class of claim and liability separately. Our results (table 3) show very little uniformity in the direction of capital flows. Next, we ran rank correlations between all the pairs of B-form and C-form categories taking 1960 and 1961 separately so as to look for uniformities within each half year. We found some significant pairwise correlations, but far fewer than we had expected, and these were mainly links between claims and liabilities, not between pairs of claims or pairs of liabilities (see app. II).

TABLE 3.—*Rank correlations, changes in U.S. claims on 18 countries, second half 1960 and second half 1961*

Item	Dollar change	Percentage change
Bank loans to foreign banks	−0.106	0.065
Bank loans to other foreigners	.337	.077
Dollar items in collection	.221	.088
Other dollar claims reported by banks	.228	.251
Dollar claims of U.S. nonfinancial concerns	.317	.348
Foreign currency deposits, banks	−.158	−.012
Same, nonfinancial concerns	[1] .470	.496
Other foreign currency claims, banks	−.174	.221
Same, nonfinancial concerns	[1] −.397	−.302

[1] Significantly different from zero at the 0.05 level.

But these differences in the destination and composition of the short-term flow may merely testify to systematic differences in regional conditions, credit ratings, and trade flows. They do not say that capital movements defy economic explanation.

II. THE CHIEF DETERMINANTS OF CAPITAL MOVEMENTS

The imperfections in the data make it very difficult to trace major developments and may obscure important relationships. Large cash flows may lurk within the figures for nonfinancial concerns and be mistaken for commercial credit. Interest rates might prove to be an important cause of changes in deposit liabilities, but this relationship might only emerge clearly if there were separate time-deposit data. Finally, we need separate figures on bank liabilities to branches and home offices abroad, because the consolidated figures obscure deposit flows; at present, one cannot determine how much foreign money is moving in and out of the Eurodollar market, save by tracing changes in ownership (fluctuation in U.S. liabilities to London and other Eurodollar centers). But the existing data, for all the imperfections, show important patterns and interrelationships.[3]

The influence of trade

Many observers have argued that the bulk of U.S. short-term lending is connected to merchandise trade. A recent paper published by the Federal Reserve Bank of New York says that "Certain types of capital movements are linked directly to international trade which, like domestic trade, depends heavily on credit. In fact, U.S. banks devote a significant proportion of their available funds to financing not only this country's foreign sales but also trade between other countries."

Prof. Philip W. Bell has also stressed the role of foreign trade in testimony before the Joint Economic Committee. He finds a close correlation between U.S. exports and U.S. lending to foreigners; the dollar claims of U.S. nonfinancial corporation correlate with U.S. exports to Europe and to other countries except Canada; so do U.S. bank loans (but not bank acceptances).

[3] The analysis summarized below is described in detail in app. I.

But we could not find these relationships with trade. None of the short-term capital series with which we worked gave a significant partial correlation with U.S. exports.[4]

It may be that the trade-and-credit nexus is nonlinear; Bell used logarithmic relationships, whereas we used linear relationships. Then, too, we might have found connections with trade had we worked with the (global) imports of other countries rather than U.S. exports; U.S. acceptance credits to finance third-country trade are more volatile than acceptance credits to finance U.S. exports. But our negative findings may be valid. They may indicate that short-term credit does not respond passively to trade, even though most of it is finance for trade. Changes in U.S. exports need not lead to changes in U.S. lending if foreigners can borrow abroad. Differences in the availability of credit and in interest rates may be the more important determinants of U.S. lending to foreigners.

The influence of interest rates

Our other findings are consistent with this last interpretation. We found many close relationships between interest rates and U.S. short-term capital. U.S. liabilities (foreign holdings of Treasury securities and other money-market assets) showed high interest sensitivity (see table 4), and might have shown even more had we tried additional interest rate differentials.[5] This result is consistent with the findings of other investigators, and, by itself, would justify close attention to U.S. interest rates as instruments of balance-of-payments policy.

TABLE 4.—*Significant partial correlations: Capital movements and interest rates*

Capital flow and country	Bill-rate difference	Eurodollar-U.S. bill rate difference
Money-market assets of foreign banks:		
United Kingdom (United Kingdom-United States, uncovered)	[1]−0.581	
Canada (United Kingdom-United States, covered)	[1]−.646	
Europe (United Kingdom-United States, covered	[1]−.531	−0.497
Latin America (United Kingdom, uncovered)	−.533	
Japan (United Kingdom-United States, covered)	[1]−.547	
Money-market assets of other foreigners:		
Canada (Canada-United States, covered)	−.520	
Europe (United Kingdom-United States, covered)	[1]−.614	[1]−.552
Latin America		[1]−.602
Liabilities of U.S. nonfinancial concerns: Canada (Canada-United States, covered)	[1]−.801	
U.S. Bank loans to other foreigners:		
Europe (United Kingdom-United States, covered)	[1].607	
Latin America		.503
Dollar items in collection: United Kingdom (United Kingdom-United States, covered)	.860	
Other dollar claims reported by U.S. banks:		
Europe (United Kingdom-United States, covered)	[1].612	
Japan (United Kingdom-United States, covered)	.499	[1]−.522
Dollar claims of U.S. nonfinancial concerns:		
United Kingdom (United Kingdom-United States, covered)	[1].709	
Canada (United Kingdom-United States- covered)	[1].636	
Europe		.519
Foreign currency deposits of U.S. nonfinancial concerns:		
Canada (United Kingdom-United States, covered)	[1]−.690	
Japan (United Kingdom-United States, uncovered)	.497	
Other foreign currency claims of U.S. banks: Europe (United Kingdom-United States, covered)	[1].689	
Other foreign currency claims of U.S. nonfinancial concerns:		
United Kingdom (United Kingdom-United States, covered)	[1].599	
Japan (United Kingdom-United States, covered)	−.455	

[1] Significant at the 0.05 level; all others are significant at the 0.10 level; for details, see app. I.

[4] Collections, however, showed a consistent relationship to the trade statistics; the separate correlation coefficients were not significant, but all of them were positive.

[5] The relationship between United Kingdom bill rates and United States bill rates (the differential used in most of this analysis) may be less relevant than the differential between United Kingdom bill rates and United States acceptance rates or United States time-deposit rates.

But we also found that U.S. short-term capital is sensitive to interest rates, a conclusion that has not received much attention in the past. It is widely thought that foreign borrowers cannot arbitrage between New York and London because they cannot borrow sterling to finance their imports from the United States or continental Europe. But they can switch between New York and London on that substantial part of their total credit needs which arises from their purchases in the sterling area, and our partial correlations argue that they do so. There is a significant relationship between the United Kingdom-United States differential and U.S. lending to continental Europe; also between the Eurodollar-United States bill rate differential and U.S. lending to Latin America.

Some of the partial correlations in table 4 deserve special note. U.S. "commercial" liabilities to Canada show high interest sensitivity. Hence, some of these may be borrowing rather than progress payments on U.S. exports. Collections also show a surprising sensitivity to interest rates; British firms may defer payments to this country when money is especially tight in Britain. Surprisingly, collections did not show any close relationship to the premium on spot sterling, used as a proxy for the speculative mood. This may say that these collections do not show large leads and lags. It may also say that the premium on spot sterling is not a good proxy for the speculators' outlook.

The dollar claims of U.S. nonfinancial concerns also show high interest sensitivity in respect of the United Kingdom-United States covered differential. This relationship may represent variations in commercial credit as credit conditions change. It may also testify to large Eurodollar flows; the Eurodollar-United States bill rate differential correlates with the United Kingdom-United States bill rate differential. But several other series respond to the Eurodollar rate without also answering the United Kingdom-United States differential: U.S. bank loans to Latin America, U.S. corporate dollar claims on Europe, and the money-market assets of "other" Europeans and Latin Americans. These relationships suggest that Eurodollar cash placements are a significant alternative to investments in New York, and what is more novel, that Eurodollar borrowing is a significant alternative to borrowing in New York.

One might argue that the correlation between U.S. lending (or cash placements) and the covered United Kingdom-United States differential really testifies to speculation, not interest arbitrage. The largest covered differential appeared late in 1960 and lasted into early 1961. It was not due to changes in interest rates but, rather to a decline in the discount on forward sterling (the premium on the forward dollar). This decline, in turn, reflected speculation. But this interpretation is open to question. Much of the short-term flow into foreign currencies was to Canada and Britain (as contrasted with the 1961 experience, when most of the flow went to continental Europe). The pound and Canadian dollar, however, were not good speculative havens, even in 1960. Furthermore, the correlation between capital movements and the forward discount on sterling (taken by itself) was never as strong as the correlation between capital movements and the covered differential.

The partial correlations in table 4 (and others in app. I) show an interesting geographic difference in investment patterns. The money-market assets of all foreign banks correlate with the United Kingdom-United States bill rate difference, but the figures for Britain move with the uncovered differential, while those of Canada, Europe, and Japan move with the covered differential. When British banks move in and out of U.S. money-market assets they tend to switch back and forth from dollar deposits. European banks, by contrast, move funds into New York when the rate differential is favorable.[6] The Latin American banks also respond to uncovered differentials, but for different reasons than the British. For them, as for the Europeans, the dollar-sterling forward rate represents a difference in cost as between swapping sterling for third currencies and

[6] This difference in pattern also shows up as a significant simple correlation between the total dollar claims of European banks and the covered United Kingdom-United States differential; there is no such correlation for the United Kingdom series.

swapping dollars for third currencies. At Latin American banks cannot and would not hedge their dollar claims by swaps into local currencies, they may be insensitive to the additional cost of covering their sterling claims.

This difference in investment patterns may have implications for monetary policy. The balance-of-payments effects of covered and uncovered arbitrage are very similar. In either case, there is an immediate capital outflow and a later inflow. This is obvious with uncovered arbitrage, but no less certain with covered arbitrage. An American who buys sterling bills and sell sterling forward generates a future cash flow back to the United States or reduces the prospective cash flow from the United States. The other party to the forward swap must buy spot dollars when the forward swap matures or hand over dollars he already holds (and would otherwise have sold for sterling). In the first case, there is an additional exchange-market demand for dollars at the close of the forward contract; in the second, there is a smaller exchange-market demand for sterling. But there is an important difference between uncovered and covered arbitrage. If investors are not sensitive to the cost of forward cover, the monetary authorities must alter interest rates to halt or reverse a flow of short-term capital. If investors do respond to the covered margin, the monetary authorities may have an extra degree of freedom, provided they can alter the cost of forward cover rather than the interest rate.

Interrelationships among capital flows

We have found several interesting connections between the short-term capital flows:

(*a*) As one would expect, U.S. dollar deposit liabilities to Canada correlate with the foreign currency liabilities of Canadian banks; Canadian banks cover part of their foreign currency liabilities by holding dollar assets. But this connection is far from perfect; the regression relationship (app. I), argues that the Canadian banks cover less than half the typical increase in their liabilities with extra dollar claims on New York.

(*b*) From what one knows about the structure of the Eurodollar market, one would expect changes in the dollar deposit liabilities of U.S. banks abroad to correlate with the dollar deposits of foreign banks here. We found a positive relationshhip. But it is not statistically significant; the weakness of the link is perhaps due to the fact that we had to use a very poor approximation to the change in branch bank dollar liabilities (the semiannual change in U.S. branch banks' liabilities including sterling liabilities, to all foreigners).

(*c*) One would expect to find a regular relationship between U.S. loans to foreigners and foreign deposits at American banks—a reflection of compensating balance requirements. There was no such relationship for foreign banks, but there was a strong correlation for other foreigners (especially for Europeans and Canadians). We also found an unexpected indirect relationship; the money-market assets of British and Latin American banks vary with their borrowing, suggesting that they may post their short-term dollar assets as collateral for short-term dollar debts.[7]

(*d*) We found a strong relationship between the foreign currency claims of Americans and their foreign currency liabilities. This link was especially strong for banks and probably reflects a new development in New York. Some New York banks have been accepting foreign currency deposits from foreigners and Americans, then lending the foreign currencies at short term to cover their positions. The foreign currencies are marks and Swiss francs, which come to New York because Germany and Switzerland limit interest payments to foreigners. The New York banks are performing the same functions as the Euro-

[7] There is also an inverse relationship between the dollar deposits of "other" foreigners and their holdings of money-market assets. This relationship is especially pronounced for the United Kingdom and Latin American data (which, remember, showed strong correlations between money-market assets and uncovered interest rate differences). There is a similar inverse relationship, but much stronger, between the European deposits of U.S. banks and the banks' other claims in European currencies.

dollar brokers. Just as dollar flow to London to earn higher rates of interest than regulation Q allows, so foreign currencies come to New York to earn higher interest rates than foreign governments allow.

Long-term capital

We made a cursory attempt to explain long-term capital movements and to analyze errors and omissions. We found that the volume of Canadian securities issued in the U.S. market responds to the difference in long-term interest rate between New York and Canada, but could not find a similar relationship for other regions. We found several simple correlations between errors and omissions and short-term capital flows (also between errors and omissions and several interest rates, especially the Eurodollar rate). But we could not devise a multiple regression relationship that would explain much of the change in errors and omissions.

Appendix I

Correlation and Regression Analysis of Short-Term Capital Movements

This memorandum outlines the largest single part of our investigation. It has three separate sections:

1. Simple correlations.
2. Multiple correlations and regressions.
3. Miscellaneous relationships.

The tables discussed in section 1 are found in annex 1; those for section 2 are found in annex 2.

1. *Simple correlations*

Seeking to isolate interrelátionships among the major short-term capital flows, we ran several sets of simple correlations.

First, we took quarterly changes in each item listed on forms B–1, B–2, and C–½ (except those that relate to official flows), and ran the intercorrelations between each pair of series. The results of this computation are summarized in tables A–1 through A–6. The numbers in those tables are the correlation coefficients that were statistically significant at the 0.10 level; the signs pertain to those coefficients that were not significant.

Several regularities appear in these tables. Some are those that one would forecast from acquaintances with monetary institutions and arrangements; other regularities defy simple explanation. But some connections one would forecast with assurance show up very weakly, if at all.

First, take three relationships that show up very weakly:

(*a*) During the last year or so, American corporations have placed large U.S. dollar deposits with Canadian banks. The Canadian banks, in turn, have apparently invested most of their U.S. dollar receipts as money-market claims on New York. These investments should appear in U.S. statistics as the deposit liabilities of the Canadian agencies to their parents in Canada. This relationship between the dollar claims of U.S. nonfinancial concerns and the dollar liabilities of the Canadian agencies shows up clearly in the Canadian data and is discussed further in section 3, below. But it does not show up in the matrix of simple correlations for Canada (table A–2). The dollar claims of U.S. nonfinancial concerns (variable 215) correlate directly with U.S. deposit liabilities to Canadian banks (variable 201), but the relationship is not statistically significant at the 0.10 level.

(*b*) If compensating balance requirement are applied to foreign loans, one would expect a direct correlation between U.S. bank loans to foreigners and foreigners' dollar deposits at U.S. banks (variables 11 and 01 in each of the six matrices). There are strong direct correlations for Japan and Canada and a weak relationship for Latin America. But the United Kingdom and continental Europe yield weak inverse relationships, as do all countries taken together. There should also be positive correlations between bank loans to other foreign-

ers and their dollar deposits (variables 12 and 05). These turn up for the United Kingdom, Canada, Europe, and Latin America, and for all countries taken together, but none of the correlations are significant; and there is a weak negative relationship for Japan. Finally, one would expect the dollar deposits of other foreigners to fluctuate along with long-term bank loans (variables 05 and 27). In fact, there are significant direct correlations for Europe, Japan and all countries and weak positive correlations for the United Kingdom and Canada, but there is a negative relationship for Latin America.

(*c*) Save where strict exchange controls apply, foreigners can pay sums due to Americans by drawing down their own dollar balances or by buying dollars from the commercial banks. Similarly, they can deposit dollars earned from the United States in their own names or sell them to their banks. One would, therefore, forecast a positive correlation between the dollar deposits of foreign banks and those of other foreigners (variables 01 and 05). There are such correlations in the United Kingdom and European data and a weak positive correlation for Latin America, but the data for Canada and Japan show weak negative relationships.

Next, consider the several relationships that show up strongly. Our simple correlations indicate that speculative movements (leads and lags) operate quite strongly on United Kingdom claims and debts. The dollar liabilities of U.S. nonfinancial concerns (109) correlate negatively with their dollar claims on Britain (115). This is what one would expect if United Kingdom residents feared a devaluation of the pound; they would pay off their dollar obligations and build up their dollar claims. The dollar liabilities of U.S. nonfinancial concerns (109) also correlate inversely with foreign currency claims of Americans (117, 118, 120, and 121). This is what one would expect with strong leads and lags; United Kingdom residents would build up their dollar claims just when Americans were running down their sterling claims. Note, too, that United States loans to United Kingdom resident (111 and 112) and the dollar claims of U.S. nonfinancial concerns (115) move in the same direction as U.S. sterling claims (117, 118, 120, and 121); United Kingdom residents apparently pay off their dollar debts just when Americans are running down their sterling claims. Finally, most of the U.S. dollar claims on Britain (111–115, totaled as 116) move counter to U.S. sterling liabilities (124–125, totaled as 126); Americans apparently pay off their sterling debts when United Kingdom residents are building up their dollar debts, then incur sterling debts when United Kingdom residents pay off their dollar debts.

The United Kingdom data also show certain other regularities. Items in process of collection (113) correlate strongly with the dollar claims of U.S. nonfinancial concerns (115); loans to banks (111) correlate strongly with loans to other United Kingdom residents (112); and British purchases of U.S. securities (129) correlate with British purchases of foreign securities traded in New York (130). There is an odd inverse correlation between the long-term claims of U.S. banks (127) and the long-term claims of U.S. nonfinancial concerns (128), a relationship that reappears with Canada and Europe and, weakly, in all other data. This particular correlation may represent a systematic substitution of long-term loans from U.S. banks for long-term open-account debt to U.S. exporters (and vice versa).

One would expect short-term flows with Canada to show the influence of leads and lags, and there is some evidence to this effect in table A–2. The liquid dollar assets of Canadians (205–207) are positively and powerfully correlated with U.S. liabilities to Canada in Canadian dollars (224 and 225); Canadians build up U.S. dollar assets at the same time that Americans build up their debts to Canada. But dollar collections (213) correlate inversely with the foreign currency claims of U.S. nonfinancial concerns (218 and 221, totaled as 223), which is the opposite of what one would forecast if leads and lags were strong. Note, too, that most U.S. dollar claims on Canada (213, 214, and 215) move together with the foreign currency liabilities of U.S. nonfinancial concerns (225).

The Canadian data reproduce some of the other regularities found in the United Kingdom statistics: Collections (213) correlate with the dollar claims of U.S. nonfinancial concerns (215). Most other U.S. dollar claims (213, 214, and 215) correlate strongly with long-term bank loans (227). And short-term

bank loans to Canadian banks (211) correlate inversely with short-term bank loans to other Canadians (212).

The European matrix resembles the United Kingdom matrix in several respects. The dollar deposits of foreign banks (301) correlate with those of other foreigners (305), and the other claims of European banks (303), chiefly acceptances, correlate with the other claims of other Europeans (307). Then, too, all U.S. dollar claims on Europe (311, 312, 313, 314, and 315) are intercorrelated, save that bank loans to foreign banks show a weak inverse relationship with bank loans to others and with collections. There is, again, some evidence of speculative movements. The dollar claims of other foreigners (305–307, totaled as 308) move counter to the foreign currency claims of Americans (317, 318, 320, and 321). But dollar collections (313) move inversely to the foreign currency claims of U.S. nonfinancial concerns (321), and all dollar claims (311–315) correlate directly with U.S. foreign currency liabilities (324 and 325). The European data also show one new phenomenon—a consistent positive relationship between foreign currency claims and liabilities; the relationship between the banks' foreign currency deposits and their foreign currency liabilities is especially strong. This relationship suggests that U.S. banks cover their positions in European currencies.

The Latin American matrix shows less uniformity than any other. There is no clear-cut relationship among U.S. dollar claims and no clear-cut lead-lag pattern. In fact, some of the correlation coefficients have signs opposite to those one would expect if leads and lags were large (409 with 417, 418, 420, and 421). The positive correlation between foreign currency claims and liabilities (421 and 425) suggests a consistent covered position rather than a lead-lag pattern.

The Japanese matrix is also peculiar, though there are some major regularities. There is, in particular, a series of powerful correlations between Japanese dollar deposits (501) and U.S. dollar claims (511–515): Japanses banks would seem to have garnished the proceeds of recent Japanses borrowing. There is also an interesting correlation between the dollar deposits of Japanese banks (501) and yen deposits by U.S. nonfinancial concerns (518) reflecting recent "swap" transactions.

The data for all countries are, of course, subject to the vagaries of each regional component, but the process of aggregation seems to average out extreme deviations in the national data and also to sharpen key regularities. Thus, there is a very strong correlation between the "other" dollar assets of foreign banks and of other foreigners (603 and 607) reflecting the marked interest sensitivity of these series.

Next, we ran correlations between each of the capital flows and a set of money-market indices (interest rate differentials and measures of liquidity). Two points should be made about these experiments:

(1) The interest rate data, described in annex 1, are far from perfect because they are averages or end of quarter figures that smooth out interest rate variations and obscure the possibilities for arbitrage. They may, therefore, understate the interest sensitivity of short-term capital flows. The forward foreign exchange rates used to build the covered differentials are also imperfect; they do not always refer to the same dates as the interest rates and may not give an accurate measurement of the covered differentials.

(2) The short-term capital statistics are the net flows in each quarter. The interest rate differences are average levels in each period. By correlating these two types of data, we implicitly assert that a given interest rate difference will cause a given inflow or outflow of cash. One can conceive of an alternative hypothesis, linking the interest rates to total claims and liabilities, and changes in the one to changes in the other. But this alternative would make sense only if we worked with absolute interest rates rather than the interest rate differentials.

Most of the interest rate statistics we have used need no explanation; they are sufficiently described in annex 1. But some of them may warrant a few words:

(033) The United Kingdom Treasury bill rate less the United States Treasury bill rate, covered and deflated by the United States bill rate. This differential is constructed to test the hypothesis that American investors are more sensitive

to a given covered differential when American interest rates are low; that an extra half percent obtainable in London is more attractive when U.S. rates are low than when they are high.

(035) and (036) The United Kingdom acceptance rate less the United States short-term bank loan rate, uncovered and covered. These differentials seek to compare credit costs in London with credit costs in the United States. But there is not much variation in the uncovered differential (035), and the correlations with the covered differential (036) consequently look much like the correlations with the discount on 3-month forward sterling, taken by itself (099 in table B–1).

(040) The net free reserves of U.S. banks. This series seeks to describe the availabiilty of bank credit in the United States. When free reserves are high, credit should be easy; when they are low, credit should be tight. Variables (041) and (042), U.S. interest rates are also used to measure credit conditions; they will be low when credit is easy and high when credit is tight.

(043) The liquid assets ratio of United Kingdom banks. This series is used as the British counterpart of (040). When it is high, bank credit should be plentiful in London; when it is low, credit should be tight.

These interest rates and money-market indices are highly intercorrelated (see table C), so that it is difficult to learn which interest rate differential is really responsible for a given capital flow. Yet there are consistent response patterns, especially a systematic geographic difference in the responsiveness of foreign short-term capital to the covered and uncovered rate differentials. Note, in this connection, that a high response to a covered differential is susceptible of several interpretations:

(*a*) If a United Kingdom-United States capital movement responds best to a covered United Kingdom-United States differential, one may infer that investors sell sterling (dollars) forward when they make short-term investments in Britain (the United States) or that they buy forward sterling (dollars) when they incur sterling (dollar) obligations.

(*b*) If European capital responds to a covered United Kingdom-United States differential, one may infer that Europeans cover their dollars and their sterling claims, or that they cover one and not the other. A premium or forward sterling may be viewed as the cost of moving from dollars into sterling or as the extra cost of swapping francs for pounds compared to the cost of swapping francs for dollars.

The "other" claims (money-market assets) of foreign banks and other foreigners (variables 03 and 07) show the highest interest sensitivity. In the United Kingdom case, bank claims show the highest correlation with two covered differentials (032 and 038). The sterling assets of U.S. nonfinancial corporations (121) also correlate with the covered differentials, while United Kingdom purchases of long-term foreign securities (130) correlate with the uncovered differentials (especially 037 and 039).

There are several other indications of interest sensitivity in the United Kingdom data. Three U.S. dollar claims (111, 112, and 115) show weak correlations with every interest-rate differential (except 036), suggesting that United Kingdom borrowing in New York is sensitive to interest rates. Note, too, that the sterling claims of U.S. banks (120) show a weak positive correlation with each covered differential, but a weak negative correlation with each uncovered differential. The money-market indexes (040–043) do not give us much extra insight.

Pass over the Canadian data for the time being and look at table B–3. These European correlations show much more interest sensitivity than the United Kingdom data. The money-market assets of banks and others link with several differentials; so do their holdings of Treasury bills and certificates. Note, incidentally, that foreign holdings of Treasury securities do not show as much sensitivity as foreign holdings of other money-market assets (none at all for the United Kingdom). This may be because Treasury securities include certificates with bills, whereas other money-market assets are apt to be commercial bills with a more uniform (90–120 day) maturity.

The pattern of European correlations is quite interesting. Banks show the most sensitivity to the covered differentials, and to the Eurodollar-United States bill rate difference (034). The Treasury securities of other Europeans likewise

answer to the covered differentials, but their other money-market assets also react to the uncovered spread. These assets incidentally, showed a marked sensitivity to the deflated bill rate differential (033).

There is one striking difference between the United Kingdom and European matrices: The total liquid dollar holdings of European banks and others show a marked interest rate sensitivity whereas those of British banks and others show none at all. This suggests that United Kingdom investors may switch back and forth between dollar bank deposits and dollar money-market assets, whereas Europeans switch between United States and foreign money-market assets.[8] To put the same point differently, total United Kingdom dollar holdings may be insensitive to interest rate differences, whereas European holdings may be very sensitive.

U.S. dollar claims on Europe seem to be more interest-sensitive than U.S. claims on the United Kingdom, though much less sensitive than U.S. liabilities. The "other" claims of U.S. banks (chiefly acceptance credit) respond markedly to the Eurodollar-United States bill rate difference, and European purchases of U.S. long-term securities seem to rise when the uncovered interest rate difference moves in favor of the United States.

As before, the Latin American data show weaker responses. The dollar claims of banks are hardly interest sensitive, though the banks' holdings of Treasury securities do react to the uncovered United Kingdom-United States differential. This response may reflect the fact that Latin Americans have small cause to cover their convertible currency investments and that, therefore, the United Kingdom-United States forward rate (the extra cost of sterling cover) may not be relevant for them. As usual, the "other" dollar claims of other foreigners show a high interest rate response, especially to the Eurodollar rate. Latin America's dollar borrowing also shows some slight interest sensitivity, but new capital issues (430b) show very little.

The Japanese data repeat familiar patterns. The money-market assets of Japanese banks answer to the covered United Kingdom-United States differentials, and Japanese acceptance financing (514) shows some sensitivity to the cost of Eurodollars. These statistics, moreover, are peculiarly sensitive to bank liquidity in Britain; note the correlation between variables 513 and 043, and between 514 and 043. Taken at face value, these connections argue that Japanese dollar borrowing goes up when money is tight in London. Although Japan can only borrow in London to finance its sterling area trade, these transactions are sufficiently large to give Japan a substantial mobility between the two financial centers. One may nevertheless be skeptical of these results, as our multiple correlations give a very different (and nonsensical) picture (see sec. 2, below). The apparent sensitivity to United Kingdom liquidity may reflect similar but independent trends; during 1958–61, Japanese dollar borrowing rose hugely and United Kingdom bank liquidity declined almost steadily.

The Canadian data are set out in table B–2. The left-hand portion tabulates correlations between capital movements and the United Kingdom-United States interest rate differentials. The right-hand portion tabulates correlations between capital movements and selected Canadian–United States interest rate differences. These last differentials are constructed in the same way as the United Kingdom-United States differentials and do not require additional comment.

Cash flows to and from Canada answer the United Kingdom–United States differentials in much the same way as flows to other countries. The money-market assets of Canadian banks respond to the covered differentials; Canadian purchases of U.S. long-term securities respond to the uncovered differentials; and Canadian purchases (U.S. sales) of Canadian securities respond to U.S. interest rates (041 and 042). Surprisingly, new Canadian issues in the U.S. market (230b) do not show very much interest elasticity.

But the Canadian data do not show much response to the Canadian-United States differentials, covered or uncovered. The money-market assets of Canadian banks move with the covered difference between Canadian day-to-day money rates and the U.S. Treasury bill rates (047), but are perversely responsive to the difference between the same Canadian rates and United States call-loan rates (048 and 049). U.S. claims on Canada show some slight

[8] This inference is confirmed below by the multiple regression analysis.

interest sensitivity; the dollar claims of U.S. nonfinancial concerns answer the covered differentials. But U.S. foreign currency claims on Canada give an anomalous result: They do not respond to the Canadian-United States differentials, then show a perverse response to the United Kingdom-United States differentials; the foreign currency claims of U.S. banks rise when London bill rates rise above U.S. bill rates. One would like to know whether these foreign currency claims are Canadian dollars or, perhaps, are sterling assets held for Americans by Canadian banks and brokers. The present method of collecting data on short-term claims do not tell us the currency involved.

Table B–6 correlates data for all countries with the same interest rate differentials we used with the separate regional statistics. It also gives a series of correlations between short-term capital movements and other major balance-of-payments items.

Variable 629 is the "Errors and omissions" entry (with the same sign as in the balance-of-payments accounts). It shows some interest sensitivity—a negative correlation with the Eurodollar-United States bill rate difference and with the long-term Canadian interest rate. As a negative "Errors and omissions" entry corresponds to a capital outflow, these two correlations suggest that some large capital flows (dollar deposits by U.S. firms and purchases of long-term Canadian securities) may be escaping the statistical net. "Errors and omissions" also correlate with changes in U.S. claims on foreigners—strongly with dollar claims and weakly with foreign currency claims.

Variable 630 is U.S. direct investment, as recorded in the balance-of-payments accounts. It correlates weakly with U.S. dollar claims on foreigners, confirming the frequent suggestion that some of the variation in direct investment is in fact, a flow of short-term credit between parents and affiliates.

Variable 631 is the total of new foreign capital issues in the U.S. market (entered with a minus sign, as in the balance-of-payments statistics). It shows some sensitivity to the U.S. long-term interest rate. Because capital issues are recorded as a debit, this positive correlation implies that new capital issues decrease when U.S. rates rise.

Variables 632 through 635 subdivide transactions in foreign and U.S. long-term securities between corporate bonds (632 and 634) and corporate stocks (633 and 635). Variables 632 and 633, net foreign purchases of foreign securities, do not show much interest sensitivity, nor any marked relationship to short-term flows. Variables 634 and 635, net foreign purchases of U.S. securities, show a distinct interest sensitivity and some connection to short-term capital.

The last two series in table B–6 attempt to break out the branch-to-parent liabilities of foreign banks' agencies in the United States. Variable 636 is the change in the agencies' deposit liabilities to foreign banks (chiefly to their parent banks). Variable 637 is the change in all deposit liabilities to United Kingdom, Canadian, and Japanese banks less the change in agency deposits. Note, first, that agency deposits account for a major part of the total change in the deposits of all foreign banks (601). Note, too, that agency and other deposits have similar intercorrelations with other capital flows, but, interestingly, opposite correlations with the dollar liabilities and dollar claims of U.S. nonfinancial concerns (609 and 615). Variable 615 is the one that would reflect the Eurodollar holdings of U.S. corporations; it correlates directly with agency deposits and inversely with other deposits.

2. Multiple correlations and regressions

This section describes our attempt to explain short-term capital flows as the joint consequence of several variables—of interest rates, other capital movements and U.S. merchandise trade. The variables used and the detailed findings are described in annex 2.

Because our basic series had only 16 observations, we could not use very many explanatory variables. Limitations on computer time also forced us to consolidate several major series. We, therefore, worked with short-term capital flows:

Dollar deposits of foreign banks.
Dollar deposits of other foreigners.
Money-market assets of foreign banks (Treasury securities and other claims).
Money-market assets of other foreigners (Treasury securities and other claims).
Dollar liabilities of U.S. nonfinancial concerns.
Short-term bank loans to foreign banks.
Short-term bank loans to other foreigners.

Dollar items in collection.
Other dollar claims reported by U.S. banks (chiefly acceptance credit).
Dollar claims of U.S. nonfinancial concerns.
Foreign currency deposits reported by U.S. banks.
Foreign currency deposits of U.S. nonfinancial concerns.
Other foreign currency claims reported by U.S. banks.
Other foreign currency claims of U.S. nonfinancial concerns.

We had also to select a subset of interest rates as proxies for the complex of interest rate relationships. We chose the United Kingdom-United States bill rate differential (uncovered and covered) which serves as a good proxy for most other short-term United Kingdom-United States differentials (see table C in annex 1). We also chose the Eurodollar-United States bill rate difference and, for Canada, the bill rate difference and daily loan rate-U.S. bill rate difference. To minimize multicolinearity, we did not use the covered and uncovered United Kingdom-United States differentials in the same equation, but ran two sets of multiple regressions, one with the covered differences then one with the uncovered difference.

These same limitations on time and on data sometimes forced us to use different sets of explanatory variables for one country's data than for others. In the United Kingdom case, for example, we had sometimes to discard one independent variable in order to experiment with the speculative index (variable 05). In the Canadian case, we had to make room for the Canadian-United States interest rate relationships. In further work on these relationships, the independent variables that did not give significant results should be discarded, and those that showed up well in other cases should be tried.

Those results studied show very little autocorrelation in the regression residuals. But we could not examine every set of residuals. A flaw in the computer program gave wrong results for several of the constant terms, introducing a systematic error into the corresponding residuals. This led to bias in the Durbin-Watson coefficient. The error was not corrected in time to rerun all the residuals.

To isolate the influence of merchandise trade, we used quarterly changes in U.S. merchandise exports to the country or region under study (or the quarterly change in the U.S. merchandise trade balance). We should probably have used the partner countries' global imports, as much American acceptance credit finances third-country trade. In the time available, however, we could not pause to compile the necessary statistics.

To isolate the influence of speculation (leads and lags) in the United Kingdom data, we used the premium on spot sterling (the excess over $2.80) as an index of speculators' expectations. There is a certain logical circularity here, as capital movements may be a major cause of the spot-rate premium, not vice versa, but we could not devise a better index.

Viewed as an effort to explain short-term capital movements, these experiments were not too successful. With 70 capital flows to be explained (14 for each of the 5 countries or regions), we could only score 18 major successes (equations that explain more than 50 percent of the total capital flow). But viewed as an effort to appraise the influence of certain independent variables (interest rates, etc.), they were quite successful. To summarize:

(*a*) Interest rates exert a powerful influence on several capital flows, especially on foreign holdings of liquid dollar assets, but also on certain kinds of U.S. lending and short-term cash placements abroad.

(*b*) There is some evidence that borrowers can move between New York and London in search of low-cost credit and that the Eurodollar market has become a significant source of credit, as well as a significant repository for cash balances.

(*c*) U.S. exports do not seem to be a major determinant of short-term capital flows. At any rate, their influence was not exposed by our equations.

These results conflict with other work on short-term capital movements, especially with a recent study by Professor Bell. Using much the same data we employed, Bell found little evidence of interest elasticity and assigned an important influence to trade. A part of this difference in results may be due to a difference in research strategy. Bell used claims and liabilities outstanding rather than net credit flows, and developed his multiple regression equations in logarithmic form.[7] One may also question the conclusions Bell has drawn from his own equations. He finds that U.S. exports to Europe explain a significant part of U.S. "trade credit" reported by U.S. banks, but only after he has dropped the trend term from his equation. When he experiments with ex-

ports and trend, exports do not appear as a significant determinant of U.S. lending. The trade data, then, may have served as a proxy for the trend term. Bell finds a similar relationship between trade credit and U.S. exports to "the rest of the world" (all countries except Canada and Europe) even when he uses a trend term. But this relationship is very much less powerful than when combined with the trend term. Bell does not find very much evidence of interest rate sensitivity, but this may be because he has used the foreign and U.S. interest rates as separate variables and has not always allowed for the cost of forward cover.

Our regression results are summarized in a series of tables attached as annex 2. Each table gives the coefficients of partial correlation and the coefficient of determination (showing how much of the total variation is explained by the relationship). The "successful" regression equations are also arrayed in the annex. Here, however, are some of the key findings:

Dollar deposits of foreign banks.—These are the largest U.S. liabilities, but gave the least successful results. We sought to explain the changes as a joint consequence of fluctuations in the U.S. trade balance (04), in foreign holdings of U.S. money-market assets (15) and in U.S. lending to foreign banks (10), and as reflecting cash collected from issues of new foreign securities in the U.S. market (13). We found very few significant partial correlations, save for Canada and Japan. Canadian deposits showed some covariation with the proceeds from securities flotations, and Japanese deposits showed a close relationship to Japanese dollar borrowing. But the Japanese regression coefficient (0.828) is too high to represent a compensating balance requirement. We also used British bank liquidity (06) and the premium on spot sterling (05) to explain United Kingdom deposits but did not get significant results.[9] Finally, we used the foreign currency liabilities of Canadian banks (12) to explain Canadian deposits, hoping to uncover the agency-to-parent relationship. This was quite successful, but the regression coefficient (0.460) is not as high as one would expect; it says that the Canadian banks have covered less than half of the increase in their foreign currency liabilities by making extra dollar investments through their U.S. agencies.

Dollar deposits of other foreigners.—These experiments were somewhat more successful. In every case, there was a positive partial correlation with borrowing from U.S. banks (11); some of the individual correlations were not significant but the likelihood of drawing five positive results if the five coefficients were truly zero is much less than 1 in 20. The partial correlations with dollar items in collection and the dollar claims of U.S. nonfinancial concerns (14) were uniformly negative, suggesting that these deposits are widely used to pay commercial obligations (that they are working balances). But there was little correlation with changes in the U.S. merchandise trade balance (04). Finally, we found a significant inverse relationship between the deposits of United Kingdom residents and their holdings of money-market assets (16), likewise with Latin America. These relationships confirm an hypothesis advanced earlier—that British funds invested in Treasury bills and other commercial paper come out of dollar bank accounts, not directly from abroad.

Money-market assets of foreign banks.—In this case, as in several others, we ran two experiments—the first with the uncovered United Kingdom-United States bill rate difference, the second with the covered difference. We found significant relationships in both cases. For Britain and Latin America, the uncovered United Kingdom-United States differential (01) gave best results (though there was very little difference between the two United Kingdom coefficients). For Canada, Europe, and Japan, the covered differential turned out well. We also found some covariation with the Eurodollar-United States bill rate difference and an interesting relationship between money-market assets and short-term borrowing from United States banks (10); British and Latin American banks may be posting liquid dollar assets as collateral for short-term loans.

Money-market assets of other foreigners.—These flows did not respond to our bill rate differentials (01 and 02), save for European funds which answered to

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[9] In another effort to explain changes in United Kingdom deposits, we used the money-market assets of United Kingdom banks (15), the dollar deposit liabilities of United States banks in London (12), the Eurodollar rate (09), and United States deposit liabilities to Western Europe (including official funds). The variable was meant to capture movements of foreign money from New York to the Eurodollar market (London). The partial correlation with United Kingdom dollar deposits was negative (as expected) but not significant, and the coefficient of multiple correlation was not very high.

the covered bill rate difference. They did respond to the Eurodollar-United States bill rate difference (09), suggesting extensive arbitrage as between money-market assets in New York and Eurodollar deposits abroad. As one would expect, this relationship was strongest for Europe and for Latin America. The Canadian data, however, showed some response to one of the interest rate differences, but a puzzling opposite response to the second.

Dollar liabilities of U.S. nonfinancial concerns.—Here, we used interest rates (02, 07, and 09) and U.S. exports (03), as well as the liquid assets ratio of United Kingdom banks (06). There was no link to trade or to the United Kingdom-United States interest rate relationship. But there was a peculiar inverse relationship to the United Kingdom money-market index; United States liabilities rose when British money-market conditions tightened. We cannot rationalize this relationship, except to recall that the liquid assets ratio displays a uniform trend throughout the period under study and may consequently serve as a proxy for a trend in U.S. borrowing. The Canadian data also shows some sensitivity to the Canadian-United States interest rate differential; United States liabilities to Canada rose when Candian rates were low compared to United States rates. Finally, leads and lags would seem to have an important influence on the United Kingdom series; United States liabilities to Britain increased when sterling was weak (05).

Short-term bank loans to foreign banks.—These series showed very little sensitivity to the independent variables chosen—the United Kingdom-United States interest rate differential, United States exports, United Kingdom liquidity, and the Eurodollar rate.

Short-term bank loans to other foreigners.—These series gave slightly better results. In every case, there was a positive partial correlation with the United Kingdom-United States interest rate differential (02), and the figures for Latin America showed a significant Eurodollar rate (09). Once again United States exports (03) did not have much impact; neither did the United Kingdom money-market index (06).

Dollar items in collection.—The United Kingdom series showed a marked sensitivity to the United Kingdom-United States differential (02) and to United Kingdom bank liquidity (06). In this case, moreover, the relationship with British bank liquidity makes good economic sense. Here, too, U.S. exports (03) showed some consistent impact; although the separate correlations were not significant, there is little likelihood that all five would be positive by pure chance. We tried to correlate collections with the dollar claims of U.S. nonfinancial concerns (17), as we had found several such simple correlations, but did not find any consistent relationship. Finally, we tried the premium on spot sterling (05), but there was no strong response.

Other dollar claims reported by banks.—Here, again, the European data showed considerable interest sensitivity (02); so did the Japanese series. Trade and United Kingdom liquidity did not show up well, save for Japan, and this one relationship was nonsensical; Japanese liabilities rose when United Kingdom liquidity was high (06). The Japanese data also showed a perverse sensitivity to the Eurodollar rate (09), rising as Eurodollar credit became more expensive compared to U.S. funds.

Dollar claims of U.S. nonfinancial concerns.—These series showed a consistent positive response to the United Kingdom-United States differential (02), especially for Britain and Canada. They also showed a strong negative relationship to U.S. exports (03). The European series is quite sensitive to the Eurodollar rate (09), suggesting that many of these dollar claims are Eurodollar deposits.

Foreign currency deposits reported by U.S. banks.—Here again we ran two experiments—one with the uncovered United Kingdom-United States bill rate differential, the other with the covered bill rate differential. But neither interest rate relationship was significant. We did much better with the foreign currency liabilities of U.S. banks (18), especially for Europe and Japan. There were powerful positive correlations between the U.S. banks' foreign currency deposits and their foreign currency liabilities. Foreign currency liabilities were also a significant explanatory variable in the Canadian case, but here the relationship was negative (suggesting a lead-lag situation). Finally, there was one significant inverse relationship between the foreign currency deposits of U.S. banks and their other foreign currency claims (20). It would appear that U.S. banks switch between European bank deposits and other claims of Europe, rather than using fresh cash to acquire other claims.

Foreign currency deposits of nonfinancial concerns.—These series also show a close relationship to foreign currency liabilities (19) and to other foreign currency claims (21). But the correlation with liabilities was positive for Europe and negative for Latin America. United States foreign currency claims on Canada moved inversely with the United Kingdom-United States bill rate differential, lending extra credence to an hypothesis advanced before (that some American investors may buy sterling bills through the Canadian banks, using Canadian funds).

Other foreign currency claims reported by banks.—Here we found very little interest sensitivity, except for Canada. In that case, moreover, it was the same perverse relationship discussed in connection with the simple correlations; United States foreign currency claims on Canada rose when the United Kingdom bill rate was high and fell when it was low. This relationship, like the one above, may represent United States purchases of British bills through the New York agencies of Canadian banks. These series did not show any consistent relationship to U.S. exports (03), or to the foreign currency liabilities of U.S. banks (18).

Other foreign currency claims of U.S. nonfinancial concerns.—The United Kingdom series showed a significant direct correlation with the covered United Kingdom-United States bill rate differential (02). This is what one would expect, as this series would reflect covered interest arbitrage by American corporations. Actually, the correlation is lower than one might have thought. Note, too, that the European data show some sensitivity to trade (03).

3. Miscellaneous experiments

We have used correlation and regression methods at several other points in this study. Two of our experiments warrant brief mention.

A. The foreign exchange position of Canadian banks

In another effort to explore the relationship between U.S. dollar placements in Canada and the behavior of Canadian banks in the New York money market, we ran a correlation between the net foreign exchange position of the Canadian banks (foreign branch accounts less foreign currency deposit liabilities, both as reported in International Financial Statistics) and a covered interest rate differential (the Canadian daily loan rate less the U.S. call loan rate). We obtained a very weak negative correlation; the Canadian banks, it seems, are not prepared to enlarge their net foreign currency positions in response to interest rate differences, even on a coverd basis. Actually, the changes in the net position are quite small:

Foreign exchange position of Canadian banks—Quarterly changes

[Millions of Canadian dollars]

	Foreign branch accounts (assets)	Foreign currency deposits (liabilities)	Net foreign currency position (branch accounts less foreign currency deposits)
1958:			
1st quarter	10	67	−57
2d quarter	225	260	−35
3d quarter	10	5	5
4th quarter	−50	−83	−33
1959:			
1st quarter	159	223	−64
2d quarter	36	2	34
3d quarter	67	249	−182
4th quarter	−35	−178	143
1960:			
1st quarter	348	368	−20
2d quarter	251	227	24
3d quarter	58	58	0
4th quarter	−324	−371	47
1961:			
1st quarter	165	181	−16
2d quarter	414	509	−95
3d quarter	128	204	−76
4th quarter	78	−60	138

Note that both of the large 1960 increases in foreign currency deposits were fully covered by branch bank investments and that four-fifths of the largest 1961 increase was also covered by additional investments.[10]

B. The components of the U.S. deficit

We ran a series of simple and multiple correlations among the chief components of the U.S. payments deficit as usually defined by the Commerce Department. We used quarterly statistics for 1951–61 (44 observations) and their components:

Z_1 Increase (+) in U.S. short-term liabilities to foreign central banks and governments, as reported by U.S. banks.
Z_2 U.S. gold loss (+).
Z_3 Overall deficit (+) measured as the gold loss plus the increase in U.S. liabilities to foreign monetary authorities (Z_1+Z_2), hereafter called the "official flows" definition.
Z_4 Increase (+) in short-term liabilities to all other foreigners as reported by U.S. banks.
Z_5 Overall deficit (+) on the usual definition (Z_3+Z_4).

Note that Z_5 omits one important series used by the Commerce Department—the change in foreign holdings of U.S. Government securities. Note, too, that we neglect changes in U.S. liabilities and gold transfers to international institutions (principally the IMF).

In our first experiment, we sought to reproduce Oscar L. Altman's correlation between foreign official acquisitions of dollar assets (Z_3) and foreign gold purchases (Z_2). We obtained this relationship.

$$Z_2=-40.9+.615Z_3 \quad (R^2=.638)$$

This equation argues that 60 percent of the "official flows" deficit exceeding $65 million per quarter will be taken out in gold.[11] It accounts for 64 percent of all U.S. gold transactions since 1951. Our result is very similar to Altman's equation (except that his was based on annual data).

Next, we sought to explain changes in official dollar holdings as the consequence of U.S. deficits and U.S. short-term interest rates (Z_6):

$$Z_1=71.0+.383Z_3-.134Z_6 \quad (R^2=.410)$$

The first regression coefficient is significant at the 0.05 level (its standard error is .072); it is the complement of the coefficient in our first equation. The second coefficient is not significant (its standard error is .411). This confirms the general view—that foreign official holdings of dollars are not very interest sensitive.

Next, we ran a correlation between changes in private foreign liquid dollar claims and the "official flows" deficit, seeking to determine whether private foreign funds behave the same way as official funds:

$$Z_3=446.6-1.219Z_4 \quad (R^2=.226)$$

This relationship is significant at the 0.05 level (the standard error of the coefficient is .348), and the minus sign is interesting. Private funds seem to move inversely to official funds. They cannot be regarded as accommodating finance but must be treated as independent disturbances.

Finally we tried to explain private capital movements by changes in the overall deficit, as defined by the Commerce Department, and by U.S. interest rates:

$$Z_4=-22.9-.046Z_5+.636Z_6 \quad (R^2=.092)$$

Neither regression coefficient is significant (the standard error of the first is 0.066, and the standard error of the second is 0.329). But private funds show much more interest elasticity than official claims on the United States. Once again, moreover, they appear as an autonomous disturbance rather than as

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[10] The figures in the table argue that the Canadian banks take foreign currency cover for most of their deposit liabilities, while the regression equations in sec. 2 of this appendix argue that they cover a much smaller fraction. There is, however, no contradiction between these two findings. (The results presented in sec. 2 relate to the U.S. dollar holdings of Canadian banks, as visible in the U.S. statistics. The figures in the table are total Canadian holdings of foreign currencies, including sterling and Eurodollars.

[11] The $65 million is derived by setting $Z=0_2$ and solving for Z_3.

compensating capital. Even though Z_4 is part of Z_5, the two are inversely correlated.

All but one of these relationships (Z_4 on Z_3) gave a Durbin-Watson ratio indicative of random residuals. In the one exceptional case, the Durbin-Watson test was not conclusive, one way or the other.

APPENDIX I

Annex 1

List of variables for simple correlations.
Table A. Intercorrelations of capital movements.
Table B. Correlations between capital movements and money-market indices.
Table C. Intercorrelations of money-market indices.

VARIABLES FOR SIMPLE CORRELATIONS

The variables in table 1a through 6b bear a three-digit code. The variables prefixed by zero are interest rates and money market indices, as follows:

031 United Kingdom Treasury bill rate less United States Treasury bill rate.
032 Same, covered.
033 Same, covered and divided by U.S. Treasury bill rate.
034 Eurodollar deposit rate (London) less U.S. Treasury bill rate.
035 United Kingdom acceptance rate less United States short-term bank loan rate.
036 Same, covered.
037 United Kingdom acceptance rate less United States acceptance rate.
038 Same, covered.
039 United Kingdom long-term interest rate less United States long-term interest rate.
040 Net free reserves of U.S. banks.
041 U.S. acceptance rate.
042 U.S. long-term interest rate.
043 Liquid assets ratio of United Kingdom banks.
044 Canadian Treasury bill rate less United States Treasury bill rate.
045 Same, covered.
046 Canadian day-to-day money rate less United States Treasury bill rate.
047 Same, covered.
048 Canadian day-to-day money rate less United States call-loan rate.
049 Same, covered.
050 Canadian long-term interest rate less United States long-term interest rate.
051 Canadian day-to-day money rate.
099 Discount (−) on 3 months forward sterling.

All of these series are measured in basis points, save for 040 (millions of dollars), 043 (tenths of a percent) and 099 (100ths of a cent). They were derived from these statistics:

Short-term interest rates:

United Kingdom: 3-month Treasury bill rate and 3-month acceptance rate: Banking and Monetary Statistics (BMS) and Federal Reserve Bulletin (FRB); average of daily rates.

United States: 3-month Treasury bill rate and 3-month acceptance rate: BMS and FRB: average of daily rates.

United States: $100,000–200,000 bank-loan rate: BMS and FRB; quarterly data.

United States: call-money rate: Bank and Quotation Record of the Commercial and Financial Chronicle (BQR); average of weekly midpoints.

Canadian day-to-day money rate and 3-month Treasury bill rate: BMS and FRB; average of daily rates.

Eurodollar 3-month deposit rate: 1958-60, average of end-month Brown-Shipley rates (O. L. Altman); then average of end-week rates furnished by Mr. Fred Klopstock.

Long-term rates:

United Kingdom, United States and Canadian long-term government bond rates: International Financial Statistics (IFS); average of daily rates.

Forward exchange rates:

United Kingdom: 1960–61, average of end-week forward discount given by Federal Reserve Board; 1958–59, BQR, average of end-week forward discounts computed from raw data.

Canada: 1960–61, average of end-month forward discount computed from IFS data; 1958–59, average of end-month forward discount computed from FRBNY data.

Free reserves: Average of daily data, FRB; all banks.

United Kingdom liquidity ratio: United Kingdom Monthly Bulletin Statistics; average monthly data.

The series prefixed by Nos. 1 through 6 are capital movements for six groups of countries:

100 United Kingdom.
200 Canada.
300 Europe (excluding the United Kingdom).
400 Latin America.
500 Japan.
600 All countries.

The second and third digits identify the capital flows, as follows:

01 Dollar deposits of foreign banks.
02 U.S. Treasury bills and certificates held for foreign banks.
03 Other dollar assets of foreign banks.
04 Total dollar assets of foreign banks (sum of 01 through 03).
05 Dollar deposits of other foreigners.
06 U.S. Treasury bills and certificates held for other foreigners.
07 Other dollar assets of other foreigners.
08 Total dollar assets of other foreigners (sum of 06 through 08).
09 Dollar liabilities of U.S. nonfinancial concerns.
11 Short-term bank loans to foreign banks.
12 Short-term bank loans to other foreigners.
13 Dollar items in collection as reported by U.S. banks.
14 Other dollar assets of U.S. banks (chiefly acceptance credit).
15 Dollar claims of U.S. nonfinancial concerns.
16 All short-term dollar claims on foreigners (sum of 11 through 15).
17 Foreign currency deposits reported by U.S. banks.
18 Foreign currency deposits of U.S. nonfinancial concerns.
20 Other foreign currency claims reported by U.S. banks.
21 Other foreign currency claims of U.S. nonfinancial concerns.
22 Total foreign currency assets reported by U.S. banks (sum of 17 and 20).
23 Total Foreign currency assets of nonfinancial concerns (sum of 18 and 21).
24 Foreign currency liabilities reported by U.S. banks.
25 Foreign currency liabilities of U.S. nonfinancial concerns.
26 All foreign currency liabilities (sum of 24 and 25).
27 Long-term claims on foreigners reported by U.S. banks.
28 Long-term claims on foreigners of U.S. nonfinancial concerns.
29 Net foreign purchases (+) of long-term domestic securities (except 629).
30 Net foreign purchases (+) of long-term foreign securities (except 630).
30a Net foreign purchases (+) of foreign securities less new issues (net of redemptions).
30b New foreign capital issues in the U.S. Market (—).

All of these series are quarterly changes in amounts outstanding, save for 29 and 30.

These additional variables were used:

131 United Kingdom banks' acceptance credit extended to nonresidents (from Bank of England Bulletin).
629 Balance-of-payments errors and omissions.
630 U.S. direct investment (—).
631 All foreign capital issues in the U.S. market (—).
632 Net foreign purchases (+) of foreign bonds.
633 Net foreign purchases (+) of foreign stocks.
634 Net foreign purchases (+) of U.S. corporate bonds.
635 Net foreign purchases (+) of U.S. corporate stocks.
636 Change in foreign agency banks' deposit liabilities to foreign banks.
637 Change in dollar deposits of United Kingdom, Canadian, and Japanese banks less change in agency deposits.

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TABLE A-1.—*Intercorrelations of capital movements—United Kingdom*

	101	102	103	104	105	106	107	108	109	111	112	113	114	115	116	117	118	120	121	122	123	124	125	126	127	128	129	130	131
101	1	−	+	0.92	0.68	−0.52	+	+	−	−	−	−	0.48	−	+	−	−0.45	0.45	+	+	+	+	−	−	+	+	0.51	+	−
102		1	+	−	+	+	+	+	−	0.59	+	+	−	+	−	+	+	−	+	−	+	−	+	−	−	+	+	+	+
103			1	+	−	−	+	−	+	−	−	+	+	−	−	+	−.45	−	−	−	−	−	−	−	−	+	.51	0.75	+
104				1	.69	−.56	+	+	−	+	−	−	.44	−	+	−	.50	+	+	+	+	+	−0.44	−	−	+	.59	.46	+
105					1	−.67	+	+	−	+	+	−	+	−	+	−0.55	−	+	+	−	+	−	−	−	+	+	+	+	−
106						1	−	0.49	−	−	+	+	−	+	−	+	.48	+	−	+	−	+	+	+	+	−0.46	−.49	−.62	−
107							1	.57	0.51	+	+	−0.52	−	−0.70	−0.63	−	+	−	+	−0.43	+	+	−	+	+	−	+	+	0.75
108								1	+	+	0.49	−.46	+	−.50	−	−	+	−	−	−	+	+	−	+	+	−	−	−.51	+
109									1	−	−	−	+	−.66	−.54	−	−	−.71	−0.47	−.52	−0.48	+	−	+	+	−	.45	+	.50
111										1	.73	+	+	+	+	+	+	+	+	+	+	−	−	−	+	−	+	−	−
112											1	+	+	+	+	+	+	+	+	+	+	+	−	+	+	−	−	−	−
113												1	−	.78	.64	+	+	+	−	+	+	−0.56	−	−0.54	−	−	−.63	−	−.45
114													1	−	+	+	−	+	−.47	+	−.53	−	−	−	+	−	.46	+	−
115														1	.78	+	+	.53	+	.53	+	−	+	−	−	+	−.63	−	−.65
116															1	+	−	.61	+	.58	+	−.49	−	−	−	+	−	−	−.68
117																1	+	+	−	.79	−	+	.70	+	−	+	−	+	−
118																	1	−	+	+	+	+	+	+	+	−	−.48	−.48	+
120																		1	+	.82	+	+	−	+	−	+	−	+	−.49
121																			1	+	.98	+	−	+	−0.43	+	−	+	+
122																				1	+	+	+	+	−	+	−	+	−.48
123																					1	+	−	+	−	+	−	+	+
124																						1	+	.95	+	−	+	+	+
125																							1	.57	−.31	+	+	+	−
126																								1	−	+	+	+	+
127																									1	−.78	−	−.45	+
128																										1	+	.47	−
129																											1	.74	+
130																												1	+
131																													1

TABLE A-2.—*Intercorrelations of capital movements—Canada*

	201	202	203	204	205	206	207	208	209	211	212	213	214	215	216	217	218	220	221	222	223	224	225	226	227	228	229	230a	230b	231
201	1	−	+	0.99	−	−	−	−	+	0.63	−0.50	+	+	+	+	+	+	−0.46	−	−	+	−	−	−	+	−	−	−	−0.64	−0.64
202		1	−	−	+	−	+	+	0.53	+	−	+	−	+	−	−0.47	−	−	−	+	−	+	+	+	+	−	+	+	+	+
203			1	+	−	−	−	−	+	−	−	−	−	−	−	−	+	−	−	−	+	−	+	−	+	0.47	+	+	−	−
204				1	−	−	−	−	+	.65	−.54	+	+	+	+	+	+	−.50	−	−	+	−	−	−	+	−	−	−	−.65	−.64
205					1	+	+	0.84	+	−.52	+	+	+	+	+	−	−	−	−	−	−	0.70	0.56	0.78	+	−	−	−	+	+
206						1	+	.70	−	−	.59	−	−	+	+	−	+	−	−	−	+	+	.46	+	+	+	−	−0.44	+	+
207							1	.58	−	−	+	+	−	−	−	−	−	−	−	−	−	.53	+	.48	+	−.57	+	−	+	+
208								1	−	−.46	.57	+	+	+	+	−	−	−	−	−	−	.64	.59	.74	+	−	−	−	+	+
209									1	+	−	+	+	+	+	+	+	−	−	−	−	+	−	+	−	−	+	.47	−	−
211										1	−.49	−	−	+	+	+	+	−	+	−	+	−	−	−	−	−	+	+	−	−
212											1	−	−	−	−	−	−	+	+	−	+	+	+	+	−	+	−	−	+	+
813												1	+	0.48	0.45	+	−0.62	−	−0.81	+	−0.80	−	.45	−	0.51	−.43	−	+	−	+
214													1	.58	.78	−	−	−	−	−	−	+	.58	+	.66	−	−	−	−	−
215														1	.94	+	+	−	−	−	−	+	.58	+	.78	−.50	−0.46	−	+	+
216															1	+	−	−	−	−	−	+	.63	+	.80	−.53	−.52	−	+	−
217																1	−	+	−	0.62	−	−.42	−	−	−	+	−	−	+	+
218																	1	−.49	.60	−.45	.83	+	−	−	+	+	−	−	−	−
220																		1	+	.82	−	−	−	−	−.51	+	+	+	.59	.66
221																			1	+	.89	+	−.55	−	−	+	−	+	+	+
222																				1	−	−	−	−	−.51	+	+	+	.51	.54
223																					1	+	−.45	−	−	+	−	−	+	−
224																						1	+	.94	+	−.43	−	−	+	+
225																							1	.62	.73	−	−	−.43	+	−
226																								1	.49	−.48	−	−	+	+
227																									1	−.59	−.45	−	−	−
228																										1	+	+	−	+
229																											1	+	−	+
230a																												1	+	.51
230b																													1	.91
231																														1

TABLE A-3.—*Intercorrelations of capital movements—Europe*

	301	302	303	304	305	306	307	308	309	311	312	313	314	315	316	317	318	320	321	322	323	324	325	326	327	328	329	330a	330b	331
301	1	+	−	0.43	0.51	−	+	+	−	−	0.56	+	+	0.44	0.54	−	0.47	+	−	+	+	+	+	+	+	−	+	−	−	−
302	----	1	+	.69	−	+	0.47	+	0.53	−	−	0.47	−	+	−	+	−	−	−	−	−	+	−	−	+	+	+	+	−	+
303	----	----	1	.68	−	0.60	.66	0.46	+	−	−	−	−0.57	−	−.48	−	−	−	−	−	−	−	+	−	+	+	+	−	+	−
304	----	----	----	1	+	.47	.71	.66	+	−	+	+	−	+	−	−	+	−	−	−	+	−	+	+	+	+	+	−	−	−
305	----	----	----	----	1	−.47	−	.47	−	+	+	−	+	+	+	+	+	+	0.57	+	0.53	+	+	0.44	0.62	−0.50	−	+	−0.44	+
306	----	----	----	----	----	1	.67	.48	+	+	−	−	−	+	−	−	−	−	−	−	−	−0.51	+	−	−	+	+	−	.56	+
307	----	----	----	----	----	----	1	.64	+	−	−	+	−	−	−	−	−	−	−	−	−	−	−	−	−	+	0.49	−	+	−
308	----	----	----	----	----	----	----	1	+	−	−	−	−	+	−	−	+	+	+	−	+	−	+	+	+	−	+	−	−	−
309	----	----	----	----	----	----	----	----	1	−0.45	−	+	−	−	−	−	+	−	−	−	+	−	−	−	−	+	−	−	−	−
311	----	----	----	----	----	----	----	----	----	1	−	−	+	+	.44	+	−	+	+	+	+	+	+	+	+	−	+	+	+	+
312	----	----	----	----	----	----	----	----	----	----	1	+	.55	+	.61	−	.49	+	+	−	.42	+	0.46	+	+	−	+	−	+	−
313	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+	+	+	+	−.64	+	−	+	+	+	−	.49	+	−	+	−
314	----	----	----	----	----	----	----	----	----	----	----	----	1	.45	.86	0.48	+	+	+	0.56	+	.53	+	.49	+	−.57	−	−0.50	+	−0.48
315	----	----	----	----	----	----	----	----	----	----	----	----	----	1	.75	+	−	+	+	+	−	+	+	+	.47	−	+	−	+	−
316	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+	+	.50	+	+	+	.44	+	−	+	−.49	+	−
317	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	−0.45	+	.98	+	.68	+	.66	.64	−	+	−	−	−
318	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+	.92	+	.69	.55	+	−	+	−	−	−
320	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	−	+	+	+	+	+	−	−	+	−	+
321	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+	+	+	.59	−.82	−	+	−	+
322	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	.75	+	.74	.72	−	+	−	−	−
323	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	.67	.55	.43	−.45	+	−	−	−
324	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	.94	.70	−	+	−	−	−
325	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	.63	.49	−	.54	−	−	−
326	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	.75	−	+	−	−	−
327	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	−.48	−	−	−.43	−
328	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+	+
329	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	−	+	−
330a	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	−	.91
330b	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+
331	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1

TABLE A-4.—*Intercorrelations of capital movements—Latin America*

	401	402	403	404	405	406	407	408	409	411	412	413	414	415	416	417	418	420	421	422	423	424	425	426	427	428	429	430a	430b	431
401	1	−	+	0.99	+	−	−	+	+	+	−	−	+	−	−	−	−0.44	+	+	−	+	+	0.56	0.57	−	+	−	−	+	+
402	---	1	−	−	−	−	+	−	−	+	+	+	−	−	+	+	−	+	+	+	+	+	+	+	+	+	+	+	+	+
403	---	---	1	+	+	+	+	+	−	+	−	−	+	−	−	−	+	−	−	−	−	+	−	−	−	−	+	−	−	−
404	---	---	---	1	+	−	−	+	+	+	−	+	+	−	−	−	−	+	+	−	−	+	.55	.57	−	+	−	−	+	+
405	---	---	---	---	1	−	−	0.92	−	0.52	+	−	−	−	+	−	+	+	+	−	+	+	+	+	−	+	−	−	+	+
406	---	---	---	---	---	1	+	+	+	−	+	−	−0.55	+	−0.46	−	.52	−	−	−	−	−	−	−	+	−	+	−	+	+
407	---	---	---	---	---	---	1	+	+	−	−	−	+	−	−	+	−	+	−	+	−	−	−	−	+	−0.46	+	+	+	+
408	---	---	---	---	---	---	---	1	+	.44	+	−	−	−	−	−	.45	+	−	−	+	+	−	−	−	+	−	−	+	+
409	---	---	---	---	---	---	---	---	1	−	+	0.45	−	+	−	+	+	0.57	+	+	+	−	−	−	−	+	0.68	−	+	−
411	---	---	---	---	---	---	---	---	---	1	0.44	−	+	−	+	+	+	+	+	+	+	0.43	+	+	−	+	−	+	+	+
412	---	---	---	---	---	---	---	---	---	---	1	+	−	+	.59	0.50	+	+	+	0.50	+	+	−	−	−	.61	−	+	+	+
413	---	---	---	---	---	---	---	---	---	---	---	1	−	+	+	+	−	+	−	+	−	+	−	−	−	+	+	−	−	−
414	---	---	---	---	---	---	---	---	---	---	---	---	1	−	.72	+	−	+	+	+	−	−	+	+	−	−	−	+	−0.70	−0.52
415	---	---	---	---	---	---	---	---	---	---	---	---	---	1	+	.54	+	+	+	0.52	+	−	−	−	+	−	+	+	−	+
416	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	.44	−	+	+	.45	+	+	+	+	−	+	−	+	−.44	−
417	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	+	+	+	.99	+	−	−	−	+	+	+	+	+	+
418	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	−	−	+	+	−.58	−.44	−.53	+	+	−	−	+	+
420	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	+	+	+	+	+	+	−	+	.50	+	+	−
421	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	+	.93	+	.97	.70	−	+	−	−	−	−
422	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	+	−	−	−	+	+	+	+	+	+
423	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	−	.56	.46	−	+	−	−	+	−
424	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	+	.60	−	+	−	−	+	−
425	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	.77	−	+	−	−	−	−
426	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	−	+	−	−	−	−
427	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	−	−	+	+	.57
428	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	−	−	+	−
429	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	−	−	−
430a	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	+	.57
430b	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1	.81
431	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	---	1

TABLE A-5.—*Intercorrelations of capital movements—Japan*

	501	502	503	504	505	506	507	508	509	511	512	513	514	515	516	517	518	520	521	522	523	524	525	526	527	528	529	530
501	1	----	+	0.95	-	+	-	-	-	0.73	0.63	+	+	+	0.51	+	0.60	-	-	+	0.43	-	0.65	0.43	-0.43	+	0	-0.56
502	----	1	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
503	----	----	1	+	+	+	-	-	-.43	+	+	-	-0.47	+	-	+	+	-	-0.44	+	-	-	-	-	-	0.48	0	-
504	----	----	----	1	-	+	-	-	-	.77	.62	-	+	+	+	+	.66	-	-	+	+	-	.51	+	-	.49	0	-.58
505	----	----	----	----	1	0.53	-	0.81	+	-	-	+	+	+	+	+	+	+	-	+	+	+	-	-	.43	-	0	-
506	----	----	----	----	----	1	+	.52	+	+	-	+	-	+	+	-	-	+	-.47	-	-	-	+	+	+	-	0	-
507	----	----	----	----	----	----	1	.44	+	-	-	0.49	+	-	+	-	-.55	-	-	-	-.52	-	+	+	+	-.74	0	+
508	----	----	----	----	----	----	----	1	.50	-	-	+	+	-	+	-	-	+	-	-	-	-	-	-	+	-.50	0	+
509	----	----	----	----	----	----	----	----	1	-	+	.59	.82	+	.75	-	-	+	-	-	-	+	+	+	-	-	0	+
511	----	----	----	----	----	----	----	----	----	1	.46	-	+	+	+	+	.51	-	-	+	+	+	.53	.51	-	.45	0	-.62
512	----	----	----	----	----	----	----	----	----	----	1	+	+	0.50	.48	+	.47	-	-	+	+	+	+	+	-.45	.54	0	-.47
513	----	----	----	----	----	----	----	----	----	----	----	1	.51	-	.53	-.46	-	+	-	-0.46	-	+	.47	+	-	-	0	+
514	----	----	----	----	----	----	----	----	----	----	----	----	1	+	.96	-	+	+	-	-	+	+	+	+	-	-	0	+
515	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+	-	-	+	+	-0.43	-	-.43	-	.53	0	-
516	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	-	+	-	-	-	+	+	.51	.46	-	-	0	-
517	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+	.99	+	.56	-	+	.58	+	0	-
518	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	-	+	.77	-	+	+	-	.51	0	-
520	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	-	+	-	+	+	+	+	-	0	.49
521	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	.61	-	-	-	-	-	0	-
522	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	.57	-	+	.58	+	0	-
523	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	-	+	-	-	+	0	-
524	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+	.70	+	-	0	-
525	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	.83	-	-	0	-
526	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	-	-	0	-
527	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	-	0	-
528	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1	0	-.55
529	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	0	----
530	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1

TABLE A-6.—*Intercorrelations of capital movements—All countries*

	601	602	603	604	605	606	607	608	609	611	612	613	614	615	616	617	618	620	621	622	623	624	625	626	627	628
601	1	−0.53	−	0.70	+	−	+	−	−	−	−0.65	+	+	+	+	−	+	−	−	−	+	+	−	+	+	−
602		1	+	−	−	0.49	+	+	0.43	+	+	−	−0.59	−	−	+	−	−	−	−	−	−	+	−	+	+
603			1	.58	−0.44	+	0.71	−	.48	−	−	+	−	−	−	−	−	−0.49	−	−0.47	−	−	+	−	−	+
604				1	−	−	.58	−	+	−	−.68	+	−	−	−	−	+	−.58	−0.46	−.44	−	+	+	+	+	−
605					1	+	−	0.77	−	0.45	+	−0.59	−	+	+	+	+	+	+	+	+	+	+	+	0.46	−
606						1	+	.81	+	+	+	−.51	−	+	−	+	+	−	−	+	+	+	+	+	.42	−
607							1	+	+	−	−	+	−	−	−	−	+	−	−	−	+	−	+	+	+	−
608								1	−	+	+	−.63	−	+	−	+	+	−	+	−	+	+	+	+	.57	−
609									1	−	−	+	+	+	+	−	+	−.48	−.59	−.43	−0.43	−	+	+	−	+
611										1	+	−	+	+	+	0.49	+	−	+	+	−	+	0.43	+	.50	+
612											1	−	−	+	+	+	+	+	+	+	−	−	+	−	+	0.56
613												1	.48	+	−	−	−	−	−	−	−.45	+	+	+	−	+
614													1	0.43	0.86	+	+	+	−	+	+	+	+	+	−	−
615														1	.75	+	0.48	−	+	+	+	+	+	+	.46	+
616															1	+	+	+	+	+	−	+	.46	+	+	+
617																1	+	+	−	.81	+	0.50	+	+	+	+
618																	1	−.43	−	−	−	+	.43	0.43	.67	−
620																		1	.51	.70	.50	+	−	+	−	−
621																			1	+	+	−	−	−	+	−
622																				1	.50	.45	+	+	+	+
623																					1	+	−	+	+	−
624																						1	.73	.96	.60	−
625																							1	.88	.65	+
626																								1	.66	−
627																									1	−
628																										1

TABLE B-1.—*Correlations between capital movement and money market indexes—United Kingdom*

	031	032	033	034	035	036	037	038	039	040	041	042	043	099
101	+	+	+	+	+	+	−	−	−	−	+	+	−	+
102	−	−	−	−	−	−	−	+	−	+	−	−	+	+
103	−0.53	−0.64	−0.58	−0.56	−0.52	+	−0.55	- 0.65	−0.45	−0.52	+	+	−	+
104	−	+	+	−	−	+	−	−	−	−	+	+	−	+
105	+	−	−	+	+	−	+	+	+	+	−	−	−	−
106	+	−	−	+	+	−	+	+	+	+	−0.45	−	+	−
107	−	−	−	−	−	−	−	−	+	+	+	+	−	+
108	+	+	+	+	+	−0.43	+	+	+	+	− .52	−	−	−
109	−	− .62	− .48	−	−	−	−	− .49	−	−	+	+	+	−
111	+	+	+	+	+	− .45	+	+	+	+	−	−	−	−
112	+	+	+	+	+	−	+	+	+	+	−	−	−	−
113	−	−	−	−	−	+	−	+	−	−	+	+	+	+
114	+	−	−	+	+	−	+	− .44	+	−	−	−	−	−
115	+	.46	+	+	+	+	+	+	−	+	+	+	−	+
116	+	+	+	+	+	−	+	+	+	+	−	+	−	−
117	−	−	−	−	−	−	+	+	−	−	−	−	+	−
118	+	+	+	+	+	− (	+	+	.52	.45	−	+	+	−
120	−	+	+	−	+	+	−	+	−	−	+	+	−	+
121	−	.57	+	+	−	.58	−	.48	−	−	+	+	−	+
122	−	+	+	−	+	+	−	+	−	−	+	+	−	+
123	−	.56	+	+	−	.49	−	.49	−	+	+	+	−	+
124	−	+	+	−	−	+	−	+	−	−	+	−	−	+
125	+	+	+	+	+	−	+	+	+	+	−	−	+	−
126	−	+	+	+	−	+	−	+	−	−	+	−	−	+
127	+	−	−	+	+	−	+	−	+	+	−	+	−	−
128	−	−	+	−	−	+	−	−	−	−	+	−	−	+
129	−	−	−	−	−	−	−	− .46	−	−	+	+	−	+
130	− .51	−	−	− .44	− .51	+	− .58	−	− .53	− .59	.55	+	−	0.50
131	−	− .45	− .57	−	−	−	−	− .47	+	−	+	+	+	

TABLE B-2.—*Correlations between capital movements and money market indexes—Canada*

	031	032	033	034	035	036	037	038	039	040	041	042	043	044	045	046	047	048	049	050	051
201	−	−	−	−	−	−	−	−	−	−	+	−	−	+	−	+	+	+	−	+	+
202	−	−	−	−	−	−	−	−	−	+	−	+	−	−	−	−	−	−	−	−	−
203	−0.57	−0.73	−0.65	−0.60	−0.48	+	−0.55	−0.58	−	−0.60	0.49	+	+	+	−	+	−0.49	0.56	0.48	−	0.55
204	−	−	−	−	−	−	−	−.43	−	−	+	+	−	+	−	+	+	+	−	+	+
205	+	−	−	+	−	−	+	−	+	+	−	+	+	−	−	−	−	−	−	+	−
206	−	−	−	−	−	−	+	+	−	+	−	−	+	−	+	−	−	+	+	−	−
207	−	−	−	−	−	−	−	−	−	−	−	+	+	−	−	−	−	+	+	−	−
208	−	−	−	−	−	−	+	−	+	+	−	+	+	−	−	−	−	+	+	−	−
209	−	−	−	−	−	−	−	−	−	−	+	+	−0.50	+	−	0.46	+	+	+	−	+
211	+	−	−	−	+	−	+	−	+	−	+	+	−	+	+	+	+	+	+	+	+
212	+	+	+	+	+	−	+	.46	−	+	−	−	+	+	−	+	−	+	−	−	−
213	−	−	−	+	−	−	−	−	+	+	+	+	−	+	+	+	+	+	+	+	+
214	+	+	+	+	+	−	+	+	+	+	−	−	−	+	+	+	+	+	−	0.48	+
215	+	−	−	.45	+	−0.54	+	−	.42	+	−	−	−	−	0.52	+	.51	−	+	.68	−
216	+	+	+	.51	+	−.52	+	−	.43	+	−	−	−.45	+	.49	+	.59	−	+	.62	−
217	+	+	+	+	+	−	+	+	+	+	−	−	+	−0.46	−	−	−	−	−	−	−
218	+	−	−	−	+	−	+	−.55	+	−	−	−	+	−	−	−	+	−	−	−	−
220	+	.72	.55	.47	+	+	+	.61	+	+	+	+	−	−	+	+	+	−	−	+	−
221	+	+	+	+	+	+	+	+	−	+	+	−	−	+	+	+	+	−	+	+	−
222	+	.58	.45	.50	+	+	+	.51	+	+	−	−	−	−	+	−	+	−	−	+	−
223	+	+	+	−	+	−	+	−	+	+	−	−	−	+	+	+	+	+	+	−	−
224	−	−	−	−	−	−	−	−	−	+	−	+	−	+	+	−	−	−	−	−	−
225	−	−	−	+	−	−	−	−	+	+	−	−	+	+	+	−	−	+	+	+	−
226	−	−	−	+	−	−	−	−	−	+	−	+	−	+	+	−	−	−	−	+	−
227	+	−	−	+	−	−.49	+	−	+	+	−	−	−	+	+	+	+	−	+	+	−
228	−	−	+	−	−	.44	−	+	−	−	+	+	+	−	−.57	−	−.51	+	−	−	+
229	−.65	−	−	−.47	−.64	.65	−.64	+	−.70	−.53	+	0.46	−	+	−	−	−.45	+	+	−	+
230a	−	+	−	−	−	.60	−	−	−	−.43	.70	.62	−	+	−	+	−	+	+	−	.62
230b	+	+	+	+	+	−	+	+	+	.43	−	+	−	−.44	+	−	+	−	−	+	−
231	+	+	+	+	+	+	−	+	+	+	+	+	−	−	+	−	+	−	+	+	−

TABLE B-3.—*Correlation between capital movements and money market indexes—Europe*

	031	032	033	034	035	036	037	038	039	040	041	042	043
301	+	−	−	+	+	−	+	−	+	+	−	−	+
302	−	−0.49	−	−0.44	−	−	−	−	−	−	−	+	+
303	−0.51	− .65	−0.63	− .64	−0.44	+	−0.46	−	−	−0.49	+	+	+
304	− .50	− .77	− .70	− .61	− .47	−	−	−	−	−	+	+	+
305	+	+	+	+	+	−0.46	+	+	+	+	−	−	−
306	− .56	− .72	− .76	− .61	− .51	+	− .51	−0.43	−	−	+	0.49	0.44
307	− .74	− .73	− .84	− .77	− .68	+	− .72	− .55	−0.56	− .75	0.54	.59	+
308	−	− .71	− .72	− .48	−	−	−	− .51	−	−	+	+	+
309	−	−	−	−	− .43	+	−	+	−	−	−	−	−
311	+	+	+	+	−	+	+	+	+	+	+	+	−
312	+	+	−	.45	+	−	+	+	.54	.55	−	−	+
313	−	−	−	−	−	+	−	−	−	−	+	+	+
314	.45	.50	+	.68	.44	−	+	+	.60	.57	−	−	−
315	+	−	−	+	+	−	+	−	+	+	−	+	+
316	+	+	+	.51	+	−	+	+	.47	.48	−	+	+
317	+	+	+	+	+	−	+	+	+	+	−	−	+
318	−	+	+	+	−	+	−	+	+	+	−	−	−
320	+	+	+	+	+	+	+	+	+	+	+	−	−
321	.48	+	+	.46	+	− .44	.48	+	+	.52	− .47	−	−
322	+	+	+	+	+	−	+	+	+	+	−	−	+
323	+	+	+	+	−	−	+	+	+	+	−	−	−
324	+	+	+	.47	.43	−	+	+	.45	+	−	−	−
325	−	−	−	+	−	+	−	−	+	+	+	+	+
326	+	+	+	+	+	−	+	+	+	+	−	−	−
327	+	+	+	+	+	−	.44	+	+	+	−	−	+
328	− .58	−	−	− .51	− .51	+	− .57	−	− .57	− .63	.48	+	+
329	− .70	−	− .56	−	− .66	.47	− .74	−	−	− .58	.81	.78	−
330a	+	−	+	−	+	−	+	+	−	−	−	− .44	−
330b	−	−	−	−	−	+	−	−	−	−	+	.55	−
331	1	−	+	−	−	−	+	−	−	−	−	−	−

TABLE B-4.—*Correlation between capital movements and money market indexes—Latin America*

	031	032	033	034	035	036	037	038	039	040	041	042	043
401	+	−	+	+	+	−	+	−	+	+	−	−	+
402	−0.46	−	−	−	−0.45	+	−	−	−	−	+	+	+
403	−	+	−	+	−	+	−	−	−	−	+	+	−
404	+	−	−	+	+	−	+	−	+	+	−	−	+
405	.65	+	+	+	.62	−0.47	0.70	+	0.53	0.62	−0.70	−0.57	+
406	−	−	−	−	−	−	−	−	−	−	−	+	+
407	− .63	−	−0.53	−0.74	− .51	.55	− .60	−	− .64	− .75	.49	.45	+
408	+	+	+	+	+	−	.47	+	+	+	− .56	−	+
409	+	−	−	+	−	−	−	−	+	+	+	+	+
411	+	−	+	+	+	−	+	+	+	+	−	−	+
412	+	+	+	+	+	−	+	+	+	+	−	−	+
413	−	+	−	+	−	+	−	+	+	+	.45	+	−
414	+	+	+	+	+	+	+	+	+	+	+	+	+
415	+	+	−	+	+	−	+	−	+	+	+	+	−
416	+	+	+	+	+	+	+	−	+	+	+	+	+
417	−	−0.48	−	−	+	−	−	−0.58	+	−	+	+	+
418	+	−	−	+	+	− .43	+	−	+	+	−	−	+
420	−	−	−	−	−	+	−	−	+	+	+	+	0.50
421	+	−	−	+	+	−	+	−	+	+	−	+	−
422	−	− .49	−	−	+	−	−	− .58	+	−	+	+	+
423	+	−	−	+	+	− .51	+	−	+	+	−	+	−
424	−	+	+	+	−	−	+	+	+	+	−	−	+
425	−	−	−	−	−	−	−	−	+	+	−	−	−
426	−	−	−	+	−	−	+	−	+	+	−	−	−
427	−	−	−	−	−	−	−	−	−	−	+	+	−
428	+	+	−	+	+	−	+	+	.53	.50	−	+	+
429	− .49	− .46	− .66	−	− .45	+	− .53	− .55	−	−	.60	.54	+
430a	−	−	+	−	+	+	−	+	−	− .46	+	−	+
430b	−	−	−	−	−	−	+	−	+	−	−	−	.49
431	+	−	−	−	+	−	+	−	−	−	−	−	+

TABLE B-5.—*Correlation between capital movements and money market indexes—Japan*

	031	032	033	034	035	036	037	038	039	040	041	042	043
501	−	+	−	+	−	+	−	+	+	+	+	+	−
502	0	0	0	0	0	0	0	0	0	0	0	0	0
503	−	− .67	− .66	−	−	+	−	− .52	−	− .45	.43	.48	−
504	−	−	−	+	−	+	−	−	+	−	+	+	−
505	+	−	+	+	+	−	+	−	+	+	+	+	−
506	−	−	+	+	−	−	−	−	−	−	+	+	−
507	−	+	+	+	−	+	−	−	−	−	+	−	−
508	+	+	+	+	+	−	+	−	+	+	+	+	− .71
509	−	+	+	+	−	+	−	−	+	+	−	+	+ .54
511	−	−	−	+	−	+	−	+	+	−	+	+	−
512	−	−	−	+	−	+	−	−	+	+	−	+	−
513	−	+	−	+	−	+	−	−	−	−	+	+	− .47
514	+	+	+	.59	+	−	+	+	+	+	+	+	− .65
515	+	−	−	+	+	+	−	−	+	+	+	+	+
516	−	+	+	.52	−	+	−	−	+	+	−	+	− .60
517	+	+	+	+	+	−	+	+	+	+	−	+	−
518	.44	+	+	.49	.46	−	.47	−	.64	.46	−	−	+
520	+	+	.44	+	+	−	+	+	+	+	−	−	+
521	+	+	+	+	+	−	+	+	+	+	−	−	+
522	+	+	+	+	+	−	+	+	+	+	+	−	−
523	.54	+	+	.48	.52	−	.56	−	.61	.53	−	−	+
524	−	+	+	+	−	+	−	+	−	−	+	−	−
525	−	+	+	+	−	+	−	+	−	+	−	−	−
526	−	+	+	+	−	+	−	+	−	−	−	−	−
527	+	−	+	+	+	− .47	+	−	+	+	−	−	−
528	−	−	−	−	+	−	+	−	+	−	−	+	+
529	0	0	0	0	0	0	0	0	0	'	0	0	0
530	+	+	+	−	+	+	−	+	−	−	+	−	−

TABLE B-6.—*Correlations between short- and long-term capital movements and capital movements with money market indexes—All countries*

	031	032	034	037	038	039	040	041	042	044	045	046	047	048	049	050
601	+	−	+	−	−	+	−	+	+	−	−	+	+	−	+	+
602	−	−0.47	−	−	−	−	−	−	+	+	−	+	−0.46	0.43	+	−0.43
603	−0.58	−.74	−0.69	−0.54	−0.53	−	−0.56	+	0.43	+	−	+	−.46	.45	+	−
604	−.44	−.69	−.49	−.45	−.71	−	−.56	+	+	+	−	+	−	+	0.45	−
605	.59	+	.44	.63	+	0.49	.55	−0.64	−.48	−	+	+	.45	−	−	+
606	−	−	−	−	+	−	+	−	−	−	+	−	−	−	−	−
607	−.61	−.66	−.72	−.58	−.44	−.45	−.61	+	.52	+	−	−	−.43	+	.49	−
608	+	−	−	+	+	+	+	−.48	−	−	+	−	+	−	−	−
609	−	−	−	−	−	−	−	+	+	0.47	+	+	+	.46	.59	+
611	+	−	+	+	−	+	+	−	−	−	−	−	+	−	−	+
612	+	+	+	+	+	+	.47	−	−	−	+	−	+	−	−	+
613	−.43	−	−	−.48	−	−	−	.55	+	+	+	+	+	+	.45	+
614	+	.45	.63	+	+	.45	.44	+	+	−	0.50	−	.57	−	+	.76
615	+	−	.57	+	−	.47	+	+	+	−	.44	+	.53	−	+	.69
616	+	+	.73	+	−	.58	.56	+	+	−	.54	+	.58	−	+	.84
617	+	+	+	+	+	+	+	−	−	−	−	−	−	−	−	−
618	+	−	+	+	−	.58	.45	−	−	−	+	+	.47	−	−	+
620	+	.74	+	+	.55	−	+	+	+	−	−	−	+	−	−	+
621	+	+	+	+	+	−	+	+	+	+	−	+	−	−	−	−
622	+	.45	+	+	+	+	+	+	+	−	−	−	+	−	−	+
623	+	+	+	+	+	−	−	+	−	−	−	−	−	−	−	−
624	+	+	+	+	+	+	+	−	−	+	−	+	+	−	−	+
625	−	−	+	+	+	+	+	−	−	+	+	+	+	+	+	+
626	+	+	+	+	+	+	+	−	−	+	+	+	+	+	−	+
627	+	−	+	+	−	+	+	−	−	+	−	+	+	+	−	+
628	+	−	+	+	−	+	+	+	+	−	−	−	−	−	+	+
629	−	−	−.56	−	−	−	−.44	−	−	+	−	+	−	+	+	−.64
630	+	+	−	+	+	−	−	−	−	−	−	−	−	−	−	−.56
631	−	+	+	−	−	−	+	+	.50	−	+	−	−	−	+	+
632	+	+	+	+	+	+	+	−	−	+	−	+	+	+	+	−
633	−	+	−	−	+	−	−	.54	+	+	−	+	−	+	−	+
634	−.63	+	−.65	+	−.81	−.76	.53	+	+	−	−	+	−.49	+	+	−.48
635	−.64	−.53	−	−.68	−.60	−	−.47	.70	.69	+	+	+	−	.45	.60	+
636	+	−	+	−	−.47	−	−	+	−	+	+	+	+	+	+	+
637	−	+	−	−	+	−	−	+	+	−	−.44	−	−	−	−	−

	629	630	631	632	633	634	635	636	637
601	+	+	−0.43	−	−	+	+	0.84	0.44
602	+	+	+	+	−	−	+	−	−
603	+	+	−	−	−	+	0.46	+	+
604	+	+	−	−	−	+	.64	.64	+
605	−	−	−	+	−0.46	−0.45	−.49	−	−
606	−	+	+	+	−	−	−	−	−
607	+	+	+	−	−	+	+	+	+
608	−	−	+	+	−.51	−	−	−	−
609	+	−	+	−	−	−	.43	+	−
611	−0.45	−0.51	+	+	+	−.68	+	−	−
612	−	−	+	+	−	−	−.46	−.67	−.52
613	−	−	−	−	+	+	.60	+	+
614	.52	−	+	−	+	−	+	+	+
615	−.51	−.42	.43	+	−	−.56	+	+	−.48
616	−.67	−.59	+	+	+	−.61	+	−	−
617	−	+	+	+	+	−	−	−	+
618	−.43	+	−	−	−	−	+	+	−
620	−	−	+	+	.48	+	−	−	+
621	−	+	+	+	+	+	−	−	−
622	−	−	+	+	.43	−	−	−	.47
623	−	+	+	+	+	+	−	+	+
624	−	−	−	+	+	−	+	−	+
625	−.43	−	−	+	+	−	+	−	−
626	−.45	−	−	+	+	−	+	−	+
627	−.53	+	−	+	−	−	+	−	−
628	+	−.48	+	+	−	−	+	−.54	−
629	1	+	−	+	−	+	−	+	+
630	------	1	−	−	−	+	−	+	+
631	------	------	1	0.49	+	−	+	−	−
632	------	------	------	1	−	−	−	−	−
633	------	------	------	------	1	+	+	−	+
634	------	------	------	------	------	1	+	+	+
635	------	------	------	------	------	------	------	------	------
636	------	------	------	------	------	------	------	1	+
637	------	------	------	------	------	------	------	------	1

TABLE C.—*Intercorrelations of money-market indexes*

	031	032	033	034	035	036	037	038	039	040	041	042	043	044	045	046	047	048	049	050	051
031	1	0.51	0.63	0.79	0.98	−0.63	0.99	+	0.85	0.84	−0.66	−0.69	−	−	+	−	0.67	−0.58	−0.54	+	−0.62
032		1	.91	.63	.48	+	.46	0.77	+	.48	−	−	−	−	+	+	.47	−	−.43	+	−
033			1	.62	.59	−	.62	.78	+	.53	−.51	−.70	−	−	+	+	.45	−	−.59	+	−
034				1	.70	−.45	.72	+	.82	.46	−	−	−	−	0.46	+	.81	−.49	−	0.74	−
035					1	−.53	.96	+	.83	.76	−.56	−.62	+	−	+	−	.58	−.58	−.55	+	−.58
036						1	−.66	+	−.71	−.62	.66	+	+	+	−	−	−.46	+	+	−	.48
037							1	+	.84	.84	−.75	−.73	+	−0.40	+	−	.58	−.59	−.58	+	−.68
038								1	−	+	−.44	−.53	+	−	−	−	−	−	.52	−	−
039									1	.89	−.47	−	−	−.44	+	−	.67	−.55	−	.55	−.55
040										1	−.66	−.55	−	−.51	.49	−	.64	−.69	−.44	.58	−.74
041											1	.87	−	+	−	+	−	.95	.56	+	.77
042												1	−	+	−	−	−	+	.62	+	.63
043													1	−	−	−0.53	−.61	−	−	−.56	−
044														1	+	.89	+	.94	.67	−	.78
045															1	+	.71	+	.44	.69	−
046																1	.46	.78	.51	−	.67
047																	1	−	+	.70	−
048																		1	.78	−	.89
049																			1	+	.75
050																				1	−
051																					1

Annex 2

List of variables for multiple correlations and regression equations.
Partial correlations and selected regression equations.

Variables for Multiple Correlations and Regression Equations

Dependent variables.—All of the dependent variables (short-term capital movements) are quarterly increases (+) or decreases (−) in amounts outstanding. All of them are measured in hundreds of thousands of dollars.

Independent variables.—Unless otherwise indicated, all dollar items are measured in hundreds of thousands of dollars and all interest rate differences are measured in basis points. For details, see the list of variables used in the simple correlations.

$^{x}01$ United Kingdom Treasury bill rate less United States Treasury bill rate.
$^{x}02$ Same, covered.
$^{x}03$ Increase (+) in U.S. merchandise exports to the ith region.
$^{x}04$ Increase (+) in U.S. merchandise trade balance with i^{th} region.
$^{x}05$ Premium on spot sterling (hundredths of a cent).
$^{x}06$ Liquid assets ratio of United Kingdom banks (tenths of a percentage point).
$^{x}07$ Canadian Treasury bill rate less United States Treasury bill rate, covered.
$^{x}08$ Canadian day-to-day money rate less United States Treasury bill rate, covered.
$^{x}09$ Eurodollar deposit rate (London) less United States Treasury bill rate.
$^{x}10$ Increase (+) in short-term bank loans to foreign banks.
$^{x}11$ Increase (+) in short-term bank loans to other foreigners plus increase in long-term bank claims of all foreigners.
$^{x}12$ For United Kingdom: Increase in foreign currency liabilities of U.S. banks in London (i.e., dollar equivalent of increase in deposit liabilities to all foreigners as reported in Bank of England Bulletin). For Canada: Increase in foreign currency liabilities of Canadian banks as reported (in Canadian dollars) by International Financial Statistics.
$^{x}13$ New capital issues of the ith region in the U.S. market.
$^{x}14$ Increase (+) in dollar items in collection (as reported by U.S. banks) plus increase in dollar claims of U.S. nonfinancial concerns.
$^{x}15$ Increase (+) in money-market assets of foreign banks.
$^{x}16$ Increase (+) in money-market assets of other foreigners.
$^{x}17$ Increase (+) in dollar claims of U.S. nonfinancial concerns.
$^{x}18$ Increase (+) in foreign currency liabilities reported by U.S. banks.
$^{x}19$ Increase (+) in foreign currency liabilities of U.S. nonfinancial concerns.
$^{x}20$ Increase (+) in other foreign currency claims reported by U.S. banks.
$^{x}21$ Increase (+) in other foreign currency claims of U.S. nonfinancial concerns.

Partial correlations.—Each of the following arrays tabulates the partial correlations obtained for the dependent variables. The final number in each column is the square of the multiple correlation coefficient (giving the percentage of total variation "explained" by the multiple regression equation).

Significance tests

DOLLAR DEPOSITS OF FOREIGN BANKS

	United Kingdom	Canada	Europe	Latin America	Japan
04	0.081	−0.149	0.046	−0.193	0.196
05	−.070				
06	−.189				
10	−.085	−0.26	−.021	.107	[1] .635
12	.173	[1] .692			
13		[2] .440	.267	−.312	
15			−.100	−.100	−.037
R^2	.2157	.7959	.0959	.1237	.5633

DOLLAR DEPOSITS OF OTHER FOREIGNERS

	United Kingdom	Canada	Europe	Latin America	Japan
04	−0.097	0.010	0.132	0.008	−0.118
05	[2] .403				
11	.357	[1] .537	[1] .530	.131	.332
14	[2] −.464	−.323	−.172	[2] −.389	−.148
16	[1] −.759	.100	−.043	[1] −.486	.214
R^2	.6220	.4182	.4242	.2971	.1580

Significance tests—Continued

MONEY-MARKET ASSETS OF FOREIGN BANKS

	United Kingdom	Canada	Europe	Latin America	Japan
1st trial: Uncovered bill-rate difererential:					
01	[1] −0.581	−0.304	−0.051	[2] −0.533	−0.016
05	−.239				
06	.163				
07		−.375			
09		.107	[2] −.497	.353	−.241
10	[1] .566	.169		[1] .583	
12		−.109			
R^2	.4675	.0387	.4970	.4091	.1516
2d trial: Covered bill-rate differential:					
02	[2] −.525	[1] −.646	[1] −.531	.026	[1] −.547
05	−.126				
06	−.068				
07		−.391			
09		.334	[2] −.456	−.138	.042
10	[2] .468	.373		[2] .396	
12		[2] −.497			
R^2	.4174	.5559	.6378	.1751	.4311

MONEY-MARKET ASSETS OF OTHER FOREIGNERS

	United Kingdom	Canada	Europe	Latin America	Japan
1st trial: Uncovered bill-rate differential:					
01	0.016	0.308	−0.284	−0.178	−0.317
05	.023				
07		[2] .437			
08		[2] −.520			
09			[2] −.464	[2] −.443	.269
11	.293	[2] .426			
R^2	.0992	.3892	.6130	.5225	.1011
2d trial: Covered bill-rate differential:					
02	−.246	−.029	[1] −.614	−.053	.007
05	.080				
07		.332			
08		[2] −.393			
09			[1] −.552	[1] −.602	.015
11	.322	[2] .387			
R^2	.1180	.3257	.7378	.5082	.0007

DOLLAR LIABILITIES OF U.S. NONFINANCIAL CONCERNS

	United Kingdom	Canada	Europe	Latin America	Japan
02	[2] −0.472	−0.335	−0.267	0.316	0.223
03	.045	−.194	−.143	−.331	−.139
05	[1] −.621				
06	−.296	[1] −.801	−.337	−.109	[2] −.516
07		[1] −.736			
09			−.259	.056	[2] −.428
R^2	.5916	.6978	.2724	.1260	.4898

SHORT-TERM BANK LOANS TO FOREIGN BANKS

	United Kingdom	Canada	Europe	Latin America	Japan
02	0.004	−0.183	0.134	0.284	0.360
03	−.191	[2] −.463	.090	−.144	−.321
05	.139				
06	−.002	−.395	.211	[2] −.458	[2] .491
07		.076			
09		−.070	.064	[2] .444	.186
R^2	.0821	.3054	.1063	.3941	.3126

SHORT-TERM BANK LOANS TO OTHER FOREIGNERS

	United Kingdom	Canada	Europe	Latin America	Japan
02	0.206	0.333	[1] 0.607	0.271	0.247
03	−.158	.187	−.357	.059	−.246
05	.067				
06	.281	.329	−.067	.277	[2] .415
07		−.078			
09		−.028	.325	.503	.299
R^2	.1739	.2138	.3752	.3197	.2372

See footnotes at end of table.

Significance tests—Continued

DOLLAR ITEMS IN COLLECTION REPORTED BY U.S. BANKS

	United Kingdom	Canada	Europe	Latin America	Japan
02	[1] 0.860	0.226	0.130	0.158	0.086
03	.292	.242	.190	.238	[2] .422
05	−.015				
06	[1] −.729	−.037	.314	.210	−.198
07		.132			
09		.198	−.253	.045	−.074
17	[2] .433		−.017	−.062	[2] −.438
R^2	.8735	.1946	.2386	.1723	.3810

OTHER DOLLAR CLAIMS ON FOREIGNERS REPORTED BY U.S. BANKS

	United Kingdom	Canada	Europe	Latin America	Japan
02	−0.038	−0.024	[1] 0.612	0.029	[3] 0.499
03	−.132	.313	.163	.051	−.015
05	.019				
06	−.066	.290	.216	−.276	[1] .568
07		−.013			
09		.232	.374	.052	[2] −.522
R^2	.0345	.3129	.5638	.0998	.6935

DOLLAR CLAIMS ON FOREIGNERS OF U.S. NONFINANCIAL CONCERNS

	United Kingdom	Canada	Europe	Latin America	Japan
02	[1] .709	[1] 0.636	[2] 0.445	0.054	0.221
03	[2] −.386	−.134	[2] −.400	−.122	−.291
05	[2] .522				
06	.201	−.296	[2] .414	−.014	.240
07		.365			
09		[1] .595	[3] .519	−.346	.078
R^2	.6383	.6179	.4411	.1578	.1298

FOREIGN-CURRENCY DEPOSITS REPORTED BY U.S. BANKS

	United Kingdom	Canada	Europe	Latin America	Japan
1st trial: Uncovered bill-rate differential:					
01	0.078	[2] 0.429	0.025	−0.002	0.334
05	.008				
07		[2] −.461			
18	.223	[3] −.514	[1] −.791	[2] −.401	[1] .593
20	.195	.116	[1] −.709	[2] .366	−.127
R^2	.0822	.4545	.7357	.2269	.3941
2d trial: Covered bill-rate differential:					
02	−.084	−.082	[2] .426	[2] −.413	.126
05	.063				
07		[2] .367			
18	.216	[3] −.489	[1] .817	[2] −.378	[1] .556
20	.165	.163	[1] −.769	.276	−.060
R^2	.0812	.3363	.7836	.3590	.3287

FOREIGN-CURRENCY DEPOSITS OF U.S. NONFINANCIAL CONCERNS

	United Kingdom	Canada	Europe	Latin America	Japan
1st trial: Uncovered bill-rate differential:					
01	0.308	−0.125	0.001	0.095	[2] 0.497
05	−.080				
07		−.306			
19	.362	.120	[1] .671	[1] −.641	.176
21	.204	[1] .592	.062	[2] .517	−.196
R^2	.2320	.4215	.4736	.4313	.2513
2d trial: Covered bill-rate differential:					
02	−.067	[1] −.690	.326	−.161	.058
05	.020				
07		−.195			
19	[2] .386	−.088	.717	[1] −.646	.055
21	.150	[2] .751	−.041	[2] .512	−.046
R^2	.1551	.6918	.5297	.4411	.0093

See footnotes at end of table.

Significance tests—Continued

OTHER FOREIGN-CURRENCY CLAIMS REPORTED BY U.S. BANKS

	United Kingdom	Canada	Europe	Latin America	Japan
1st trial: Uncovered bill-rate differential:					
01	−0.174	0.065	0.033	0.024	[2] 0.435
03	[2] .428	−.236	.041	.174	.102
05	.217				
07		.300			
18	.087	−.012	.067	−.094	[2] .445
R^2	.2940	.1512	.0146	.0453	.2538
2d trial: Covered bill-rate differential:					
02	−.091	[1] .689	.033	−.043	.239
03	[2] .463	−.125	.003	.223	.070
05	.196				
07		.220			
18	.153	.024	.313	−.286	.204
R^2	.2781	.5527	.1056	.1153	.1080

OTHER FOREIGN-CURRENCY CLAIMS OF U.S. NONFINANCIAL CONCERNS

	United Kingdom	Canada	Europe	Latin America	Japan
1st trial: Uncovered bill-rate differential:					
01	−0.215	0.059	−0.087	0.287	−0.348
03	.031	−.311	[3] .473	.176	.110
05	.195				
07		.179			
R^2	.0749	.1288	.2414	.0999	.1956
2d trial: Covered bill-rate differential:					
02	[1] .599	.261	−.160	.235	[3] −.455
03	.237	−.263	.312	−.136	.275
05	−.125				
07		.137			
R^2	.3777	.1856	.1179	.0881	.2471

[1] Denotes a partial correlation coefficient that is significantly different from zero at the 0.05 level.
[2] Denotes a partial correlation coefficient that is significantly different from zero at the 0.20 level.
[3] Denotes a partial correlation coefficient that is significantly different from zero at the 0.10 level.

Selected regression relationships.—The equations set out below are those that "explain" more than 50 percent of the variation in the dependent variable. The numbers in parentheses are the standard errors of the regression coefficients. Coefficients that are significant at the 0.05 level have been underlined. The subscripts attached to the dependent variables identify the country or region:

Y_u United Kingdom
Y_c Canada
Y_c Europe
Y_a Latin America
Y_j Japan

Dollar deposits of foreign banks:

$$Y_e = -584.9 - \underset{(.226)}{.113}X_{04} - \underset{(2.867)}{.244}X_{10} + \underset{(.145)}{\underline{.460}}X_{12} + \underset{(.498)}{.811}X_{13}$$

$$Y_j = 17.2 + \underset{(.122)}{.085}X_{04} + \underset{(.291)}{\underline{.828}}X_{10} - \underset{(.722)}{.092}X_{15}$$

Dollar deposits of other foreigners:

$$Y_u = -6.6 - \underset{(.089)}{.028}X_{01} + \underset{(.736)}{1.026}X_{05} + \underset{(.529)}{.639}X_{11} - \underset{(.230)}{.380}X_{14} - \underset{(.154)}{\underline{.569}}X_{16}$$

Money-market assets of foreign banks:

$$Y_c = 114.6 - \underset{(1.531)}{\underline{4.096}}X_{02} - \underset{(1.625)}{2.185}X_{07} + \underset{(1.271)}{1.426}X_{09} + \underset{(.651)}{1.060}X_{10} - \underset{(.033)}{.060}X_{12}$$

$$Y_e = 1698 - \underset{(8.007)}{\underline{18.083}}X_{02} - \underset{(6.840)}{12.632}X_{09}$$

Money-market assets of other foreigners:

$$Y_e = 187.5 - \underset{(.790)}{\underline{2.215}}X_{02} - \underset{(.674)}{\underline{1.610}}X_{09}$$

$$Y_a = 198.5 - \underset{(1.087)}{.208}X_{02} - \underset{(.929)}{\underline{2.525}}X_{09}$$

Dollar liabilities of U.S. nonfinancial concerns:

$$Y_u = 646.4 - \underset{(.625)}{1.110}X_{02} + \underset{(.043)}{.006}X_{03} - \underset{(.429)}{\underline{1.144}}X_{05} - \underset{1.473)}{1.512}X_{06}$$

$$Y_c = 2227 - \underset{(.616)}{.727}X_{02} - \underset{(.024)}{.016}X_{03} - \underset{(1.461)}{\underline{6.485}}X_{06} - \underset{(.907)}{\underline{3.270}}X_{07}$$

Dollar items in collection:

$$Y_u = 229.8 + \underset{(.124)}{\underline{.664}}X_{02} + \underset{(.006)}{.006}X_{03} - \underset{(.073)}{.004}X_{05} - \underset{(.230)}{\underline{.774}}X_{06} + \underset{(.016)}{.024}X_{17}$$

Other dollar claims reported by U.S. banks:

$$Y_c = 990.9 + \underset{(1.521)}{\underline{3.899}}X_{02} + \underset{(.040)}{.022}X_{02} + \underset{(2.599)}{1.910}X_{06} + \underset{(1.044)}{1.298}X_{09}$$

$$Y_j = -4214 + \underset{(3.769)}{7.190}X_{02} - \underset{(.396)}{.020}X_{02} + \underset{(6.573)}{\underline{15.040}}X_{06} - \underset{(2.662)}{5.404}X_{09}$$

Dollar claims of U.S. nonfinancial concerns:

$$Y_c = -792.4 + \underset{(1.094)}{\underline{3.648}}X_{02} - \underset{(.075)}{.104}X_{03} + \underset{(.751)}{1.525}X_{05} + \underset{(2.577)}{1.756}X_{06}$$

$$Y_c = 2130 - \underset{(3.775)}{\underline{9.865}}X_{02} - \underset{(.117)}{.050}X_{03} - \underset{(7.338)}{7.190}X_{06} + \underset{(4.772)}{5.921}X_{07} + \underset{(3.485)}{\underline{8.149}}X_{09}$$

Foreign currency deposits reported by U.S. banks:

$$Y_c = -10.0 + \underset{(.818)}{1.337}X_{02} + \underset{(.212)}{\underline{1.039}}X_{18} - \underset{(.787)}{\underline{3.277}}X_{20}$$

Foreign currency deposits of U.S. nonfinancial concerns:

$$Y_c = 51.7 - \underset{(.444)}{\underline{1.402}}X_{02} - \underset{(.614)}{.405}X_{07} - \underset{(.794)}{.234}X_{19} + \underset{(.248)}{\underline{.560}}X_{21}$$

$$Y_e = -44.4 + \underset{(.607)}{.728}X_{02} + \underset{(.361)}{\underline{1.288}}X_{19} - \underset{(.784)}{.111}X_{21}$$

Other foreign currency claims reported by U.S. banks:

$$Y_c = -94.0 + \underset{(1.247)}{\underline{3.937}}X_{02} - \underset{(.051)}{.021}X_{03} + \underset{(1.779)}{1.33}X_{07} + \underset{(.869)}{.071}X_{18}$$

APPENDIX II

RANK CORRELATIONS

This appendix describes one more attempt to analyze recent U.S. experience with short-term capital movements. In an effort to avoid the econometric problems posed by time-series analysis, we made a cross-sectional study of two

recent periods—the second half of 1960 and the second half of 1961. We selected 18 countries that have entries in most of the B-form and C-form categories and ranked them by the size of the capital flow to (or from) the United States.[12] The country with the largest increase in each class of claims (or liabilities) was ranked first for that class and period.

We then calculated Spearman's coefficient of rank correlation for each pair of claims and liabilities. The results are summarized in tables A-1 and A-2. The numbers in those tables are the rank correlations that were significant at the 0.05 level; the signs pertain to coefficients that were not significant. The code numbers are the same as those used in the simple time-series correlations (app. I, annex 1). Items 03, 04, 06, and 07 were not used in these rank correlations because several countries did not have claims in those categories.

Table A-1 gives rank correlations based on dollar changes in claims and liabilities. Table A-2 gives a second set based on percentage changes in claims and liabilities. Several correlation coefficients changed signs when we worked with percentage changes rather than dollar changes. This is because small dollar changes may give rise to large percentage changes when the amounts outstanding are quite small to start.

The results of this computation are not at all impressive—less so than the simple correlations in appendix I. There are several significant correlations in each matrix, but very few endure from one year to the next. In fact, only two correlations are significant in both panels of table A-1 (01-17 and 11-20). The first of these may represent window dressing by U.S. and foreign banks—the mutual exchange of deposit obligations so as to enlarge each bank's assets. The second correlation defies simple explanation. Four correlations are significant in both panels of table A-2 (01-17, 03-25, 09-11, and 11-15). The first of these is window dressing once again; the others are not easily explained.

In another application of this same technique, we juxtaposed each 1960 ranking with the corresponding 1961 ranking and ran another set of correlations. The results of this analysis are summarized in the body of this report (table 5). They show very little uniformity between one year and the next.

Appendix II

TABLE A-1.—*18 country rank correlations: 2d half 1960 and 2d half 1961*

[Dollar changes]

	01	03	05	09	11	12	13	14	15	17	18	20	21	24	25
1960—01	1	−	−	−	+	−	−	+	+	0.56	+	+	+	−	+
03		1	+	+	+	+	+	+	+	−	−	−0.48	−	0.58	+
05			1	+	+	+	0.50	+	−	−	−	−	−	.56	−0.51
09				1	+	−	−	−	−	+	−	+	−0.41	−	−
11					1	+	−	+	+	−	+	−.51	+	+	+
12						1	+	−	+	−	−	−	+	+	−
13							1	+	+	−	+	+	+	+	−
14								1	0.51	+	−	+	.45	+	+
15									1	+	−	+	.69	−	.42
17										1	+	+	+	−.43	+
18											1	+	+	−	+
20												1	+	−	+
21													1	−	.60
24														1	−
25															1
1961—01	1	0.42	+	−	−	+	−.39	−	−	.71	+	+	+	+	−
03		1	+	+	−0.38	+	−	−	+	.65	+	+	+	+	−.36
05			1	+	−	.066	−	+	−	+	+	+	−	−	−
09				1	−	−	−	+	−	+	+	−	+	−	−
11					1	−	+	+	+	−	+	−.49	−	+	+
12						1	+	−	+	+	+	+	−.37	−	−
13							1	−	+	−.42	−	−	−.76	+	−
14								1	−	−	−0.39	+	−	−	−.40
15									1	−	−	+	+	+	−
17										1	+	+	+	+	−
18											1	−	−.69	−.40	−.51
20												1	+	−	+
21													1	+	+
24														1	+
25															1

[12] Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland, United Kingdom, Argentina, Brazil, Chile, Mexico, Venezuela, India, Japan, Australia, South Africa, and Canada.

TABLE A-2.—*18 country rank correlations: 2d half 1960 and 2d half 1961*

[Percentage changes]

	01	03	05	09	11	12	13	14	15	17	18	20	21	24	25
1960—01	1	+	+	+	0.38	−	+	+	0.37	0.44	−	0.40	+	−	+
03	----	1	+	0.37	+	+	+	+	.41	+	+	+	+	+	0.62
05	----	----	1	+	.50	−	+	+	−	−	−	+	−	+	+
09	----	----	----	1	.39	−	+	−0.50	+	.42	−	+	−	−	−
11	----	----	----	----	1	−	−	−	.43	−	−	+	+	+	.45
12	----	----	----	----	----	1	−	−	+	−	−	−	+	−	+
13	----	----	----	----	----	----	1	+	.40	−	+	+	+	+	−
14	----	----	----	----	----	----	----	1	+	+	+	+	0.59	+	+
15	----	----	----	----	----	----	----	----	1	+	−	+	.45	−	.44
17	----	----	----	----	----	----	----	----	----	1	+	+	+	−	+
18	----	----	----	----	----	----	----	----	----	----	1	+	−	+	+
20	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+
21	----	----	----	----	----	----	----	----	----	----	----	----	1	−	+
24	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+
25	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1
1961—01	1	+	−	+	−	+	−0.42	−	−	.61	+	+	+	−	−
03	----	1	+	+	−.70	+	−	−	+	.59	−	−	.45	−	−.37
05	----	----	1	+	−	+	−	−	−	−	+	−.53	+	−	−
09	----	----	----	1	−.43	+	−.42	−	−	+	−	−	+	−	−
11	----	----	----	----	1	−	+	.45	.38	−	+	−	.39	0.41	−
12	----	----	----	----	----	1	−	+	+	−	+	−	−	−	−
13	----	----	----	----	----	----	1	+	−	−.36	0.44	+	−.46	+	−
14	----	----	----	----	----	----	----	1	−	+	+	.39	−	−	−
15	----	----	----	----	----	----	----	----	1	−	−	−	+	.57	+
17	----	----	----	----	----	----	----	----	----	1	−	+	.45	+	−.38
18	----	----	----	----	----	----	----	----	----	----	1	+	−.51	−	−
20	----	----	----	----	----	----	----	----	----	----	----	1	+	+	+
21	----	----	----	----	----	----	----	----	----	----	----	----	1	+	−
24	----	----	----	----	----	----	----	----	----	----	----	----	----	1	+
25	----	----	----	----	----	----	----	----	----	----	----	----	----	----	1

A SURVEY OF CAPITAL MOVEMENTS AND FINDINGS REGARDING THEIR INTEREST SENSITIVITY

By Benjamin J. Cohen, Balance of Payments Division, Federal Reserve Bank of New York

OFFICE CORRESPONDENCE

FEDERAL RESERVE BANK OF NEW YORK,
JULY 5, 1963.

To: Mr. Holmes.
From: Benjamin J. Cohen, Balance of Payments Division.
Subject: A survey of capital movements and findings regarding their interest sensitivity.

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Evidence regarding the question of whether international capital and gold flows tend to be interest induced is becoming more abundant, and more confusing. In my memorandum of January 29 entitled "The Interest Sensitivity of Certain Capital Movements in the U.S. Balance of Payments," I presented some new statistical findings. In some respects, these findings were at variance with those presented by Professor Bell in his published study for the Joint Economic Committee[1] and with those presented in a 1962 Treasury study for which Professor Kenen served as a consultant.[2] In an attempt to reconcile some of these findings, and also to attach some quantitative importance to the underlying relationships, I have examined each of the major categories of capital movements recorded in the U.S. balance of payments. These flows are considered from two aspects: (a) their relative size; and (b) their prospective responsiveness to changes in interest rates.

1. SUMMARY AND CONCLUSIONS

International capital movements may be influenced by changes in either the availability or the cost of credit. The two aspects of monetary conditions are naturally related (in one sense the level of interest rate is the measure of credit availability), but the relationship is not at all systematic. Availability is the more difficult to analyze for its quantitative effect on capital flows, and I have not attempted to do that here. The analysis in this memorandum is concerned solely with the prospective responsiveness of capital movements to interest rate changes; the conclusions assume that credit availability and bank liquidity are given.

Needless to say, even the effect of interest rates on capital flows is difficult to estimate. All we have available are historical data, which tell us something only about past relationships. To assert that they tell us something about potential responsiveness as well, we must assume that structural conditions and behavioral relationships are and will continue to be the same. While this may be considerably unrealistic, it is necessary for any sort of quantitative estimation.

We must also assume that changes in international interest rate relationships are possible. For example, we must be able to assume that the sudden appearance of an interest rate differential, due to a rise in U.S. rates relative to abroad, will not be followed immediately by sympathetic rate rises in foreign financial centers. Of course, a differential would probably be erased in time by induced capital movements, but it is just these flows which we hope to estimate. For this purpose, we must assume that the flows will not be prevented by autonomous monetary policies designed to keep interest rate differentials from ever appearing.

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[1] Philip W. Bell, "Private Capital Movements and the U.S. Balance of Payments Position," Factors Affecting the United States Balance of Payments, compilation of studies prepared for the Subcommittee on International Exchange and Payments of the Joint Economic Committee (Washington, 1962) pp. 395–482.

[2] "Short-Term Capital Movements and the U.S. Balance of Payments" October 1962. Hereafter referred to as the Kenen study.

Even making these necessary assumptions, we cannot estimate precisely the responsiveness of capital movements to interest rate changes. Historical data permit us to make generalizations about qualitative relationships. But on the basis of evidence currently available, we cannot yet estimate by how much interest rates must change to generate a given size capital flow. At best, we can simply suggest the volume of capital flows that might be associated with "substantial" rate changes.[3]

Consider first transactions in U.S. and foreign long-term securities. Portfolio capital movements have been sizable in recent years, but have not demonstrated much of a responsiveness to interest rate movements. All available evidence indicates that except for the tiny amount of transactions in U.S. corporate bonds, foreign long-term capital flows have been notably insensitive to interest rates here and abroad. Net U.S. purchases of foreign bonds (predominantly new issues) have shown some relationship to interest rates, but it seems to be the timing of purchases which is affected rather than the amounts. Because of the deficiencies of capital markets elsewhere, changes in long-term interest rates would probably not have a large effect on our longrun balance-of-payments position.

The two major recent studies of U.S. short-term capital movements have seemed, at first glance, to arrive at diametrically opposed conclusions, with Bell arguing that these flows are determined mainly by U.S. exports and Kenen insisting that only interest rates matter. However, careful scrutiny reveals that the conclusions are not so far apart as they seem. Kenen produced no evidence to disprove Bell's contention that the large flow of "trade credit" (bank loans to "others" and collections outstanding) to underdeveloped areas has tended to move closely with the level of U.S. exports to the same areas. On the other hand, Bell seems to agree with Kenen that some other U.S. short-term capital movements are responsive to interest rates. These are the short-term dollar claims of U.S. nonfinancial corporations, at least some of the "trade credit" extended to Canada and Europe, and perhaps all of the "other" dollar bank claims (mainly bankers' acceptances). Furthermore, it is important to note that both Kenen and Bell agree that the "Errors and omissions" item in our international accounts apparently includes a large amount of unrecorded nonfinancial corporate dollar claims which are also interest sensitive. The magnitude of these several categories is such that a "substantial" rise in U.S. short-term interest rates relative to those abroad might be associated with a reduction in our balance-of-payments deficit of as much as $750 million in a year.[4] This is admittedly a crude estimate, but it does suggest that monetary policy can have an influence on the U.S. short-term capital account.

Available evidence indicates that monetary policy is also capable of influencing private foreign short-term capital flows. Foreign official dollar holders do not pay attention to interest rate considerations. But private foreign dollar holders—at least those on the continent of Europe—do seem to be concerned with relative short-term yields here and abroad. A rise in U.S. rates relative to abroad might reduce private switching out of dollar assets by as much as $600 to $700 million in a year (decreasing the outflow of dollar liabilities to foreign official institutions by the same amount). While this would not reduce our deficit as currently defined, it would protect our gold stock.

2. FOREIGN AND U.S. INVESTMENT IN LONG-TERM SECURITIES

Transactions in long-term portfolio capital have been sizable in recent years, and in general have tended to be an adverse influence on the U.S. balance of payments. While foreigners have added substantial amounts to their holdings of U.S. long-term securities. Americans have been investing even more heavily in foreign long-term securities. As a result, there has been a net portfolio outflow in every year but one since 1957. The total outflow in the last 6 years

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[3] In some circumstances "substantial" might imply interest rate changes of one-half of 1 percent, or even less. In other circumstances larger rate changes might be required.

[4] The reduction would be smaller if it were associated with a rise in the dollar premium in the forward exchange market (in lieu of a rise in U.S. short-term interest rates), even though investors choosing between U.S. and foreign money-market assets are usually concerned with "covered" rather than with "uncovered" rate differentials (i.e., with rate differentials adjusted for forward premiums or discounts). The analysis shows that many of the interest sensitive claims seem in fact to be Eurodollar deposits: when U.S. investors choose between U.S. money-market assets and Eurodollar deposits, they naturally pay no attention to the forward exchange market.

has amounted to almost $3.7 billion. The two basic components of portfolio capital flows—foreign investment in U.S. portfolio securities and U.S. investment in foreign portfolio securities—will be examined separately.

(a) Foreign investment in U.S. securities

Foreigners have purchased about $1.6 billion of U.S. portfolio securities since 1957. As table I indicates, foreign long-term capital flows can be divided into three categories of securities (*a*) U.S. Government bonds and notes;[5] (*b*) U.S. corporate bonds; and (*c*) U.S. corporate stocks. The last of these three categories can be eliminated immediately as being insensitive to interest rates here or aboard. Few economists would argue that foreign transactions in U.S. stocks are determined primarily by relative or absolute interest rate considerations. Significantly, the elimination of this category removes more than $1 billion of the net portfolio inflow since 1957, or approximately 65 percent of the cumulative total.

TABLE I.—*Net purchases (+) of U.S. long-term securities by foreigners 1957–62*

[In millions of dollars]

	1957	1958	1959	1960	1961	1962	Total
All U.S. securities	+141.7	−2.8	+1,124.3	+377.7	+735.7	−718.2	+1,587.0
U.S. Government bonds and notes	−52.3	+35.2	+688.9	+126.5	+512.0	−752.1	+487.8
U.S. corporate securities	+194.0	−38.0	+435.4	+251.2	+223.7	+33.9	+1,100.2
U.S. corporate bonds [1]	+49.4	+18.3	+72.5	+49.8	−98.9	−20.7	+64.4
U.S. corporate stocks	+144.6	−56.3	+362.9	+201.4	+322.6	+60.6	+1,035.8

[1] Includes small amounts of local government bonds.

Of the remaining two categories, the larger is net foreign transactions in U.S. Government bonds and notes. Foreigners have purchased almost $490 million of U.S. Government long-term obligations in the last 6 years; this represents about 31 percent of the cumulative inflow of portfolio capital since 1957. Like foreign transactions in U.S. stocks, this category does not seem to be influenced by interest rate considerations. In fact, not one of the investigations under discussions was able to uncover the slightest trace of interest sensitivity. Professor Bell, for example, using a regional approach, could not find one significant correlation between net foreign purchases and either United States, British, or Canadian long-term interest rates. My aggregative approach yielded similarly barren results.[6] These negative findings would seem to indicate that U.S. Government long-term securities are treated as liquid assets by foreigners, and are bought and sold with little regard for their yields relative to yields abroad. Foreign transactions apparently have reflected instead the gradual relaxation of capital-market restrictions abroad and the changing liquidity preferences of foreign dollar holders.

The last category—net foreign transactions in U.S. corporate bonds—has represented only about 4 percent of the net portfolio inflow since 1957, but it is the only category that has shown any sensitivity to interest rates. I found high coefficients of correlation linking this category to the differential between the British Government bond rate and the United States Government bond rate and the United States corporate bond rate. Using a slightly shorter period, Professor Kenen found an even stronger relationship between the category and the former rate differential. Professor Bell also seems to have achieved much the same result.[7] Unfortunately, the relatively small size of this flow belies the promise of these positive findings: the regression equations which I

[5] The reader is reminded that changes in foreign holdings of U.S. Government bonds and notes, which are normally considered liquid liabilities to foreigners, are included "below the line" in U.S. balance-of-payments accounts, i.e., as part of the U.S. payments deficit. For the purpose of the present analysis it seemed more appropriate to include this category in the discussion of long-term portfolio capital.

[6] This was so even though I attempted to correlate this category with both long-term and short-term rates and rate differentials.

[7] Professor Bell did not correlate U.S. corporate bonds directly, but he did find a higher degree of correlation when he used all U.S. bonds than when he used U.S. Government securities alone. See his app. II.

computed indicate that a full 1 percent rise in our long-term rates relative to rates abroad would be associated with increased net foreign purchases of U.S. corporate bonds—or decreased net sales—of about only $25 million per quarter The benefit to our balance of payments would be negiligible.

(*b*) *U.S. investment in foreign securities*

Table II shows that U.S. investors have purchased about $5.3 billion of foreign portfolio securities since 1957. Approximately one-fifth of the total—some $1.1 billion—consisted of net purchases of foreign stocks, just matching the total of net foreign purchases of U.S. stocks. Like foreign transactions in U.S. stocks, this category can be eliminated immediately as being insensitive to interest rate considerations. The remaining four-fifths of the U.S. long-term capital outflows—a huge $4.2 billion since 1957—consisted of net purchases of foreign bonds, including both new issues and "seasoned" securities. By virtue of its magnitude, this item is the single most important long-term portfolio capital flow to be considered for its prospective responsiveness to interest rates.

TABLE II.—*Net U.S. purchases (—) of foreign long-term securities, 1957–62*

[In millions of dollars]

	1957	1958	1959	1960	1961	1962	Total
All foreign securities	−722.1	−1,362.5	−749.8	−644.2	−828.8	−994.6	−5,302.0
Stocks	−29.1	−336.7	−237.8	−82.7	−369.8	−78.1	−1,134.2
Bonds	−693.0	−1,025.8	−512.0	−561.5	−459.0	−916.5	−4,167.8
Net new issues of foreign securities[1]	−418.0	−870.0	−530.0	−473.0	−387.0	−853.0	−3,531.0

[1] New issues (including small amounts of stock issues) less redemptions equals net new issues.

Source: Department of Commerce.

However, while U.S. transactions in foreign bonds might be expected to exhibit a fair degree of interest sensitivity, they do not in fact seem to have done so in the recent past. The Federal Reserve Bank of Philadelphia selected nine countries which accounted for over 60 percent of total foreign bond sales in this country during the period 1947–61, computed the differential between long-term interest rates in each of these countries (usually government bond rates) and that in the United States, and correlated changes in this differential with changes in the net bond sales of each country for the entire 15-year period and for selected subperiods.[8] The bank was unable to find any significant relationships between the two variables. Likewise, Professor Bell, examining net foreign bond sales by regions,[9] and Professor Kenen, examining aggregate foreign bond sales, were also unable to uncover any significant linear association with differentials involving the United States, United Kingdom, and Canadian rates of interest.

I employed an aggregative approach similar to Professor Kenen's, and while I was also unable to uncover any significant linear association with rate differentials, I did find that net U.S. purchases of foreign bonds correlated significantly with the average absolute yields of both U.S. Government bonds and U.S. corporate bonds. This suggests that rates of interest in this country are an important consideration, not in relation to rates elsewhere at the same point of time, but rather in relation to rates here at past and future points of time. In other words, rates of interest in this country may be a principal determinant of the timing, rather than of the volume, of U.S. transactions in foreign bonds. The conclusion is reinforced by Professor Bell's finding that, in the case of several categories of foreign bonds (in particular Canadian, but also continental European and IBRD, bonds), interest rates seem to have an influence on deviations from trend, although not on the trend itself. In his words, "it is the timing of purchases which is affected rather than the absolute amounts."[10]

[8] "How Sensitive to Interest Rates? Some Established Evidence," Federal Reserve Bank of Philadelphia Business Review, November 1962, pp. 8–10.

[9] In the body of his text, Professor Bell keeps referring to net foreign sales of new issues. This choice of wording is misleading, because a careful reading of his app. II (which formally describes his procedures and results) reveals that he has in fact dealt with net foreign sales of all bonds (including seasoned securities) as well as new issues.

[10] Loc. cit., p. 420.

In seeking to explain why the level of U.S. rates should affect just the timing of purchases, it is useful to remember that the great majority of foreign bonds sold in this country are new issues.[11] One of the most important reasons for the considerable number of new foreign issues in this country is the limited availability of funds elsewhere. The Canadian capital market, for example, cannot meet all of the demands of its own national borrowers, who must consequently raise vast amounts of funds in New York. Similarly, the capital markets of the European countries (except Switzerland and the Netherlands) are too underdeveloped or restricted to satisfy the needs of their own countrymen, let alone that of their neighbors or of the underdeveloped countries. The volume of foreign flotations here has consequently been large, and because of the market deficiencies elsewhere, it is usually only the timing of issues that can be influenced by interest rates.[12] This seems to explain why both Professor Kenen and I found that new issues in the United States were unrelated to any rate differentials, but were correlated significantly with U.S. long-term rates alone.[13]

This conclusion implies that U.S. monetary policy, as it affects long-term interest rates, can probably have little influence on our long-run balance-of-payments position. A substantial rise in the level of our interest rates might be associated with a reduction in the volume of foreign bond sales here for some short period of time—perhaps for as much as 3 to 6 months—as prospective foreign borrowers are induced to postpone their new issues. However, given the institutional and legal impediments to foreign borrowing in other financial centers, many of these new issues are likely eventually to take place: for any longer period of time—a year or more—the overall volume of foreign bond issues might be virtually unaffected (assuming interest rates continue to move within the same range as in the recent past). The conclusion coincides with our earlier conclusion that very few foreign transactions in U.S. bonds are interest sensitive, either. At least for the near future, it seems, interest rate changes cannot be expected to have much effect on long-term portfolio capital movements.

3. U.S. SHORT-TERM CAPITAL MOVEMENTS AND "ERRORS AND OMISSIONS"

Movements in the U.S. short-term capital account have been almost as large as movements in the U.S. long-term capital account. As table III indicates, U.S. banks and nonfinancial corporations have since 1957 added almost $4.1 billion to their recorded short-term claims on foreigners; almost 85 percent of the increase was in dollar claims. The largest movements have occurred since 1959, and were heaviest in 1960 and 1961 when the outflow reached a rate of almost $1.5 billion a year. Even taking into consideration the relatively moderate ($500 million) outflow in 1962, it is plain that U.S. short-term investments abroad have become a quantitatively significant factor in our persistent payments deficits.

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[11] It is difficult to determine precisely a breakdown of net foreign bond sales between new issues and seasoned securities: total sales are determined from U.S. Treasury forms (which provide no such breakdown), while net sales of new issues are determined by the Department of Commerce on the basis of information from other sources. Nevertheless, a rough breakdown can be gotten by subtracting net new issues (i.e., new issues less redemptions) from total sales (remembering that the Commerce Department's figures on new issues include small amounts of stock issues). By this calculation it seems that about 85 percent of all foreign bonds bought by U.S. investors between 1957 and 1962 were new issues.

[12] It should be noted that the cost of floating a foreign loan in the United States actually tends to exceed the comparable cost in either Switzerland or the Netherlands. For further evidence as well as an elaboration of the condensed argument in the text, see this author's "The Relationship Between European Capital-Market Development and the U.S. Balance of Payment," Feb. 19, 1963.

[13] Although Kenen and I used slightly different time periods, we both found a correlation coefficient linking new issues and the U.S. Government bond rate of −0.50. Professor Kenen did not attempt to correlate new issues and the U.S. corporate bond rate, but I did, finding a significantly higher correlation coefficient of −0.65.

TABLE III.—*Net exports (+) of U.S. short-term capital, 1957–62*

[In millions of dollars]

	1957	1958	1959	1960	1961	1962	Total
U.S. banks:							
Dollar claims	+255.9	+292.2	+62.5	+727.7	+1,083.0	+337.7	+2,759.0
Foreign currency claims	−2.4	+50.5	+19.5	+262.5	+106.7	−42.3	+394.5
Total	+253.5	+342.7	+82.1	+990.1	+1,189.6	+295.4	+3,153.4
U.S. Nonfinancial corporations:							
Dollar claims	+22.6	−68.9	+37.0	+219.0	+389.4	+148.4	+747.5
Foreign currency claims	+8.1	+11.7	−52.3	+137.9	+6.1	+77.6	+189.1
Total	+30.7	−57.2	−15.3	+356.9	+395.0	+226.0	+936.6
All U.S.:							
Dollar claims	+278.5	+223.3	+99.5	+946.7	+1,472.4	+486.1	+3,506.5
Foreign currency claims	+5.4	+62.2	−32.8	+400.4	+112.8	+35.3	+583.3
Total	+284.2	+285.5	+66.8	+1,347.0	+1,585.1	+521.4	+4,090.0

Furthermore, there has been a sharp swing in the "Errors and omissions" item in our international accounts from a net inflow in 1957–59 to a net outflow in 1960–62 (table IV). In 1962 the concealed net dollar outflow was $1 billion. Many economists believe that the "Errors and omissions" item is composed primarily of unrecorded changes in U.S. short-term claims on foreigners. If this view is correct—available evidence, as I shall indicate, tends to support it—then U.S. short-term funds, recorded and unrecorded, have in fact been exported since 1959 at a rate of $1.5 to $2 billion a year. With these transactions taking place on such a large scale, and adding directly to the U.S. deficits, it is important to know whether they might be responsive to monetary policy.

TABLE IV.—*Errors and omissions in the U.S. balance of payments, 1957–62*

[In millions of dollars]

	1st quarter	2d quarter	3d quarter	4th quarter	Year
1957	+470	+446	+384	−143	+1,157
1958	+221	+137	+171	−41	+488
1959	+74	+273	−51	+116	+412
1960	+74	−100	−90	−476	−592
1961	+16	−296	+243	−565	−602
1962	+90	−144	−406	−540	−1,000
Total					−137

Consider first the recorded U.S. short-term outflow. Kenen and Bell have conducted the only major studies of the factors determining the volume and volatility of these transactions in recent years. Yet at first glance, their conclusions seem to be far apart. Thus Professor Bell asserts he found very little evidence of interest sensitivity, but he was able to uncover a close correlation between U.S. exports and U.S. lending to foreigners. Professor Kenen, on the other hand, was unable to discover any relationship with trade, but he did find a close correspondence between interest rates and U.S. short-term capital. Their positions appear to be irreconcilable.

To some extent, the divergence of findings was inevitable. There are two reasons. In the first place, the investigations covered different time periods. Professor Kenen was concerned with data for the period 1958 to 1961, inclusive. Professor Bell's data begins with the first quarter of 1957. The inclusion of the year 1957—a year of still inconvertible currencies and of extraordinarily large U.S. exports (in the wake of Suez)—was bound to bias his results toward an association with trade, since foreign importers probably had relatively less recourse to financing in foreign markets in 1957 than in any year since.

In the second place, while the methods of the two investigators largely overlapped, each derived important results from techniques that were not attempted by the other. For example, when examining the association of U.S. capital to

trade, Professor Kenen employed a linear approach relating absolute changes of the dependent and independent variables, and got negative results. But Professor Bell used a logarithmic approach relating proportional changes, and his results were positive. Conversely, Professor Bell employed only Treasury bill rates in each of the major financial centers. Professor Kenen made use of other short-term interest rates as well, in particular the rate on 90-day Euro-dollar deposits, and found that they gave rise to some of his most significant correlations.

Actually, the divergence is more apparent than real. A closer examination reveals that the results of the two investigations, when ranked according to their association with either trade or interest rates, are in fact complementary. That is, Professor Bell found that U.S. exports are most closely related to those capital flows (e.g. U.S. bank loans, collections outstanding, and "other" dollar claims) for which Kenen found the least interest sensitivity. And Professor Kenen found that interest rates are most influential on those capital flows (e.g. nonfinancial corporations' dollar claims) for which Bell found the least relationship to trade. In effect, the two sets of findings reinforce one another, and emphasize that it is important to look at each category of U.S. capital separately.

Recorded U.S. short-term capital movements are normally classified into eight categories, as in table V:

1. Bank loans to foreign official institutions.
2. Bank loans to foreign banks.
3. Bank loans to all other foreigners.
4. Bank collections outstanding.
5. Other bank short-term claims payable in dollars.
6. Nonfinancial short-term claims payable in dollars.
7. Bank short-term claims payable in foreign currencies.
8. Nonfinancial short-term claims payable in foreign currencies.

TABLE V.—*U.S. short-term capital flows, 1957–62*

[In millions of dollars]

	1957	1958	1959	1960	1961	1962	Total
1. Bank loans to foreign official institutions	+65.3	+158.8	−49.8	−60.6	+38.1	+30.4	+182.2
2. Bank loans to foreign banks	−19.9	+53.9	+58.2	+26.8	+184.8	+243.5	+547.3
3. Bank loans to all other foreigners	−27.4	+124.6	+32.6	+22.0	+140.3	+28.7	+320.8
4. Bank collections outstanding	−17.0	−1.8	+95.2	+88.6	+95.3	+38.9	+299.2
5. Other bank dollar claims	+254.9	−43.3	−73.8	+651.1	+624.2	−4.0	+1,409.1
6. Nonfinancial dollar claims	+22.6	−68.9	+37.0	+219.0	+389.4	+148.4	+747.5
7. Bank foreign currency claims	−2.4	+50.5	+19.5	+262.5	+106.7	−42.3	+394.5
8. Nonfinancial foreign currency claims	+8.1	+11.7	−52.3	+137.9	+6.1	+77.6	+189.1
Total	+284.2	+285.5	+66.8	+1,347.0	+1,585.0	+521.4	+4,090.0

Bell's and Kenen's findings regarding these eight categories of U.S. short-term capital are summarized in table VI.

TABLE VI.—*Bell's and Kenen's findings regarding U.S. short-term capital*

Code: T=Relationship with trade.
I=Relationship with covered interest-rate differentials.
E=Relationship with Eurodollar-United States rate differentials.
NR=No consistent relationship.
NE=Not examined.

	Geographic area			
	United Kingdom	Europe	Canada	Rest of world
1. Bank loans to foreign official institutions	NE	NE	NE	NE
2. Bank loans to foreign banks:				
Bell	NE	NE	NE	NE
Kenen	NR	NR	NR	NR
3. Bank loans to all other foreigners:				
Bell	NR	NR	NR	T
Kenen	NR	I	NR	NR
4. Bank collections outstanding:				
Bell	NR	NR	NR	T
Kenen	I	NR	NR	NR
5. Other bank dollar claims:				
Bell	T	T	NR	T
Kenen	NR	E	NR	E [1]
6. Nonfinancial dollar claims:				
Bell	NR	NR	NR	NR
Kenen	I	I, E	I, E	NR
7. Bank foreign-currency claims:				
Bell	I	I	NR	NR
Kenen	NR	NR	I	NR
8. Nonfinancial foreign-currency claims:				
Bell	I	I	NR	NR
Kenen	I	NR	NR	NR

[1] Japan.

The table lists only those relationships which appeared consistently in either set of results. The United Kingdom and continental Western Europe are listed separately, although it should be noted that Bell examined flows to these two areas jointly. Similarly, Bell examined jointly bank loans to "other" foreigners (3) and bank collections outstanding (4), although they are listed separately in the table to contrast his results with those of Kenen. On the other hand, I have followed Bell's example in consolidating results referring to areas other than Canada and Europe into a category labeled "rest of world" (which I shall refer to below as the underdeveloped countries, despite the inclusion of Japan), even though Kenen employed a finer geographic breakdown; except in the case of "other" bank dollar claims, Kenen did not find significant results for any subgroup of this broad geographic category. Even a casual glance at the table will substantiate the fact that, category by category, Kenen's and Bell's results are not irreconcilable. But since a casual glance would not be sufficient for the purposes of this study, a more detailed examination of each of the categories follows.

Bank loans to foreign official institutions (1) accounted for only about 4.5 percent of the total increase of U.S. short-term claims between 1957 and 1962. The increase was wholly in loans to underdeveloped countries, as loans to continental European governments were actually being reduced. Neither Kenen nor Bell attempted to examine this category of U.S. capital, and there is no reason to question their decision; interest rates are not among the considerations determining this flow of funds.

Bank loans to foreign banks (2), which have also been extended primarily to the underdeveloped countries, accounted for about 13 percent of the increase of U.S. short-term claims since 1957. The largest outflows have taken place in the last 2 years. Because foreign banks, particularly in underdeveloped areas, often play a quasi-official role in their own countries—they are supposed to be part of the "official family"—bank loans to them are probably determined largely by the same considerations determining bank loans to foreign official institutions. And since interest rates are not among these considerations, Bell also did not attempt to examine this category of U.S. capital. His judgment was confirmed by Kenen, who did examine bank loans to foreign banks, but was unable to find any relationship with interest rates.

Bank loans to all other foreigners (3) and bank collections outstanding (4) together increased $620 million from 1957 to 1962, accounting for about 15 percent of the total rise of U.S. short-term claims during this period. Professor Bell combined these two categories into a single composite, which he labeled "trade credit." The label derives from Bell's finding that amounts outstanding from underdeveloped countries tended to move closely with the level of U.S. exports to the same areas. Because the largest flow of funds—about three-quarters of the total—did in fact go to these same underdeveloped countries (table VII), Bell concluded that these two categories of U.S. capital consist largely of credits extended to foreign importers in need of short-term commercial financing. Kenen seems prepared to concede to Bell on this point. It is true, of course, that Kenen did not find any significant correlations between either category and trade, but this is probably for the reason mentioned earlier. He did find that collections outstanding from all regions (the larger of the two categories) were positively associated with U.S. exports, and as Kenen himself admits, there is little likelihood that all of the relationships "would be positive by pure chance." [14]

TABLE VII.—*Bank loans to all other foreigners and bank collections outstanding ("trade credit"), 1957–62*

[In millions of dollars]

Area	1957	1958	1959	1960	1961	1962	Total
Europe	+17.4	+8.9	+3.7	+10.9	+64.3	−23.6	+81.6
United Kingdom	−1.1	−.7	+1.9	+5.2	−5.6	+3.3	+3.0
Continent	+18.4	+9.7	+1.7	+5.9	+69.7	−26.8	+78.6
Canada	−18.5	+78.6	+55.1	+14.5	+3.2	−43.2	+89.7
Rest of world	−43.2	+35.1	+69.1	+85.0	+168.5	+134.4	+448.9
Total	−44.4	+122.8	+127.8	+110.6	+235.6	+67.6	+620.0

Thus, both professors agree that bank loans and collections are closely associated with movements of trade. But it should be clear that the degree of association, which can be weak or strong, is logically a function of the ability of borrowers to switch from one source of trade credit to another. Whenever possible, foreign importers can be expected to shift the locale of their trade financing to take advantage of changes in credit conditions. Most underdeveloped borrowers, once having established a regular financing relationship with this country, are unable to switch easily to another credit source (this is particularly true of the Latin Americans, who represent a large proportion of the total underdeveloped borrowers here); this no doubt explains the strong correlation between trade and "trade credit" to underdeveloped areas evident in Bell's results. However, borrowers in the developed countries are not so limited in their ability to shift the locale of their trade financing. They have the option of borrowing at home. And in making purchases from the sterling area (though not from Europe or the United States),[15] they can arbitrage between New York and London. (Depending on the short-term differential between the two centers and the forward exchange rate, traders can borrow in one market or the other and cover forward.) To some extent such arbitrage seems actually to have taken place: Kenen found rather high correlations between the covered United Kingdom-United States differential and both loans to continental Europe and collections outstanding from the United Kingdom. Arbitrage movements of this sort help to explain Bell's failure to uncover any relationship between trade and "trade credit" to the developed countries.[16]

Movements of trade credit to Europe, therefore, and perhaps also to Canada, do seem to be sensitive to interest rate considerations. But it should be recalled how small these particular regional flows are: There is not much room here for benefit to our balance of payments. Most of the trade credit extended by U.S. banks goes to underdeveloped countries, where interest rates have little or no effect on the total demand for U.S. funds.

[14] P. 17, app. I.
[15] Non-sterling-area importers are permitted by British regulations to borrow sterling only for purchases made in the sterling area.
[16] Bell actually conceded that the covered differential may be of some importance for the flow of trade credit to Europe. See pp. 440 and 474.

Other bank claims payable in dollars (5) have increased more than $1.4 billion in the last 6 years and account for almost 35 percent of the total increase in U.S. short-term claims during this period (they account for about one-half of the total increase in total bank claims payable in dollars). What are included in "other" bank claims? Professor Bell argues that, with respect to Canada and Europe, this category contains mainly Eurodollar deposits, presumably of U.S. banks and individuals. But this interpretation is wrong. U.S. banks do not as a rule invest directly in Eurodollar deposits, and U.S. nonfinancial corporations do not need to go through U.S. banks to do so. Bell produces no evidence to support his contention. In fact, he himself admits that movements of "other" bank claims vis-a-vis Canada and Europe in 1960 and 1961 did not parallel at all the differential between Eurodollar and U.S. interest rates. And Kenen, who attempted correlations over longer time periods, found the Eurodollar differential to be significant only with regard to continental Europe. For that matter, neither Kenen nor Bell could find any interest rate to be related consistently with the flows to developed regions. The item "other" bank claims vis-a-vis Europe and Canada, in short, seems in fact to be a polyglot of various forms of credit subject to diverse sorts of considerations.

Suppose, nevertheless, that interest rates are among the most important of these diverse considerations. The hypothesis still offers little encouragement to monetary policymakers. As table VIII shows, the outflow of "other" bank claims to Europe and Canada has accounted for only about 5 percent of the total outflow of "other" bank claims since 1957 (less than 2 percent of the total outflow of U.S. short-term capital). Here, also, there is not much room for benefit to our balance of payments.

TABLE VIII.—*Other bank short-term claims payable in dollars, 1957–62*

Area	1957	1958	1959	1960	1961	1962	Total
Europe	+83.9	−54.0	−110.0	+13.2	+49.6	+34.5	+17.2
United Kingdom	−3.1	−1.0	−1.3	+9.4	+16.5	−8.9	+11 6
Continent	+87.1	−52.9	−108.9	+3.7	+33.1	+43.5	+5.6
Canada	−2.8	+7.1	−12.2	+28.6	+24.3	+12.6	+57.6
Rest of world	+173.7	+3.7	+48.6	+609.2	+550.4	−50.9	+1,334.7
Total	+254.9	−43.3	−73.8	+651.1	+624.2	−4.0	+1,409.1

However, consider the other component of this category—"other" bank claims on underdeveloped areas—which accounted for about one-third of the outflow of U.S. short-term capital between 1957 and 1962. Bell found an especially strong relationship with the level of U.S. exports; Kenen found no such relationship but once again probably for the reason mentioned earlier (p. 17). It is well known that the outflow was dominated by special acceptance arrangements made by U.S. banks with Japanese banks and trading groups, particularly in 1961 and 1962, to finance imports from this country. During these 2 years, three-quarters of the outflow of "other" bank claims to underdeveloped areas went to Japan (table IX). Bell and others have argued that in this case there was no discernible connection between the capital outflow and interest rates. This was supposed to be a matter of the availability of credit; the Japanese had by the end of 1959 reached their limit in London (mainly in Eurodollar credits but also in sterling) and, having no alternative opportunities for outside financing, presumably had to obtain funds in New York.

TABLE IX.—*Other bank claims on Japan and on other underdeveloped areas, 1960–61*

[In millions of dollars]

Area	1960				1961				Total
	1st quarter	2d quarter	3d quarter	4th quarter	1st quarter	2d quarter	3d quarter	4th quarter	
All underdeveloped areas	+229.7	+6.9	+186.7	+185.9	+211.2	+113.2	+45.2	+180.8	+1,159.6
Japan	+74.0	+62.9	+108.2	+139.8	+224.5	+128.4	+44.0	+104.9	+886.7
All others	+155.7	−56.0	+78.5	+46.1	−13.3	−15.2	+1.2	+75.9	+272.9

However, the theme of availability does seem to have been overplayed. It is true, of course, that Japanese borrowing came to a halt in the Eurodollar market, and eventually also in New York, because (among other factors) bankers finally refused to extend additional credits to Japan at any rate of interest. But it is also true that up until that time the Japanese borrowed in both markets, and they may have been paying some attention to interest rates. This has been suggested by Professor Kenen, who found a rather strong correlation between the U.S. outflow to Japan and the Eurodollar differential over the 4-year period 1958–61.[17] It is possible that in times more normal than 1960–61, the outflow to Japan and the underdeveloped world would be responsive to interest rate changes in the New York and Eurodollar markets. But we should be aware, for purposes of policy, just how small that outflow has actually been in more normal times; for the 4 years 1957–59 and 1962, "other" bank claims on underdeveloped areas and Japan increased only about $175 milion.

As far as bank claims payable in dollars (categories 1–5) are concerned, therefore, Bell's and Kenen's findings, and our interpretation of them, offer little encouragement to policymakers. Together these five categories accounted for about two-thirds of the total outflow of U.S. short-term capital between 1957 and 1962. Yet only a small part of the total seems to have been even slightly responsive to interest rate movements. Suppose, being as optimistic as possible, we assume that "trade credit" extended to developed areas and all of the outflow of "other" bank claims are potentially susceptible to interest-rate variations. Even though we have thus posited a qualitative relationship, we still have no information regarding the quantities involved. We do know that in the past 6 years the "normal" export of U.S. capital through these categories has cumulated to only about $420 miilion; the amplitude of fluctuations from year to year has averaged about $125 million. In the absence of more precise econometric analysis, we can just assume that the average annual amplitude of fluctuations roughly approximates the amount by which these capital exports might normally vary in a year in response to interest rate changes. On this account, a substantial rise in our interest rates relative to abroad would succeed in reducing the annual outflow of dollar bank claims by perhaps $100 to $150 million. A less sanguine estimate would be in the neighborhood of $50 to $100 million. There is no need to point out how small the reduction would be if we wished to make our assumptions as pessimistic as possible. In general, we must conclude that bank claims payable in dollars have not as a rule been interest sensitive. If any of the outflow of U.S. capital has been interest sensitive, it must have been in the last three categories (6, 7, and 8).

In contrast to dollar bank claims, the short-term dollar claims of U.S. nonfinancial corporation (6) have demonstrated a marked sensitivity to interest rate movements. This is important because movements in this category have become quite large in recent years. In the period of 1957–59 there was scarcely any net change in the outstanding volume of nonfinancial dollar claims abroad. but since 1960 they have increased $750 million (almost one-fifth of the total U.S. capital outflow), with almost 85 percent of the increase occurring vis-a-vis Canada and Europe (table X). The dollar claims of U.S. nonfinancial concerns on underdeveloped areas no doubt represent primarily trade credit extended to foreign importers, and so it is not surprising that Neither Bell nor Kenen could find any correlation with interest rates. But most corporate dollar claims are held vis-a-vis Canada and Europe, and these are almost certainly temporarily idle balances invested where the return is highest. This interpretation has been substantiated by Professor Kenen, who found that the outflow to these two areas was consistently related to the United Kingdom-United States Treasury bill differential. He also found that movements to Canada and (continental) Europe were strongly related to the Eurodollar differential,[18] suggesting that some of these dollar claims are Eurodollar deposits. Professor Bell concurs that the interest rate differential between dollar deposits in Europe and Treasury bills in the United States has been significant in attracting dollar funds of U.S. nonfinancial corporations. In short, this is one category of U.S. short-term capital which does seem to be responsive to interest considerations.

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[17] Because of the preponderance of Japan in the total, Kenen therefore found a fairly strong correlation also between this outflow to all regions and the Eurodollar differential.

[18] It is important to note that he therefore found that the total movement to all regions was also related to the Eurodollar differential. (London Eurodollar rate less United States Treasury bill rate).

TABLE X.—*Claims payable in dollars of nonfinancial corporations, 1957–62*

[In millions of dollars]

Area	1957	1958	1959	1960	1961	1962	Total
Europe	−18.1	+11.9	+22.0	+132.4	−6.9	+17.3	+158.6
United Kingdom	−1.8	−1.1	+7.1	+102.5	−56.7	+7.5	+57.5
Continent	−16.2	+13.0	+14.9	+30.0	+49.6	+10.0	+101.3
Canada	+1.5	−19.0	+6.3	+41.0	+382.3	+61.6	+473.7
Rest of world	+39.1	−61.9	+8.7	+45.4	+14.1	+69.5	+114.9
Total	+22.6	−68.9	+37.0	+219.0	+389.4	+148.4	+747.5

The foreign currency claims of banks (7) and nonfinancial corporations (8), which together increased about $580 million between 1957 and 1962 (about 14 percent of the total U.S. capital outflow), should also—theoretically—be interest sensitive. Presumably, a bank or corporation will invest in foreign currency assets in order to obtain the most profitable return for given conditions of risk and liquidity. Movements of U.S. funds, therefore, should respond to movements of the relevant short-term interest rate differentials.

Given this presumption, it seems strange that Kenen and Bell could not find more evidence of interest sensitivity in these two categories. Professor Bell did find that the outflow of bank and nonbank funds to Europe was significantly related to the covered United Kingdom-United States differential; since about 75 percent of the outflow to Europe was into sterling (table XI), the relationship probably reflects covered interest arbitrage between London and New York. But Bell was unable to find significant relationships vis-a-vis any other region. Professor Kenen found that movements of bank claims to Canada correlated with interest rate movements, but could find a significant correlation vis-a-vis Europe only with respect to nonbank claims. The evidence does not seem to support the theoretical argument that these types of foreign currency claims are interest sensitive.

TABLE XI.—*Foreign currency claims of banks and nonfinancial corporations, 1957–62*

[In millions of dollars]

	1957	1958	1959	1960	1961	1962	Total
Banks:							
Europe	−6.1	+31.2	+0.9	+124.8	−6.5	−9.6	+134.7
United Kingdom	+6.8	+20.3	−1.8	+105.7	−83.3	+41.8	+89.5
Continent	−13.0	+11.0	+2.8	+19.3	+77.0	−51.4	+45.7
Canada	+3.6	+17.3	−5.2	+104.5	+88.0	−70.3	+137.9
Rest of world	+.2	+21.1	+23.8	+33.1	+24.9	+37.4	+121.5
Total	−2.4	+50.5	+19.5	+262.5	+106.7	−42.3	+394.5
Nonfinancial corporations:							
Europe	+1.3	+2.4	−36.9	+111.0	−6.5	+53.4	+124.7
United Kingdom	+2.9	+7.9	−18.3	+116.2	−18.3	+9.6	+100.0
Continent	−1.6	−5.6	−18.4	−5.1	+12.7	+44.0	+26.0
Canada	+1.5	+9.0	−7.0	+24.0	−24.8	+18.6	+21.3
Rest of world	+5.1	+.2	−8.5	+3.1	+37.8	+5.4	+43.1
Total	+8.1	+11.7	−52.3	+137.9	+6.1	+77.6	+189.1
Total foreign currency claims:							
Europe	−4.8	+33.6	−36.0	+235.8	−13.0	+43.8	+259.4
United Kingdom	+9.7	+28.2	−20.1	+221.9	−101.6	+51.4	+189.5
Continent	−14.6	+5.4	−15.6	+14.2	+89.7	−7.4	+71.7
Canada	+5.1	+26.3	−12.2	+128.5	+63.2	−51.7	+159.2
Rest of world	+5.3	+2.3	+15.3	+36.2	+62.7	+42.9	+164.7
Total	+5.4	+62.2	−32.8	+400.4	+112.8	+35.3	+583.3

In this case, however, I think there are good reasons for discounting the evidence and for accepting the theoretical argument as sound. In the first place, the only rate differentials employed by Kenen and Bell involved U.S. short-term rates at one end and either Canadian, British, or (London) Eurodollar rates at the other; it is quite possible that more positive results would have been obtained had they, in addition, tried other bilateral differentials. In the second place, and even more important, movements of U.S. funds into and out of foreign currency assets during the period under discussion were affected by waves of exchange rate speculation which attacked, at different times and among other currencies, the U.S. dollar, the Canadian dollar, and the pound sterling. Had it been possible for Kenen and Bell to abstract from speculative influences, it is quite possible that they would have found a greater responsiveness to interest rate movements. I do not think it too optimistic to conclude that U.S. foreign currency claims, like U.S. nonfinancial dollar claims, are potentially sensitive to shifts in monetary policy.

In the past 3 years, foreign currency and nonfinancial dollar claims have together increased $1.3 billion, with an average annual amplitude of fluctuations of about $450 million. Making the same assumptions as before (p. 202) ,we may conclude that a substantial rise in our interest rates relative to abroad could reduce the export of U.S. capital through these categories by as much as $400 to $500 million in a year. Taking into consideration our conclusion regarding dollar bank claims, we can estimate a total decline in the U.S. deficit on the order of one-half billion dollars. This estimate is necessarily very rough, given current information, and is probably a maximum figure. Nevertheless, it does indicate that interest rates can have a far-from-neglibile effect on recorded U.S. short-term capital movements.

The effect, moreover, would almost certainly be supplemented by a change in unrecorded dollar flows. For as previously noted (p. 120), there is substantial evidence that the net figure for unrecorded transactions in our international accounts—the "errors and omissions" item—consists largely of unrecorded changes in U.S. claims on foreigners. Professor Bell, for instance, found that of all the categories in the U.S. balance-of-payments data, only the U.S. short-term capital item correlated—and correlated strongly—with the errors-and-omissions item. Professor Kenen also found that unrecorded transactions were most strongly associated with changes in total U.S. claims on foreigners.

When he disaggregated the U.S. short-term capital variable, Professor Bell discovered that movements of errors and omission items corresponded most closely with changes in dollar claims vis-a-vis Canada and Europe as reported by U.S. nonfinancial corporations. It will be remembered that these claims showed a strong relationship to the differential between the London Eurodollar rate and the U.S. Treasury bill rate. This relationship is important because Professor Kenen, in attempting to associate the errors-and-omissions item with interest-rate movements, found that unrecorded transactions correlated most closely with this same Eurodollar differential. These results suggest that the errors and omissions item consists to a large extent of unrecorded transactions by U.S. nonfinancial corporations in the Eurodollar market. It is quite likely, therefore, that the errors-and-omissions item is also potentially responsive to interest-rate considerations.

The potential interest sensitivity of the errors and omissions item is of great importance to policymakers because of its large size and because of its rapid shift to the debit column in recent years. Since 1960, the concealed net dollar outflow has totaled $2.2 billion; since 1957, the change in the outflow from year to year has ranged from virtually zero to $1 billion (an average annual amplitude of fluctuation of about $500 million). Even if only one-half of the concealed outflow consists of unrecorded increases in nonfinancial dollar claims, the effect of relatively higher U.S. interest rates might, on our assumptions, be a shift of $250 million in a year. Adding to this the prospective shift in recorded claims, we see that the U.S. deficit might decline by as much as $750 million in a year—certainly a substantial improvement in our payments position. While I cannot emphasize strongly enough how rough this estimate is. I think it clearly suggests that interest rates have an effect on U.S. short-term capital flows.

4. FOREIGN SHORT-TERM CAPITAL MOVEMENTS

As a result of our large payments deficits, U.S. short-term liabilities to private and official foreigners have risen rapidly. Table XII shows that the largest increases have occurred since 1959; the total increase in the last 6 years was a huge $10.2 billion. Virtually all of the new U.S. liabilities are denominated in dollars.[19] About three-quarters of the cumulative total are now held by official institutions, and about one-quarter by private foreigners (mainly commercial banks).

TABLE XII.—*Net changes in U.S. short-term liabilities to foreigners, 1957–62*

[In millions of dollars]

Liabilities	1957	1958	1959 [1]	1960	1961	1962	Total
Dollar liabilities	+296.8	+940.8	+3,365.8	+1,757.9	+1,315.7	+2,385.3	+10,053.3
To foreign official institutions	−63.2	+774.9	+2,105.5	+1,908.8	+409.9	+2,420.7	+7,556.6
To private foreigners	+360.0	+165.9	+1,261.3	−151.9	+905.8	−35.4	+2,495.7
Foreign-currency liabilities	+10.6	+9.0	+15.6	+27.8	+71.8	+3.6	+138.4
Total	+307.6	+949.6	+3,372.5	+1,785.6	+1,389.5	+2,389.0	+10,193.8

[1] Includes the U.S. subscription to the International Monetary Fund of $1,031,000,000.

That both private and official foreign short-term capital flows have fluctuated sharply in recent years can be seen from available statistics. Many of the fluctuations have reflected switching by private foreigners between U.S. and foreign short-term assets. These private foreign capital movements do not affect the size of the U.S. balance-of-payments deficit, as currently defined, but they do have a direct relevance for the U.S. gold position. To the extent that private switching into and out of dollar assets represents a response to interest-rate changes, a decline in U.S. rates will result—ultimately—in U.S. gold losses, as foreign official institutions seek to maintain their traditional gold/dollar ratios. If, in addition, foreign official reserve-asset preferences are interest-sensitive, the increase in U.S. gold sales will be even larger. Because there may, therefore, be a direct interrelation of U.S. gold reserves and interest rates here and abroad, it is useful to consider the interest sensitivity of private and official foreign short-term capital movements.

It would be appropriate to begin this discussion with Professor Bell, who examined 23 individual countries for which reasonably adequate data were available for the period 1957–61. His procedure was to trace the relationship between short-term interest rates (in New York and London) and each country's "ratio of dollar assets to total foreign exchange reserves." He found that, with very few exceptions, none of the countries were responsive to interest-rate movements. Unfortunately, these results mean rather little, since Bell did not have access to unpublished data, and therefore could not distinguish between the assets of foreign commerical banks and those of foreign official institutions. Instead, he could only lump them together into something called the foreign exchange reserves of the banking system as a whole. This method of consolidation is unsatisfactory because it necessarily obscures the fact that dollar liabilities owned by foreign commercial banks are a more remote threat to our gold reserves than the same liabilities when owned by foreign official institutions. More important, the method is unsatisfactory because it tells nothing about the interest sensitivity of either private foreigners or official foreigners alone.

Robert Gemmill, of the Federal Reserve Board, has examined the two groups of foreign dollar holders separately.[20] With respect to foreign official dollar

[19] Not only have movements in U.S. foreign-currency liabilities been extremely unimportant in these years, they seem also to have been totally independent of interest-rate movements. Professor Kenen tried several different relationships but could not find any significant correlations between interest rates and foreign-currency claims on this country. His evidence, while isolated, is convincing. At any rate, the flows involved are too small to warrant further mention. For these reasons, U.S. liabilities denominated in foreign currencies will not be discussed in the remainder of this memorandum.

[20] Robert F. Gemmill, "Interest Rates and Foreign Dollar Balances," Journal of Finance, September 1961, pp. 363–376.

holdings, he examined 26 countries for the period 1956–60, and could not find any relationship between the proportion of dollar assets[21] in official reserves and the rate on U.S. Treasury bills. His conclusion—that foreign official reserve-asset preferences are not interest sensitive—has been echoed by Professor Bell, who showed that interest rates had no influence during the period 1956–61 on the gold/dollar ratio of foreign official institutions in the aggregate. Again, for the period July 1957–June 1962, I could not find any significant correlation between short-term interest rates and overall ratio of changes in dollar liabilities to official foreigners to changes in U.S. monetary reserves. The evidence is persuasive: Official reserve-asset preferences seem to have been determined independently of interest-rate considerations.

Nor is there any reason to suppose opposite. Central banks have always been concerned first to avoid the windfall losses associated with devaluation or inconvertibility, and then to maintain legal or conventional minimum gold stocks; interest rates have normally entered the picture, if at all, only as a determinant of the composition (not the volume) of official dollar balances. In the future, moreover, the role of interest rates is likely to be even smaller. Recent changes in the international monetary standard emphasize close central-bank collaboration in the foreign exchange markets (the Basle agreements) and in the London gold market (the gold pool), subordinating individual bank income-maximization to the general interests of the system. In short, there is every reason to believe that most foreign official dollar holders have been, and will cointinue to be, insensitive to interest rates.[22]

Private foreign dollar holders, on the other hand, have demonstrated an important degree of sensitivity to interest rates. Gemmill graphically compared deviations from trend of total private dollar holdings[23] with the U.S Treasury bill rate and with the United Kingdom-United States covered Treasury bill rate differential. He concluded that total private holdings do in fact move with the interest variables. Using a correlation technique, I achieved much the same result. In particular, I found significant correlations between several short-term interest differential and (*a*) changes in dollar liabilities to private foreigners and (*b*) the ratio of changes in dollar liabilities to private foreigners to the total outflow of dollars and gold to official foreigners. The evidence seems to indicate that private foreign dollar holders are in fact responsive to interest rate movements. Professor Kenen has addressed himself to the question of which categories of dollar liabilities are most sensitive.

Dollar liabilities to private foreigners are normally classified into three categories, as in table XIII:

1. Bank liabilities to foreign banks.
2. Bank liabilities to all other foreigners.
3. Liabilities of U.S. nonfinancial corporations.

TABLE XIII.—*Private foreign short-term capital flows, 1957–62*

[In millions of dollars]

Liabilities	1957	1958	1959	1960	1961	1962	Total
1. Bank dollar liabilities to foreign banks	+50.1	+47.6	+1,140.6	+103.9	+673.5	−147.2	+1,868.5
2. Bank dollar liabilities to all other foreigners	+222.0	+178.2	−32.4	−168.5	+127.3	+211.3	+537.9
3. Dollar liabilities of nonfinancial corporations	+87.9	−59.9	+143.1	−87.3	+105.0	−99.5	+89.3
Total	+360.0	+165.9	+1,251.3	−151.9	+905.8	−35.4	+2,495.7

[21] Because most countries do not publish data on dollar holdings separately, Gemmill substituted foreign exchange holdings. This practice probably had no effect on his conclusions since holdings of foreign exchange other than dollars during this period were small and relatively stable.

[22] It is of interest that Professor Kenen, in his recently published study of central bank reserve asset-preferences did not even consider interest rates as a determining factor. See Peter B. Kenen, "Reserve-Asset Preferences of Central Banks and Stability of the Gold-Exchange Standard" (Princeton, Studies in International Finance, No. 10, 1963).

[23] Actually he used total private dollar holdings excluding Canada, because he felt Canadian holdings were influenced by other factors (among them, exchange-rate speculation). However, the other evidence cited in the paragraph refers to total private dollar holdings.

U.S. bank dollar liabilities to foreign banks (1) have increased almost $1.9 billion since 1957, accounting for a full three-quarters of the total increase of private foreign dollar holdings during the period, More than one-half of the new claims in this country by foreign banks were accumulated in 1959, after external convertibility was restored in Europe. By far the most active foreign banks have been those in continental Europe, and it is significant that Professor Kenen found that flows between the United States and continental Europe demonstrated the greatest degree of interest sensitivity, in particular to the covered United Kingdom-United States differential. Continental European banks, in short, do seem to switch in and out of dollar assets in response to relative changes in interest yields. Other foreign banks, by contrast, did not show any significant degree of interest sensitivity. According to Kenen, this suggests that they switch back and forth between dollar bank deposits and dollar money-market assets, rather than between U.S. and foreign assets. This pattern of behavior is important because it was repeated when Kenen examined (2) U.S. bank dollar liabilities to "other" foreigners (which increased by almost $540 million and accounted for about one-fifth of the total increase of U.S. liabilities—see table XIV) : only continental Europeans seem to switch in and out of dollar assets in response to changes in the covered United Kingdom-United States short-term differential. [24]

TABLE XIV.—*Bank dollar liabilities to all other foreigners, 1957–62*

[In millions of dollars]

Area	1957	1958	1959	1960	1961	1962	Total
Europe	+136.7	−24.8	−16.8	−87.9	+36.6	+140.3	+184.1
United Kingdom	+43.0	+22.3	−33.6	−25.1	+50.9	+124.9	+182.4
Continent	+94.1	−47.3	+17.0	−62.9	−14.0	+15.2	+2.1
Canada	+4.6	+44.9	+9.3	−70.6	+12.8	−46.7	−45.7
Rest of world	+80.6	+157.8	−24.9	−10.2	+77.9	+117.9	+399.1
Total	+222.0	+178.2	−32.4	−168.5	+127.3	+211.3	+537.9

Movements of the dollar liabilities of U.S. nonfinancial corporations (3) have been small in recent years, and the total increase since 1957 has been only $89.3 million (table XV). Kenen found that only the claims going to Canada and the United Kingdom were interest sensitive, the former to the covered Canada-United States differential, the latter to the covered United Kingdom-United States differential. However, the flows going through these categories have been too negligible to hold out much promise of benefit to the U.S. balance of payments.

TABLE XV.—*Dollar liabilities of nonfinancial corporations, 1957–62*

[In millions of dollars]

Area	1957	1958	1959	1960	1961	1962	Total
Europe	+3.1	+24.0	+131.2	−100.0	+62.2	−73.1	+47.4
United Kingdom	+6.8	+3.1	+26.5	−36.2	+41.6	−19.8	+22.0
Continent	−3.7	+20.7	+104.6	−63.8	+20.7	−53.0	+25.5
Canada	+44.0	−43.7	+22.1	+5.2	−21.0	+5.3	+11.9
Rest of world	+40.9	−40.2	−10.4	+7.6	+63.9	−33.8	+28.0
Total	+87.9	−59.9	+143.1	−87.3	+105.0	−99.5	+89.3

[24] According to Kenen's results, continental European banks and "others" also seem to respond in some measure to the differential between London Eurodollar rates and United States Treasury bill rates, suggesting arbitrage between United States money-market assets and Eurodollar deposits abroad.

The flows of bank dollar liabilities between the United States and continental Europe, on the other hand, have been substantial. While the total increase in such liabilities to continental Europe between 1957 and 1962 was only about $175 million, the average annual amplitude of fluctuation was about $675 million. A substantial rise in our interest rates relative to aboard, therefore, might (under our assumptions) decrease the outflow of dollar liabilities to European official institutions by as much $600 to $700 million in a year. While this would not diminish the calculated deficit, it would reduce the pressure on our gold stock.

(The following statement was received from David E. Bell, Administrator, Agency for International Development, and is included in the record by order of the chairman.)

A.I.D. AND THE U.S. BALANCE OF PAYMENTS

It is sometimes claimed that U.S. foreign assistance is responsible for the balance-of-payments deficit and the gold drain—that it has "undermined" the U.S. dollar. This argument seriously distorts the true situation by singling out one of many factors that contribute to this deficit—and a relatively small and decreasing factor at that—by giving no credit for long-range benefits which will accrue to the U.S. balance of payments from its foreign assistance programs; and by ignoring the significant role economic aid plays in maintaining current U.S. exports at a high level.

A small and declining element

Economic aid is only one of many elements in the balance of payments. In calendar year 1962, for example, payments which contributed to the $2.3 billion deficit included $16 billion for merchandising imports, $2.4 billion for net military expenditures, $3.3 billion of U.S. long- and short-term private investment abroad, $2 billion in tourist expenditures, and only $1.1 billion of dollar outflows attributed to "economic aid"—of which the A.I.D. portion was $960 million.

A.I.D. expenditures entering the balance of payments have declined sharply in recent years and under recently tightened policies they will continue to drop. The pattern from fiscal year 1961, the year prior to organization of A.I.D., to 1965, is as follows:

Total A.I.D. offshore expenditures (commodities and services)

	Millions
Fiscal year 1961 (actual)	$1,065
Fiscal year 1962 (actual)	983
Fiscal year 1963 (preliminary)	791
Fiscal year 1964 (estimated)	685
Fiscal year 1965 (estimated)	500

This decline in expenditures entering the balance of payments results from the fact that the newer procurement regulations have taken effect increasingly as commitments made in earlier years have been liquidated. The full effect of these regulations is only now beginning to be felt. Further tightening is being applied to the fiscal year 1964 funds now under consideration by the Congress. (For an explanation of procurement policies, including recent changes, see A.I.D. press release 63–171, Aug. 4, 1963.)

Today, fully 80 percent of A.I.D. funds are committed for the export of U.S. goods and services—not dollars. Of the less than 20 percent which will enter the balance of payments, all but a minor fraction will be spent in less-developed—not developed—countries. Procurement is permitted in the emerging areas when it is competitive with U.S. products and to enable these countries to meet a portion of their foreign exchange needs through trade. The Brookings Institution estimates that around 40 percent of the free foreign exchange available to less-developed countries is ultimately spent in the United States. In Latin America, where A.I.D. programs have increased most rapidly in recent years, the ratio is 55 percent.

Aid and U.S. earnings

The effect of existing A.I.D. procurement policies has been to increase A.I.D.-financed exports of commodities and services sharply. In fiscal year 1964 they are estimated at almost $1.6 billion, more than double the 1961 level.

By confining an increasingly larger proportion of its commodity financing to U.S. exports, economic aid contributes to the U.S. merchandise trade surplus. In calendar year 1962, U S. merchandise exports totalled $20.5 billion and the surplus over imports was $4.3 billion. If the $2.3 billion in commodities financed by "economic aid", as broadly defined (including Public Law 480 surplus agricultural commodities, as well as A.I.D.-financed exports), are deducted, the surplus would be reduced to $2 billion. (See chart 1.)

Aid and the long-term balance of payments

Looking beyond the immediate balance-of-payments problem, there are positive long-term gains to be won for the United States from the establishment of growing economies abroad—the main purpose of our aid programs.

Prosperous nations buy more than poor ones. U.S. exports to the Marshall plan countries more than doubled from 1953 to 1962. Our exports to Japan more than tripled from 1950 to 1962. But our sales to the less-developed countries rose by only 15 percent during the 1950's. Chart 2 graphically illustrates that developed countries buy more from the United States.

In many of the developing countries—where our aid goes today—A.I.D.-financed exports are finding acceptance and becoming familiar to consumers. This should enhance our normal commercial export markets in the future as incomes and international purchasing power rise.

Some criticisms

1. It is sometimes said that the elimination of economic aid would wipe out the balance-of-payments deficit. While this inference seems warranted by a superficial examination of some summary arrangements of official statistics, it is not justified.

One summary from which such an inference might be drawn appeared recently in the New York Times. It dealt with the 1962 balance of payments as follows:

	Billions [1]
Credits	$7.6
Trade	4.3
Investment income	3.3
Debits	9.9
Military spending	2.4
Economic aid	3.5
Private investment	2.5
Short-term funds	.6
Tourist spending	.9
Deficit	2.3

[1] This summary is 1 of several contained in official Department of Commerce statistics.

This arrangement of the data seems to suggest that there occurred a $3.5 billion outflow attributable to "economic aid." The unwary reader might infer that elimination of economic aid would more than wipe out the deficit.

The $3.5 billion "debit" for economic aid is derived by deducting $764 million—$617 million in loan repayments and $147 in IDB and IDA disbursement to restricted accounts in the Treasury—from gross economic assistance of $4.3 billion. But as table 2 shows, the latter includes $3.2 billion involving no dollar outflow ($2.3 billion of merchandise exports plus $0.9 billion of services and other items).

The dollar outflow from economic aid did not, therefore, total $3.5 billion in 1962. It was less than $1.1 billion, as indicated in table 1.

Today, as already indicated, the outflow is even smaller. Under present A.I.D. policies, for every $1 billion reduction in AID programs, $800 million fewer U S. exports would be financed, and balance-of-payments savings would be less than $200 million.

2. It is sometimes charged that foreign aid, whether or not tied to U.S. procurement, has an adverse effect on the U.S. balance of payments because it makes goods and services available that countries might otherwise buy with their own funds. There have been "guesses" that this adverse effect is equiva-

lent to 100 percent, 34 percent, 26 percent, or some other proportion of total economic aid.

The evidence shows, however, that commercial imports from the United States have flourished and the U.S. share of the local market has improved in countries assisted by our economic aid programs, except when the recipient's normal foreign exchange earnings have dropped sharply.

For example, a recent study of 32 countries outside of Latin America receiving about 80 percent of all A.I.D. and Public Law 480 assistance between 1957 and 1962 shows that total imports from the United States rose about four times as fast as total economic aid. In addition, imports from the United States as a percent of total imports by those countries rose from 13.5 to 14.5 percent during the period.

In Latin America, however, commercial imports from the United States decreased, and the U.S. share of the local market dropped. The decrease in commercial imports, in fact, was almost twice as great as the increase in U.S. aid. The decrease occurred because dollar earnings fell for reasons—such as the drop in coffee prices—having nothing to do with the aid program. And the drop in earnings was greater than the increase in aid. The net dollar loss, after deducting offsets of U.S. economic assistance, was about as much as the drop in Latin American imports from the United States.

A.I.D. assistance is extended to help countries import more than their own earnings allow. It is intended to add to regular imports, rather than substitute for them. That is why economic aid has shifted from the developed to the less-developed countries—it is the latter whose earnings are now far short of import needs for development and security. And that is why ordinary commerce with assisted countries tends to thrive, as the above evidence shows.

TABLE 1.—*Economic assistance in the U.S. balance of payments, calendar year 1962*

[In millions]

Derivation of the $3.5 billion economic aid debit:

Gross economic assistance in balance of payments	$4,281
Less regular transactions:	
(a) Scheduled loan repayments	617
(b) Changes in associated liabilities (restricted accounts in U.S. Treasury)	147
Total	764
Net regular transactions	3,517

Composition of gross economic assistance:

Program	Total	Transactions involving no immediate dollar outflow from the United States				Dollar flows
		Total	Merchandise exports	Services	Capital transactions	
Foreign Assistance Act	1,925	966	679	282	5	[1] 959
Agricultural programs	1,335	1,322	1,220	102		13
Export-Import Bank	621	621	442	48	131	
Other [2]	400	302	4	123	175	98
Totals	4,281	3,211	2,345	555	311	1,070

[1] Includes $132 million cash payments for State Department-administered programs (U.N.-Congo, UNTA, etc.).

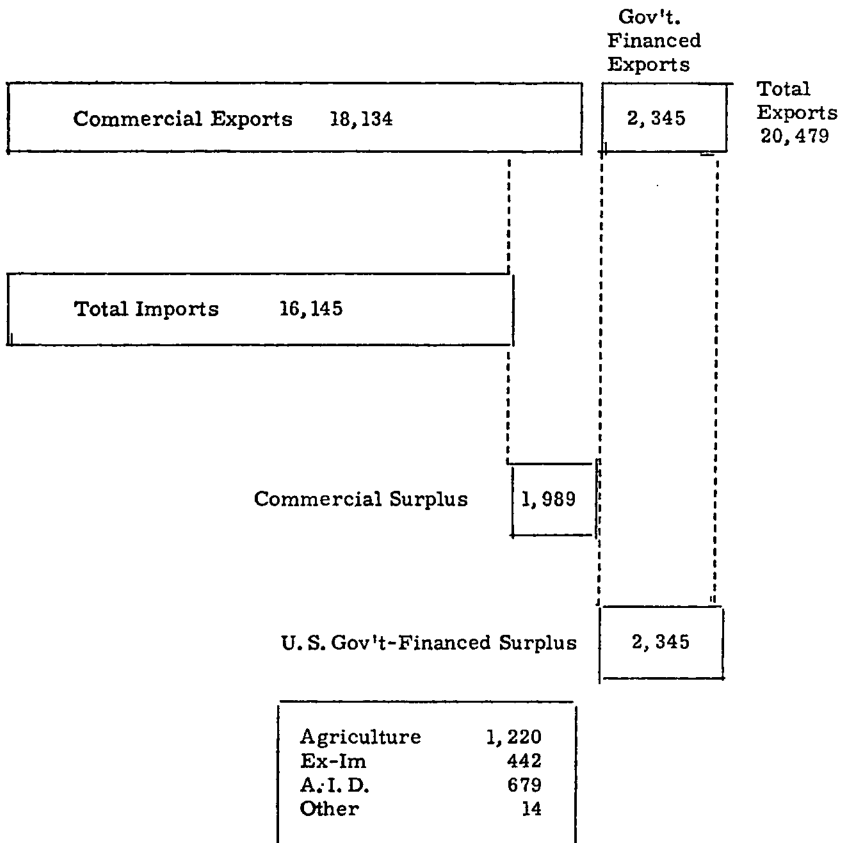
[2] IDB, IDA, U.N. bond, Peace Corps, etc.

Source: U.S. Department of Commerce, Office of Business Economics, Balance of Payments Section, Statistics and Reports Division, July 23, 1963.

CHART 1

U.S. NON-MILITARY TRADE SURPLUS IN 1962

$ millions

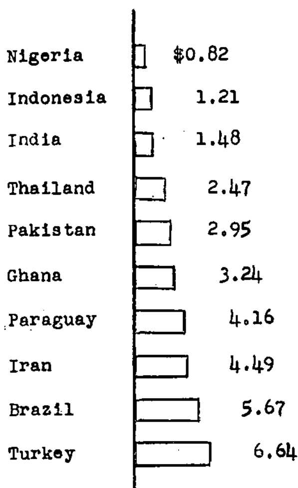


SOURCE: "U.S. Balance of Payments"
U.S. Dept. of Commerce

CHART 2

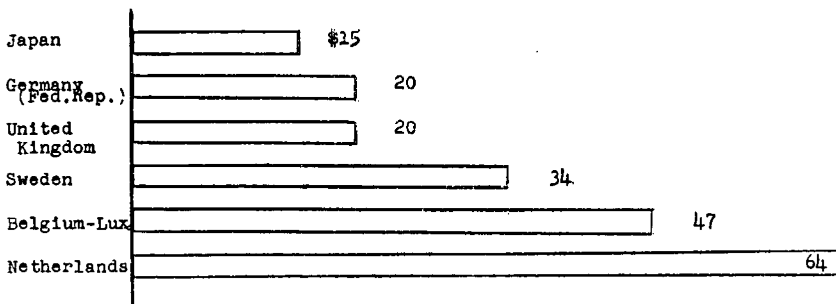
ECONOMIC DEVELOPMENT BROADENS U.S. MARKETS

UNDERDEVELOPED COUNTRIES BUY LITTLE FROM U.S.



U.S. Exports in 1962 per inhabitant of country of destination.

DEVELOPED COUNTRIES BUY MORE FROM U.S.



(Whereupon, at 12:45 p.m., the joint committee was adjourned, subject to call of the Chair.)

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