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THE UNITED STATES BALANCE OF PAYMENTS

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

EIGHTY-EIGHTH CONGRESS

FIRST SESSION

PART 2

Outlook for United States Balance of Payments

JULY 29 AND 30, 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 35 cents

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THE UNITED STATES BALANCE OF PAYMENTS

MONDAY, JULY 29, 1963

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

The joint committee met, pursuant to notice, at 10 a.m., in Room 1302, Longworth House Office Building, Hon. Henry S. Reuss presiding.

Present: Representative Reuss (presiding), Senators Douglas, Proxmire, Javits, Miller, and Jordan; and Representatives Griffiths, Widnall, and Hanna.

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

Representative REUSS. Will Mr. Salant, Mr. Despres, Mr. Krause, and Mrs. Rivlin have a seat, please.

The Joint Economic Committee will be in order and will continue its study into the balance of payments and related problems.

We are very delighted to have here with us this morning four of the authors of the history-making Report of the Brookings Institution entitled "The United States Balance of Payments in 1968," which is being made public over this weekend.

We of the Joint Economic Committee are very happy to have been used as one of the sources of introducing this Brookings Institution paper to the public.

The authors of the study are represented here this morning by Mr. Walter S. Salant, of the Brookings Institution: Mr. Emile Despres, of Stanford University; Mr. Lawrence B. Krause, of Brookings; and Mrs. Alice M. Rivlin, of Brookings.

The other major participants in the study were not able to be here today, and are Mr. William Salant and Prof. Lorie Tarshis.

It is a sort of old home week gratification to the Joint Economic Committee that a number of these experts, notably William Salant, Emile Despres, and Lorie Tarshis, have been, in the last 2 years, consultants to the Joint Economic Committee and the International Payments and Exchange Subcommittee of the Joint Economic Committee, and played an important role in the various publications of the Joint Economic Committee, notably our recommendations on balance of payments and the International Monetary Fund made by the International Exchange and Payments Subcommittee in August 1961, just 2 years ago.

So you are very welcome, Mrs. Rivlin and gentlemen.

I understand, Mr. Salant, that you have a paper which summarizes the thinking and recommendations of your book, which you would like to present to this subcommittee in order to start things off.

Mr. SALANT. Yes; that is correct, Mr. Chairman.

Representative REUSS. Do we have copies of that here?

Mr. SALANT. They should be arriving any minute.

Representative REUSS. May I ask how long the paper is, Mr. Salant?

Mr. SALANT. It is longer than I should read. I have deleted parts of it for purposes of reading, and it is likely to run about 35 minutes, or perhaps 40 minutes.

Representative REUSS. If agreeable with you and your associates, without objection the paper in full will be made a part of the record.

Will you now proceed in your own way, either by reading it or paraphrasing, a summary, or any way you wish.

STATEMENT OF WALTER S. SALANT, BROOKINGS INSTITUTION; ACCOMPANIED BY EMILE DESPRES, STANFORD UNIVERSITY; LAWRENCE B. KRAUSE, BROOKINGS INSTITUTION; AND MRS. ALICE M. RIVLIN, BROOKINGS INSTITUTION

Mr. SALANT. Thank you, Mr. Chairman.

I would propose to read the paper with certain portions deleted and the full statement can be made a part of the record. (See p. 233.) I hope you will tell me if I am not using this microphone correctly.

We are happy to have this opportunity to present to your committee the main conclusions of a study which a group of us at the Brookings Institution have completed. This study is devoted to the outlook for the major components of the U.S. balance of payments in 1968 and the international financial problems commonly associated in the public mind with U.S. balance-of-payments deficits.

The study is the joint product of all six authors. The chairman has already mentioned who they are and which of them are present, so I need not repeat that.

I would like to say, though, that it is apparently inevitable that our conclusions will be called Brookings conclusions, and I would like to make clear that the findings and conclusions are entirely those of the authors. They do not purport to represent the views of the Institution, its trustees, officers, or other staff members.

Now, a few words about the background of the study are necessary. The President asked the Council of Economic Advisers, the Treasury, and the Bureau of the Budget for an appraisal of the balance-of-payments outlook over a period of years, 6 years. The Council, acting on behalf of itself and the other two agencies, asked Brookings to undertake the study. Work began in the early spring of 1962 and was completed and submitted to the Council in January of this year, except for the final chapter dealing with policy questions.

In its present form the study is a revision of the version submitted to the Council. We have brought it up to date so far as possible.

I should like to add that the revisions have some figures which were completed just before the report went to press and have not been seen by the officials who sponsored the study.

I would like to emphasize that all projections of net balances in international payments are highly speculative, for reasons set forth

fully in the study. We regard the report's quantitative projections for 1968 as less important than its exposition of the economic significance of the net balance and its identification of what determines the net balance in the long run.

The United States has had a total deficit or "overall deficit" in international payments, as this term is used in current discussion, in every year beginning with 1950, with the sole exception of 1957. In view of the common assumptions that the deficit is the sole cause of weakness in the dollar and that whatever is called a deficit must be bad, it is necessary to make clear the relation between the strength of a country's currency and its balance of payments, and also how the United States uses the term "deficit" and what the economic significance of that definition is.

The dollar, in the markets and eyes of the world, has undergone a dramatic change during the past decade. Ten years ago it was regarded as a superstrong currency. It had been in short supply since before World War II, and some observers expected it to remain in short supply for the indefinite future, owing to basic forces which they claimed to see at work in the world.

For most of the period since 1958, however, it has been weak. This weakness has been an important factor in inhibiting the United States from pursuing domestic monetary and fiscal policies that could raise its national output, with its present manpower and other resources, by a substantial amount—estimated by the Council of Economic Advisers at $30 billion to $40 billion per year.

The change in the position of the dollar from a strong to a weak currency reflects in part the deterioration of the U.S. balance-of-payments position. But it also reflects other things: changes in the liquidity position of the United States, the state of confidence and other factors that affect the willingness to hold dollar assets.

Indeed, the experience of the past 10 years has made it clear that the dollar can be strong in the foreign exchange markets when the United States had a deficit in its balance of payments. The implication for the future is that elimination of the deficit may not suffice to restore the dollar's strength because that alone might not restore its previous unique status in the eyes of foreign and domestic holders.

My second introductory point relates to the definition of the deficit. For any country or region, the sum of all external payment is equal to the sum of all external receipts. This is a matter of double-entry bookkeeping. Thus the concept of a deficit or surplus implies that only selected categories of payments and receipts are included in the calculation of the net balance and that the others are treated as financing, or balancing, items. As the term "total deficit" is used in current U.S. discussions, it refers to the excess of our payments over our receipts arising from all transactions other than changes in monetary reserve assets, and the reported flow of foreign capital invested in liquid dollar assets, including all U.S. Government securities other than some new special issues. U.S. receipts from foreigners, private as well as official, who acquire liquid dollar assets are excluded from the calculation, but payments that the United States makes to acquire short-term claims on foreigners are included as payments, in calculating the deficit.

You will see at once from this that a deficit does not imply a reduction in the total net wealth of the United States. Total net wealth includes domestic assets, and changes in them of course do not enter the calculation of the deficit in our international transactions. It does not even imply a reduction in the net international assets of the United States; that is, in the excess of U.S. foreign assets plus gold over U.S. foreign liabilities. Indeed, the net international assets of the United States have been growing while it has been having deficits. The concept of total deficit comes closer to representing a reduction of net U.S. foreign assets in liquid form. But, in fact, it does not even represent quite that, because the definition that the United States has been using includes in liquid assets only gold and convertible currencies in official hands, and some drawing rights on the International Monetary Fund.

Increases in short-term assets abroad owned by U.S. private citizens, even in countries with convertible currencies, are not treated as liquid assets for this purpose, but are treated in the same way as long-term investment abroad. Thus their acquisition contributes to the deficit.

Similarly, since our liquid liabilities are defined as including foreign holdings of long-term U.S. Government securities, a switch by foreigners from American corporate securities to Treasury bonds increases the U.S. deficit. Thus the total deficit on this definition means a reduction only in a portion of the total U.S. net international liquid position.

This differs greatly from what "deficit" means in business or household office. A business firm would have a deficit, on this definition, even if it made a profit on its current operations, expanded its plant and equipment, and financed most of the expansion from undistributed profits and issuance of new stocks, so long as any part of the financing came from drawing down its cash assets or borrowing on a demand note.

The United States is in a different position from such a purely commercial firm. To improve the analogy, we must suppose that the firm, having been in a very strong financial position, begins to accept deposits from other firms. In effect, it becomes a bank as well as a commercial enterprise. This extension of its operations is partly a result of its previously acquired prestige. In the eyes of some, the fact that other firms keep money on deposit with it is also a source of additional prestige. This fact, however, also gives the firm new burdens.

Now its liquidity may be impaired not only because of its own commercial operations, but also because one of its depositors loses cash to some third business which keeps its money elsewhere—in another bank or in its own safe.

In either of these events, the trading-banking firm would have a deficit, according to the definition used in our balance-of-payments statistics.

To perfect the analogy, we must suppose that there is no Federal Reserve System, so that this firm performs its banking functions without the benefit of a central bank.

This analogy, with some additions which are included in my written statement, may make clearer the meaning of the U.S. deficit and the present position of the United States.

I now come to the framework of our analysis.

While there may be greater immediate interest in our conclusions, I think there is more of lasting value in the analytical approach we use, which for some may be a novel way of thinking about the U.S. balance of payments.

The first point is that any substantial and persistent changes in the U.S. net balance of payments will be reflected in opposite changes in the net balances of Western Europe. This generalization—and it is a broad one, to be applied with caution and qualifications—reflects the empirical observation that the rest of the world, in the aggregate and over periods of several years, does not have substantial net surpluses or net deficits. This generalization is basically a reflection of the fact that most of the countries of the world have a demand for imported goods and services so intense that they cannot, or in any case do not, accumulate reserves, and that they also do not have sufficient reserves to run deficits for any protracted periods.

Because the U.S. economy is a very large one, different types of transactions in the U.S. balance of payments are closely interrelated. Changes in some transactions tend to be offset by changes in others. For example, changes in U.S. imports are very likely to result in changes in U.S. exports, or in U.S. dividend receipts, if the imports come from countries in whose export industries we have large investments.

Similarly, increases in foreign aid are likely to feed back to changes in U.S. exports, if the aid is to countries which obtain a large portion of their imports from the United States. There are also relations between U.S. capital outflow and U.S. trade. Some of these relations are obvious, but some of them are more roundabout and less obvious. For example, an increase——

Representative REUSS. Mr. Salant, could you tell us at this point about where you are in your paper? The papers have now arrived.

Mr. SALANT. Yes. I am at the bottom of page 7, and by the time some people get them, I will be at the top of page 8.

Representative REUSS. Proceed.

Mr. SALANT. As I say, some of these relations are obvious but some of them are more roundabout and less obvious.

For example, an increase in U.S. business activity which increases demand for imported raw materials and raises their prices may raise the cost of production of our European competitors more than it raises ours, and it may thereby improve our competitive position in manufactured products.

Similarly, savings in foreign aid may give rise to compensating changes in capital movements or vice versa.

In all of these cases there is an interrelationship between the first and the second points I have made. Increases in imports from non-European areas are more likely to increase U.S. exports than are increases in imports from Western Europe, because non-European countries tend to spend their foreign-exchange receipts, not to accumulate reserves.

The same applies to payments for purposes other than imports.

These feedbacks from one item in the U.S. balance of payments to another must be taken into account in appraising efforts to reduce the U.S. deficit. For example, $1 million of foreign-aid expenditures

has much less effect upon the deficit than $1 million of military expenditures because the military expenditures go to Europe and cause very little feedback to our receipts, whereas the foreign-aid expenditures go mostly to non-European countries and in most cases do have a substantial feedback to our receipts.

It is also desirable to distinguish among non-European countries according to the portions of changes in their payments that go, directly and indirectly, to the United States and the portions that go, directly and indirectly, to Europe. U.S. payments to Latin America, for example, affect U.S. receipts to a much greater extent than do U.S. payments to Africa.

The third main point in the framework of our analysis is that U.S. international transactions are in large part a reflection of relations between internal developments in the United States and elsewhere. And, as the first point implies, "elsewhere" means mainly Western Europe. The balance of payments is only the part of the iceberg that is showing.

If we want to understand and project it, we must understand and project the larger part that is submerged. Ideally we need to know all the quantitative relations between these internal factors in an area, not only in the United States but also in the rest of the world, and the area's international transactions.

So much by way of background. We now come to the question of our projections for the future.

The focus of our study is on the year 1968, as the Council requested, but we make no attempt to project cyclical or other short-term influences that may prevail in that year.

The record shows that both cyclical and random factors can cause very large changes in major components of receipts or payments in a single year. Such factors cannot be predicted far in advance. Therefore our projections for the year 1968 should be interpreted not as projections of actual values for 1968 but of trend values.

For the same reason, unpredictability, we make no attempt to project short-term capital movements, special transactions, or errors and omissions. We concentrate on the net basic balance, which is the excess of payments over receipts on account of goods and services, foreign aid, and the flow of private long-term capital, and on the factors determining this balance.

The concept of basic balance that we use excludes not only short-term capital movements and unrecorded transactions, but also prepayments of loans to the U.S. Government—which we regard as induced by the existence of a deficit on other accounts and, therefore, as distorting the basic position—and increases in nonliquid Government liabilities.

Even the basic balance, so defined, changes rapidly from year to year. This you might see if you will look at table 2 of my statement.

In analyzing the outlook for the basic balance in 1968, we do so on two alternative sets of assumptions concerning the future course of the U.S. economy and that of Western Europe, the two areas that we regard as crucial.

I shall not describe all the assumptions in detail. The main ones are shown in table 1. It is sufficient to say that the main differences be-

tween the two sets of assumptions are, first, that the growth in gross national product is lower in the second set of assumptions than in the first, for both the United States and Western Europe; and, second, that we have assumed that resistance to price increases in Western Europe is greater and more effective under the second set of assumptions than under the first.

On the first set of assumptions we arrived at the conclusion that the fundamental forces at work will make for a basic U.S. surplus of nearly $2 billion by 1968, an improvement of $3.4 billion, as compared to the 1961–62 average basic deficit, when it averaged $1.5 billion.

The improvement shows up largely in increases in net exports of goods and services, including a substantial rise in income from private investment abroad.

This increase is reinforced by a decline in military expenditures and by a somewhat smaller decline in the outflow of private long-term capital. These gains are offset, but only partially, by an increase in expenditures for foreign aid. These projections are also shown in table 2, to which I have already referred.

This way of breaking down the projected change in the total balance accords with what the balance-of-payments statistics would show. It would be an error of analysis, however, to infer from it that a given change in one component is the cause of an equal change in the basic balance. Such an inference would not take account of the feedbacks involved in the projected changes, to which I have already referred.

I have included as table 3 of this statement a table which shows the projected changes between 1961 and 1968 in two ways. The top half of table 3 shows the items more or less as they are grouped in the balance-of-payments statistics. The lower half puts together the gross amount of each independent change and its projected feedback. It makes clearer than the upper half does how much the projected independent changes affect the net balance.

There are two major reasons for the projected improvement under the first set of assumptions. One is the improvement in the U.S. competitive position. Our assumptions imply that prices and costs in Western Europe, primarily on the Continent, will rise substantially, relative to the costs and prices in the United States.

Reinforced by the assumed rise in Western Europe's real income, the effect will more than offset the effects of the assumed rise in our real income on imports of goods and services and the adverse effects of discrimination by the European Economic Community against us and some of our customers.

The improvement in our competitive position arises fundamentally from differences between the United States and Western Europe in the prospective growth of the labor supply.

The growth of the labor force in Western Europe is expected to decline, and this decline will be reinforced by a projected cut in the average length of the workweek.

In the United States, in contrast, the existing labor force is underemployed and the growth in the labor force is expected to accelerate. On our assumptions as to Western European policies, the tightness in Western Europe's labor market will cause a substantial increase in wages and also in labor costs per unit of output—more than double the average annual rise in the labor cost per unit of output in the United States.

Thus we project substantial upward cost pressure in Western Europe, and sufficient aggregate demand to carry this cost pressure through to a substantial rise in prices.

In our judgment, this rise in Western Europe's GNP prices would be accompanied by a rise of export prices—a situation which did not occur during the 1950's. During most of the postwar period, investment in Western Europe was more concentrated on export goods and import-competing goods than we think it will be between now and 1968.

The second major reason for the projected improvement in the basic balance is a substantial rise in net receipts associated with past and current international long-term investments. This rise results from both an increase in investment income and a decline in the net outflow of long-term capital.

These influences are reinforcd by an expected decline in military expenditures abroad. They are only partially offset by the adverse effects of discrimination by the European Economic Community on imports from the United States and some of its customers, and by the net effect of assumed increases in foreign aid.

Under the alternative set of assumptions, which on the whole we think are more realistic, the improvement in the basic deficit compared to the revised figures for 1961—revised since we submitted our report to the Council of Economic Advisers—is so small in relation to the possible error that it should not be regarded seriously, but it is a large improvement over 1962. It leaves the United States in basic deficit to the extent of about a half billion dollars.

More of the difference between the results obtained under the two sets of assumptions reflects the difference in European prices, rather than the difference in the assumed changes in real income.

Under the second set of assumptions, the competitive position of the United States improves by a good deal less than it does under the first.

I have mentioned that the business of projecting the implications of given assumptions for net balances of payments is a particularly hazardous one. I do not refer merely to the risk that the basic assumptions may be wrong—which is indeed a hazard. I refer, rather, to the fact that even if future changes in real income and prices and other basic variables do lie between the values we have assumed, their effects on the basic balance may lie outside the range we project.

The sources of possible error in estimating payments implications of given assumptions are stated in our report, and I think there is not enough time for me to delve into them right here.

Aside from these possible errors in the influences we do project, other things that we do not try to project may also change. Some of them, such as steel strikes and crop failures, may have merely transitory effects. But others may be lasting changes and may have profound effects on international trade. Some cause our estimates of the improvement in the U.S. basic balance to be understated; others cause them to be overstated.

In the light of all the considerations—and I am skipping several paragraphs of my statement now—our best guess is that the basic deficit will be eliminated by 1968. If the initial assumptions come close to being realized, there is a definite possibility that a significant basic surplus will develop.

The U.S. Government has not, on the whole, compromised its basic foreign policy and defense objectives because of balance-of-payments considerations. These considerations, however, have played an important role in failure to achieve maximum production and employment. The additional slack in using productive capacity at a level associated with unemployment of 6 percent instead of, say, 4 percent of the labor force involves losing output which has been estimated by the Council of Economic Advisers at about $30 billion to $40 billion every year.

Policies tying economic aid to procurement in the United States and requiring military expenditures to be made in the United States rather than made abroad add considerable cost to the taxpayer. They also arouse resentment in the rest of the free world, protect the high-cost U.S. industries from the spur of foreign competition and foster poor allocation of resources.

Moreover, there is increasing pressure to compromise the objectives of foreign aid for balance-of-payments reasons. It is clearly in the interests of the United States to develop an international monetary mechanism that will permit adjustments to take place without compromising other goals—in payments and balances, that is.

The present international monetary system is essentially a system of quasi-fixed exchange rates with international reserves held in gold and national currencies, principally dollars and sterling. The price of gold in terms of dollars is fixed, and other currencies are pegged to the dollar, thereby providing a fixed structure of exchange rates among various currencies.

The pegs are adjustable, however. Adjustments have been made often enough to keep the possibilities of further changes alive in the minds of central banks and private owners of capital.

In our view, the fixity of exchange rates is a virtue. By removing much of the uncertainty of international transactions, it tends to increase the volume of trade and productive international investment, thus contributing to efficient use of world resources. The more certain it is that the rates will be maintained, the greater are these advantages.

We believe, therefore, that the present system of fixed exchange rates should be strengthened, so as to preserve and enhance its advantages and mitigate its disadvantages.

The main disadvantage of the present fixed rate system is that it requires countries whose payments are not in balance to restore balance more rapidly than may be consistent with important domestic and international objectives.

Deflationary measures, the classical means of improving the balance of payments, cut employment and real incomes—effects which are neither politically feasible nor economically desirable in a modern industrial country.

In the United States, large absolute reductions in real income cause only small decreases in imports, and these decreases are partly offset, owing to the feedbacks referred to already, by decreases in exports, so that very substantial declines in total production and income are necessary to induce relatively small improvements in the net balance of payments.

Furthermore, higher interest rates, while discouraging domestic investment, may not be effective in attracting capital to a currency when stronger currencies are available.

If an international payments system is to provide the benefits of fixed parities without these disadvantages, it must generate confidence in the fixity of the parities. With greater liquidity, we believe this confidence would probably develop, because it would gradually be recognized that payments adjustment at fixed parities is possible if enough time is available.

I now come to our view regarding the actions needed in the next few years.

The United States should immediately begin to press for an agreement to strengthen international liquidity. Since the study and negotiations needed to obtain agreement on a new mechanism for international liquidity may take a long time, however, the United States will be obliged to deal with its balance-of-payments problems within the framework of the present mechanism.

Even if the projections of this report are realized, there probably will be deficits for the next several years. However, U.S. reserves are so large, compared to likely levels of the deficit, that we see no reason for concern about financing these deficits while working to improve the international monetary system.

Despite the substantial reduction in U.S. monetary reserves and the large increase in liquid claims of foreigners, U.S. reserves and other resources for meeting continuing deficits remain very great. The U.S. Government should make clear that it regards its reserves as existing to be used for these purposes.

The statutory requirement of a gold reserve against Federal Reserve notes and deposit liabilities, for example, long ago ceased to serve any useful purpose. It should be abolished. Its abolition would make clear that the reserves are available to the full and at all times, not merely in emergencies, to serve their only useful function.

The United States should also draw on the International Monetary Fund—as it now proposes to do—to finance some of its future deficit. Such drawings would help to promote the idea that use of the Fund's resources is not an act of last resort; more willingness of Fund members to draw on it would increase effective liquidity.

Such steps would establish that the United States is willing to use its reserves and credit facilities to support the dollar.

We do not recommend that the Government at this time take steps to improve the balance of payments other than measures which seem desirable in themselves. Actions already taken, such as tying aid and restricting certain types military expenditures abroad, should be regarded as temporary. Further restrictive measures of this type would be of negligible benefit, if not positively harmful. To cut aid or military expenditures for balance-of-payments reasons would be an unwise and unnecessary sacrifice of more important objectives.

As the balance-of-payments deficit declines, foreign aid expenditures should gradually be untied.

We have stressed that measures which might endanger U.S. economic growth and the restoration of high employment levels should not be adopted for balance-of-payments reasons. This means we think that it is inadvisable to raise interest rates in an attempt to affect inter-

haps also to innovation and to technological improvement. These effects are fully felt only after several years.

Our projections lead us to believe that the dollar value of international transactions will grow by at least 35 percent between 1961 and 1968.

If U.S. deficits continue in 1963 and 1964 but diminish to zero between 1965 and 1968—and I am now talking about total deficits, not basic deficits—and if monetary gold stocks grow at the same rate as they did between 1947 and 1961, gold and dollar reserves will rise by about 12 percent between 1961 and 1968. This compares with the 35 percent increase in international transactions.

The discrepancy between these two increases has implications for the world liquidity situation. World monetary reserves would shrink in relation to the level of international monetary transactions.

Whether this relative decline would create a problem of liquidity depends, of course, on whether liquidity is adequate now, and how much the need for liquidity grows in relation to the growth of the value of world transactions. So far as the need for liquidity is concerned, we think that imbalances in total international payments will increase in relation to total payments. The major countries are likely to be faced with persistent imbalances arising not so much from deficiencies or excess of aggregate demand, but from structural factors, such as changes in technology, in competitive positions, or in the structure of world demand for their products.

Imbalances arising from such causes cannot be eliminated quickly without jeopardizing domestic economic growth, price stability, or other vital objectives. To avoid jeopardizing these objectives, equilibrium must be reached gradually. The existing monetary mechanism will not provide enough liquidity to finance deficits over periods long enough to permit such gradual adjustment. Without the means of financing deficits over such periods, preoccupation with balances of payments is likely to override considerations that are fundamentally more important.

The deficit countries will be placed under increasing constraints. Such a situation might well induce actions that would restrain their rates of growth unduly.

Indeed, these restraints could prevent the forces making for improvement in the U.S. balance of payments from materializing fully. If a U.S. balance-of-payments surplus should begin to develop, some other countries would begin to move toward deficit positions and might take restrictive measures to stop this movement. In that event, the forces making for improvement of the U.S. payments position would merely have caused the world to exchange one problem for another. Thus there is a dilemma: A strengthening U.S. balance of payments would leave the world as a whole, and the United States, too, little if any better off than does a U.S. deficit. This suggests to us that the fundamental problem may not be the U.S. balance-of-payments deficit but rather the world's monetary system.

It is often said that maintenance of balance in international payments, if not an ultimate end of policy, is a means of restraining countries from pursuing undesirable economic policies. We think balance-of-payments discipline, like any other discipline, is desirable only as a means to ends that are desirable. It is not desirable if it requires the subordination of higher priority objectives.

Even if a significant improvement does occur over the whole period between 1962 and 1968, random disturbances and short-term fluctuations in the United States or in Western Europe, Japan, or Canada may have large transitory effects on the net balance. Year-to-year fluctuations are large and erratic, so the underlying trend may be difficult to discern.

This general observation leads me to comment in greater detail on the changes that may occur between 1962 and 1968.

Since cyclical changes and random factors may have very big effects on the net balance, it would be foolish to try to estimate the path that the basic balance will take between now and 1968. One consideration is that some improvement in our competitive position is likely in the next few years; indeed, if relative price changes in the United States and Western Europe are any indication, some has probably occurred already.

But we do not know whether this has yet been reflected in the trade position, if one adjusts the recorded position—as one should—for cyclical and random factors. We do expect some improvement in the U.S. competitive position to show up clearly by the end of 1964. We also expect cuts in military expenditures abroad and other deficit-reducing measures to have most of their effects on the basic balance by that time.

There are offsetting considerations, however. First, we have assumed a recovery in the United States in the next 2 years sufficient to reduce unemployment to 4 percent. Such a recovery would raise imports simultaneously, while its favorable effects would lag behind.

Second, the adverse effects of EEC discrimination will also be felt more strongly in the near future, but the favorable effects of negotiations under the Trade Expansion Act cannot offset them for at least 2 years.

Third, the basic balance may also be worsened by a recession or a slowing-down in Western Europe's economic growth.

For these reasons, it may be difficult to discern an underlying trend in the next 2 years, even if one exists. Random or cyclical factors may eliminate the basic deficit in some quarters, while they may raise it in other quarters to annual rates of $3 billion or even $4 billion.

Our guess is that the average basic deficit for 1963 and 1964 will not differ much from that of the 1961–62 average of $1.5 billion.

Any substantial improvement is likely to appear clearly, however, by 1965 or 1966. By that time the cumulative effect of any changes in the relation between United States and Western European prices will presumably outweigh the more transitory effects of any adverse cyclical or random factors.

Moreover, after several years the effects of differences between rates of growth of the United States and Western European labor supplies—which reflect differences in the increases in their postwar birth rates as well as differences in the assumed workweek—will have become marked.

Finally, as I have already noted, there is a considerable lag in the beneficial effect of high employment on our competitive position. To the extent that this effect occurs, it does so by increasing investment and thereby putting us on a more rapid growth path, by creating a climate more favorable to mobility of labor and capital, to avoidance of new restrictive practices, and to elimination of existing ones—per-

national flows of capital, unless the adverse domestic effects of higher rates can be fully offset by fiscal expansion. The balance of payments and other goals will be served, however, by wage and price restraint during the course of recovery to high employment. Restraint on wage and price increases will benefit the U.S. competitive position without retarding domestic economic growth.

Devaluation of the dollar also should be rejected. Devaluation might actually weaken, rather than strengthen, the dollar. If other countries—especially those in the European Economic Community (EEC)—devalued their currencies in line with the dollar, the U.S. deficit would not be reduced, but the future willingness of foreigners to accumulate dollar assets would be curtailed.

Even if other major currencies were not devalued, however, devaluation of the dollar should be rejected. Devaluation is appropriate only when a balance-of-payments deficit is clearly caused by a fundamental disequilibrium that is not likely to diminish in the future.

Our projections suggest substantial future improvement at the current exchange rate. Devaluation, therefore, might throw the United States into substantial surplus and other countries into deficit.

We think the United States should bargain vigorously with the EEC for trade liberalization in the coming negotiations under the General Agreement on Tariffs and Trade and insist on some minimum concessions. A satisfactory agreement should preserve and enlarge foreign markets for temperate zone agricultural products, liberalize EEC imports of manufactured goods, especially those from Japan and underdeveloped countries, and reduce discrimination against tropical products of Latin America and other non-EEC countries. Agreement should not, in our view, be sought at any price.

The U.S. Government should make a major effort to establish with other countries an adequate international liquidity mechanism. The immediate task is to formulate a plan which meets the criteria for a satisfactory system. The next task is to seek international agreement on such a plan.

We propose four requirements of a satisfactory system:

1. It must provide enough liquidity at the outset to finance substantial imbalances while adjustments are taking place, and it must provide for increases in liquidity as the need for liquidity grows.
2. Additional liquidity which takes the form of credit should be available readily and promptly, and for a period long enough to permit elimination of the deficit. Substantial amounts should be obtainable automatically by deficit countries. By agreement, additional amounts should be made available to countries with particularly intractable balance-of-payments problems if appropriate measures for dealing with these problems are being taken.
3. The possibility of shifting reserves from weak to strong currencies must be prevented. These problems would be avoided if industrial countries committed themselves to hold a substantial fraction of their reserves in an international institution, with creditor countries accumulating credits in an international unit of account and debtor countries accumulating similarly denominated debits or reducing previously acquired credits.
4. For such a system to work, it is probably necessary that the principal financial and industrial countries consult fully and fre-

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quently and coordinate policies that have substantial effects on international payments.

As to getting an agreement, Western European countries are not likely to be receptive to U.S. proposals which seem only to ask them to commit themselves more irrevocably and firmly to propping up the present dollar exchange standard. If the United States wishes to gain European support for an international liquidity arrangement, therefore, it must consider the possibility that the dollar's role as a reserve currency might be curtailed.

It is sometimes said that full maintenance of the dollar's postwar role as a reserve currency is essential to U.S. national power or prestige. We think this view mistaken. The economic power and prestige of the United States come primarily from its high productive potential and its success in using that potential. Reduction of the reserve currency role of the dollar would have far less effect on U.S. prestige than continuation of the present failure to operate the U.S. economy at or near capacity.

Beyond this, which is mainly a question for the United States to answer for itself, is the question whether other countries will agree to a system providing greater liquidity while the United States is in a deficit position. Perhaps agreement will prove to be difficult to reach in this situation. But we shall not know until we try. The Government should not defer beginning discussions merely because there is a deficit. If agreement does prove difficult to reach, it may become easier to reach later as the deficit declines and the surpluses of other countries diminish.

Hope of agreement should not be given up, therefore, while there is a prospect that the U.S. deficit will disappear. And the United States itself should resist any tendency to lose interest as its payments position improves.

If it becomes clear that agreement on a satisfactory liquidity mechanism cannot be obtained, the United States must seek an alternative. The best alternative, in our view, would be a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc, with fixed rates within each bloc and flexible rates between them.

The only significant fluctuations we would expect would be in the rates between the dollar-sterling bloc on the one hand and the Western European bloc on the other.

There are some true costs in adopting our second-best, two-bloc proposal which we have explained. Owing to the time I am not going to say any more about this alternative proposal. I would just like to make clear our decisive preference is for a system of fixed rates with an adequate liquidity mechanism. If we can't get this, we think the alternative proposal would be the next best.

More important than the choice of mechanism is our major policy thesis: That the United States seek agreement on an international payments mechanism that permits adjusting national balances of payments without compromising the important goals of national and international policy.

Thank you very much. I am sorry I have taken longer than I forecast. I hope our projections on balance of payments are better than my forecast of the time required for the statement.

(The complete statement of Walter S. Salant, follows:)

STATEMENT BY WALTER S. SALANT, BROOKINGS INSTITUTION

I am happy to have this opportunity to present to your committee the main conclusions of a study which a group of us at the Brookings Institution have completed. This study is devoted to the outlook for the major components of the U.S. balance of payments in 1968 and the international financial problems commonly associated in the public mind with U.S. balance-of-payments deficits.

The study is the joint product of six senior authors. Four of us are here today. In addition to myself, those present are Mrs. Alice Rivlin, a senior member of the Brookings Institution's economic staff, Prof. Emile Despres, of Stanford University, and Lawrence Krause, until last month a member of the Yale University Economics Department and now a senior member of the Brookings economics staff. The other two authors, William Salant and Prof. Lorie Tarshis of Stanford University, live in California and unfortunately were unable to come east for this hearing.

Although it is apparently inevitable that our conclusions will be called Brookings conclusions, I should like to make clear that the findings and conclusions are entirely those of the authors. They do not purport to represent the views of the Brookings Institution, its trustees, officers, or other staff members.

A few words about the background of the study are necessary. The President asked the Council of Economic Advisers, the Treasury, and the Bureau of the Budget for an appraisal of the balance-of-payments outlook over a period of years. The Council, acting on behalf of itself and the other two agencies, asked Brookings to undertake the study. Work began in the early spring of 1962. Three of the authors live in California and several had other commitments, some of which took them out of the country for protracted periods. The study was nevertheless completed and submitted to the Council (except for the final chapter dealing with policy questions) in January of this year.

The study in its present form is a revision of the version submitted to the Council. We have brought it up to date so far as possible. You will notice, for example, that the balance-of-payments statistics for the United States used throughout the present version are those published as recently as last month in the June Survey of Current Business.

I should like to add that the revisions of some figures were completed just before the report went to press and have not been seen by the officials who sponsored the study.

I want to emphasize that all projections of net balances in international payments are highly speculative, for reasons set forth in the study. The authors regard the report's quantitative projections for 1968 as less important than its exposition of the economic significance of the net balance and its identification of what determines the net balance in the long run.

The United States has had a "total" or "overall" deficit in international payments, as this term is used in current discussion, in every year beginning with 1950, with the sole exception of 1957. In view of the common assumptions that the deficit is the sole cause of weakness in the dollar and that whatever is called a "deficit" must be bad, it is necessary to make clear the relation between the strength of a country's currency and its balance of payments, and also how the United States uses the term "deficit" and what the economic significance of that definition is.

ECONOMIC SIGNIFICANCE OF THE TOTAL NET BALANCE

The U.S. dollar in the markets and eyes of the world has undergone a dramatic change during the past decade. The dollar, 10 years ago, was regarded as a superstrong currency. It had been in short supply since before World War II, and some observers expected it to remain in short supply for the indefinite future, owing to basic forces which they claimed to see at work in the world.

For most of the period since 1958, however, it has been weak. This weakness has been an important factor in inhibiting the United States from pursuing domestic monetary and fiscal policies that could raise its national output, with its present manpower and other resources, by a substantial amount—an estimated $30 to $40 billion per year, according to the Council of Economic Advisers.

The change in the position of the dollar from a strong to a weak currency reflects in part the deterioration of the U.S. balance-of-payments position. But it also reflects other things—changes in the liquidity position, the state of con-

fidence, and other factors that affect the willingness to hold dollar assets. Indeed, the experience of the past 10 years has made it clear that the dollar could be strong in the foreign exchange markets when the United States had a deficit in its balance of payments. The implication for the future is that elimination of the deficit may not suffice to restore the dollar's strength because that alone might not restore its unique status in the eyes of foreign and domestic holders.

My second introductory point relates to the definition of the deficit. For any country or region, the sum of all external payment is equal to the sum of all external receipts. This is a matter of doubly-entry bookkeeping. Thus, the concept of a deficit or surplus implies that only selected categories of payments and receipts are included in the calculation of the net balance and that the others are treated as financing, or balancing, items. As the term "total deficit" is used in current U.S. discussions it refers to the excess of our payments over our receipts arising from all transactions other than (*a*) changes in monetary reserve assets (gold, convertible currencies held by the monetary authorities for stabilization purposes, and the virtually automatic component of U.S. rights to draw on the International Monetary Fund); and (*b*) the reported flow of foreign capital invested in liquid dollar assets, including all U.S. Government securities other than some new special issues. U.S. receipts from foreigners, private as well as official who acquire liquid dollar assets are excluded from the calculation, but payments that the United States makes to acquire short-term claims on foreigners are included.

You will see at once that a deficit does not imply a reduction in the total net assets or wealth of the United States. Total net assets include domestic assets, and changes in them of course do not enter the calculation of the deficit in our international transactions. It does not even imply a reduction in the net international assets of the United States, i.e., in the excess of U.S. foreign assets plus gold over U.S. foreign liabilities. Indeed, the net international assets of the United States have been growing while it has been having deficits. The concept of total deficit comes closer to representing a reduction of net U.S. foreign assets in liquid form. But it does not even represent that, because the definition the United States has been using includes in liquid assets only gold and convertible currencies in official hands. Increases in short-term assets abroad owned by U.S. private citizens, even in countries with convertible currencies, are not treated as liquid assets for this purpose but are treated in the same way as long-term investment abroad. Thus, their acquisition contributes to the deficit. Similarly, since our liquid liabilities are defined as including foreign holdings of long-term U.S. Government securities, a switch by foreigners from American corporate securities to Treasury bonds increases our deficit. Thus, the total deficit on this definition means a reduction in only a portion of the total U.S. net international liquid position.

This differs greatly from what "deficit" means in business or household finance. A family is normally said to be running a deficit when its expenses for consumption and maintenance of capital exceed its income. If the balance-of-payments concept were applied to a family, we would count in the family expenditures not only its current expenses but also its expenditures on houses, stocks and bonds, and other long-term assets, and we would deduct from these expenditures not merely its receipts from income but any receipts from long-term borrowing to finance the purchase of these assets. Thus, a family whose only transaction consisted of buying a house for cash would have a deficit—in the balance-of-payments sense—equal to the price of the house; one which financed the purchase wholly by a mortgage would have no deficit.

A business firm would have a deficit, on this definition, even if it made a profit on its current operations, expanded its plant and equipment, and financed most of the expansion, from undistributed profits and issuance of new stock, so long as any part of it, however small, was financed by drawing down its cash assets or borrowing on a demand note. This is true even if the business has a subsidiary which is adding to its bank deposits.

The United States is in a different position from such a purely commercial firm. To improve the analogy, we must suppose that the firm, having been in a very strong financial position, begins to accept deposits from other firms. In effect, it becomes a bank, as well as a commercial enterprise. This extension of its operations is partly a result of its previously acquired prestige. In the eyes of some, the fact that other firms keep money on deposit with it is also a source of additional prestige. This fact, however, also gives the firm new burdens. Now its liquidity may be impaired not only because of its own commer-

cial operations but also because one of its depositors loses cash to some third business which banks elsewhere or keeps its money in its own safe. In either of these events, the trading-banking firm would have a "deficit," according to the definition used in our balance-of-payments statistics. To perfect the analogy, we must suppose that this trading-banking firm is operating in the days before there was a Federal Reserve System, so that it performs its banking functions without the benefit of a central bank. To be up to date, we should add that there is an institution—called the IMF—in which it and other businesses have put funds and that our business can borrow back the funds it has put in. To be still more up to date, we should also add that this institution has recently arranged to have 10 of the major businesses which put money into it agree to lend it a limited amount of additional money which it, in turn, can lend to any of them that needs temporary financing—provided the potential lenders do not feel that their own liquidity positions prevents their lending.

This analogy may make clearer the meaning of the U.S. deficit and the present position of the United States.

FRAMEWORK OF ANALYSIS

While there may be greater immediate interest in our conclusions, I think there is more of lasting value in the analytical approach we use, which may be a novel way of thinking about the U.S. balance of payments.

The first point is that any substantial and persistent changes in the U.S. net balance of payments will be reflected in opposite changes in the net balances of Western Europe. This generalization—and it is a broad one, to be applied with caution and qualifications—reflects the empirical observation that the rest of the world, in the aggregate and over periods of several years, does not have substantial net surpluses or net deficits. This generalization is basically a reflection of the fact that most other countries of the world have a demand for imported goods and services so intense that they cannot, or in any case, do not, accumulate reserves, and that they also do not have sufficient reserves to run deficits for any protracted period.

It is true that some of these countries run deficits which may be fairly substantial for a year or so, but they then have to curtail their imports and restore their positions, i.e., they pay off or fund the short-term debt incurred in financing the deficit or they replenish the depleted reserves. Some of these countries also may have substantial surpluses for a year or two, but the evidence is that they then tend to expand their imports and run down their reserves. This generalization is a simplification. It may not be true for every country, but it seems to be true in the aggregate.

One implication of this generalization is that one can test any proposition about whether a given change will affect the U.S. net balance significantly and over a period of several years by asking whether it will have the opposite effect on the net balance of Western Europe. If something which appears in the first instance to affect the U.S. balance of payments does not have an opposite effect on the balance of payments of Western Europe as a whole, it is advisable to look again, to see whether the change that one originally thought would affect the U.S. balance may not directly or indirectly cause some compensating change, leaving the U.S. deficit or surplus substantially unaffected.

This test leads to my second general point: Because the U.S. economy is a very large one, different types of transactions in the U.S. balance of payments are closely interrelated. Changes in some transactions tend to be offset by changes in others. For example, changes in U.S. imports are very likely to result in changes in U.S. exports—or in U.S. dividend receipts, if the imports come from countries in whose export industries we have large investments.

Similarly, increases in foreign aid are likely to feed back to changes in U.S. exports, if the aid is to countries which obtain a large portion of their imports from the United States. There are also relations between U.S. capital outflow and U.S. trade. Some of these relations are obvious, but some of them are more roundabout and less obvious. For example, an increase in U.S. business activity which increases demand for imported raw materials and raises their prices may raise the cost of production of our European competitors more than it raises ours, and thereby improve our competitive position in manufactured products.

Similarly, savings in foreign aid may give rise to compensating changes in capital movements or vice versa.

In all these cases, there is an interrelationship between the first and second points I have made. Increases in imports from non-European areas are more likely to increase U.S. exports than are increases in imports from Western Europe because non-European countries tend to spend their foreign exchange receipts, not to accumulate reserves.

These feedbacks must be taken into account in appraising efforts to reduce the U.S. deficit. For example, a million dollars of foreign-aid expenditures has much less effect upon the deficit than a million dollars of military expenditures because the military expenditures go to Europe and cause very little feedback to our receipts, whereas the foreign-aid expenditures go mostly to non-European countries and in most cases do have a substantial feedback to our receipts. It is also desirable to distinguish among non-European countries according to the portions of changes in their payments that go, directly and indirectly, to the United States and the portions that go, directly and indirectly, to Europe. U.S. payments to Latin America, for example, affect U.S. receipts to a much greater extent than do U.S. payments to Africa.

The third main point is that U.S. international transactions are in large part a reflection of relations between internal developments in the United States and elsewhere. And, as the first point implies, "elsewhere" means mainly Western Europe. The balance of payments is only the part of the iceberg that is showing. If we want to understand and project it, we must understand and project the larger part that is submerged. Ideally, we need to know all the quantitative relations between these internal factors—not only in the United States but in the rest of the world—and international transactions, including the division of other country's international payments among the payee countries.

So much by way of background.

THE PROJECTIONS

The focus of our study is on the year 1968, as the Council requested, but we make no attempt to project cyclical or other short-term influences that may prevail in that year. The record shows that both cyclical and random factors can cause very large changes in major components of receipts or payments in a single year. Such factors cannot be predicted 6 years in advance. Therefore, our projections for the year 1968 should be interpreted not as projections of actual values for 1968 but of trend values for 1968.

For the same reason, i.e., unpredictability, we make no attempt to project short-term capital movements, special transactions, or errors and omissions. We concentrate on the net basic balance, which is the excess of payments over receipts on account of goods and services, foreign aid, and the flow of private long-term capital, and on the factors determining this balance. The concept of basic balance that we use excludes not only short-term capital movements and unrecorded transactions, but also prepayments of loans to the U.S. Government (which we regard as induced by the existence of a deficit on other accounts and therefore as distorting the basic position), and increases in nonliquid Government liabilities.

TABLE 1.—*Initial and alternative assumptions on total output and price changes in the United States and Western Europe, 1961–68*

[Percentage changes]

Item	Initial assumptions	Alternative assumptions
Total output:		
United States	+43	+36
Western Europe	+33	+29
Ratio of United States to Western Europe	+8	+5
Prices:		
United States:		
GNP deflator	+11	+11
Export prices	+4	+4
Western Europe:		
GNP deflator	+20	+11
Export prices	+11	+7
Rest of world: Export prices	0	0
Indexes of price ratios (1961=100):		
United States export prices to Western Europe GNP deflator	87	94
United States GNP deflator to Western Europe export prices	100	104
United States to Western Europe export prices	94	97
United States to Western Europe GNP deflators	92	100

Even the basic balance, so defined, changes rapidly from year to year, as you can see from table 2 of this statement. In 1957 the basic deficit was $400-some million. It rose by $3.3 billion between 1957 and 1958 and by another $1 billion in 1959 to nearly $4.7 billion. In 1960, when the total deficit increased slightly, the basic deficit declined by more than $2.8 billion and in 1961, it fell by another $1 billion. Last year, although the total deficit declined slightly, the basic deficit increased by $1.3 billion—from some $800 million in 1961 to $2.1 billion in 1962.

In analyzing the outlook for the basic balance in 1968, we do so on two alternative sets of assumptions concerning the future course of the U.S. economy and that of Western Europe, the two areas that we regard as crucial.

Assumptions

I shall not describe all the assumptions in detail. It is sufficient to say that the first projection is based on the assumption of a gross national product in 1968 of approximateliy $743 billion for the United States—measured in 1961 prices—or a rise of 43 percent from the 1961 level. For Western Europe, the rise of GNP is projected at 33 percent in the same period. As to prices, we assumed an 11-percent rise in the implicit deflator for the U.S. gross national product between 1961 and 1968. We obtained assumptions regarding the level of foreign aid and military expenditures abroad, and assumed that exchange rates will remain at their present levels.

We were given no assumptions about price movements in Western Europe. To deduce them, we projected cost pressures and, concluding that they would increase greatly, then projected aggregate demand in relation to output to see if the cost pressures would be likely to force European prices to rise. For the initial assumptions, we assumed that any such tendencies could not or would not be effectively counteracted by Western European governments. We also had to make our own judgments about the rise in export prices of manufactured goods relative to the rise in GNP prices—for both Western Europe and the United States.

The alternative projections assume that GNP in the United States and Western Europe will grow by 10 percent less than under the initial assumptions. We assume, however, that the GNP deflator for the United States will rise by the same amount as under the initial assumptions, and that foreign aid and military expenditures abroad would be the same as under the first assumptions. In the second projections, however, we assume that European governments will use monetary and fiscal policy more effectively to dampen the price rise.

Thus, the main differences between the two sets of assumptions are (1) that the growth in GNP is lower in the second than in the first set for both the United States and in Western Europe and (2) that resistance to price rises in Western Europe is assumed to be greater and more effective under the second set than under the first. These assumptions are summarized in table 1 of this statement, which is identical with table VIII-1 of our report.

Conclusions about 1968

On the first set of assumptions, we conclude that fundamental forces at work will make for a basic surplus of nearly $2 billion by 1968, an improvement of $3.4 billion compared to the 1961–62 average basic deficit of $1.5 billion. The improvement shows up largely in increases in net exports of goods and services, including a substantial rise in income from private investment abroad. This increase is reinforced by a decline in military expenditures and by a somewhat smaller decline in the outflow of private long-term capital. These gains are offset, but only partially, by an increase in expenditures for foreign aid. These projections are shown in the attached table 2, which also shows the basic balances for 1959–62 and the projected changes from the 1961–62 average.

TABLE 2.—*Basic balance of the U.S. international payments and its components, 1959–62, projections for 1968, and projected change from 1961–62 average*

[Billions of dollars]

	Net goods and services [1]	Net private long-term capital [2]	Government capital and aid [3]	Basic balance [3]
1959	−0.4	−1.6	−2.6	−4.7
1960	3.3	−2.1	−3.0	−1.8
1961	5.0	−2.1	−3.7	−.9
1962	4.3	−2.5	−3.9	−2.1
1961–62 average	4.6	−2.3	−3.8	−1.5
Projected 1968:				
Initial assumptions	9.1	−1.5	−5.8	1.9
Alternative assumptions	6.7	−1.5	−5.8	−.6
Projected change, 1961–62 to 1968:				
Initial assumptions	+4.5	+.8	−2.0	+3.4
Alternative assumptions	+2.1	+.8	−2.0	+.9

[1] Includes net outflows of private remittances. Beginning in 1960, these net outflows include inflows, for indemnification payments, which are not included in figures for 1959 and earlier years. See "Survey of Current Business," vol. 43 (June 1963), p. 26. Excludes exports financed by military grants.

[2] Consists of flows of U.S. private long-term capital and foreign long-term capital other than transactions in U.S. Government securities.

[3] Includes changes in Government holdings of foreign currencies other than holdings of convertible currencies by monetary authorities for stabilization purposes. Also includes pensions and other unilateral transfers. Excludes payments of $2,745 million in 1947 to the International Monetary Fund for original U.S. subscription and of $1,375 million in 1959 for an increase in the U.S. subscription. Excludes military grants. Receipts from prepayments of foreign debts to the U.S. Government, amounting to $435 million in 1959, $48 million in 1960, $668 million in 1961, and $666 million in 1962, are excluded from Government receipts of long-term capital and from the basic balance. Also excluded are receipts from increases in nonliquid short-term liabilities of the U.S. Government amounting to $26 million in 1960, $85 million in 1961, and $865 million in 1962. These receipts have been added to the figures in the short-term capital column in those years.

TABLE 3.—*Projected changes in U.S. basic balance of payments between 1961 and 1968, as shown in statistics and as net effects of gross independent changes*

[Billions of dollars]

Components of basic balance	Actual, 1961	1968 projection		Projected changes from 1961 to 1968	
		Initial assumptions	Alternative assumptions	Initial assumptions	Alternative assumptions
Classified in statistics:					
Net exports of goods and services [1]	5.0	9.1	6.7	+4.2	+1.7
Net private long-term capital	−2.1	−1.5	−1.5	+.6	+.6
Government transfers and loans, net	−3.7	−5.8	−5.8	−2.1	−2.1
Basic balance	−.8	1.9	−.6	+2.7	+.2
Classified by net effect of gross independent changes:					
Imports of military services net				+1.0	+1.1
Less effect on exports				−.2	−.2
Net effect on basic balance				+.8	+.9
Private long-term capital and investment income				+2.1	+2.1
Less effect on exports				−.7	−.7
Net effect on basic balance				+1.4	+1.4
Government loans, transfers, and interest, net				−2.2	−2.2
Less effect on exports				+2.0	+2.0
Net effect on basic balance				−.2	−.2
Changes in real income, absolute and relative prices and European aid, and effects of EEC				+.7	−1.8

[1] Includes net private remittances.

NOTE.—Components do not always add to totals because figures are rounded.

Source: Table VIII-2 of "The United States Balance of Payments in 1968."

This way of breaking down the projected change in the total balance accords with what the balance-of-payments statistics would show. It would be an error of analysis, however, to infer from it that a given change in one component is the cause of an equal change in the basic balance. Such an inference would not take account of the feedbacks involved in the projected changes. I have included as table 3 of this statement a table which shows the projected changes between 1961 and 1968 in two ways. The top half of table 3 shows the items more or less as they are grouped in the balance-of-payments statistics. The lower half puts together the gross amount of each independent change and its projected feedback. It makes clearer how much the projected independent changes affect the net balance.

There are two major reasons for the projected improvement under the first set of assumptions. One is the improvement in the U.S. competitive position. Our assumptions imply that prices and costs in Western Europe—primarily on the Continent—will rise substantially relative to prices and costs in the United States. Reinforced by the assumed rise in Western Europe's real income, the effect will more than offset the effects of the assumed rise in our real income on imports of goods and services and the adverse effects of discrimination by the EEC against us and some of our customers.

The improvement in our competitive position arises fundamentally from differences between the United States and Western Europe in the prospective growth of the labor supply. The growth of the labor force in Western Europe is expected to decline and this decline will be reinforced by a projected cut in the average length of the workweek. In the United States, however, the existing labor force is underemployed and the growth in the labor force will accelerate. On our assumptions as to Western European policies, the tightness in Western Europe's labor market will cause a substantial increase in wages and also in labor costs per unit of output—more than double the average annual rise in the United States. Thus, we project substantial upward cost pressure in Western Europe, and sufficient aggregate demand to carry this cost pressure through to a substantial rise of prices.

In our judgment, this rise in Western Europe's GNP prices would be accompanied by a rise of export prices—a situation which did not occur during the 1950's. During most of the postwar period, investment in Western Europe was more concentrated on export goods and import-competing goods than we think it will be between now and 1968. That is why we expect the relationship between movements of export prices and of GNP prices in Western Europe in the future to be different from the relationship in the 1950's.

The second major reason for the projected improvement in the basic balance is a substantial rise in net receipts associated with past and current international long-term investments. This rise results from both an increase in investment income and a decline in the net outflow of long-term capital.

These influences are reinforced by an expected decline in military expenditures abroad. They are only partially offset by the adverse effects of discrimination by the European Economic Community on imports from the United States and some of its customers, and by the net effect of assumed increases in foreign aid.

Under the alternative set of assumptions, which on the whole we think more realistic, the improvement in the basic deficit compared to the revised figures for 1961—revised since we submitted our report to the Council of Economic Advisers—is so small in relation to the possible error that it should not be regarded seriously, but it is a large improvement over 1962. It leaves the United States in basic deficit to the extent of about one-half billion dollars.

Most of the difference between the results obtained under the two sets of assumptions reflects the difference in European prices, rather than the difference in the assumed changes in real income. Under the second set of assumptions, the competitive position of the United States improves by a good deal less than under the first.

I have mentioned that the business of projecting the implications of given assumptions for net balances of payments is a particularly hazardous one. I do not refer merely to the risk that the basic assumptions may be wrong—which is indeed a hazard. I refer, rather, to the fact that even if future changes in real income and prices and other basic variables do lie between the values we have assumed, their effects on the basic balance may lie outside the range we project. The sources of possible error in estimating payments implications of given assumptions are stated in our report, but I want to mention a few here.

One is that the projections of the balance-of-payments implications of the assumed variables—GNP, prices, and others—are derived from quantitative relationships estimated for the most part from data for the period 1948–60. Even for that period, these relationships may not correctly measure the effects of these variables on international transactions. Or they may attribute the effects to the wrong factors. Most factors other than real GNP and relative prices are omitted. Furthermore, even if the equations correctly measure the average effects of the individual variables upon international transactions in the period 1948–60, these relationships were not stationary during that period and may change further in the future.

Aside from these possible errors in the influences we do project, other things that we do not try to project—because there is no way to estimate either them or their effects quantitatively—may also change. Some of them—such as steel strikes and crop failures—may have transitory effects. But others—such as basic changes in supply and demand conditions for individual commodities important in international trade, or changes in large sectors of the economy—may be lasting changes and may have profound effects on international trade. Some cause our estimates of the improvement in the U.S. basic balance to be understated; others cause them to be overstated.

The factors of understatement are, first, that our projections of U.S. exports take no account of export drives and other special efforts to increase U.S. receipts from the sale of goods and services abroad. We doubt that the effects of such efforts can be large in relation to total receipts, but it is possible that over a period their effects might be significant in relation to the deficit.

A more important consideration is that the rise in Western Europe's prices may be greater than we project, even under the initial assumptions. The projected rise of Western European prices, under both assumptions, is based on the estimated increases in costs per unit and a judgment as to how much of these cost increases are likely to be reflected in prices. Thus, it is essentially a "cost-push" measurement rather than a "demand-pull" measurement. Since we also find that excess demand would exist, we conclude that the price rises indicated by the cost-push are not implausibly high. We did not adjust them upward, however, to take account of the additional effects of excess demand. We therefore regard the price increases that we project for Western Europe as the minimum rises consistent with the assumptions that underlie them. Since the U.S. competitive position appears to be sensitive to changes in relationships between Western European and United States prices, any understatement of Western European price increases may be important.

Finally, a return to fuller utilization of capacity in the United States will be accompanied by a substantial increase of investment, and a more rapid rise in output per man-hour than has occurred in recent years. This effect has not been explicitly taken into account. Our assumption regarding the rise of U.S. export prices reflects a judgment about how sustainable present relationships between export and other prices are, but it is only an intuitive judgment. Because reliable data are lacking even for past export prices, it is impossible to test any hypotheses, however plausible, concerning the relationship of export prices to other prices.

On the other side, one of the factors which might cause our initial projection to be too optimistic is that the rise in U.S. prices, which affects the U.S. competitive position, may be too low to be consistent with the rise in U.S. real income assumed in the initial projection.

A second possibility is that Canada, which we have included among the countries likely to spend all the foreign exchange that they receive, may make a vigorous and successful effort to build up its reserves by earning a basic surplus—not only in the coming year or so, but over a longer period. In this event, our projection of U.S. exports to non-European countries as a group would be overstated.

In the light of all the considerations, our best guess is that the basic deficit will be eliminated by 1968. If the initial assumptions come close to being realized, there is a definite possibility that a significant basic surplus will develop.

Even if a significant improvement does occur over the whole period between 1962 and 1968, random disturbances and short-term fluctuations in the United States or in Western Europe, Japan, or Canada may have large transitory effects on the net balance. Year-to-year fluctuations are large and erratic, so the underlying trend may be difficult to discern. This general observation leads me to comment in greater detail on the changes that may occur between now and 1968.

Conclusions about changes during the period 1962–68

Since cyclical changes and random factors may have very big effects on the net balance, it would be foolish to try to estimate the path that the basic balance will take between now and 1968. One consideration is that some improvement in our competitive position is likely in the next few years; indeed, if relative price changes in the United States and Western Europe are any indication, some has probably occurred already. But we do not know whether this has yet been reflected in the trade position, if one adjusts the recorded position—as one should—for cyclical and random factors. We do expect some improvement in the U.S. competitive position to show up clearly by the end of 1964. We also expect cuts in military expenditures abroad and other deficit-reducing measures to have most of their effects on the basic balance by that time.

There are offsetting considerations, however. First, we have assumed a recovery in the United States in the next 2 years sufficient to reduce unemployment to 4 percent. Such a recovery would raise imports simultaneously, while its favorable effects would lag behind. Second, the adverse effects of EEC discrimination will also be felt more strongly in the near future, but the favorable effects of negotiations under the Trade Expansion Act cannot offset them for at least 2 years. Third, the basic balance may also be worsened by a recession or a slowing down in Western Europe's economic growth.

For these reasons, it may be difficult to discern an underlying trend in the next 2 years, even if one exists. Random or cyclical factors may eliminate the basic deficit in some quarters, while they may raise it in other quarters to annual rates of $3 billion or even $4 billion. Our guess is that the average basic deficit for 1963 and 1964 will not differ much from that of the 1961–62 average of $1.5 billion.

Any substantial improvement is likely to appear clearly, however, by 1965 or 1966. By that time, the cumulative effect of any changes in the relation between United States and western European prices will presumably outweigh the more transitory effects of any adverse cyclical or random factors.

Moreover, after several years, the effects of differences between rates of growth of the United States and western European labor supplies, which reflect differences in the increases in their postwar birth rates, will have become marked.

Finally, as I have already noted, there is a considerable lag in the beneficial effect of high employment on our competitive position. To the extent that this effect occurs, it does so by increasing investment and thereby putting us on a more rapid growth path, by creating a climate more favorable to mobility of labor and capital, to avoidance of new restrictive practices, and to elimination of existing ones, and perhaps also to innovation and to technological improvement. These effects are fully felt only after several years.

Outlook for world trade and reserves

Our projections lead us to believe that the dollar value of international transactions will grow by at least 35 percent between 1961 and 1968. If U.S. deficits continue in 1963 and 1964 but diminish to zero between 1965 and 1968—I am now talking about total deficits, not basic deficits—and if monetary gold stocks grow at the same rate as they did between 1947 and 1961, gold and dollar reserves will rise by about 12 percent between 1961 and 1968. This compares with the 35-percent increase in international transactions. World monetary reserves would thus shrink in relation to the level of international transactions.

Whether this relative decline would create a problem of liquidity depends, of course, on whether liquidity is adequate now and how much the need for liquidity grows in relation to the growth of the value of world transactions. So far as the need for liquidity is concerned, we think that imbalances in total international payments will increase in relation to total payments. The major countries are likely to be faced with persistent imbalances arising not so much from deficiences or excesses of aggregate demand but from structural factors, such as changes in technology, in competitive positions, or in the structure of world demand for their products. Imbalances arising from such causes cannot be eliminated quickly without jeopardizing domestic economic growth, price stability, or other vital objectives. To avoid jeopardizing these objectives, equilibrium must be reached gradually. The existing monetary mechanism will not provide enough liquidity to finance deficits over periods long enough to permit such gradual adjustment. Without the means of financing deficits over such periods, preoccupation with balances of payments is likely to override considerations that are fundamentally more important. The deficit countries will be placed under increasing constraints. Such a situation might well induce actions that would restrain their rates of growth unduly.

Indeed, these restraints could prevent the forces making for improvement in the U.S. balance of payments from materializing fully. If a U.S. balance-of-payments surplus should begin to develop, some other countries would begin to move toward deficit positions and might take restrictive measures to stop this movement. In that event, the forces making for improvement of the U.S. payments position would merely have caused the world to exchange one problem for another. Thus, there is a dilemma: A strengthening U.S. balance of payments would leave the world as a whole—and the United States, too—little if any better off than does a U.S. deficit. This suggests that the fundamental problem may not be the U.S. balance-of-payments deficit but the world's monetary system.

It is often said that maintenance of balance in international payments, if not an ultimate end of policy, is a means of restraining countries from pursuing undesirable economic policies. Balance-of-payments discipline, however—like any other discipline—is desirable only as a means to ends that are desirable. It is not desirable if it requires the subordination of higher priority objectives.

The U.S. Government has not, on the whole, compromised its basic foreign policy and defense objectives because of balance-of-payments considerations. These considerations, however, have played an important role in failure to achieve maximum production and employment. The additional slack in using productive capacity at a level associated with unemployment of 6 percent instead of, say, 4 percent of the labor force involves losing output estimated at about $30 billion to $40 billion every year.

Policies tying economic aid to procurement in the United States and requiring military expenditures to be made in the United States rather than abroad add considerable cost to the taxpayer. They also arouse resentment in the rest of the free world, protect high-cost U.S. industries from the spur of foreign competition and foster poor allocation of resources. Moreover, there is increasing pressure to compromise the objectives of foreign aid for balance-of-payments reasons. It is clearly in the interest of the United States to develop an international monetary mechanism that will permit adjustments to take place without compromising other goals.

THE NEED TO IMPROVE THE INTERNATIONAL MONETARY MECHANISM

The present international monetary system is essentially a system of quasi-fixed exchange rates with international reserves held in gold and national currencies (principally dollars and sterling). The price of gold in terms of dollars is fixed, and other currencies are pegged, to the dollar, thereby providing a fixed structure of exchange rates among various currencies. The pegs are adjustable, however. Adjustments have been made often enough to keep the possibilities of further changes alive in the minds of central banks and private owners of capital.

In our view, fixity of exchange rates is a virtue. By removing much of the uncertainty of international transactions, it tends to increase the volume of trade and productive international investment, thus contributing to efficient use of world resources. The more certain it is that the rates will be maintained, the greater are these advantages. We believe, therefore, that the present system of fixed exchange rates should be strengthened so as to preserve and enhance its advantages and mitigate its disadvantages.

The main disadvantage of the present fixed rate system is that it requires countries whose payments are not in balance to restore balance more rapidly than may be consistent with important domestic and international objectives. Deflationary measures, the classical means of improving the balance of payments, cut employment and real incomes—effects which are neither politically feasible nor economically desirable in a modern industrial country. In the United States, large absolute reductions in real income cause only small decreases in imports, and these decreases are partly offset by decreases in exports, so that very substantial declines in total production and income are necessary to induce relatively small improvements in the net balance of payments. Furthermore, higher interest rates, while discouraging domestic investment, may not be effective in attracting capital to a currency when stronger currencies are available.

Rapid adjustment is especially difficult if exchange rates that are normally fixed may be changed when an imbalance in payments is judged to be fundamental. The prospect that a weak currency may be devalued discourages stabilizing capital movements and fosters destabilizing movements. This reinforces the basic factors originally responsible for the currency's weakness. Moreover, when the authorities decide to devalue or are forced to do so, they usually make the devaluation so great that no one will doubt that the new rate can be maintained.

As a result, currencies which have been overvalued before their parities are altered are likely to be undervalued afterward.

If an international payments system is to provide the benefits of fixed parities without these disadvantages, it must generate confidence in the fixity of the parities. Given greater liquidity, this confidence would probably develop, because it would gradually be recognized that payments adjustment at fixed parities is possible if enough time is available.

ACTIONS NEEDED IN THE NEXT FEW YEARS

The United States should immediately begin to press for an agreement to strengthen international liquidity. Since the study and negotiations needed to obtain agreement on a new mechanism for international liquidity may take a long time, however, the United States will be obliged to deal with its balance-of-payments problems within the framework of the present mechanism.

Measures to finance the deficit

Even if the projections of this report are realized, there probably will be deficits in the U.S. balance of payments for the next several years. However, U.S. reserves are so large, compared to likely levels of the deficit, that we see no reason for concern about financing these deficits while working to improve the international monetary system. Despite the substantial reduction in U.S. monetary reserves and the large increase in liquid dollar claims of foreigners, U.S. reserves and other resources for meeting continuing deficits remain very great. The U.S. Government should make clear that it regards its reserves as existing to be used for these purposes.

The statutory requirement of a gold reserve against Federal Reserve notes and deposit liabilities long ago ceased to serve any useful purpose. It should be abolished. Its abolition would make clear that the reserves are available to the full and at all times, not merely in emergencies, to serve their only useful function.

The United States should also draw on the IMF—as it now proposes to do—to finance some of its future deficit. Such drawings would help to promote the idea that use of the Fund's resources is not an act of last resort; more willingness of IMF members to draw on it would increase effective liquidity.

Such steps would establish that the United States is willing to use its reserves and credit facilities to support the dollar.

Measures to improve the balance of payments

We do not recommend that the Government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves. Actions already taken, such as tying aid and restricting certain types of military expenditures abroad, should be regarded as temporary. Further restrictive measures of this type would be of negligible benefit, if not positively harmful. To cut aid or military expenditures for balance-of-payments reasons would be an unwise and unnecessary sacrifice of more important objectives.

As the balance-of-payments deficit declines, foreign aid expenditures should gradually be untied.

We have stressed that measures which might endanger U.S. economic growth and the restoration of high employment levels should not be adopted for balance-of-payments reasons. This means that it is inadvisable to raise interest rates in an attempt to affect international flows of capital, unless the adverse domestic effects of higher rates can be fully offset by fiscal expansion. The balance of payments and other goals will be served, however, by wage and price restraint during the course of recovery to high employment. Restraint on wage and price increases will benefit the U.S. competitive position without retarding domestic growth. The Government's efforts in this direction should be stepped up as the country moves toward full employment.

Devaluation of the dollar also should be rejected. Devaluation might actually weaken, rather than strengthen, the dollar. If other countries—especially those in the European Economic Community (EEC)—devalued their currencies in line with the dollar, the U.S. deficit would not be reduced, but the future willingness of foreigners to accumulate dollar assets would be curtailed. Even if other major currencies were not devalued, however, devaluation of the dollar should be rejected. Devaluation is appropriate only when a balance-of-payments deficit is clearly caused by a fundamental disequilibrium that is not likely to diminish in the future. Our projections suggest substantial future improve-

ment at the current exchange rate. Devaluation, therefore, might throw the United States into substantial surplus and other countries into deficit.

The United States should bargain vigorously with the EEC for trade liberalization in the coming negotiations under the General Agreement on Tariffs and Trade and insist on some minimum concessions. A satifactory agreement should preserve and enlarge foreign markets for Temperate Zone agricultural products, liberalize EEC imports of manufactured goods, especially those from Japan and underdeveloped countries, and reduce discrimination against tropical products of Latin America and other non-EEC countries. Agreement should not be sought at any price.

Measures to improve arrangements for international liquidity

The U.S. Government should make a major effort to establish with other countries an adequate international liquidity mechanism. The immediate task is to formulate a plan which meets the criteria for a satisfactory system. The next task is to seek international agreement on such a plan.

We propose four requirements of a satisfactory system:

1. It must provide enough liquidity at the outset to finance substantial imbalances while adjustments are taking place, and it must provide for increases in liquidity as the need for liquidity grows.
2. Additional liquidity which takes the form of credit should be available readily and promptly, and for a period long enough to permit elimination of of the deficit. Substantial amounts should be obtainable automatically by deficit countries. By agreement, additional amounts should be made available to countries with particularly intractable balance-of-payments problems if appropriate measures for dealing with these problems are being taken.
3. The possibility of shifting reserves from weak to strong currencies must be prevented. These problems would be avoided if industrial countries committed themselves to hold a substantial fraction of their reserves in an international institution, with creditor countries accumulating credits in an international unit of account and debtor countries accumulating similarly denominated debits or reducing previously acquired credits.
4. For such a system to work it is probably necessary that the principal financial and industrial countries consult fully and frequently and coordinate policies that have substantial effects on international payments.

As to getting an agreement, Western European countries are not likely to be receptive to U.S. proposals which seem only to ask them to commit themselves more irrevocably and firmly to propping up the present dollar exchange standard. If the United States wishes to gain European support for an expanded international liquidity arrangement, therefore, it must consider the possibility that the dollar's role as a reserve currency would be curtailed.

It is sometimes said that full maintenance of the dollar's postwar role as a reserve currency is essential to U.S. national power or prestige. We think this view mistaken. The economic power and prestige of the United States come primarily from its high productive potential and its success in using that potential. Reduction of the reserve currency role of the dollar would have far less effect on U.S. prestige than continuation of the present failure to operate the U.S. economy at or near capacity. To return to my earlier analogy, a merchant may get some prestige in being known as not only the biggest merchant but also a banker in his community. His banking role may justify him in making some sacrifices to maintain the more liquid position that he needs since he has opened himself to withdrawals by depositors. But if he has to scrimp on the more important foundations of his prestige—reduce his efficiency by not maintaining up-to-date equipment in his major business or injure the long-term prospects for his business by not sending his sons to college or both—then it is time he asked himself how much the additional prestige of his banking role is really worth. If, beyond that, he has to beg his depositors to keep their funds with him, the question is still easier to answer.

Beyond this, which is mainly a question for the United States to answer for itself, is the question whether other countries will agree to a system providing greater liquidity while the United States is in a deficit position. Perhaps agreement will prove to be difficult to reach in this situation. But we shall not know until we try. The Government should not defer beginning discussions merely because there is a deficit. If agreement does prove difficult to reach, it may become easier to reach as the deficit declines and the surpluses of other countries diminish. Hope of agreement should not be given up, therefore, while there is

a prospect that the U.S. deficit will disappear. And the United States itself should resist any tendency to lose interest as its payments position improves.

An alternative international monetary mechanism

If it becomes clear that agreement on a satisfactory liquidity mechanism cannot be obtained, the United States must seek an alternative. The best alternative, in our view, would be a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc, with fixed rates within each bloc and flexible rates between them. Within Western Europe, the logic of economic integration demands that fixed parities be maintained among the members of the European Economic Community, a fixity which they could easily effectuate. Countries whose economies are closely alined to the major members of each bloc would presumably wish to tie their currencies to that bloc. The only significant fluctuations, therefore, would be in the rates between the dollar-sterling bloc on the one hand and the Western European bloc on the other. Violent changes in these exchange rates would be prevented by intervention of the stabilization authorities in the foreign exchange markets. In practice, we would expect the range of these fluctuations to be limited.

This modified flexible exchange rate system would allow the United States greater national autonomy in the use of fiscal policy, since the external consequences of such policies would be offset by movements in the exchange rate. The fluctuations in themselves would correct basic imbalances between currency blocs without imposing general deflation in deficit countries or general inflation in surplus countries. Such a system would also reduce the need for international reserves.

Nevertheless, there are some true costs in adopting our second-best, two-bloc proposal. The volume of international trade and capital movements between the members of the two blocs would probably be smaller than under a system of fixed parities with adequate provision for international liquidity. The unity and cohesion of the free world would probably be better served by a system of fixed parities with provision for adequate liquidity. That is why we regard the two-bloc system as inferior to such a system. We believe its shortcomings to be less serious, however, than those of any alternative that would be available if the improved fixed parity system could not be attained. It would eliminate the deflationary bias inherent in fixed rates with inadequate liquidity. Since it would contribute to more rapid economic growth, world trade might be larger than under the present system, despite the impediment of rate flexibility. It would be the least harmful means of obtaining international balance if it were not possible to develop a fixed exchange rate system with adequate provision for liquidity.

We repeat, however, that in our view it is only a second-best proposal. Our decisive preference is for a system of fixed rates with an adequate liquidity mechanism. More important than the choice of mechanism is our major policy thesis: That the United States seek agreement on an international payments mechanism that permits adjusting national balances of payments without compromising the important goals of national and international policy.

Representative REUSS. Thank you, Mr. Salant.

We will now proceed under the 10-minute rule.

I want to congratulate the panel for its truly great contribution to the discussion of balance of payments. I can see all sorts of sacred cows slaughtered on the battlefield here.

To name a few which you have put out of their misery—the notion which we have heard so often expressed that the so-called constraints of the balance of payments are somehow a good thing. I think you point out quite correctly that if a country is pursuing inflationary policies to its detriment, then it may be that the additional goad toward morality that you get through a balance-of-payments deficit may be helpful, but the main point you make is that if a country like ours has the opposite problem, one of limited use of resources and unemployment, then the balance-of-payments constraint is a most perverse thing, working in the wrong direction, and that the free

world ought to take some measures to relieve itself of that kind of constraint.

You also please a good many members of the Joint Economic Committee when you point out that tightening money, raising interest rates, raising the rediscount rate, is a very odd way to restore growth and cure unemployment at home and that to do it for balance-of-payments reasons is to let the tail wag the dog.

A third sacred cow whose imminent death I note as a result of what you have said here today is the confusion in the minds of many policymakers between the long-term need for total additional world liquidity and additional reserves and the immediate problem with which we are confronted of seeing that the existing supply of reserves is adequately marshaled so as to free individual countries from undue constraints of the balance of payments.

The administration tends to say, "Well, we do need to look to the situation 4 or 5 years hence when, because of new gold on the market and because the dollar will then no longer be supplying additional reserves, the total free world stock of reserves is inadequate."

What you point out, though, is that even if we brought our payments into balance immediately, there would still be a very serious problem of insulating each country from the untoward effects of not only deficits but short-term capital movements and other effects on convertibility which aren't going to disappear when we do get our payments into balance.

I would like to ask you to spell out a little more the thinking behind your plea for an immediate new monetary mechanism on the part of the free world. You have recommended that we not delay further but make up our minds on the outlines of such an agreement and then ask our 10 or 12 free world advanced country allies to join with us in putting such an agreement into effect.

How do you answer—I think I know what you are going to say and I agree with you—how do you answer the rebuttal of those in high places who say that you are premature, that we have got 5 or 6 years before total free world liquidity is really strained and that we can afford to wait until then?

Either Mr. Salant or any of his associates.

Mr. SALANT. I would like to, in connection with any of the questions, call upon my colleagues as well as myself.

I would say with regard to this question that you asked, it seems to me the besetting sin of governments is to wait until the crisis is upon them before doing something. If something is clearly foreseeable, it seems to me that preparations to meet it should be made in advance.

Now, as we know from, for example, the Bretton Woods Conference, a revamping of the international monetary system takes time to work out, to obtain agreement about, and there is an educational process for the general public that is required as well as the problem of negotiating with other governments.

Having regard to the possible time requirements, it seems to me that it is not too soon to begin and I think this is certainly the reason in the minds of my colleagues.

It is quite possible—and I think perhaps this is what the Secretary of the Treasury had in mind when he said it isn't possible to do it

now—that we will not get the agreement that we would like to get, or that we would like to see the United States want to get, while the United States is in deficit. That we recognize. I mentioned that possibility in the statement. But that doesn't mean that it is too early to begin. It may mean merely that your forecast of success, of immediate success, is low; but if our balance of payments improves and the balance of payments of other countries deteriorates, as it necessarily must if ours improves, the countries will, we think, take a more hospitable view toward rearrangements, assuming that their present view is not hospitable, which I am not sure about.

Representative REUSS. Because it has never been tested.

Mr. SALANT. It hasn't been tested. We haven't tried. We know that the United Kingdom has put forward a plan, is not satisfied with the present arrangements. I at least do not know that this is not true of others.

Representative REUSS. Aren't you also saying that this business of waiting until we shuck off our deficit before proceeding, aren't you saying that that is really an irrelevant factor, that the need for a reform of the free world's monetary mechanism exists independently of the deficit position of this country?

Mr. SALANT. Yes. We are saying in effect that there will be large and persistent imbalances and that the system is inadequate to take care of adjustment to those imbalances. It doesn't matter who has them. The system is still inadequate. And there is danger, in fact, that if we were to wait, and if indeed our balance-of-payments deficit should be eliminated, there is some danger that we would forget this act and tend to lose interest in it.

Representative REUSS. Now a question about your projections on attaining—I won't say balance—a better situation in our balance of payments by 1968. Frankly I hope you are right and while I thoroughly agree with all of your recommendations, I find you a little on the optimistic side and I would like to explore this with you.

What kind of a growth rate do you postulate from now until 1968 on, first, the administration assumptions which they gave you, and, secondly, your more realistic alternative assumptions? Something like 4.8 percent a year from the administration and 4.3 percent a year from you. Isn't that right?

Mr. SALANT. We have expressed these in table 1 as rates, as percentage increases over the whole period.

Representative REUSS. Will you break those down on an average?

Mr. SALANT. On an average annual basis, they will be found, by the way, for those who have a copy of the report, in chapter——

Senator DOUGLAS. Excuse me. I think the chairman is right on this point, 4.8, 4.3 percent.

Representative REUSS. Is that about it? Will you give them to me over a 5-year cumulative period?

Mr. SALANT. I think this is right, 4.8 and 4.3.

Representative REUSS. If my arithmetic is wrong, please correct me later. But let us assume that is right. I will now point out to you, of course, what you well know, and I am referring to the President's 1963 Economic Report, that our growth rate in this country during the period 1945 to 1957 was 3.9 percent and during the period 1957 to 1962 it was 3, a flat 3 percent, so that the projection you are

making on the first assumption involves almost a 50-percent increase in the growth rate of improvement year to year, does it not? Not that this is impossible, but I want to indicate what we are assuming.

Mr. SALANT. The rate of growth of the labor supply will be substantially larger in the United States and that is one element in it.

I think probably the major element is the assumption of a more rapid rate of growth. And we are starting from a position of considerable unemployment.

Representative REUSS. And you are figuring on the reduction of our unemployment to a 4-percent target within the next year and a half?

Mr. SALANT. That is correct.

Representative REUSS. Well, fine. I think that you have to take some assumptions and the only point of my questions is that you have taken the assumptions that would flow from a rigorous and vigorous determination by the executive branch, the Congress and the people of the United States that they want to stop fooling around and bring unemployment down to 4 percent, something which hasn't happened for the last 6 years. Is that not so?

Mr. SALANT. Yes, that is correct.

Perhaps Mr. Despres would like to add something.

Mr. DESPRES. The projections that we have made are not highly sensitive to our assumptions about the Western European and the U.S. growth rates. They are somewhat sensitive to them. But the more important factor, so far as the trade balance is concerned, is changes in the relative competitiveness of the United States vis-a-vis Western Europe with respect to internationally traded goods, and here we have concluded that this will move perhaps moderately, perhaps rather sizably in our favor during the period to 1968.

Representative REUSS. Suppose, God forbid, that we just continue as we have been and have in 1968 an unemployment rate of 5.8 percent. What would this do to your projections for balance of payments?

Mr. SALANT. Well, in the short run it would involve a lower level of imports. In the longer run it would make the United States less attractive to foreign capital and to U.S. capital and would, because of the lower level of domestic investment that it would involve, probably prevent the improvement of our output per man-hour and the improvement of our competitive position which we think a higher level of employment would permit.

Representative REUSS. And when you say in the longer run, you mean by 1968?

Mr. SALANT. Yes.

Representative REUSS. So that in a nutshell, while I gather you are not prepared to state just what our deficit would be in 1968 if our lag in licking unemployment continues, your testimony is that we would still have a very sizable deficit by 1968 which would continue to be a cause of concern.

Mr. SALANT. Well, what you are in effect asking me to do is to work through a third set of assumptions on balance-of-payments consequences which we have not done and which I might say is a great deal of work. But if you want a guess about it, I would not think that maintaining a lower level of operations than capacity permits would be helpful in the long run to the balance-of-payments deficit, and over a sufficiently long run I think it would be harmful.

Maybe others of my colleagues would like to comment on that, too.

Representative REUSS. Doesn't at least one of your colleagues think that you have been understating the problem, saying it would not be helpful? Doesn't anybody think a continuation of our economic lag would be hurtful to the progress of our balance of payments 5 or 6 years from now, 1968?

Mr. SALANT. Perhaps I am being too judicious.

Mr. DESPRES. The general view we have taken on this, I think, is that a rise in the level of employment, economic expansion, is probably in its immediate impact adverse in its effect on the balance of payments. But that this is only the immediate impact effect; economic expansion, unless it is accompanied by sharp price rises, is likely over time to be favorable to growth of productivity and therefore competitiveness, and is likely also to attract capital here if you give it time.

By the same token, a continuation of high unemployment and stagnation here, while it may superficially seem to be holding down our imports, and so on, is really worsening our competitiveness in all probability in the long run, especially since the prices of the manufactured goods we export tend to be sticky; they won't be lowered just because there is unemployment. I think most of us have the same feeling that I believe the chairman of the committee has, that our balance-of-payments interests would not be served by a prolongation of the present level of unemployment.

Representative REUSS. You started out fine but you ended up denying a negative.

Mr. DESPRES. I don't think we could say categorically that our balance of payments would be worse if unemployment were prolonged. I think our general hunch is in that direction, but the——

Representative REUSS. Your whole set of assumptions, it seems to me, on happiness by 1968 in the balance of payments, depends upon moving forward economically, increasing our growth rate, which inevitably means reducing unemployment. Only thus could we get more productive and efficient, sell more abroad at easy prices. Only thus do we make America a more attractive magnet for domestic and foreign capital.

This is how you work out the salvation in our balance of payments by 1968.

Mr. SALANT. Not wholly, Mr. Chairman. If I could just make one comment by way of elaboration of what Mr. Despres said. He used the term "expansion." I think it might be desirable to make a distinction between expansion, the process of getting from the present level to a higher level, and the maintenance of a higher level. The process of expansion may produce adverse effects. The maintenance of a high level will do the things that we think are favorable in the balance of payments.

As to our projection depending upon the assumption of the expansion here, it depends to a very large degree—more, I would say—on the expected rise of money costs in Western Europe relative to here.

I think Mr. Krause would like——

Mr. KRAUSE. There is a second kind of feedback that has to be taken into account, and this might be called a policy feedback. If the United States does not move forward toward solving our unemployment problem, and if our balance of payments starts to improve forcing

a worsening balance of payments on Europe, we will demonstrate that a depressed economy can make progress on its balance of payments. The Europeans, therefore, are unlikely to have the same sort of expansionary policies that they have had in the past. Our deflationary policies will spill over, forcing Europe to deflate at the same time, and may even prevent the improvement of the balance of payments the United States is seeking.

So we may sacrifice full employment for improvement in the balance of payments and never achieve it.

The only thing we would achieve would be to spread deflationary effects abroad.

Representative REUSS. Thank you.

I am exceeding my time limit.

Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Salant, I want to add my words of appreciation for the scholarly job that you and your colleagues have done on a very, very difficult problem. I hope you won't mind if I cannot concur in the views of our chairman in reacting favorably to all of your recommendations, however.

In connection with your assumptions that we will have by 1968 $743 billion of GNP, what annual rate of growth is that premised on?

Mr. SALANT. That was the 4.8 figure.

Senator MILLER. Is that in turn premised on a tax cut such as has been recommended by the administration, or the nonexistence of the tax cut?

Mr. SALANT. It is a premise that means—well, the means of attaining the level was not what we took into consideration. This is not a forecast, it is a projection. That is to say, by this distinction between projection and forecast, I mean it is a working out of the implications of the assumption. We don't know how the $743 billion would be obtained, nor if it would be obtained so far as that goes.

Senator MILLER. In other words, you merely accept the Council of Economic Advisers' guidelines of a 4.8 percent annual economic growth rate. You didn't probe into the underlying factors behind it.

Mr. SALANT. Yes. To work out the rate on the first assumption. But we also made a second projection involving a slower rate of growth and a lower level of GNP in the United States for 1968.

Senator MILLER. But you had no particular guidelines to follow in projecting a lower annual growth rate. You just made an arbitrary decision as to what that would be. You didn't premise it on any particular factor such as whether or not there would be a tax cut, whether or not we might have a recession, and so on.

Mr. SALANT. That is correct.

Senator MILLER. Thank you.

Now, I would like to have it clear in my mind as to what you mean by an 11-percent rise in the implicit deflator. Do I read you correctly in this respect, that if you are forecasting an increase in GNP to $743 billion by 1968, we might expect during the interim period from 1961 to 1968 around $80 billion worth of inflation?

Mr. SALANT. The $743 billion is in 1961 prices.

Senator MILLER. But in 1968 prices what would it be?

Mr. SALANT. We have assumed it would be about $817 billion, if my arithmetic is correct. We have assumed an 11-percent rise in the

prices implicit in the gross national product, and adding 11 percent to $743 billion gives me $817 billion.

Now, I believe that is correct.

Senator MILLER. So by subtracting $743 billion from $817 billion we come up with roughly an estimated $74 billion of inflation during this period of time. Is that correct?

Mr. SALANT. Of price rise, yes.

Mr. DESPRES. There are many economists who believe that there is an upward bias in the particular price index that is used for deflating the GNP, and that 1½ percent a year—they would not accept this as a measure of inflation, but if you adopt this as a measure of inflation, then the figures are all right.

Senator MILLER. I don't know what else we are going to adopt. I am just taking the Council of Economic Advisers' figures as you are. Maybe they are not perfect, but what else have we got to use? If we can use something better, I am all for it. But when the Council of Economic Advisers uses implicit price deflators, I think we had better use them unless we have something better to use.

Mr. DESPRES. There is a whole host of price indexes and one could adopt as the measure of inflation any price index he takes a fancy to. I am just saying many economists believe that there is an upward bias in this one.

Senator MILLER. I appreciate your pointing that out but may I point out that those economists are usually the ones who don't like to admit what is happening to the people's hard-earned money.

As I say, I don't care what we use so long as it is sound, and if you can figure out something that is better than the President's Council of Economic Advisers, it is all right with me. But when I take the figures they furnish this committee in Economic Indicators and I find that just in the first two quarters in this year alone our GNP is eaten up by over a third through inflation, about $4.8 million, I must say I recognize what appears to be a pretty valid projection by Mr. Salant of $7 billion or $8 billion inflation per year through 1968. Now, the question I want to get to, once we have a meeting of the minds on this step, is why do you use that projection? Instead of estimating $817 billion GNP in 1968 versus $743 billion in 1961 prices, why not say $750 billion or $760 billion or $770 billion? Why do you have to get up to $817 billion?

Mr. SALANT. This assumed rise of 1½ percent a year in the GNP price index accords with an average of what we have had in recent years. That was the reason it was used.

With regard to this price index in relation to others, I might add that it is a little bit different from the others and one of the reasons it has an upward bias is that it does not—well, let me say first any price index is an average of prices for various categories of commodities.

In a normal price index, one keeps the weights of those different categories constant from year to year. This index has shifting weights and it happens that the prices that are rising most tend to have increasing weight as time goes on. So if it were put together with constant weights, the rise would probably be less than 11 percent over the same 7-year period.

Senator MILLER. You merely took what we have been averaging out over the last several years and projected the same rise in the future.

Mr. SALANT. That is right.

Senator MILLER. Now, in your statement, Mr. Salant, you say that reduction of the reserve currency role of the dollar would have far less effect on U.S. prestige than continuation of the present failure to operate the U.S. economy at or near capacity.

May I say I thoroughly agree with that statement but I am not quite sure why you made it. Are we faced with such a choice? Do we have to go one way or the other or can't we preserve the reserve currency role of the dollar and at the same time take care of the failure to operate the U.S. economy at or near capacity? It seems to me you are saying that you only have a choice between two very bad extremes. Why can't we do both?

Mr. SALANT. What I had in mind in making that statement was some reduction, not surely an elimination, of the reserve currency role. The reserve currency role imposes burdens on the United States and if one of those burdens is to press us to pursue a policy which prevents expansion to a high level of employment, then we have taken that choice of alternatives upon ourselves.

Now, our view is that we should go ahead and expand anyway.

Senator MILLER. May I comment that we seem to be begging the question when you say "if it prevents." Suppose it doesn't prevent, and why must it prevent? Why can't we have the preservation of the reserve currency role of the dollar and at the same time meet our problems on the U.S. economy?

Mr. DESPRES. The point we had in mind on that was this. Many of the proposals for expanding international liquidity, for new international liquidity arrangements, would involve some curtailment of the reserve currency role of the dollar. We believe that the adoption of one or another of these arrangements would help our economic growth as well as the economic growth of the free world generally.

We also believe that the reluctance of some elements of the administration to entertain some of these suggestions is due to what we regard as an excessive concern with the preservation of the dollar's reserve currency role and therefore the unwillingness to admit any rival forms of reserve holding.

So it is in that sense that we see a conflict between these two things.

Senator MILLER. Well, I appreciate your clearing that up because that doesn't hit me quite as hard as the way you set it forth in the statement, but I would like to have a responsive answer to my question as to whether or not you think we can preserve the reserve currency role of the dollar and at the same time meet our requirements for operating the U.S. economy at or near capacity.

Mr. DESPRES. I think it is unlikely in the long run. I think that the kind of policies and the kind of measures we will be forced to go in for, if we try to keep the existing international monetary system operating unchanged—which is what the preservation of the reserve currency role of the dollar means—I think that that will interfer seriously with our economic growth and with our foreign aid and other international commitments.

So I think there is a real conflict.

Senator MILLER. It is unlikely but it is possible, you say.

Mr. DESPRES. I don't regard any of my looks into the future as certain, but I regard this one as having as high a degree of probability as any others that I can make.

Representative REUSS. Chairman Douglas?

Chairman DOUGLAS. I, too, wish to commend the panel on what I think is a very excellent report.

The first question I would like to ask is addressed to a statement on page 252 of the book. You state that the 25-percent gold reserve against Federal Reserve notes and deposit liabilities is irrational.

Now, I think I know what you mean and if you mean what I think you mean, I agree with you, but I wondered if you would be willing to state for the record why you regard it as irrational.

Mr. SALANT. It seems to me that we have a substantial gold reserve which is, let us say, on the floor of Fort Knox. We paint a red line on the floor around about three-quarters of it and we say: that part we can't use to finance imbalances in our international payments.

If anybody were to say, why can you not use it, about the only thing you could say would be, well, 50 years ago somebody painted a red line on the floor and said you can't step over the line.

It can't be used domestically. An American citizen can't go to the Treasury and say, here is a $20 or $100 bill, give me gold for it. What is it doing there? It is useless. If it were said that it is there because its amount is used to limit the expansion of the money supply of the United States, I think the answer is that we have people in the Federal Reserve System and the Treasury Department, who are not noted for their wild-eyed inflationism, who will take care that the money supply doesn't increase excessively anyway, and leaving this large fraction of our gold reserves in a position where we can't use it without saying there is an emergency, there is a crisis, simply immobilizes it, uselessly. Indeed, if you ever want to use it, you have to announce that there is a crisis when in fact there may be none.

It is more than irrational. It is antirational.

Chairman DOUGLAS. You speak of that as a statutory requirement and I suppose in one sense it is, but it is a statutory requirement which, as I understand it, can be waived by administrative decision of the Federal Reserve Board, isn't this true, for 30 days, and then the additional 30 days can be tacked on to that, isn't that true?

Mr. SALANT. I understand that is true, but when you have such an arrangement, you are in effect saying that it is an arrangement which is temporary because it should be used only in a crisis. You wouldn't have made it temporary if you didn't think that it should be used only to meet a crisis, and there is no reason why it should be temporary that I can see.

Chairman DOUGLAS. Now, may I ask a question about your recommendation for increased international liquidity. I assume that this is based on the assumption that the gold supply will not increase commensurately with the increase in the total volume of world trade and deficit and surpluses in world trade, and that some time the supply of dollars will diminish.

Doesn't this imply that an international monetary authority would create additional international monetary purchasing power and do it in the form of loans to countries which have deficits of international payments?

Mr. SALANT. I think it implies that there would be some sort of credit-creating mechanism or else some kind of mechanism that would reduce the need for reserves.

There are many ways in which additional reserves could be put into the system, not necessarily through countries in balance-of-pay-

ments deficits. The Stamp plan, for example, or some other way—I mean the plan of Maxwell Stamp.

Chairman DOUGLAS. The countries with payments deficits and which do not have gold credited to them will naturally try to get this international medium of exchange and the only way they can do it is by loans from the international authority, isn't that so?

Mr. SALANT. Or from another country which could get one.

Chairman DOUGLAS. This I think is the most serious question about international liquidity. Theoretically I think it is correct. Namely, does not this give to the international monetary authority the power to grant or to deny loans to countries—and I can picture people at the head of the international monetary authority who would be very reluctant to make loans to countries which were expanding employment, and whose price level might be rising slowly.

In other words, I would expect the most likely candidate for the head of this international authority to be Mr. William McChesney Martin, and under these conditions we might be successful in restraining production all over the world in addition to the United States, and that therefore turning this over to the international bankers will really release copious supplies of water upon any attempts to expand employment within the various countries.

So this might turn into a process of spreading ruin and scattering it throughout the rest of the world.

What do you say to that?

Mr. SALANT. One implication of our report is that we are in a good position to spread it all over the world right now without having an international institution. And my second thought is that, if that is the case, at least it wouldn't be the fault of the institution. I mean, the institutional arrangements would not be defective. It would be something else.

Chairman DOUGLAS. Have you thought about a governing board of this international monetary authority, how it would be selected? Would it be comparable to the International Monetary Fund or the World Bank?

Mr. SALANT. No. I have not given much thought to that. I think Mr. Krause and Mr. Despres both——

Mr. KRAUSE. There are two ways, at least, out of this particular problem. One approach would have an international monetary organization as the credit granting authority, but by stipulating the rules under which credit is granted, the directors would have very little discretionary authority in the restriction of grants.

A second approach would not have an international monetary authority as the center of the plan. A deficit country can always borrow on its own currency to finance a deficit as long as surplus countries agreed to take it. If you insure that all currencies are accepted for financing a deficit, then you wouldn't need an international authority. We were particularly vague and did not specify which type of organization we preferred because we think this question requires a great deal of study and would necessitate a second volume of at least this size.

Chairman DOUGLAS. Now, suppose the——

Mr. DESPRES. May I add——

Chairman DOUGLAS. Yes, indeed.

Mr. DESPRES. The main point I wanted to add to this is that we entirely agree that the purpose of an international liquidity arrangement is to relieve countries of undesirable constraints, and one of the requirements that we set forth in the report is that there should be a substantial amount available on an automatic basis.

To be sure, you can't make that unlimited, but the limits of automatically available credit should be fairly wide for the reasons that we have given, and our objections to the present rather piecemeal arrangements that are being developed with foreign central banks and governments is that they are very short term, very discretionary, very piecemeal, and ad hoc.

Now, the European Payments Union in the earlier postwar period had automatic credit lines up to a certain limit so that a country in deficit settled its deficit partly in gold and convertible currencies and partly in credit on the basis of agreed fractions.

We think that some such principle as that ought to be adopted in an international liquidity arrangement and it is only after the automatic quota has been exhausted that the matter gets into the discretionary hands of the financial people.

Chairman DOUGLAS. One final question if I may ask. Now, suppose that the European Economic Community refuses to come into this free world monetary authority, as you rather suspect it will refuse, for many years, at least. Then you have an English-speaking union with flexible exchange rates between it and the European Economic Community, but fixed rates within the English-speaking community.

Suppose Great Britain refuses to come in and we are left alone. Then what?

Mr. SALANT. I can't say that we thought of that possibility. I didn't, at least.

Mr. DESPRES. I think it is unlikely but that is not what you want.

Chairman DOUGLAS. You think it is unlikely that Great Britain will refuse to come in?

Mr. DESPRES. Yes. On the earlier part of the question, Senator Douglas, I don't think we are necessarily pessimistic about the Europeans. The thing I would say is this, that within other governments there is a divergence of views about this problem just as there is within this Government, and if you deal with the matter by negotiations among the central bankers, for example, they will be the last in any of these countries, in almost any of them, to recognize the existence of a problem requiring new institutional arrangements.

Chairman DOUGLAS. Then you propose to turn over the authority to these very central bankers who have not taken any steps to deal with the problem and who refuse to do so.

Mr. DESPRES. No. I would propose that the negotiation on this shouldn't be left to the central bankers and I would also say that on this kind of a flexible rate system, if it came to that, I doubt very much that the continental European countries would want to see any substantial appreciation of their currencies in terms of the dollar and the pound or even in terms of the dollar alone, and I would think therefore that the threat of a flexible rate system might very well be sufficient to bring into being the kind of international liquidity arrangement that we want.

If the continental European countries want to avoid appreciation of their currencies, as I feel confident they do, the only option left to them

would be to accumulate claims on the country whose currencies would otherwise depreciate.

Representative REUSS. Senator Jordan?

Senator JORDAN. Mr. Chairman, I, too, appreciate the fine statement that has been presented by the panel this morning. I spend a good deal of my time shuttling back and forth between the Manpower Subcommittee hearings in the Labor Committee and other committee assignments, so for that reason you will see my concern with your first basic assumption.

You have assumed a recovery in the United States in the next 2 years sufficient to reduce unemployment to 4 percent.

Those of us who work daily with this problem over in that Manpower Subcommittee would be interested in learning upon what you base this optimistic projection.

Mr. SALANT. This is not a forecast, Senator Jordan. This is an assumption—the consequences of which for the balance of payments we were asked to work out.

Senator JORDAN. I see. It is not your own assumption. It was given to you as one of the tangible bases from which you were to make your projection.

Mr. SALANT. We were in effect asked to estimate as best we could the implications of certain assumptions. And that is the task that we sought to perform in the analytical parts of this report.

There is no implication that we would bet that this assumption would be realized or that it will not be realized.

Senator JORDAN. Are these implications set forth in your report?

Mr. SALANT. The body of the report, central portion of the report, is a working out of the implications of these assumptions for the balance of payments. I think the answer is "Yes," if I understand the question.

Senator JORDAN. Thank you. I would be interested to know what the panel thinks about the administration's interest equalization type of proposal.

Mr. SALANT. I suggest that Mr. Krause, who did the work on the private investment chapter, may want to answer that.

Mr. KRAUSE. Senator, I think basically we are of the belief that no further policy measures were needed at this time. We do not view the situation at present as critical. Indeed, we make the statement that you can always expect to get fluctuations in a quarter or a half a year that indicate the situation is getting worse even though the long-run situation is in fact getting better. Indeed, two of the major customers of the United States, Japan and Canada, set their balance of payments aright last year and one would expect that the major immediate impact would be on the United States.

Therefore, it is not unusual to find that the U.S. balance of payments deteriorated in the last quarter of 1962 and the first half of this year.

However, if it is believed that new policy measures are needed, then the equalization tax is probably as good a one as could be proposed.

However, you must always distinguish between improving the balance of payments and stopping a capital flow. These are not identical. You may deter some capital flow and pay for it in lower exports or some other feedback in the balance of payments.

Senator JORDAN. Then you regard the situation as not being enough of an emergency to warrant the action that was taken in this respect.

Mr. KRAUSE. In general that is right, sir.

Senator JORDAN. Thank you. Thank you, Mr. Chairman. I yield.

Representative REUSS. Mrs. Griffiths?

Representative GRIFFITHS. Thank you, Mr. Chairman.

I would like to ask you, when you point out that if we corrected our balance-of-payments problem and it would result in other nations then running deficits which they would attempt to correct, are you really saying that as long as everyone makes a balance of payments their main work they court additional problems within their domestic economy?

Mr. SALANT. Yes. I would say that is a very good summary.

Representative GRIFFITHS. Would it be correct to say that they actually court domestic disaster? Singly?

Mr. SALANT. I don't know how strong a word one should use but something unpleasant and unnecessary and something that sacrifices a higher priority objective to one that ought not to have such high priority.

Representative GRIFFITHS. Why do you feel that the United States should not take some of the actions which you suggest that other economies would take to correct their balance-of-payments deficit?

Mr. SALANT. Well, the same reason we would suggest the others ought not, if the liquidity mechanism were adequate to make it unnecessary for them to take constraining measures. The reason we think the United States should not take restrictive measures is that we think the present level of output in the United States is far below what it can be and should be, and that measures should not be taken to lose this potential output merely to meet this problem.

I don't know if that point is responsive.

Representative GRIFFITHS. In place of serving, the world is really controlling the actions to a too great degree.

Mr. SALANT. Well, it is exercising an undesirable restraint on it and will do so increasingly in the future.

Representative GRIFFITHS. What in your opinion would be the effect of permitting aid items to be purchased in Canada or Japan?

I notice that you specifically mentioned that they should be permitted in those two countries.

Mr. SALANT. We think that a large portion of any foreign exchange receipts earned by Japan and Canada come back to the United States directly and indirectly and that the net adverse effects on the U.S. balance of payments of having recipient countries spend the proceeds of aid in Japan and Canada as contrasted with their spending them in the United States are relatively small.

Representative GRIFFITHS. Thank you.

Now, would you explain to me how your alternative system would work?

In more detail, would you explain it, the alternative monetary system?

Mr. SALANT. We think that there would be fixed rates which would be rather easy to maintain within the blocs and that the fluctuations in rates between the blocs would be rather small because we don't think that either bloc would like to see its rate appreciate much in relation to

the other bloc, and would rather tend to purchase the currencies of the other bloc to prevent an appreciation of its own rate. We think that such flexibility of rates as there would be under those circumstances would contribute to adjustment of payments imbalances because the rate changes themselves would tend to increase the exports and reduce the imports of the bloc whose rate was declining. This would take off some of the burden that would exist under a system of fixed exchange rates—reduce internal pressures to deflate in the bloc with the adverse balance.

I don't know if this is the degree of detail that you had in mind. It is the general idea of the proposal which, as we have said, is in our view distinctly second best.

Mr. Despres would like to add something.

Mr. DESPRES. On the actual mechanics, what we envisage here is an agreement between the British and the U.S. Governments under which each would buy such amount of the other's currency as was necessary to maintain a fixed rate here of $2.80 to a pound. The U.S. Government would cease to stand ready to buy or sell gold at a fixed price.

We consider it likely that the countries whose ties, economic and financial, are largely with Britain or with the United States—and this includes the bulk of the free world other than continental Western Europe—that they would peg their currencies to the dollar or the pound as in fact they do now. So that there would be, as it were, a single currency area consisting of most of the free world other than continental Western Europe and the gold that we have would continue to be used for exchange rate stabilization purposes, subject to the understanding that this would be handled flexibly, that when the balance of payments was running, let us say, in favor of continental Europe against the pound-dollar bloc, that the continental European currencies would be allowed to appreciate somewhat and, to some extent, we would use gold to settle the balance.

When the current was the other way, the movement or exchange rate would be the other way.

But, you see, you would have a large area of exchange stability within each bloc and a limited amount of flexibility between the two blocs.

Representative GRIFFITHS. You would assume that the European Economic Community would be one bloc and that England and the other areas of Europe——

Mr. DESPRES. England and the sterling area, so-called.

Representatives GRIFFITHS. United States and Japan, and so forth.

Mr. DESPRES. And Latin America.

Representative GRIFFITHS. Latin America would be another?

Mr. DESPRES. Yes.

Representative GRIFFITHS. I see.

Now, may I ask one more question. What in your judgment would be the effect upon the people of the United States and upon the financial community of the world if we announced that we were no longer going to have statutory requirements of a gold reserve against Federal Reserve notes? Upon the people of the United States, upon the financial communities of the world? What would be the effect in your judgment?

Mr. SALANT. Well, observing that division of the population that you have drawn, I would say the people outside the financial community wouldn't know what happened except as they read it in the papers, and what they would think of it would probably depend upon what the papers said about it.

They can't get the gold now. They are not, so far as I know, oppressed by the rapidity of the expansion of the money supply, and they might be surprised to learn that the requirement whose abolition was announced had ever existed.

Representative GRIFFITHS. A whole generation has been born and has grown to adulthood that has never even seen a gold coin. They don't even know it is in use. They don't even know that there is such a thing, I agree with you perfectly. And it would not have any effect on the people of the United States unless it was blown up into some tremendous thing.

But what about the financial communities of the world?

Mr. SALANT. So far as the financial community is concerned, my guess would be that they ought to think, and they would think, that the reserves which the United States has to defend—to use the common word, the value of the dollar on foreign exchange markets—were greatly strengthened.

I have seen, more or less by accident, in the Journal of Security Analysts, some months ago—which was called to my attention because of an article about the balance of payments—a report elsewhere in the magazine of a conference of security analysts. They were asked their views about a number of policy questions. The one about which they were most nearly in unanimous agreement was that this requirement was useless.

I was tremendously surprised to learn that this element of the financial community agrees with us so heartily about this point.

Representative GRIFFITHS. Thank you.

Representative REUSS. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Professor Salant, you stated that your group received certain basic assumptions from the Council of Economic Advisers as a basis for your study, that is, a 4-percent unemployment rate, and a 1½-percent annual rate for inflation. Would you furnish us with a complete list of all of the assumptions you were given?

Mr. SALANT. They are in the full report, Mr. Congressman. I could append them to the statement but I think they are in the volume you have.

Representative WIDNALL. I haven't found it yet and I didn't notice any reference in the foreword of the book to the fact that the report was based on assumptions given to you by the Council of Economic Advisers.

Mr. SALANT. Well, on page 39 of the study you will see a section with the heading "Basic Assumptions and Methods Used in Projecting Real Income and Price Changes," and throughout the chapters on special areas of the balance of payments you will find further assumptions stated, but I think the major assumptions are given beginning on page 39. Then may I mention again that we then made another set of assumptions and worked it out a second time on an alternative set

of assumptions which is on page 60. The alternative assumptions are stated on the bottom of the page there.

Mrs. RIVLIN. There is also a good summary in the last chapter beginning on page 213. The assumptions, the initial assumptions, are briefly summarized on pages 213 and 214 and the alternatives are given a little later in the chapter.

Representative WIDNALL. Thank you. That will do it.

Professor Salant, the Brookings study in effect advocates the policy of sitting tight while awaiting favorable economic developments which are assumed will occur to improve the situation with a minimum of pain or effort on our part. A deterioration of the Western European situation and a sharp improvement in our own, will, in short, correct our deficit even while the level of our aid expenditures overseas is assumed to increase substantially. Is that a true characterization of your report?

Mr. SALANT. Yes; I think it is.

Representative WIDNALL. Now the study's generally hopeful point of view is in sharp contrast to a position taken by Secretary Dillon before the Joint Economic Committee on July 8. Secretary Dillon said there was not much more time to waste in solving the deficit problem, and that unless very substantial progress is to be made in the next year or two, the United States would face a very uncomfortable situation.

Now how do you reconcile your report with what Secretary Dillon said?

Mr. SALANT. Well, I can only say we are not as alarmed as he is about it. I think ours is the only study that has attempted to look as far ahead as 1968, and because of that longer look, we go into things which are less transitory in the internal economies of Western Europe and the United States which we think are bound to assert themselves after a few years.

If you were making a short-term projection or forecast, you would not be concerned perhaps with things which are fairly clear, like changes in the rate of growth of labor supply in Western Europe relative to the United States.

These things become important and are fundamental in a longer look.

One of the things, in other words, that is unique about this study is that it has looked over a longer span of time and I think has, therefore, considered more fundamental determinants of the balance of payments than any other study that I know about.

Representative WIDNALL. One more question, Professor Salant. In arriving at this conclusion, what was the greatest factor which led to that determination? There are many things that enter into it, I know, but what would you say was the outstanding point of this segment of your study that led you to feel as hopeful as you do about it?

Mr. SALANT. I think if I were to select one thing, it would be the effects on the competitive position of the pressure on costs in Western Europe, owing to the labor supply situation, but there are also the implications of recovery in the United States for the rates of return on capital here and the fairly clearly foreseeable effects on U.S. receipts of investment income. But the biggest thing is the change in the competitive position.

Representative WIDNALL. And you don't feel that we are going to again have that tremendous impact of labor demands and labor pres-

sures which have contributed to increased cost factors in our own production?

Mr. SALANT. The question is the relationship of these pressures to those in Western Europe, and we don't have fears on that score.

Representative WIDNALL. That is all. Thank you very much.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. There are many helpful and constructive aspects of this report. I think this has been a wonderful lesson for those of us who at best are part-time congressional economists. I have learned a lot this morning.

I particularly like the emphasis on the necessity for improvement in international liquidity and the reasons for it, and especially the fact which you point out that an adverse balance of payments on our part is a favorable balance of payments on the part of our European allies and friends whose economic success we want to promote. Increased liquidity, I take it, is important so we can have more leeway, so we can have periods, as I understand it, of adverse experience over a number of years for all of the countries of the free world while they can work to develop their economies.

We have to expect that we are going to have periods of several years duration that are adverse in the future as we have had in the past.

However, I am very concerned, as some of our Republican colleagues have been, about the assumption and the implications behind these assumptions for a different reason.

In the first place, accepting the assumption that we can achieve by 1968, or during this period leading up to 1968, a rate of 4 percent unemployment—what does that mean? That means to me that we are going to have to have a substantial increase in our money supply every year. Also, we will probably have a continuation of our fairly loose fiscal policy.

You say in the latter part of your report that if we are going to maintain interest rates at this level, we have to have fiscal policies which offset them.

I would go much further than that. If we are going to have 4 percent unemployment, any realistic appraisal of our economic situation would suggest that we will need an expansionary monetary policy to complement, not contradict, our fiscal policies.

Now I ask you these questions. First, to what extent, if any, would your conclusions and recommendations be changed if your assumptions turn out not to be the case?

In other words, would you vary your recommendations if we find that our GNP will not grow at this rate, if we find we do not attain our goal of 4 percent unemployment, if we continue to have, say, 6 percent unemployment, maybe more?

Second, take your foreign aid assumption, which obviously was not gotten from Mr. Passman or Wayne Morse, but was gotten from the AID people themselves, if this turns out to be rosy, what would be the consequences?

And, third—and this is most important of all—suppose your assumptions on the so-called failure to restrain costs in Europe turn out not to be the case.

My feeling is on the basis of the Canadian and Japanese experience to which you referred. These countries are willing to practice austerity, and can without upsetting the whole world situation, and if

they do, and if in the aggregate your assumptions turn out to be wrong, then what policy should we follow?

Mr. SALANT. Well, we have two sets as we have noted. As to the first, if unemployment continues, then the recommendations that we would make, I would think, would not be mainly balance-of-payments recommendations. I am not sure what you have in mind in asking that question, whether our recommendations with regard to liquidity mechanism would change?

Senator PROXMIRE. What I had in mind was this, that you base your recommendations on the assumption, or the conclusion, that given these assumptions, we will have a favorable balance of payments by 1968, or, if not favorable, almost favorable balance of payments.

Will this condition still be true if the unemployment, the economic growth in the United States, is not as you estimate it but if it continues on the present rate as it has continued for the past 6 or 8 years?

Mr. SALANT. Our major recommendations would apply whether we have the deficit or whether the deficit is eliminated. That is, our recommendations regarding the monetary mechanism. If aid were lower, we would expect that a substantial part of the difference between what we have assumed and what it actually was would be offset by a lower level of exports, though not all would be offset, and we would expect that the deficit would be somewhat lower but not nearly so much as the difference in aid would suggest.

In fact, the effect on the deficit would be, we think, a good deal less than half the difference in aid, more like perhaps 30 percent.

Now, if Western Europe, which is the third question, if Western Europe exercises greater restraints of its price level than we have assumed in the first assumption, I refer you to the second assumption which does assume a much smaller rise in prices.

Senator PROXMIRE. Much what?

Mr. SALANT. Much smaller rise in prices in Western Europe than we have assumed in the first assumption. If it were still less than that, then I think our payments position would be worse than we have projected even in the second assumption.

Senator PROXMIRE. Would it not be possible if these assumptions—particularly the assumption with regard to lower growth rate in the United States and less inflation in Europe—if those things were the fact, would that not tend to persuade you that perhaps—and I am delivering this at Mr. Krause—that perhaps the proposal made by the Secretary of the Treasury or by the administration, at least, for an interest equalization tax, would that not seem to be more acceptable or more necessary?

Mr. KRAUSE. I think that is right, Senator, but of the assumptions that you are changing the one most crucial is with respect to European prices and costs.

Senator PROXMIRE. Let me interrupt to say what gives me a lot of pause on this is the fact that we have a substantial favorable balance of trade and that means that other countries have a substantial unfavorable balance of trade, and you are relying on an even more substantial favorable balance of trade.

You are assuming that these other elements, foreign aid, our investment abroad, and so forth, are likely in the aggregate at least to be about the same as they are now or maybe even more adverse in terms of our balance of payments.

Would you say our balance of trade is going to get that much better between now and 1968? I am wondering how realistic that is in view of so many factors in the success of European marketing all over the world.

Mr. KRAUSE. One of the solutions for relieving pressures in an economy with labor shortage is to seek real goods outside the country because they are unable to produce them at home.

I think there is nothing that on the face of it suggests that the United States cannot achieve a larger surplus in our balance of trade. I was about to say that, of the assumptions which you have changed, the one that I would think least likely is that the Europeans will be able to restrain their price pressures more than we have assumed.

As a matter of fact, I think we are rather conservative in estimating how much European prices are going to go up. We are projecting a rate that is less than what has actually happened in the last few years.

Senator PROXMIRE. I agree with you 100 percent if you assume the governments are not going to exercise the kind of restraints that they can exercise if they have price controls and wage controls. But it would seem that on the basis of European history and their experience, and so on, they would be much more likely to impose those kinds of restraints than we would be in this country. If you just have pure economic factors, that is, the fact that they have limited unemployment and a great need and want and relatively big opportunity to expand their consumer credit system, and so forth, then I would agree, but it seems that in France, in England, and in Italy, if not in Germany, they would be likely to use wage control limitations and price restraints. Isn't that possibly true on the basis of their record?

Mr. KRAUSE. I think they might try to resort to this kind of measure, but if there is not a national crisis such as a war, these controls can be rather ineffective in keeping down the actual costs of labor. In Germany we know that a lot of the wage increases that have been granted have not been achieved through contract changes, which are the kinds of things that a government could control, but through upgrading of classifications. This could go on all the time if there was a real labor shortage. The economics of the labor market would yield higher returns to workers.

Mr. SALANT. May I add a word on that point?

Senator PROXMIRE. Yes.

Mr. SALANT. In the situation that we envisage, the level, the pressure to raise wage rates would come from both sides of the wage bargaining table so long as there wasn't rather extreme repression of aggregate demands.

What is called incomes policy—that is efforts to restrict the increase of wages—are readily circumvented. We think the market pressures, the market forces pushing wages up would be extremely strong not only on the side of labor but also on the side of employers.

I would like to also call to your attention something I left out of the statement as I read it but which is in the written statement, that we have projected the rise in Western Europe's prices simply on the basis of the degree of cost push and a judgment as to how far the upward costs would be reflected in price rises. We have taken no account of any additional pressures that would come from the demand side.

We did attempt to see whether excess demand would exist in order to see whether prices would rise even as much as the cost push suggested. We found that excess demand probably would exist and so we assumed that prices would rise by as much as the cost push, but we did not add anything to the price rise that we derived in that way for the additional effects of the pull of excess demand.

Therefore, we think that the estimates of cost and price rises in Western Europe, certainly under the second set of assumptions, are quite probably conservative.

Senator PROXMIRE. My time is up. I would just like to say that I think if we are going to follow vigorous and aggressive monetary expansion policies and continue with the fiscal policy, which I don't necessarily agree with, continue with it, it would seem to me the President's proposal for interest equalization tax makes sense.

My time is up.

Representative REUSS. Senator Javits?

Senator JAVITS. Mr. Chairman, I was late for reasons of the test ban treaty. I would like to yield to the Senator.

Senator MILLER. I have already asked.

Senator JAVITS. Thank you.

I just have a few questions. Gentlemen and lady, I am greatly interested in your feeling that by 1968 there will be a substantial improvement in our basic balance, almost if we do nothing further about it, and I would like you to take note of the testimony of Secretary of the Treasury Dillon on July 9 before this committee in which he said that he did not believe that we could stand the present rate of imbalance in our international payments for more than a year or two without getting into serious trouble.

Now, could you reconcile those two points of view?

Mr. SALANT. Well, that question was raised before you came in, Senator. Our view is that the situation is not as critical as the Secretary apparently thinks. How serious the trouble is depends in part on how serious you think it is.

We think that the United States has ample reserves to finance deficits over the period that he had in mind and that the arrangements the Treasury has made with other countries are very helpful as temporary measures to strengthen those defenses. But we think if you take a look ahead for more than a few years, as we have tried to do, the outlook is for an improvement, and with that outlook in prospect we don't fear that there is an imminent crisis.

Senator JAVITS. So you would disagree with the Secretary on his conclusion?

Mr. SALANT. Yes, I would say so.

Senator JAVITS. Now, I noted with the greatest interest that you would recommend the creation of an adequate international liquidity mechanism. I would like to call your attention to a resolution, introduced by me, together with Senator Miller, who is here today, and introduced in the House by Representative Thomas B. Curtis, which seeks to get our country to move in that direction.

Have you by any chance examined our resolution? It is Senate Concurrent Resolution 53. I gather you have not.

Mr. SALANT. Senator, I have to confess that I haven't.

Senator JAVITS. That is all right.

Mr. SALANT. I am aware of the general idea of it but I haven't read the resolution itself.

Senator JAVITS. Now, I would like to ask you this question. I beg your pardon.

Mr. SALANT. I was simply going to say, as you put it just now, I think we are in favor of getting going on this right away; we agree that you should get going.

Whether it requires a conference or not, that is a question of procedure about which we haven't formed an opinion. Perhaps we are not in a position to form an opinion.

A conference, of course, always takes a good deal of preparation. The first thing is the preparation and the study of what would be a desirable plan.

Senator JAVITS. In any case, you are agreed that we should go forward and try to establish such a mechanism and that the present arrangements for currency swaps, for loans, denominated in the currency of the creditor country, for $6 billion of supplementary resources which the IMF has been supplied through the special borrowing arrangement agreed to by 10 leading industrialized countries, are not adequate and are not to stand in the place of our effort to create some new international system which will provide more liquidity; is that correct?

Mr. SALANT. That is correct. We agree with you on that.

Senator JAVITS. Now, I have come across a very interesting juxtaposition of your ideas and the ideas of other distinguished people, and I have reference to the well-known recent report on our situation by the Bank for International Settlement. They come up to the same conclusions on the facts and come to totally different conclusions on the remedy, and I don't know whether you are aware of that or not. I came across their discussion of the existing international monetary system between pages 30 and 33 of their report, and it impressed me greatly.

The following is stated on page 32:

> Some proposals for new forms of international liquidity have been aimed at relieving the pressure on the U.S. gold stock. It is inevitable that the continued rise in official reserves of dollars should make the holder sensitive to the possibility of exchange risk and lead to gold exports. While this is a real problem, it is one that has arisen not from shortage of liquidity but from the huge volume of liquidity which the U.S. external deficit created almost automatically owing to the simple fact that the dollar was accepted as reserve by foreign monetary authorities.

So far they say almost exactly what you do. They go on, however, and they say on the same page:

> The basic problem in the international payments has not been liquidity, therefore, but balance-of-payments disequilibrium—persistent in the case of the dollar even with substantial underutilization of domestic resources, and periodic in the case of sterling when expansion is allowed to gather some momentum.

To shorten my question, they go on to recommend the classic remedy, that is, that we make our prices more competitive with those of other countries by increasing our productivity faster than wage rates; that our Government expenditures abroad either be reduced or financed to

the extent necessary by longer-term borrowing abroad; and that, unless we pursue a tighter monetary policy, we have "little alternative other than direct controls of some sort." They also state:

The fact that a substantial part of the U.S. gold stock is legally designated as cover against the internal money supply, where it serves no function, naturally increases the doubts about the adequacy of the gold stock to fulfill its essential function in setting international balances.

Do you care to comment upon that juxtaposition of ideas?

Mr. SALANT. There is a sentence in there which I have seen which in structure is identical with ours and in content exactly the opposite, almost as though they had seen our sentence and decided to reverse it, where they say the problem is not a liquidity problem, but it is a balance-of-payments problem.

All I can say about that is that we disagree with them. If they put in the same class, as a means of tidying up the U.S. balance of payments, a reduction in military expenditures and a reduction in foreign aid, we think it is not difficult to show that their analysis is defective.

The effects on the net balance of a dollar of military expenditures, which are made primarily in Western Europe and have very little feedback on U.S. receipts, and of a dollar of foreign aid, which was made outside Western Europe and has a very large feedback on U.S. receipts, the difference between those two is very great, and putting them in the same class seems to me to be very deficient, a very deficient analysis.

Senator JAVITS. Now is it not a fact that we have extremely large long-term investments overseas upon which we are getting a mighty good return right now, and that our problem with respect to our balance of payments is taking our balance sheet in toto—that we are deficient in liquidity although we are very rich in assets in terms of our international financial position?

Mr. SALANT. It shows we are very rich in overall assets. So far as whether it shows we are very deficient in liquidity is concerned, the country as a whole has a better international liquid position than the present method of showing the deficit suggests, because changes in private short-term assets abroad are not included as part of changes in our liquid position, as measured by the deficit. Changes in liabilities are. Liquid liabilities are included to the full. Liquid assets are included only to the extent that they are held by the monetary authorities, that is to say, the Treasury and the Federal Reserve.

Senator JAVITS. How much of a difference would that make?

Mr. SALANT. Do you have those offhand? Private short-term?

Mr. DESPRES. The total of our private short-term? No, I don't have them.

Mr. SALANT. I am afraid I don't have them here and I don't trust my memory as to what the approximate figure is. They are in the Federal Reserve Bulletin and we can supply those for the record, if you wish.

Senator JAVITS. Even if they would be in the hands of the Government, long-term investment would give us a very strong position, would it not?

Mr. SALANT. Yes.

Senator JAVITS. So that the difference between the United States and other countries is very largely attributable to the amount of state

ownership of the means of production and state trading in productive enterprise, isn't that correct?

Mr. SALANT. I am not sure I follow you there.

Senator JAVITS. Well, in other words, the difference between the United States and other countries is that in this country, state ownership of the means of production, to wit, long-term assets wherever they may be located, and the state trading, to wit, the control of short-term assets wherever they may be located, is much less than it is with most other countries.

Mr. SALANT. Well, if the state control of assets in other countries extended to foreign assets, there would be a considerable difference, but I am not aware that it does.

Senator JAVITS. So that our problem is to convert these resources, both the governmental long-term resources and private long- and short-term resources, into meaningful terms as far as our international imbalance in payments is concerned.

Would you say that is correct?

Mr. SALANT. Yes.

Senator JAVITS. And you feel that a new international monetary mechanism is necessary for that purpose, is that the conclusion of this study?

Mr. SALANT. To provide adequate liquidity.

Senator JAVITS. Do you look with favor upon the Federal Reserve technique as suggested by some of the great experts who have thought about this?

That is where additional productive enterprise will create additional credit in the international sphere as it does with the Federal Reserve at home.

Mr. SALANT. I am not quite sure what you are referring——

Mr. DESPRES. International central bank.

Senator JAVITS. Yes. In other words, the general direction of your thinking with regard to the modification of the present international liquidity mechanism is in the direction of an international central bank technique.

Mr. DESPRES. Or a number of variants thereof.

Senator JAVITS. The fundamental idea being that credit shall no longer be dependent strictly upon exchanges of gold but shall also be dependent upon the value which is inherent in productive enterprise and what is produced, and that it should grow to the size of that enterprise as it moves in international trade; am I correct?

Mr. SALANT. Grow in international transaction.

Senator JAVITS. And the gold base is too narrow for the purpose.

Mr. SALANT. That is right, and its prospective growth makes it likely to become still more inadequate, increasingly inadequate.

Senator JAVITS. My time is up but I would like to say that I agree with you thoroughly. I think that is the path that we have to take. I like the idea of an international monetary conference because it is analogous to the great success, to wit, of the Bretton Woods Conference of 1944. It would be a way of dramatizing for the world what this is all about, dramatizing especially for the people of our own country to whom the whole balance-of-payments problem sounds as if it is from Mars, because, if we take the orthodox prescription for dealing with

balance of payments, it is probably going to be less, not more, employment and less, not more, production expansion.

The President will have been right in stating that the bookkeepers will have defeated us if we follow the orthodox financial route, and I say we don't want to do that.

Thank you.

Representative REUSS. Representative Hanna?

Representative HANNA. I am not a member of this committee and I really don't know what I can contribute, but as a philosopher rather than an economist, I am very interested in one aspect of these exchanges.

One thing it brings to my mind is that the quality of the question is not really appreciated until you know the reason for which it is asked. It has been an interesting thing for me to try to read behind the questions, the reasons for which they are asked, and then to compare the reasons for the answer. The framework of reference in both the reason for the question and the reason for the answer appears to me to be somewhat different in many of the exchanges, and yet as Mr. Javits commented, it seemed to me that the frame of reference was coming closer together, which brings me to another philosophical observation.

I think when you are attacking an establishment, and I think we are, in this approach, by and large attacking an establishment, you have to remember the statement of Jeremy Bentham that when you are doing this, you must recall that truth is elusive and dogma is deadly. It seems to me that this shows up another aspect of the question and that is that we tend to think that the whole is the substance of its parts, made up of its parts, and it is not at all.

It is made up of the substance of its parts and interrelationships, and too many of the questions and answers we get on exchange are down to the question: Is foreign aid part of our balance-of-payments problem? Yes, it is. Does foreign aid cause a flow of dollars out of the United States? Yes, it does. If we stop the flow of dollars, will this improve our balance-of-payments position? Yes, it will. But it doesn't answer a question that has remained unasked which is: Is there any relationship between the flow of foreign aid dollars with the other components of this aid? I think what you have been trying to tell us is that it does have a very definite relationship, for instance, to an export-import situation. I gathered from all this that the most important part of this problem is the interactions and interrelationships of the components of the problems, and that one of the things we haven't had and you are now developing and greatly need is a better understanding of the interactions and interrelationships within these components. Finally I take it that your ultimate analysis leads you to the position that with expanding trade and limited gold in dollars, increased liquidity is the only answer ultimately, so that for the long-term answer, you have, as Mr. Javits has pointed out, believed that this is the direction in which we should be traveling.

Is this in any way cogent to what we have been discussing?

Mr. SALANT. That is correct and I am glad that you mentioned this question of interrelationships. We have a section early in our report beginning on page 15 headed "Interrelations Between Components of the Balance of Payments," and we try to make it very

clear there that the U.S. balance of payments is replete with interrelationships between the different components and that it is a serious mistake to assume that because a certain payment amounts to x billion dollars, it contributes x billion dollars to the deficit.

It may contribute something close to x billion dollars to the deficit. It may contribute something close to zero to the deficit.

Representative HANNA. I think, Mr. Chairman, that this is a fairly important point because my reaction to the presentation even of the President's program is that it is based on too much of a simple approach such as, well, in the old German song that we all sang in schooldays, you asked the question, "Ist das nicht der schnitzelbaum?" and there comes a resounding and assuring answer, "Ja, das ist der schnitzelbaum."

But it doesn't tell you anything about what is "schnitzelbaum."

It doesn't tell you anything about what is schnitzelbaum or about the desirability of schnitzelbaum as taken with German pancakes as against boiled cabbage and dark beer or light beer, and as a connoisseur of schnitzelbaum, maybe this is important.

So I want to say that this, to me, is the nature of the problem that we are getting at.

Mr. SALANT. May I add one thing to what I said, and Mr. Despres would like to add something, also.

In this statement that I prepared, we have shown the changes, projected changes, between 1961 and 1968 in the balance of payments in two ways (p. 238). The upper half of that table, or rather the upper fraction of it, shows the major categories of the balance of payments after the changes in them as they would appear in the balance-of-payments statistics. In the lower part of the table we have divided the total change in the basic balance in a different way in an effort to bring out these interrelationships.

You will see, for example, that we have a change in payments and then the change in receipts that we projected as being associated with that change in payments, and the difference between them is then shown as the net effect on the basic balance.

I think Mr. Despres would like to add something to this.

Mr. DESPRES. As an illustration of that general principle, the working out of the implications of the new tax proposal applied to the American purchase of foreign securities is a good example. The first question is "Will this tend to reduce American purchases of foreign securities?" and the answer is "Yes." Then the next question is "Will this help our balance of payments?" and the answer to that is, I think, so far as it reduces our purchases of European securities it will help our balance of payments. If it is applied to Canadian and Japanese securities, it probably won't help our balance of payments, and indeed it may have the opposite effect because Japan and Canada are countries that have operated on rather modest reserves, relying upon the United States, being financially dependent upon us in a sense to tide them over balance-of-payments difficulties.

To the extent that it causes them to feel that this is no longer available to them as readily, it may cause them to adopt economic policies which will result in the holding of larger reserves, probably at the expense of the U.S. reserves. In other words, the adaptations which these countries will make to less ready access to our capital markets

are likely not merely to compensate but to overcompensate, and therefore the balance-of-payments advantage when we try to apply it to countries like Canada and Japan is likely to be nil or negative.

That is one rather striking illustration of this interrelationship mechanism.

Representative REUSS. On that same subject, however, I gather from what you say, Mr. Despres, that you favor rather than reject some sort of a capital issues tax as applied to European borrowings in this country, or at least borrowings by European countries which are in the balance-of-payments surplus.

Mr. DESPRES. No. I agree with Mr. Krause. I would rather do nothing. I would rather see a greater willingness on the part of the United States to use its reserves. In the phrase used by a friend of mine who has often appeared before this committee, Charles Kindleberger, the correct rule is: "Don't just do something, stand there." And this would be my view.

However, if the dominant mood is that we have to do something, I think that this tax, provided Canada and Japan are exempted, is less harmful than most other things I could think of that might be done, and it is in this rather negative sense that I would be in favor of it. If we must act, this is a less bad action than most others.

I would say it is less bad than some of the measures we have already taken with respect to tying aid, for example, and some of the measures that are taken to substitute high cost domestic procurement for foreign procurements in our military expenditures abroad.

It isn't a good measure but it is not a very bad one.

Representative REUSS. Now, let me turn to the effect of Common Market tariff discrimination against the United States and the rest of the non-Common Market world as it bears upon our balance of payments, and I would like to have you turn with me to the two remarkable charts on pages 102 and 103 of your book. This may be within the area of Mr. Krause, incidentally.

To me these two tables, table 4–3 and table 4–4, tell an almost shocking story. Table 4–3 indicates that even after the so-called Dillon round of tariff negotiations, the number of tariffs on major items which would be increased over the tariff formerly imposed by the dominant supplier would be some 46, and the number of tariffs which declined over that previously in force on the part of the dominant supplier would be something like 10.

This conclusion, it seems to me, and I would like you to check me on this, comes down to this, that the United States has, despite all puffs and claims to the contrary, taken quite a severe shellacking as a result of the Common Market, and that our reciprocal trade position is not as good as it was before the institution of the Common Market external tariff. True or false?

Mr. KRAUSE. All external countries take a shellacking in that sense when a Common Market is formed because discrimination is being introduced that wasn't there before. Because the United States was the largest single trading nation before the Common Market, the impact on the United States is probably greater than on other countries.

Representative REUSS. You know, our State Department issued glowing press releases at the conclusion of the Dillon round attempting to point out that we were actually advantaged by the Common

Market's external tariff as finally agreed upon in their round. I felt that those press releases were unjustified.

What do you think about them?

Mr. KRAUSE. Sir, all I remember of these press releases was a reference to the Dillon round itself which suggested that the United States may have come off a little bit better in what we got as compared to what we gave.

I don't recall an overall view of the Common Market external tariff at that time.

Representative REUSS. But the requirements of GATT and particularly article 24 of GATT stipulates, do they not, that a customs union like the Common Market is permissible only where, when you get all through with its transition to its external tariff, its incidence on imports is no greater on the average than it was prior to the imposition of the external tariff. Isn't that what GATT requires?

Mr. KRAUSE. That is correct.

Representative REUSS. And isn't the thrust of your table on page 102 that quite markedly that GATT requirement was not met and that we are worse off than we were before?

Mr. KRAUSE. In my view, this is true.

Representative REUSS. Now, let's turn to table IV–4 on page 103 of your study in which you set forth the amount of reduction that would be required in the Common Market's external tariff in order to bring this country back to where it was before the Common Market's external tariff with respect to the individual national tariff of the dominant supplier country member of the Common Market. That is what table IV–4 is all about, is it not?

Mr. KRAUSE. Yes.

Representative REUSS. And as I read that table, taking up some 20 or more leading industrial groups of commodities, in a great many of those cases a reduction of more than 50 percent would be needed just to bring us back to where we were before without any reference to improving; isn't that so?

Mr. KRAUSE. Yes. One note of caution, however, ought to be sounded. This table overlooks any overall improvements of competitive position that may come about through changes in cost. This table just examines the tariff. In other words, the fact that we are projecting an improvement in the competitive position of the United States means that we do not need as much tariff reduction to return the United States to its previous competitive position.

Representative REUSS. Of course, this is always true in any tariff discussion. If one party suddenly becomes more competitive and productive than the other, then this mitigates the effect of the tariff on trade.

Mr. KRAUSE. That is right.

Representative REUSS. But talking of tariffs, the next point of your table here is that we are going to have to reduce Common Market tariffs in many cases by much more than 50 percent in order to bring ourselves out tariffwise where we were before the external tariff was set up.

Mr. KRAUSE. On those items this could be true.

Representative REUSS. It is then a cause for tears that our Trade Expansion Act fails to include the provision urged by Senator Doug-

las and myself, among others, which would have permitted us to bargain tariffs down in selected categories by more than 50 percent, which power we now lack under the act as adopted, except for one or two categories like aircraft and margarine.

Mr. KRAUSE. I don't feel qualified to comment on the way in which the authority should be granted, but I agree that I would like to see larger tariff cuts permitted than those confined to 50 percent.

Representative REUSS. Now, a question about where we come out in 1968. It has been said that on the alternative assumption, that is, the assumption that the drafters of the Brookings report regard as more realistic, we come out in 1968 about even. I notice in the table, appendix table 10 on page 289 of your report, that is the last page, we would end up in 1968 with a basic deficit of about $600 million a year. Is that right?

Mr. SALANT. That is correct.

Representative REUSS. And to that must be added the so-called nonbasic deficit, that is, short-term capital outflows, errors and omissions, and whatever, is that not so?

Mr. SALANT. Well, that could have either sign.

Representative REUSS. It could have either sign but that is not now included in the $600 million projected deficit, is it?

Mr. SALANT. Beg pardon?

Representative REUSS. It could have either a plus or minus sign, I grant you, but that is not included in the $600 million projected deficit for 1968.

Mr. SALANT. That is correct. It is not included.

Representative REUSS. Well, now, if it had the same kind of a sign that it has been having recently, that is, a negative one, and if it is in the same approximate volume as we have been experiencing recently, and I don't understand that your report comes to grips with ways of changing that because you deal only with the basic deficit, we could end up in 1968 on your assumption with another deficit of a couple of billion dollars, could we not?

Mr. SALANT. We could. I would like to call your attention, though, to a table on page 6 of our report which shows in a single figure the difference between the basic balance and the total balance. In other words, which includes the errors and omissions, the prepayments and the short-term movements of U.S. short-term capital.

Those were heavily negative in only 2 years, 1960 and 1961, when they were $2 billion and $1.5 billion, respectively. They were positive for about 10 years before that, for all but 2 of about 10 years before that—not very large, it is true, though there was an inflow of a billion dollars in 1957. So it could—I would stick to the proposition that it could have either sign, and under circumstances in which the basic deficit had diminished, and also in which—I would hope—it was known that measures were being taken to improve the monetary mechanism, it could well be positive.

Representative REUSS. Would you think that the following is a fair summary of the position of the Brookings Institution report and a summary of the administration position? Secretary Dillon and the administration generally feel that the balance-of-payments problem is very serious indeed, but that no fundamental measures need to be taken with respect to our monetary mechanism in order to render ourselves less vulnerable to it.

You all believe that the balance-of-payments deficit is much less serious but you believe that substantial and fundamental therapy in our international monetary mechanism is necessary.

Is that too ironic a statement of the differences?

Mr. SALANT. I would say that with regard to our position, it is completely correct, and with regard to the Secretary's statement, I think it is correct in saying that he regards the present situation as critical.

The second half of the view you attributed to him was that nothing needs to be done about the monetary mechanism. On that I think the Treasury view has changed considerably since September. At that time you may recall the Treasury made it, I think, fairly clear that it didn't think anything was necessary of a long-term character, although it did think that action was necessary, and Under Secretary Roosa made it clear that he was taking—the Treasury was taking steps such as swap arrangements and the other ad hoc things which were referred to once earlier this morning.

The present view of the Treasury, as I read it from the Secretary's testimony before this committee on July 8, is that something is likely to be necessary; it isn't possible or necessary now, but we are studying it and we welcome all proposals.

This is a very different tune, as I hear it, from what was being sung in September. So that I don't think there is quite as much divergence—and I think it is the Treasury that has moved.

Representative REUSS. Well, I hope you are right. On the other hand, as I read the Treasury statements and the President's July 18 balance-of-payments message, what they are saying—this is an important point and I would like your view on it—what they are saying is that in the sweet by-and-by, when we get over our balance-of-payments deficit, then the accretions to world monetary reserves will slough off markedly because there won't be dollar reserves and deficits moving around any more.

Therefore, says the Treasury, at that time we will have to do something about seeing that the free world generally has an adequate total of reserves.

Now, I guess everybody agrees with that. I would have thought that the real question was in the interim, and at a time like the present when there are large amounts of dollar deficits floating around the free world being used as reserves, doesn't there need to be a system of offsetting the deficits of one country so that it can, as I thought your report had pointed out, take the 4 or 5 or 6 years that may be needed for it to adjust its productivity, its price structure, its technology, its ways of doing business, so that it can get over the crisis? And I don't find anything in what the Treasury or the administration has said that indicates that it recognizes the need for this.

In other words, I am rather sharply distinguishing between the question of adequate total free reserves and the intermediate term question of seeing that what reserves there are now in existence are adequately marshaled to the service of the free world, in such a way that temporary imbalances don't cause crises.

Mr. SALANT. Well, the adequacy of reserves has to be considered in the context of credit facilities that are available, too, which serve as a substitute for reserves.

I would say that in the last—how many weeks is it—3 weeks, 2 or 3 weeks, there has been a change in the U.S. position. The drawing on the Monetary Fund is a new action. It shows movement on the part of the Treasury and the U.S. Government.

Representative REUSS. Still, however, it doesn't suggest that anybody is in favor of a change in the international monetary mechanism so that large automatic offsets can be provided for unbalancing movements in the next few years pending the time when you will need a larger total.

If you find that in anything that has been said, I wish you would point it out so that I can give credit where credit is due.

Mr. SALANT. Well, I take a slightly more optimistic view of the Treasury position, or let me say the movement in the Treasury position. It is not where I would like to see it now, but it seems to me it is getting there, or at least it is moving in the direction that we would like to see.

When the Secretary said "it isn't possible or necessary now," I don't know what he meant by "it isn't possible." He may have meant it isn't tactically possible now. In that case he may have meant no more than the point that we make, that other countries may be unwilling to do anything while we are in a deficit position. But he may have meant, as you apparently think, that he isn't interested now. The statements that this is a matter to be studied are so different, however, from the statements made last September, which were that this is a matter not to be talked about, that I don't feel on the whole as pessimistic as you do about it.

I don't know whether my colleagues feel the same way about this or not.

Representative REUSS. Well, I think that we have kept you gentlemen for a long time.

Mr. Hanna, do you have anything else?

Mr. HANNA. No, sir.

Representative REUSS. I want to thank you all and the Brookings Institution very much, not only for your remarkable and constructive report but for your willingness to sit here for 3 hours this morning and go into the details as you have. The Joint Economic Committee will now stand adjourned until 10 o'clock tomorrow morning, at which time we will convene in room 1202, New Senate Office Building, to hear a panel discussion on the Brookings Institution report which we have just heard explained today.

We now stand adjourned until that time.

(Whereupon, at 1:15 p.m., the hearing was recessed, to reconvene at 10 a.m., Tuesday, July 30, 1963.)

THE UNITED STATES BALANCE OF PAYMENTS

TUESDAY, JULY 30, 1963

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

The joint committee met, pursuant to notice, at 10:05 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss presiding.

Present: Representative Reuss (presiding); Senators Douglas, Pell, Proxmire, Javits, and Miller.

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

Representative REUSS. Good morning. The Joint Economic Committe will be in order for a continuation of its hearings on the balance of payments.

We welcome this morning Mr. G. A. Costanzo, vice president of the First National City Bank of New York; Mr. Walther Lederer, Chief of the Balance-of-Payments Division of the Department of Commerce; Prof. Gardner Patterson, director of the Woodrow Wilson School of Public and International Affairs at Princeton; and there will shortly be joining us Mr. Hal Lary of the National Bureau of Economic Research.

Each of you gentlemen has a prepared paper. In accordance with the rule, without objection, the papers will be received into the record.

We would now like to ask each one of you to proceed in your own way, either by reading the paper, summarizing, going beyond it, or proceeding in any way you like.

Mr. Costanzo, would you start off, sir?

STATEMENT OF G. A. COSTANZO, VICE PRESIDENT, FIRST NATIONAL CITY BANK OF NEW YORK

Mr. COSTANZO. Thank you, Mr. Chairman.

I appreciate this opportunity to appear as a witness before this committee on a subject which I consider of vital importance to the economic future not only of this country, but of the whole free world, in the next 10 or 20 years.

Though I find myself in deep disagreement with the conclusions and recommendations——

Representative REUSS. Excuse me, Mr. Costanzo. Would you move your microphone a little closer to you? This is such a cavernous room, I am afraid some of those in the back will not be able to hear you.

Mr. COSTANZO. Although I find myself in deep disagreement with the conclusions and recommendations of the study before us, I con-

gratulate the authors on the excellence of the physical work and analysis of the intricate interrelationships between the various components of our balance of payments.

I hope that the study will serve to provoke public discussion and help clarify the choices and risks before us.

At the same time, I would be less than frank if I did not add that the study unfortunately will help to convince the dollar skeptics more than ever that we are headed for exchange controls and/or devaluation, and thereby contribute to a further erosion of confidence in the dollar.

I have little quarrel with the projections themselves. In the time available, the authors have done an excellent job of applying available statistical knowledge to the problem.

My main criticism of the projections relates to the assumptions that the political pressures and strong commitments to full employment policies will prevent Western European governments from pursuing vigorous anti-inflationary policies. This runs counter to all evidence.

Western Europe, especially the continental countries, have had great experience in the postwar period with domestic inflation and balance-of-payments disequilibrium. The debate on the proper role of monetary and fiscal policies, which we are currently going through in this country, was resolved in most of the European countries 10 years ago. Flexible monetary policies won the day in Europe, and experience has taught them that there is no simple and direct relationship between either "easy" or "tight" money and economic growth.

As we all know, the French earlier this year responded quickly to emerging pressures on prices with ceilings on commercial bank credit. Until a different breed of men emerges in positions of leadership in the finance ministries and central banks of Western Europe, a policy based on European inflation to bail us out would be a serious miscalculation.

The report concluded that our balance-of-payments problem is structural in nature, and its solution requires structural adjustments which require time.

I do not know of a country with a balance-of-payments deficit where the same arguments have not been advanced. But sooner or later corrective monetary and fiscal measures have had to be taken, and the result has been a sudden disappearance of that deficit.

Recent monetary experience is full of such examples—Greece, Japan, France, Spain, Argentina, et cetera.

The report complains that preoccupation with the balance of payments is increasingly threatening priority national objectives. This is an amazing statement and implies that in some way we can isolate this problem from the rest of the economy. There is no question but that sustained economic growth and full employment is the ultimate goal of national economic policy. But this is no mean objective and requires all the skill and wisdom we can muster in day-to-day management to achieve the right combination of monetary, credit, budgetary, debt management, price, wage, and, yes, even balance-of-payments policies. And in the kind of world we live in, we will be in continuous pursuit of our ultimate objective, never quite reaching it.

Of course, our balance-of-payments problem is bothersome, and so are all the other economic problems we must face. But the health and vigor of our economy will depend on our ability to face and solve these problems and not in finding rationalizations for running away from them.

Consider for a moment what would happen if the American public as well as foreigners lost confidence in our will and ability to balance our external accounts. While foreigners hold liquid dollar assets of some $22 billion, we should not overlook the fact that Americans hold liquid assets of almost $500 billion. How would these people behave if they were ever convinced of the inevitability of exchange controls or devaluation? They would seek refuge in some other currency. A shift abroad of 3 percent of this mass of liquid dollar assets would completely exhaust our gold stock. We are now in the sixth year of serious balance-of-payments disequilibrium. How many more years can this situation continue before confidence in the dollar gives way?

We are here dealing with complex business psychology and no one can predict if or when the erosion of confidence will provoke a capital flight. This is the calculated risk in postponing decisive action to correct our balance-of-payments problem. And the costs of miscalculation are high. A flight of capital from the United States would mean a breakdown of our existing international monetary system and force inflationary policies on us with serious repercussions on the level of economic activity and employment throughout the free world. Where would we then be with respect to our priority national objectives?

In conclusion, I would like to sum up what I would consider the constructive approach to our balance-of-payments problem.

1. Our broad political, economic, and national security objectives require that we give a top priority to the correction of our balance-of-payments deficit.

2. In doing so, we can be confident that the solution is within our control. As Triffin points out in his "Gold and Dollar Crisis," a balance-of-payments gap—

> can arise only if it's financed, and its financing for a country as a whole can come from two sources: net foreign disinvestments by the nonbank sectors of the economy, or net borrowings from the domestic banking system.

Since the overall volume of credit which the banking system can create is in the hands of the Federal Reserve System, our balance-of-payments deficit can be eliminated at any time by simply refraining from financing them. It is within our power to reduce or eliminate our balance-of-payments deficit by not fully offsetting gold losses.

3. However, in view of the lack of agreement in this country on the effects of such a monetary policy on the domestic economy and since we still have time for an orderly solution, the problem should be approached on a coordinated basis on three fronts:

(*a*) A flexible monetary policy permitting our monetary authorities on a practical day-to-day basis to weigh the needs of our domestic economy against the need for domestic price stability and continuous progress toward balance-of-payments equilibrium;

(*b*) Fiscal policies to stimulate the growth of our economy accompanied by efforts to reduce dollar military expenditures abroad or a more equitable sharing of this burden by our allies; and

(*c*) Wage-price restraints to maintain and improve our competitive position in world markets.

4. Provided we can show actual progress and convince the world that we have a firm policy and program for restoring balance-of-payments equilibrium, I would favor IMF drawings to curb gold

losses in the interim pending full balance. However, I believe it would be a mistake to tamper with the gold reserve requirement, at least until the U.S. dollar is again beyond suspicion.

5. There is no evidence of a shortage of international liquidity today. In fact, except for the dollar, the world currencies are in remarkably good balance. In contrast with the post-World War I experience, great strides have been made since the end of World War II in establishing an efficient international financial system. The results have been more than doubling in the value of world trade compared with a 50-percent decline in the interwar period of 1920–38. We have today a network of convertible and realistically valued currencies unknown for more than 50 years. It would be a serious mistake to drastically redo the International Monetary Fund, which has proven its effectiveness, by these results. It is no mean accomplishment that the Fund today enjoys the confidence of the free world's business and financial community. A different institution with people of a different philosophy might or might not enjoy this confidence. The Fund has ample resources today to deal with any foreseeable problem threatening the international monetary system. Moreover, the Fund's charter has proven itself a flexible instrument, and problems of international liquidity can be dealt with within the existing framework of the Fund, when and if such problems should arise. We have far too many problems requiring solution now to warrant dissipating our efforts on problems which may or may not be with us at some future date.

(The complete statement of Mr. Costanzo follows:)

STATEMENT BY G. A. COSTANZO, VICE PRESIDENT, FIRST NATIONAL CITY BANK

The future of the U.S. economy in the next 10 or 20 years as well as that of the free world depends to a large extent on whether we find the economic and political wisdom to solve our balance-of-payments problem. While balance-of-payments disequilibrium is a familiar phenomenon in the rest of the world, it is something new for us. It was not too long ago that economists wrote about the chronic dollar shortage and the need for structural changes in the U.S. economy. Although we have been running balance-of-payments deficits since 1949, it is only recently that the problem has come to public attention. Economists have done surprisingly little work in this field. For this reason, I welcome the Brookings study even though I find myself in deep disagreement with its conclusions and recommendations. I hope that the study will serve to provoke public discussion and help clarify the choices and risks before us.

The labeling of our balance-of-payments problem as structural and recommendation of a "do-nothing" policy except to beg for foreign credits is surprisingly similar to the reaction of many of the underdeveloped countries in seeking a solution to their economic problems by exporting them abroad. There is no doubt in my mind that the report will result in a further erosion of confidence in the dollar. It will convince the dollar skeptics more than ever that we are headed for exchange controls and/or devaluation. In saying this, however, I do not mean to deprecate the excellent statistical work and analysis contained in the first seven chapters of the book. These chapters make a real contribution in pointing out the intricate interrelationships and the fruitful areas for corrective action.

I have little quarrel with the projections themselves. In the time available, the authors have done an excellent job of applying the available statistical knowledge to the problem. But I repeat that the previous work in this area has been very scanty and a great deal of research is needed on the basic relationships, especially the interrelationships between domestic monetary liquidity and external balance. Moreover, as the authors themselves warn us, on page 31, "projections of net balance in international payments * * * are highly speculative, even more so than economic forecasts in general * * * relatively small

errors in the projections of gross receipts and payments would make for large errors in the projection of the net balance." And, in fact, a reduction in the assumed rate of inflation in Western Europe in the 7-year period from 20 to 11 percent with respect to the GNP deflator and 11 to 7 percent with respect to export prices, was largely responsible for the $2.5 billion difference in the projected 1968 U.S. basic balance under the two sets of assumptions.

My main criticism of the projections relates to the assumption with respect to the willingness and ability of Western Europe to cope with inflationary pressures. This is the assumption with the greatest weight in the final results of the projections. This factor alone contributes in the projections to an improvement in our balance of payments of $4.4 billion under the "initial" assumptions and $1.3 billion under the "alternative" assumptions. While there is no doubt that the trend in money wages has been in our favor since the end of 1959, it would be imprudent on our part to assume that this trend will continue and even accelerate. The gains in productivity in continental Europe since 1958 have been impressive, and there is no evidence of any substantial change in this trend as yet. In 1962, output per man-hour in the United States increased by 3.7 percent. The comparable percentages for France, Germany, Italy, and the Netherlands were 4.4, 7.2, 11.9, and 4.5, respectively. Continental Europe, therefore, has a greater margin for money wage increases.

The assumption that political pressures and strong commitments to full employment policies will prevent Western European governments from pursuing vigorous anti-inflationary policies runs counter to all evidence. Western Europe, especially the continental countries, have had great experience in the postwar period with domestic inflation and balance-of-payments disequilibrium. The debate on the proper role of monetary and fiscal policies, which we are currently going through in this country, was resolved in most of the European countries 10 years ago. Flexible monetary policies won the day in Europe, and experience has taught them that there is no simple and direct relationship between either "easy" or "tight" money and economic growth. In spite of balance-of-payments surpluses, in the 5-year period from the end of 1957 to the end of 1963 the Bank of France and the Bank of Italy actually reduced their outstanding credit and the German Bundesbank expanded its credit by 24 percent. We in the United States, on the other hand, in spite of a cumulative deficit in the period of almost $16 billion, permitted an increase in Federal Reserve credit of over $9 billion, an increase of 32 percent. As we all know, the French earlier this year responded quickly to emerging pressures on prices with ceilings on commercial bank credit. Until a different breed of men emerge in positions of leadership in the finance ministries and central banks of Western Europe, a policy based on European inflation to bail us out would be a serious miscalculation.

The report concluded that our balance-of-payments problem is structural in nature, and its solution requires structural adjustments which require time. This is reminiscent of the chronic dollar shortage days and the need for structural adjustments in the U.S. economy. In the 1950's many economists argued that the Japanese and Greek economies were structurally out of balance and would require massive investments over many years to end inflation and restore balance-of-payments equilibrium. But in both countries these seemingly intractable problems responded quickly to correct monetary and fiscal policy. The same was true in France as late as 1958 and in Spain in 1959. Similarly, we find the results of financial mismanagement in underdeveloped countries explained away as structural problems. I find it difficult, therefore, to accept the structural changes thesis.

The report complains that preoccupation with the balance of payments is increasingly threatening priority national objectives—full employment, military strength, development of underdeveloped areas, and freedom of "economically productive international transactions." This is an amazing statement and implies that in some way we can isolate this problem from the rest of the economy. There is no question but that sustained economic growth and full employment is the ultimate goal of national economic policy. But this is no mean objective and requires all the skill and wisdom we can muster in day-to-day management to achieve the right combination of monetary, credit, budgetary, debt management, price, wage and, yes, even balance-of-payments policies. And in the kind of world we live in we will be in continuous pursuit of our ultimate objective, never quite reaching it. Of course, our balance-of-payments problem is bothersome, and so are all the other economic problems we must face. But the health and vigor of our economy will depend on our ability to face and solve these problems and not in finding rationalizations for running away from them.

Consider for a moment what would happen if the American public as well as foreigners lost confidence in our will and ability to balance our external accounts. While foreigners hold liquid dollar assets of some $22 billion, we should not overlook the fact that Americans hold liquid assets of almost $500 billion. How would these people behave if they were ever convinced of the inevitability of exchange controls or devaluation? They would seek refuge in some other currency. A shift abroad of 3 percent of this mass of liquid dollar assets would completely exhaust our gold stock. We are now in the sixth year of serious balance-of-payments disequilibrium. How many more years can this situation continue before confidence in the dollar gives way? We are here dealing with complex business psychology and no one can predict if or when the erosion of confidence will provoke a capital flight. This is the calculated risk in postponing decisive action to correct our balance-of-payments problem. And the costs of miscalculation are high. A flight of capital from the United States would mean a breakdown of our existing international monetary system and force deflationary policies on us with serious repercussions on the level of economic activity and employment throughout the free world. Where would we then be with respect to our priority national objectives?

The authors warn us that "to allow balance-of-payments considerations to prevent the fuller utilization of its productive capacity that would accompany a fall in unemployment from 6 to 4 percent of the force would be to forego output estimated at about $30 to $40 billion per year." But to ignore the balance of payments runs the serious risk of a world depression with a loss of output in the United States and the rest of the world many times the potential gain of $30 to $40 billion. Can we afford to gamble the fate of the American people and the whole free world with a policy of "going for broke"?

In conclusion, I would like to summarize what I would consider a constructive approach to our balance-of-payments problem:

1. Our broad political, economic, and national security objectives require that we give a top priority to the correction of our balance-of-payments deficit.

2. In doing so, we can be confident that the solution is within our control. As Triffin points out in his "Gold and Dollar Crisis," a balance-of-payments gap "can arise only if it's financed, and its financing for a country as a whole can come from two sources—net foreign disinvestments by the nonbank sectors of the economy, or net borrowings from the domestic banking system." Since the overall volume of credit which the banking system can create is in the hands of the Federal Reserve System, our balance-of-payments deficit can be eliminated at any time by simply refraining from financing them. It is within our power to reduce or eliminate our balance-of-payments deficit by not fully offsetting gold losses.

3. However, in view of the lack of agreement in this country on the effects of such a monetary policy on the domestic economy and since we still have time for an orderly solution, the problem should be approached on a coordinated basis on three fronts:

(*a*) A flexible monetary policy permitting our monetary authorities on a practical day-to-day basis to weigh the needs of our domestic economy against the need for domestic price stability and continuous progress toward balance-of-payments equilibrium;

(*b*) Fiscal policies to stimulate the growth of our economy accompanied by efforts to reduce dollar military expenditures abroad or a more equitable sharing of this burden by our allies; and

(*c*) Wage-price restraints to maintain and improve our competitive position in world markets.

4. Provided we can show actual progress and convince the world that we have a firm policy and program for restoring balance-of-payments equilibrium, I would favor IMF drawings to curb gold losses in the interim pending full balance. However, I believe it would be a mistake to tamper with the gold reserve requirement at least until the U.S. dollar is again beyond suspicion.

5. There is no evidence of a shortage of international liquidity today. In fact, except for the dollar, the world currencies are in remarkably good balance. In contrast with the post-World War I experience, great strides have been made since the end of World War II in establishing an efficient international financial system. The results have been a more than doubling in the value of world trade compared with a 50-percent decline in the interwar period of 1920–38. We have today a network of convertible and realistically valued currencies unknown for more than 50 years. It would be a serious mistake to drastically redo the International Monetary Fund which has proven its effectiveness by these results.

It is no mean accomplishment that the Fund today enjoys the confidence of the free world's business and financial community. A different institution with people of a different philosophy might or might not enjoy this confidence. The Fund has ample resources today to deal with any foreseeable problem threatening the international monetary system. Moreover, the Fund's charter has proven itself a flexible instrument, and problems of international liquidity can be dealt with within the existing framework of the Fund, when and if such problems should arise. We have far too many problems requiring solution now to warrant dissipating our efforts on problems which may or may not be with us at some future date.

Mr. COSTANZO. Mr. Chairman, one final footnote. I learned my brand of economics at the Brookings Institution before the war. I spent 15 months there as a fellow and member of the staff. Something has changed in the interim—either I have changed or the institution. I am not sure which.

Representative REUSS. I should point out, with reference to what you have just said, Mr. Costanzo, that the authors of the Brookings Institution study who were with us yesterday pointed out that they, and they alone, were responsible for the study, and it was the feeling of the committee generally that Brookings Institution in commissioning and supporting the thoughtful study, no matter what opinion one may have about its conclusions, had rendered a public service, which indeed you, from your preliminary remarks, seem to agree with, too.

We now have with us Mr. Hal Lary, Associate Director of Research of the National Bureau of Economic Research.

You are very welcome here, as always, Mr. Lary.

If you would like an opportunity to catch your breath, I will call on your associates first and then come back to you.

Mr. LARY. That might be better. I am sorry; there was a little confusion in my directions about where to go this morning.

Representative REUSS. All right.

Let's ask Mr. Lederer of the Department of Commerce to proceed, then.

STATEMENT OF WALTHER LEDERER, CHIEF, BALANCE-OF-PAYMENTS DIVISION, U.S. DEPARTMENT OF COMMERCE

Mr. LEDERER. I would like to read the statement here, but I will be glad to answer questions afterward.

Before going into the substance of this discussion, I would like to emphasize that this study has not been the subject of a thorough examination in our Department, and the Department has not taken a position concerning the findings and recommendations in this book. Consequently, I am speaking here entirely for myself. Whatever I can say at this time will be limited to somewhat superficial impressions, since I had only a short time to go through the book, and no occasion to check various questions with the authors themselves. I am going to limit my comments to the balance-of-payments estimates for 1968.

What we find in this book is a projection, not a forecast. A projection is based on an extrapolation of certain trends and relationships observed in the past and the assumption of certain developments to which these relationships are applied. The result of the exercise depends, therefore, to a large extent on the assumptions. If these

assumptions themselves are reliable forecasts of what is likely to happen, then the projections also become a forecast, but usually—and that applies also to this study—the assumptions are given. This can be a useful exercise because it may show the effects of variations in these assumptions, while the major relationships are assumed to continue unchanged.

It can be a somewhat dangerous exercise, however, if the projections are mistaken to be actual forecasts. I am afraid a tendency in that direction may even be found in the conclusions in this book and that tendency may also have influenced the policy recommendations in the final chapter. There is also a danger that readers may take the conclusions as an unconditional forecast rather than an estimate of what may happen if certain decisive conditions conform to given assumptions.

Since there is that danger, it is necessary first to look at these assumptions, to examine whether they can be relied upon to become realities, and how consistent they are. Then I shall review—somewhat superficially only—some of the relationships which have been used to make the estimates, then the measures used in evaluating the balance-of-payments problem, and finally the conclusions which have been drawn.

The assumptions concerning the U.S. economy given to the Brookings Institution included a growth rate of real GNP for the years 1961–68 nearly twice as high as during the years 1953–60, with unemployment going down to 4 percent, and prices of manufactured products at least remaining stable. This is a very favorable assumption. To increase the rate of growth requires first that the factors affecting economic expansion are identified and second, that effective measures are taken to change them appropriately. To achieve the stipulated rate of growth and, at the same time, maintain a reasonable stability in the overall price level, complicates the choice of stimulating measures and presumably also requires that they are combined with, or include, greater efforts to keep prices stable than were necessary in recent years when the growth rate in demand and output was less, and excess supplies of manpower and plant capacities limited the development of supply stringencies.

In Europe, real GNP is assumed to grow at about the same rate as during the years 1955–60 while GNP prices would rise at an average annual rate of 2.75 percent. The projected distribution of GNP by major types of expenditures shows that the total of all domestic demands would rise more relative to 1960–61 than the total output, thus providing greater impediments to exports in 1968 than was the case in the more recent years. While this assumption is possible, it also seems to be relatively favorable to the United States. In fact, the improvement in the U.S. balance of payments on trade and services accounts is more or less the implicit result of these assumptions.

With private and public consumption demand in Europe rising considerably faster than output and therefore also incomes, savings must be assumed to be declining considerably. Since the demand for investments is also assumed to rise somewhat faster than output, it would follow that strong upward pressures on interest rates would develop. In the introduction to the chapter on "Private Foreign Investments," page 119, the assumption is made, however, that the

general level of interest rates in the United States and Western Europe would not differ greatly from the present structure, but that the current spread may narrow somewhat as rates in Europe can be expected to decline.

These assumptions are contradictory unless the further assumption is made, that the money supply in Europe is sufficiently expanded to compensate for the initial shortfall of savings relative to investments. This rise in money supply would also facilitate the rise in prices.

The faster rise in the money supply and demand relative to the productive capacity in Europe would, of course, be the result of Europe's accumulation of international reserves, and constitute the principal part of the mechanism from which the ultimate readjustment of the international balance of payments could be expected. The operation of that mechanism requires, however, that governments support its operation. The assumption is made in the book, in the projections as well as in the recommendations, that European governments will continue to accept its implications, even if they are inflationary for their own economies, as long as the disequilibrium in international payments continues, and that they will not attempt to neutralize the inflow of funds from abroad.

Again, while this assumption is not entirely outside the range of the possible, it is quite favorable for us.

Another assumption which simplifies the estimating procedure, but is perhaps a little more favorable to us than can be expected realistically, is the tendency of less developed countries to spend their foreign exchange earnings as soon as they are obtained. In general that situation applies today. There are some countries in that group, however, whose incomes are rising sufficiently to permit them to increase their international monetary reserves. In a period of rather high business activity both in the United States and in Europe as is assumed for 1968, the earnings of the less-developed countries will be relatively high, delivery periods for many commodities purchased by them will be relatively long, so that some rise in their reserves should also be anticipated.

That increase would affect the balances of payments of the European countries as well as that of the United States. How much the United States would be affected will depend in part on whether the less developed countries whose reserves are rising are closer trading partners of us or of the European countries, and in part on our general competitive position in world markets.

The next problem I would like to take up is concerned with the relationships which are used to convert these assumptions into balance-of-payments figures.

In estimating U.S. exports a formula is used in the study which includes as variables changes in foreign income as well as changes in the competitive position of the United States relative to other industrialized countries.

The estimate of U.S. exports to Western Europe for 1968 under favorable assumptions comes to $12.7 billion, compared with $7 billion in 1961, table III–10, page 90. Of the total increase of $5.7 billion, about $2.2 billion is attributed to the rise in real incomes in Europe and to a small increase in U.S. export prices while $3.5 billion is attributed to the improvement in the competitive position of the United States, resulting from the faster rise in prices in Europe than in the United States.

Because by far the larger part of the improvement in our exports and all of the improvement in our trade balance depends on the assumption concerning the changes in our competitive position, we attempted to examine the formula which is the basis of the export estimate.

From the published formula we find that for the years 1952–61 about 88 percent of the changes in exports to Europe could be explained by the growth in real incomes in Europe and by the change in our competitive positions as measured by relative price movements. Through a separate calculation we tried to find out how much of the changes in exports could be explained only by the changes in real incomes and found that the latter variable explained about 69 percent. That leaves only 19 percent of the overall explanation which could be attributed to the relative price changes including the changes in currency relationships. Furthermore, most of the explanatory value of the price relationships seems to apply only to few of the years covered here, most of which are in the early 1950's. The effects of relative price movements on our exports to Europe during the more recent years would be difficult to prove on the basis of the variables used in the report. Yet, as mentioned earlier, the assumptions about relative price movements are the main factor upon which the projected improvement in the exports hinges.

This should not imply that a relative rise in foreign prices would not help our exports, but that we hardly have a reliable basis for making quantitative estimates of the effects of given price changes.

I have a few charts back there which might illustrate the point. If you want me to, I can demonstrate with them later.

The projected decline of capital outflows and rise in investment incomes also contribute considerably to the prospective improvement of the balance of payments. To make reasonable estimates in that area over so long a time is particularly difficult. While the arguments presented in the study appear to be quite plausible, they are, of course, closely tied to the underlying assumption. Actually, capital outflows are also affected by many factors which have not been taken into consideration.

The outflow of funds through direct investments may decline in the longer run as a result of the growth of funds available from depreciation reserves and undistributed earnings of the affiliated foreign enterprises, as the study states. This tendency is often offset, however, by investments made abroad in new enterprises or by purchases of equity interests from foreign owners.

The decline in capital outflows for direct investments anticipated in the study has not materialized so far. In fact, it is likely to be larger in 1963 than in any other recent year. The assumption that it will shrink to about half the current rate by 1968 may be realized, but it seems to be weighted on the favorable side.

Other factors possibly influencing the outflow of capital are the liquidity of domestic financial institutions and business corporations, and the development of domestic lending opportunities and practices.

With somewhat different assumptions and different evaluations of the various factors contributing to international capital movements, one may have come to rather different estimates.

Another consideration in evaluating the Brookings study is that the projections are made for a measure entitled the "basic balance."

That balance excludes special Government transactions, such as receipts from advance debt repayments by foreign countries, advances on military orders, and medium term borrowing. These transactions are properly omitted, since they can only provide temporary relief to the balance of payments. However, the measure of the "basic balance" also leaves our private capital flows classified as being short term and so-called errors and omissions which include all the transactions for which data cannot be collected, or for which data are not collected properly or which are subject to statistical errors. Both items can be affected by temporary and erratic capital flows, but apparently they contain to a large extent transactions which are affected by the same basic economic forces which also affect the other segments of our balance of payments.

During the last 3 years, the total of these transactions moved from net debits of about $2.1 billion in 1960 to $2.4 billion in 1961 and down again to $1.6 billion in 1962. As far as we can judge now, we have again rather substantial net debits on these items in the first half of 1963.

It is possible that the experience during the last 3½ years may have changed by 1968 and the balance on these items would be zero, but this would appear to be another favorable assumption.

To sum it up, it appears that the doubts which one may have concerning assumptions and methods of estimates are resolved in the study overwhelmingly on the side which would favor the U.S. balance of payments.

The authors of the study also had some hesitations in that respect and consequently prepared estimates under somewhat less favorable assumptions. Although these assumptions were not applied to capital flows and investment incomes, the estimates resulted in a balance which is improved over the one achieved in 1961 by less than one-fourth billion dollars.

The conclusions which I would draw from the study would be, therefore, that under very favorable conditions the current balance-of-payments deficit may perhaps create the conditions abroad which will help to achieve balance in international payments. We cannot say, however, that the favorable change in our balance of payments has already set in, nor do we know with reasonable certainty when the turning point will come, or whether these forces alone will be sufficient to achieve a new equilibrium. It would not be advisable to rely primarily on developments which would tend to affect adversely the competitive capabilities of other industrialized countries. That we can wait for such developments would be a rather risky assumption, even over the longer run.

It will be safer to assume, therefore, that the improvement in our balance of payments will depend first of all on our own actions to strengthen the competitive capability and performance of our own economy in world markets and to make it more attractive for domestic and foreign capital investments.

Representative REUSS. Thank you.

Mr. Lederer, you spoke of having two charts which illustrate some of the points you have made.

Mr. LEDERER. Yes, sir.

Representative REUSS. Do you have those with you?

Mr. LEDERER. Yes.

Representative REUSS. Without objection, they will be received and made part of the record, and if you care to add any explanation of those charts, that will be quite all right.

Mr. LEDERER. The charts refer to the estimates of U.S. reports to Western Europe.

The first chart shows the actual exports from 1952 through the first half of 1963 and the values which can be obtained from the formula employed in the Brookings study for the past period as well as for 1968. For the latter year the estimate of $12.7 billion under the favorable assumption is shown as well as the estimate of $10.4 billion arrived at under the less favorable assumption.

The important point illustrated by this chart is that already in 1961, and much more so in 1962 and the first half of this year, the actual exports fell short of what they should have been according to the formula employed in the study. In 1962 the shortfall was about $900 million, and it increased further in the first half of this year.

The second chart shows the same actual exports but in comparison with a line calculated on the basis of a formula measuring the relationship during the period 1952–61 between U.S. exports (adjusted for price changes) and the real GNP of the principal Western European countries. This formula differs from that employed in the Brookings study by leaving out the relationship of U.S. exports to movements of prices in Europe relative to prices of goods exported by the United States.

The changes in relative price movements are shown in the lower line. A rise in that line indicates an increase in foreign prices relative to our export prices, or—in terms of the Brookings study—an improvement in our competitive position. A rise in that line should, theoretically, result in export values to rise (or decline less) in comparison to the amounts that could be expected on the basis of foreign GNP.

The chart shows that between 1953 and 1956 when our competitive position improved somewhat (as shown on the lower line), exports rose, indeed, more than the line calculated on the basis of the average relationship between exports and European production. During the following years, however, the changes in exports relative to the calculated amount can hardly be explained by the movement in relative prices. In particular, in the more recent period, the relative price movements which were very favorable for us appeared to have had very little effect on exports. Actual exports in 1962 and the first half of 1963 did not rise relative to the values which might have been expected on the basis of the past relationships to real GNP in Europe. The large improvement in exports which in the Brookings study is expected to result from the changes in price relationships, therefore, cannot yet be observed on the basis of the data and relationships used in the report.

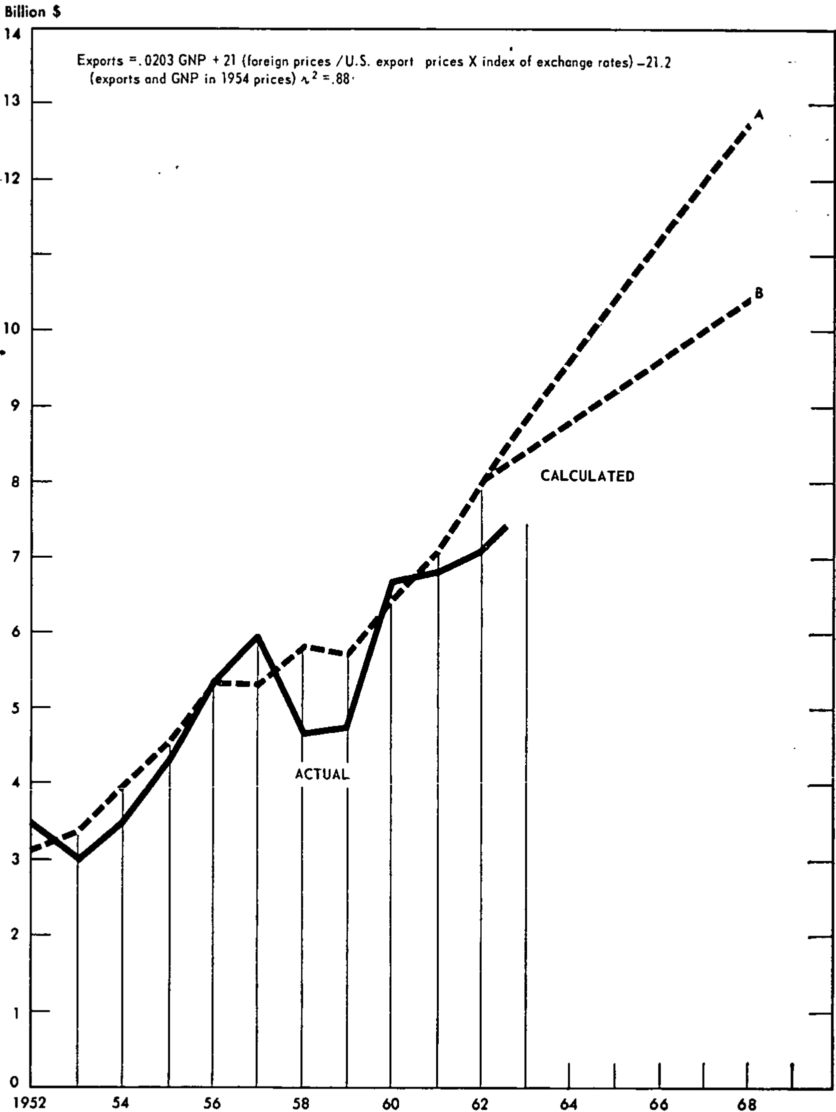
That should not be interpreted, however, that relative price changes are not important. So far, however, their effect cannot be measured, and it cannot be computed how large the price changes would have to be and for how long they would have to be effective in order to reestablish equilibrium in the balance of payments.

The failure of relative price changes to affect exports so far points to another consideration, however. The effectiveness of relative price changes on the aggregate value of our exports is likely to rise more or less in proportion to the variety of competitive goods entering the

export market. In that connection it may be important to remember the composition of our exports to Europe: In 1962 about 24 percent consisted of foodstuffs; 40 percent of industrial materials (including 9 percent of agricultural materials, chiefly cotton); 27 percent were capital goods, but only 5 percent were consumer goods. Even a relatively large increase in European prices of finished products relative to our own will not help to raise exports materially unless we are able to widen the variety of our exports, particularly in the consumer goods field.

(The charts referred to follow:)

Exports to Western Europe Projected on Basis of Production and Relative Prices



U.S. Department of Commerce, Office of Business Economics

Exports to Western Europe Projected on Basis of Production Alone

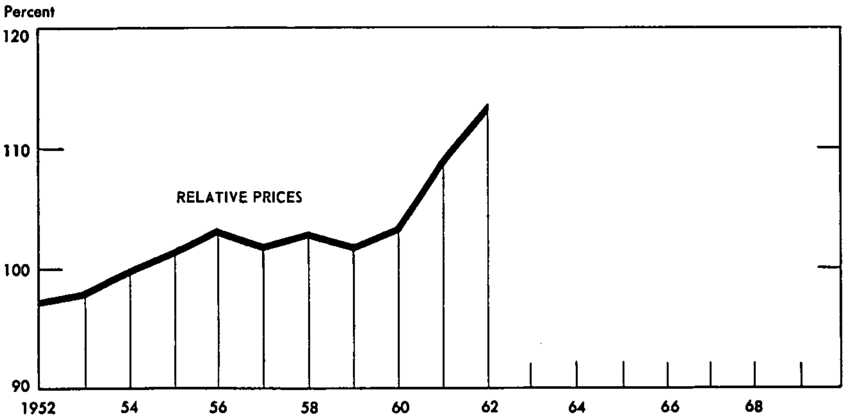
Billion $

Exports = – 2.76 + .031 GNP (in 1954 prices) r^2 = .69

12
11
10
9
8
7
6
5
4
3
2

A
B
CALCULATED
ACTUAL

Percent



U.S. Department of Commerce, Office of Business Economics

Representative REUSS. Thank you, Mr. Lederer. Mr. Patterson, will you proceed, sir.

STATEMENT OF GARDNER PATTERSON, DIRECTOR, WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY

Mr. PATTERSON. Mr. Chairman, gentlemen, in your invitation to appear before you this morning you asked me to comment on "the assumptions, methods, scope, and inferences of the Brookings study, rather than the policy recommendations which conclude (it) * * *." I will, with minor exceptions, respect those conditions. First, I must offer an apology. The document before us first came into my hands just over a week ago and I regret that in the days since some other tasks have come my way which could not be postponed. I have given therefore far less time to preparing this statement than I should and I am afraid my comments today are not going to be very helpful to you. My statement is short so I will read it.

Let me say at the outset that this study is a highly competent attack on an exceedingly difficult problem. Indeed, it took a lot of nerve to accept the task and the authors are properly humble about the trustworthiness of their final estimates as to the trends in the U.S. balance of payments in 1968. The problems of forecasting several years ahead in such a complex area as our balance of payments are legion, and the possibility of large errors is great, stemming, as they recognize, from inadequate statistics, from an incomplete knowledge as to just how the international economic system has worked in the past, from even less knowledge as to how the old variables will interact in the future, and from almost no knowledge as to what new variables will be operating in the future and how important they will be quantitatively.

Their general conclusions make pleasant reading. They find there is a good chance that by 1968, the operation of structural economic forces already at work and the continuation, in general, of present policies will result in our basic balance of payments being in moderate surplus, or with only a small deficit. What is equally important, though less newsworthy, is their repeated statements that the margin of error in their estimates is very great, that some of their "findings" are little more than "guesses," and that "it is difficult to feel much confidence in these figures." The comment I most want to make about this study then is that I hope those who use it will pay attention not only to the general conclusions but also to the severe qualifications which the authors have put upon them. The dangers of misuse of this study are great. I would have been happier if the authors had left more of their estimates in the form of a range. Nonetheless, they did convince me that the chances are quite good that our balance-of-payments position on basic transactions will be improved by 1968.

The chapters on foreign aid, foreign investment, military expenditures and, as I shall elaborate a bit later on, that on the Common Market, are excellent. They present a great deal of complex material in an analytically rewarding fashion. The inferences and conclusions strike me as correct.

On the general question of scope one is hard put to find fault because the authors have paid at least passing attention to almost every conceivable factor that could be relevant. However, the amount of

attention given to each of them is often a matter of judgment and so there is still room for disagreement. It is easy to understand why they chose to pay no more than passing attention to several of the non-quantitative factors which have a strong influence upon developments in our balance of payments. As they recognize, there is no satisfactory way of projecting them or of making quantitative estimates of their effect on trade. Still, given the other wide margins of error in the items they do consider, it may well be that some of these factors, especially those discussed briefly on pages 227–230, may in the end be ones which make the difference between a deficit and a surplus in 1968. In particular, it seems to me that, in the event, the introduction of new commodities or of sharp changes in consumers' preferences for internationally traded goods may prove to be among the most important variables of all. Many of us have hoped, perhaps naively, that improvement in the U.S. balance of payments might come from new products, from innovations that are likely to be developed in an economy such as ours which is currently probably spending over $15 billion for research and development, very likely more than all of Western Europe. It would be a foolish man who would make a single quantitative estimate of this, but it would have been helpful had the authors chosen to make a general appraisal of its possible significance and the direction of its influence.

Although the record to date is apparently discouraging, I would also be inclined to give more weight than they do to the beneficial effect upon our balance of the official efforts now being mounted to increase U.S. exports. In an economy the size of ours one has the hunch that it would not take much of an effort on the part of the American business community in the direction of becoming somewhat more export minded to expand our exports in an amount that would be significant relative to the size of our deficit. Again, this is not something that lends itself to quantitative measurement, and one can understand why the authors paid so little attention to it. Still, one would have liked a fuller discussion of this and more research is needed here. On the matter of scope, as I note below, I think a serious weakness is the casual treatment given to devaluation.

Perhaps the most striking of their findings is that the improvements they foresee in the U.S. balance of payments depend very heavily on Western Europe suffering more inflation in the next several years than does the United States. Indeed, the increase in export prices in Western Europe of something approaching double that they assume for the United States is necessary, given their other assumptions and analysis, to result in a situation in 1968 whereby the U.S. basic deficit is reduced to roughly $600 million a year. Given their other assumptions and analyses, it takes an assumption of an inflation of export prices in Western Europe nearly triple that of the United States to produce a surplus in our basic balance of around $2 billion in 1968.

This is worrisome because it argues that our balance-of-payments problem is likely to be solved, given our present policies, and given the basic trends in the economy that the authors see at work, only if Western Europe fails to solve its own financial problems and once again enters a period of serious inflation. There is no doubt that strong inflationary pressures are at work in Western Europe, and I think these probably involve not only the usual demand and supply

factors but, more important for present purposes, a restructuring of income distribution in favor of labor. I, too, expect the United States to benefit during the next year or so from the inflation now emerging in Europe. But inflation is a matter not only of the pressures that are at work in the economy to produce it but also of the political will and strength to take such measures as are necessary to present it. It is here that I read the probable future somewhat differently than the authors. My guess, and it is no more, is that the European governments, having had in living memory only too much unhappy experience with the international and domestic consequences of inflation, probably will, well before 1968, take the measures necessary to prevent a rise in prices that is appreciably greater than that in the United States. I note that Congressman Curtis, a member of this committee, on July 8 presented evidence in the Congressional Record showing that several European governments have recently taken measures to curtail inflation. As I interpret his remarks, he too believes the Europeans are likely to be as successful as we in this matter of resisting inflation.

The authors have, I think, shown some inconsistency in their judgment on this question. On page 242, when speaking of the need for new arrangements to increase international liquidity, they state that, faced with increasing balance-of-payments pressures and reserves which they are reluctant to see reduced, Western European countries "probably would take measures to cut their imports and restrain demand—even at the cost of slower growth * * *." If the European authorities can be expected to take measures to reduce their rate of growth rather than lose liquidity, I see no reason why we can expect them to tolerate the relative rate of inflation assumed in the early chapters of this study.

I find optimistic, too, but I hope correct, the authors' assumptions that the United States can enjoy an assumed average growth rate of 4.8 percent per year and suffer an increase in export prices of only 4 percent between now and 1968. Will it be possible to increase employment by nearly 2 percent per year, to achieve an increase of nearly 3 percent in output per man-hour, and to keep constant labor's share in the proceeds from the sale of GNP? Perhaps, but we will be lucky if this happens. If it doesn't, then our balance of payments will tend to improve less than the study shows.

The authors also seem to have taken an optimistic position when they assume that for purposes of calculating our balance-of-payments basic deficit they can ignore all of the world except Western Europe. This is done on the grounds that these countries' reserves are too low to permit them to import more than they export and that their needs and wants in the period under study are so great that they are unlikely to build up reserves. I have nothing but sympathy with their decision not to take into account our trade with these areas.

To have done so would have multiplied their chores. And relationships between the United States and Western Europe are of much greater significance for purposes of this study than those between the United States and the rest of the world. Nevertheless, this assumption does bias the results in favor of a reduction in the U.S. deficit. It is probably true that the reserves held by these countries are not sufficient to permit them to run much of a deficit, but the obverse is not so clear.

The chances of the rest of the world as a whole accumulating some reserves during the next several years, or at least being in the process of accumulating several hundred million dollars per year by 1968, seems to me to be quite high. If these countries' economic development goes forward and their economic situation improves, as we hope that it will, and as our aid programs are helping it to do, one would expect the making of some investment in international reserves will come progressively to have a relatively higher priority. The possibility of increasing reserves seems to me to be especially strong in the case of Canada, though I would expect to find some of this in the other countries as well. Incidentally, lumping Canada (which takes nearly a fifth of our merchandise exports and imports and has most intimate of economic relations with us) with Africa, Asia, and Latin America, seems to me to hide a lot of the more interesting problems in our international economic relations.

Turning to other parts of the study, I find particularly useful the treatment of the European Economic Community and the U.S. balance of payments. I hope this excellent chapter receives much attention. On July 18, last, President Kennedy in his balance-of-payments message to Congress stated that the "primary long-term means" for increasing our commercial trade surplus will be implementation of the Trade Expansion Act of 1962. He stated that the United States was preparing to use to the fullest extent the authority given by that act in an across-the-board drive for lower tariffs and against other barriers to trade. Many have assumed that an enlarged market for U.S. exports would be found in the Common Market. Others, less sanguine, have hoped that the Trade Expansion Act would at least permit us to hold our own in the EEC. It is therefore sobering to read this chapter in the Brookings study. The authors do a service in reminding us again that the economic union, and the common tariff, and the discrimination that it involves against the exports of all outsiders, are chosen not only for protecting domestic producers but also as vehicles for satisfying political desires. Resistance to lowering the Common Market common tariff is therefore going to be very severe indeed. The authors are also correct in pointing out that up to now some special factors have been operating to reduce the adverse impact on the United States of the EEC discrimination but that they may soon no longer operate.

The report then makes the critically important point that the "protectiveness" of the common tariff cannot be measured simply by its absolute height nor does the fact that it has been, or will be, decreased mean there is less protection than before the Community was established. With the removal of tariffs inside the Community it is the low-cost European producers who will determine the competition to be faced by the United States throughout the Common Market. The common tariff will be protective and will divert U.S. exports to the extent that it is still sufficiently high to protect these low-cost producers, no matter what member country they are in. Thus, the common tariff may very well be reduced by significant amounts and still be more of a barrier for American exports to the group of countries as a whole than was the higher tariff before the union was formed but when the low-cost producers amongst the various countries had to compete in all other members of the new union on the same basis as the United States.

The authors attempted to measure this protection and to show the extent to which the Common Market tariffs on a series of products important in the U.S. export trade would have to be lowered in order that the protection given to what is likely to be the dominant supplier within the market would be no greater than the protection granted them before the Common Market was formed.

This is a convincing demonstration that very substantial reductions—in many cases over 50 percent—in the common tariff will have to be negotiated if the U.S. exporters are to maintain themselves in the Common Market. The figures given probably underestimate the amount of tariff reduction that would be needed to preclude new discrimination against American exporters for it is likely that at least some of the pre-EEC tariffs on imports into the low-cost countries had excess protection in them. Keeping in mind that so long as Britain is not a member of the Common Market the maximum amount that the American tariffs can be reduced for most if not all of these items under the new Trade Expansion Act is 50 percent, one finds that the prospects for maintaining ourselves in the European market for many of these important commodities very poor indeed. It also seems to me likely that the loss to the United States may be even greater than the $200 million calculated on page 104. This would happen if, in the years ahead, the capacity of the low-cost Western European producers to provide these commodities proves adequate to meet all market needs at prices below that which U.S. goods could be sold *after* paying the common tariff. In this event, it may well be that the United States would be excluded from the market entirely for several important categories.

It is clear that for this important group of commodities modest reductions in tariffs are likely to be of little or no help to the United States. Indeed, I would emphasize the authors' conclusion that modest reductions may worsen our balance-of-payments position. To the extent American tariffs include little or no "excess," and this is probably true for a lot of goods today, a reciprocal reduction under the circumstances outlined here would increase U.S. imports and have no beneficial effect on U.S. exports.

There seems nothing to add, except one's agreement, to the study's conclusion that the effect of the Common Market is going to be virtually to exclude many U.S. agricultural products and to reduce the exports of many other farm goods. Similarly, the effect on U.S. exports to third countries is going to be unhappy from the point of view of the United States. I agree with the inference of the study that, whatever may be the advantages to us on the political level, from the point of view of our balance of payments, the EEC creates for us very serious problems (and these may in turn detract from whatever political advantages there are) and that sweeping reductions must be made in the common tariff if the United States is to avoid suffering substantial decline in export earnings. The current newspaper reports of the position being taken by some of the members of the European Common Market in preliminary negotiations do not make one have very high hopes. Messrs. Herter, Blumenthal, and their colleagues have an exceedingly tough and important assignment.

It is clear that those who have been basing their hopes for an improvement in our net balance of payments on the assumptions that

reciprocal tariff reductions negotiations under the new Trade Agreements Act stood a better than 50–50 chance of improving our balance-of-payments position have been unduly optimistic. This is not to detract from the great advantages we can expect to accrue to us from any increase in trade that a reciprocal reduction in import barriers may bring, even if it has no effect, or even, within limits, an adverse effect, on our net deficit. I cannot state too strongly my belief that a vigorous effect to use all the authority in the Trade Expansion Act is our most important international economic task during the coming year or two.

The report seems to me to be weak in merely brushing away the question of whether the dollar should be devalued, after citing the usual reasons for not doing so. This question deserves more attention in a study of this scope, especially since the study shows that quite a few favorable developments are needed if we are to have confidence that our present policies and the underlying economic changes now underway will overcome the deficit. This is anything but a simple problem and I would not argue that devaluation is indicated today, largely, I must admit, because I doubt Europe will tolerate it now. But it is not apparent that it can be rather pre-emptorily set aside for the foreseeable future. Among the major conclusions of the Brookings study is that one of the most powerful forces leading toward balance in our international accounts is a change in relative prices as between European and American export goods. This change in relative prices, to do its job, must not be limited to only one or two countries but must cover a good many of the major trading nations. This is already something of a case for devaluation, unless you share the authors' belief that the Europeans are going to have much more inflation than we for the next several years. The combination in the United States in recent years of a distressingly high level of unemployment together with a persistent balance-of-payments deficit is, of course, the classic example of a country with an overvalued currency. Particularly distressing has been the considerable amount of what perhaps can be called "back-door devaluation" that has been going on in recent years.

The Brookings study notes the great increase in the tying of American aid, in the severity of the "Buy American" regulations of the Defense Department, in the reduction in goods American tourists can bring back duty free, in the many new restrictions on expenditures abroad by our Armed Forces, et cetera. The matter of devaluation has become an important question for the United States; it should have received much more attention than it did.

Though we were not asked to take note of the policy recommendations of the report, I want to make a couple of brief comments. I support their recommendations for trying to create a new international payments mechanism designed to permit substantial increases in international reserves as the need for them grows. There are many ways of doing this and this committee has in the past considered several of them. The Brookings study does not get involved in the details and so neither will I. One aspect of their recommendations here which I do not like is the introduction of a system of permanently fixed exchange rates. The advantages of stable exchange rates are obvious and most of them are briefly cited by the authors. There are,

however, many situations where changes in prices provide the most efficient incentives to make the optimum adjustments, often involving investments, to restore the nation's international equilibrium. These incentives operate not just between industrial countries providing similar products where price elasticity can be expected to be high, but in the other countries as well. I do not see the advantages, net, to giving up any adjustment mechanism, and especially one that often is so efficient as changes in relative prices.

I do not like the second alternate offered: that of a flexible exchange rate system between two major currency blocs, dollar-sterling on the one hand and the EEC currencies on the other. My broad objections to this two-bloc system are three: First, it seems to assume a coordination or shared economic policy interests among the United States and the sterling area countries which I do not believe exists; second, this device would tend to increase the regionality and divisiveness of the free world and make even more difficult the resolutions of the sorts of problems discussed in the Brookings study on the EEC.

Third, adoption of such a second-best solution would probably operate to defer for a very long time the acceptance of the best solution. I wonder, too, what are the implications of creating two such currency blocs when both of the world's important international capital markets are in one of them? Not enough details are given as to how much flexibility is envisaged in the exchange rates between the two blocs—or what policies are to guide the monetary authorities in intervening in the market—to warrant any comments on this aspect of the proposal.

I support fully the recommendations that the United States take a strong negotiating or bargaining position with the Common Market in the upcoming tariff negotiations. Only good words can be said for the recommendations that the various "back-door" devaluations represented by tying aid, export subsidies, et cetera, et cetera, be abandoned at the earliest possible time, that the statutory requirement of a gold reserve against Federal Reserve notes and deposit liabilities be abolished, that the United States make more use of the IMF, and that we not attempt to redress our balance of payments by raising tariffs or by cutting foreign aid that we would otherwise find it in our interest to extend.

Thank you.

Representative REUSS. Thank you, Mr. Patterson.

Mr. Lary?

STATEMENT OF HAL B. LARY, ASSOCIATE DIRECTOR OF RESEARCH, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. LARY. Mr. Chairman, let me thank you for your invitation to appear before this committee. I do so in a purely personal capacity, and under the same handicaps that others have mentioned because of the relatively short time to review a large and challenging volume.

The Brookings study has the great merit of trying to make a systematic appraisal of future trends affecting the balance of payments. We can be grateful to Mr. Salant and his colleagues for their willingness to undertake this task despite its hazards and the risk that their projections may be taken more literally than they would wish.

Any projection must be subject to serious qualifications. I remember a friend of mine who, in talking about his neighbor's sunflowers, said, "If they grow as much next year as this, they will be up to the second or third story." I reminded him that the sunflower is an annual and has to start over again every year. We are subject to some of the same difficulties in making economic projections.

Subject to this note of caution, I am in general agreement with what seem to me to be the broad trends foreseen in the analysis, including the current and prospective strengthening of our competitive position, and agree with the conclusion that, under the assumptions given, developments here and abroad should tend to eliminate the deficit and possibly produce a surplus in the balance on basic transactions in our international accounts.

I would, however, question some of the supporting parts of the analysis. Some of my queries would point to a less favorable and others to a more favorable development of the balance of payments than that foreseen in the study. In the latter respect, I may differ from some of my colleagues on the panel who seem to have concentrated on the parts about which they would take a less hopeful view.

To start with the considerations which may have unfavorable implications for our future position, I would point to the strong and continuing growth in our imports of manufactures. A table attached to my statement shows that these imports rose by 133 percent from 1953–55 to 1960–62 and increased their share in total U.S. imports from 21.6 to 35.5 percent. Their dynamic course compared with the much slower growth of our exports of manufactures can also be judged from the attached chart. (See pp. 306–307.) I suggest that, in these projections of our foreign trade, it would have been desirable to consider separately each of the major groups of products rather than work only with aggregate data. And I suspect that the method actually employed may understate the prospective growth of our imports.

I am troubled by similar doubts with respect to the projection of U.S. exports to Western Europe. These amounted to $7 billion in 1961. Under the initial assumptions employed in the study, they would rise by $1.9 billion to 1968 with the growth of Western European GNP and by an additional $300 million as the direct effect of a 4 percent rise in U.S. export prices. Since, however, Western European prices are assumed to rise even more, the resulting improvement in our competitive position would yield a further $3.5 billion of U.S. exports to Western Europe.

This last increment is, of course, of key importance to the whole analysis. It seems reasonable to suppose that most of this competitive gain would have to come in manufactured goods. These goods constitute something less than half of our total exports to Western Europe. It would thus appear that the fulfillment of the Brookings projections on the initial assumptions may imply more than a doubling of U.S. exports of manufactures to Western Europe from 1961 to 1968. If so, the projected total may be rather too high. And, again, I think that it would have been useful to consider the prospects for major groups of products rather than to make the projections exclusively in terms of aggregate data.

My doubts on this score are reinforced by the failure of the study to give more than passing attention to the relative pace of technological development in the United States and other industrial countries.

This important but elusive question illustrates the difficulty of giving quantitative expression to all of the relevant variables.

The international spread of technology is one of the ways in which American investment in manufacturing abroad has added to the competitive power of other countries. As rightly stressed in the Brookings study, these investments have many advantages for ourselves as well as for others. The study also states, however, that:

> The crux of a judgment as to whether foreign direct investment improves or weakens the U.S. balance of payments is the actual amount of the displacement of domestic production by imports and by loss of exports as a result of sales from foreign facilities.

The study nevertheless presents in table V-8 hypothetical estimates of the balance-of-payments effects of American investment in European manufacturing from which this crucial factor is explicitly omitted. I understand the reasons for this omission and doubt that anyone can make a valid generalization about this question in the present state of knowledge. Some cause for concern is nevertheless suggested by my table on trade in "research intensive" products. It will be noted that our export performance over the past decade has been weakest in some of the products in which our investment in European manufacturing has been most active. One may worry lest our exports now also falter in some other lines in which, more recently, American manufacturing facilities in Europe have been rapidly expanding.

This is again a reason for seeking to create a more favorable climate for investment in the United States. It is also a reason for trying to insure that the real advantages underlying foreign investment are not artificially enhanced by the policies of European countries such as exaggerated trade preferences within the Common Market, direct or hidden import restrictions, fiscal privileges, and other special inducements.

So much for ways in which our trade and payments position may be less favorable than judged in the Brookings study. I believe that the study may also underestimate some of the favorable factors. Let me begin with a different aspect of the subject which I have just been discussing—that is, the balance-of-payments effects of American investment abroad. The study projects the income on these investments, including interest on U.S. Government loans, at $5.8 billion in 1958. This is an impressive figure and might even appear to be on the liberal side. Note, however, that this income has been rising by some $500 million a year in the last 2 or 3 years and is expected to reach a total of about $4.7 billion in 1963. That would leave an increase of only $1.1 billion, or little more than $200 million annually, during the next 5 years to reach the Brookings projection for 1968. This strikes me as much too low, particularly since our income from foreign investments has not yet benefited very much from the wave of American investment in Western Europe during the last several years. Mr. Lederer, of the Commerce Department, would have a better basis for expressing a view but, as a rough guess, I should think that the projection might well be exceeded by $1 billion, more or less.

Next, it seems to me that the Brookings study may seriously underestimate the increase in Western Europe's imports from third countries and, therewith, the indirect benefits to the U.S. balance of payments

from this source. I refer in particular to table II–8 on page 57. It will be seen that exports of the rest of world to Western Europe amounted to $21 billion in 1961, or twice as much as rest of world exports to the United States. Yet the projections show a smaller absolute increase in the first than in the second and a far smaller increase expressed in relative terms—19 percent in rest of world exports to Western Europe as against 45 percent in rest of world exports to the United States.

As may be seen in the attached table, recent historical experience would suggest a much larger rise than that indicated in Western European imports from third countries. Very roughly, I should think that we might reasonably expect an increase of, say, 30 percent, or $6 billion, in these imports from 1961 to 1968 under the assumptions given for growth in the Western European economy.

This increase could be even greater if there is a relaxation in the severe discrimination now practiced in Western Europe against imports of manufactures from Japan and other low-wage countries, to which the report has called attention.

I have now noted various respects in which the Brookings study may tend either to overstate or to understate the extent of the improvement to be expected in the U.S. balance of payments. Without suggesting that these pluses and minuses would neatly offset each other in the final calculations, I should like to express again my general concurrence with the main trends foreseen in the study under the assumptions given with respect to growth rates in this country and in Western Europe. It would have been useful, however, if the two sets of basic assumptions employed had been translated, in each case, into more than one set of balance-of-payments projections. This would have made the presentation more cumbersome, but it would have served, far better than verbal qualifications, to alert the reader to the wide margins of uncertainty in the figures.

The Brookings report properly stresses the severe handicaps imposed upon the analysis by the lack of satisfactory measures of foreign trade prices. The members of this committee will be interested, I believe, to know that the National Bureau of Economic Research is trying, in a major project supported by the National Science Foundation and carried out with the cooperation of business firms, to point the way toward closing this major gap in our information. We should be glad to provide the committee with further particulars about the scope and methodology of the study, if that would be of interest.

Mr. Chairman, I have confined my remarks to the analytical aspects of the study. I would have various qualifications or dissent with respect to some of the policy recommendations. But I will defer comment on that part of the study at this time.

Representative REUSS. I did not quite understand the point you made just now. Did you say, Mr. Lary, that your paper does include some observations about the policy recommendations?

Mr. LARY. I have several points of either qualification or outright disagreement with the policy recommendations.

Representative REUSS. I think if you could summarize those right now, it would be helpful.

Mr. LARY. I should be glad to do so.

Let me say first that I am puzzled by the division of emphasis in the final chapter on policy recommendations as between current issues

respecting the domestic economy and its external transactions, and those issues which, though needing to be studied now, nevertheless become current in an operational sense only later and, indeed, only after the projections derived in the study are actually fulfilled.

I should have liked very much to see more attention given, for instance, to the relative roles of monetary and fiscal policy in this country. This seems to me to be of crucial importance both to the operation of the domestic economy and our hopes for more vigorous growth, on the one hand, and to the strengthening of our balance of payments, on the other.

It seems to me that our tax system in particular has become so onerous that it has forced this country to rely excessively on easy money as the way of stimulating recovery and expansion. It was possible for us to rely heavily on the monetary instrument as long as our external position was so uniquely strong. I do not see how we can continue to do so today. A better balance between fiscal policy and monetary policy seems to me to be absolutely essential to the operation of the international monetary system in a way consistent also with the demands of the domestic economy.

I therefore regard the tax revision issue as being of the most crucial importance at this time to our prospective external and internal development, and regret that the Brookings study has passed so lightly over these current issues in preference to others which seem to me to be somewhat more remote.

With respect to these latter isues, I would agree with the argument that, for the future growth of international transaction and for the protection of domestic economies against external strains, we need to strengthen and improve the international monetary system.

I am, however, surprised that this particular problem, even though it needs to be studied now, has been given so much emphasis in the study. As various press reactions already show, this kind of recommendation is so easily taken as a solution to our present balance-of-payments problems. For my part, I do not regard it as being directed to the acute balance-of-payments difficulties which we have been and still are experiencing. One would have to be very sanguine indeed about the willingness of other countries to enter into large new credit commitments to feel that this recommendation is closely related to the overcoming of the deficit or, I should say, the financing of the deficit in our balance of payments.

I do not think that the authors of this study are suffering from any confusion on this point, but I strongly suspect that the emphasis given to it in the report may lead to confusion elsewhere among those already disposed to look to reform of the international monetary system as the answer to our problem.

Finally, I do not regard the suggestion, intriguing though it is, for a modified flexible exchange rate system as even a second-best alternative. I know that many economists are attracted to the idea of flexible rates in the hope that such a regime would give more freedom to domestic economic policy. It is interesting, however, that many other economists are attracted to flexible rates for just the opposite reason: that is, the belief that governments would have to be more cautious in their domestic policies lest the currency come into question.

My own feeling is that the political judgment of the second group is sounder than that of the first. To float the dollar would be to

inject another highly sensitive issue into the arena of economic and political controversy in this country, and domestic economic policy, instead of being set free, might very well be more constrained than before.

(The complete statement of Mr. Lary follows:)

STATEMENT BY HAL B. LARY, ASSOCIATE DIRECTOR OF RESEARCH OF THE NATIONAL BUREAU OF ECONOMIC RESEARCH

Let me thank you for your invitation to appear before this committee. It will be understood that my comments are offered in a personal capacity and that I am not speaking for the National Bureau of Economic Research.

The Brookings study has the great merit of trying to make a systematic appraisal of future trends affecting the balance of payments. The report is explicit concerning the assumptions, methods, and uncertainties involved. It contrasts favorably in this respect with many other appraisals in which major conclusions are reached on the basis of past statistics implicitly projected into the future with little or no attempt to assess current and prospective elements of change.

We can, therefore, be grateful to Mr Salant and his colleagues for their willingness to undertake this task despite its hazards and the risk that their projections may be taken too literally. They are quite right in assigning chief value not to their particular quantiative results but rather to their analysis of the forces which they expect to produce these results. It is important to realize that any analysis of future prospects, even if made with the greatest of care, must be subject to serious qualifications, and that the basis for making economic projections in general and, I think, balance-of-payments projects in particular is weak. There are too many things which we do not know about the character of the relationships involved and their persistence over time and too many imponderables in future developments to permit one to speak with assurance. These reservations apply to my own remarks and also to the Brookings study, as the authors have not failed to stress.

I. AGREEMENT WITH BROAD LINES OF THE BROOKINGS ANALYSIS

I am in general agreement with what seem to me to be the broad trends foreseen in the analysis, which I would sum up as follows:

(1) Western European countries are likely to continue to expand at a rate such as to produce continued pressure in the labor market and further increases in costs and prices.

(2) With our existing and prospective labor supply and given appropriate policies, the United States should be able to step up significantly its own rate of growth without generating an excessive rise of costs and prices.

(3) If these conditions are fulfilled, the United States could expect a large increase in its surplus on goods and services account with other countries and a reduction in the net outflow of private long-term capital.

(4) The United States will need to count on increasing its economic aid to less-developed countries and can do so with only limited adverse impact on its balance of payments. It can also expect substantial economies in net military expenditures abroad.

(5) Finally, these influences altogether will tend to eliminate the deficit and possibly produce a surplus in the balance on basic transactions in our international accounts.

Though agreeing with this main line of argument, I would question some of the supporting parts of the analysis and also, as I shall note later, some of the conclusions or implications for policy. Some of my queries regarding the analytical aspects would point to a less favorable and others to a more favorable development of the balance of payments than that foreseen in the study.

II. CONSIDERATIONS LESS FAVORABLE IN IMPLICATIONS FOR THE BALANCE OF PAYMENTS

Prospective growth of U.S. imports

Among the considerations which may have unfavorable implications for our future payments position, I would point to the strong and continuing growth in our imports of manufactures. A table attached to this statement shows that these imports rose by 133 percent from 1953–55 to 1960–62 and increased

their share in total U.S. imports from 21.6 to 35.5 percent. Their dynamic course compared with the much slower growth of our exports of manufactures can be judged from the chart, especially part B drawn on a ratio scale. Over the period mentioned our exports have grown more than our imports of finished manufacturers in absolute value, but only moderately more and very much less in percentage terms. And before long we would be gaining less even in absolute terms, if these relative rates of increase were to continue. I do not think that this will happen, largely because of the response of our manufacturers and traders to intensified competition. But the relevant point here is that, in projections of our foreign trade, it would be desirable to consider separately each of the major groups of products rather than work only with such aggregative data as in the present study. And I suspect that the method actually employed may understate the prospective growth of our imports.

Projection of U.S. exports to Western Europe

I am troubled by similar doubts with respect to the projection of U.S. exports or, more specifically, that part concerning our exports to Western Europe. These exports amounted to $7 billion in 1961. Under the initial assumptions employed in the study, they would rise by $1.9 billion to 1968 with the growth of Western European GNP before considering the effects of price changes. The direct effect of a 4 percent rise in U.S. export prices would be to increase the 1968 value of these exports by $300 million. Since, however, Western European prices are assumed to rise much more than ours, the resulting improvement in our competitive position would yield a further 38.5 percent, or $3.5 billion, of U.S. exports to Western Europe, making a total of $12.7 billion in 1968 (first line of table III–10, p. 90).

This last increment of $3.5 billion is, of course, of key importance to the analysis. It seems reasonable to suppose that most of this competitive gain would have to come in manufactured goods rather than in industrial materials or foodstuffs. In these latter products, trade controls tend to be more severe and price elasticities of demand are lower and, in some commodities such as cotton, the relevant price comparisons would be between the United States and third countries rather than between the United States and Western Europe.

I assume therefore that the improvement in our competitive position would have to be registered chiefly in our exports of manufactures. These goods constitute something less than half of our total exports to Western Europe (on basis of data in table IV–1, page 98, on U.S. exports to the EEC and United Kingdom). It would thus appear that the fulfillment of the Brookings projections on the initial assumptions may imply more than a doubling of U.S. exports of manufactures to Western Europe from 1961 to 1968. If so, the projected total may be rather too high, even after the qualifications made in chapter IV for the adverse effects of the European Common Market. And, again, I think that it would have been useful to consider the prospects for major groups of products rather than to make the projections exclusively in terms of aggregative data.

Rate of technological progress at home and abroad

My doubts on this score are reinforced by the failure of the study to give more attention to the relative pace of technological development in the United States and other industrial countries. One finds, I believe, only a brief paragraph on this topic at the end of chapter III and a few other incidental references elsewhere. This elusive question illustrates the difficulty of giving quantitative expression to all of the relevant variables. Some hint of its importance is given by my table on U.S. foreign trade in "research-intensive" products. This table overlaps, of course, with the data which I have already given on trade in finished manufactures. And I suspect that my table purports to show too much in that much of the trade included is motivated by factors other than technological advantage. The figures nevertheless give support to the view that advanced technology is becoming more evenly distributed among the industrial countries. Pending further study, I should not want to risk underestimating our own technological progress. But it may be that we have lost some of the advantages which we previously enjoyed. Here, too, a faster rate of growth in the American economy should help to strengthen our competitive position.

Trade effects of American investment in foreign manufacturing

The international spread of technology is one of the ways in which American investment in manufacturing abroad has added to the competitive power of other countries. As rightly stressed in the Brookings study, these investments

have many advantages for ourselves as well as for others. The study also states, however, that, "The crux of a judgment as to whether foreign direct investment improves or weakens the U.S. balance of payments is the actual amount of the displacement of domestic production by imports and by loss of exports as a result of sales from foreign facilities (p. 143). It then, nevertheless, presents in table V–8 hypothetical estimates of the balance-of-payments effects of American investment in European manufacturing from which this crucial factor is explicitly omitted (see note *b* to the table and also p. 146).

The reasons given for inability to estimate the displacement effect are convincing but do not, I think, justify a calculation of the balance-of-payments consequences without it. There is probably no satisfactory way of judging the amount of domestic production lost through investment in foreign manufacturing. It is equally difficult to judge the amount of domestic production thereby created, since manufacturing subsidiaries abroad may become important outlets for industrial materials and components and for complementary finished products from the United States. Perhaps it would have been preferable to enter in table V–8 a broad range of figures, from plus to minus, to show how great the uncertainty is with respect to the net effect. Both favorable and unfavorable examples may be cited from actual experience, but I doubt that anyone can make a valid generalization in the present state of knowledge. Some cause for concern is, nevertheless, suggested by my table on trade in "research-intensive" products. It will be noted that our export performance over the past decade has been weakest in some of the products in which our investment in European manufacturing has been most active. One may worry lest our exports now also falter in some other lines in which, more recently, American manufacturing facilities in Europe have been rapidly expanding.

This is again a reason for seeking to create a more favorable climate for investment in the United States. It is also a reason for trying to insure that the real advantages underlying foreign investment are not artificially enhanced by the policies of European countries such as exaggerated trade preferences within the Common Market, direct or hidden import restrictions, fiscal privileges, and other special inducements.

III. CONSIDERATIONS MORE FAVORABLE IN BALANCE-OF-PAYMENTS IMPLICATIONS

U.S. income from foreign investments

So much for ways in which our trade and payments position may be less favorable than judged in the Brookings study. I believe that the study may also underestimate some of the favorable factors. Let me begin with a different aspect of the subject which I have just been discussing—that is, the balance-of-payments effects of American investment abroad. The study projects the income on these investments, including interest on U.S. Government loans, at $5.8 billion in 1958. This is an impressive figure and might even appear to be on the liberal side. Note, however, that this income has been rising by some $500 million a year in the last 2 or 3 years and is expected to reach a total of about $4.7 billion in 1963. That would leave an increase of only $1.1 billion, or little more than $200 million annually, during the next 5 years to reach the Brookings projection for 1968. This strikes me as much too low. Mr. Lederer of the Commerce Department would have a better basis for expressing a view but, as a rough guess, I should think that the projection might well be exceeded by $1 billion, more or less.

My general impression is reinforced by the fact that, as can be seen in table V–3 (page 128) of the study, the recent rise in our income from foreign investments has not yet benefited very much from the wave of American investment in Western Europe during the last several years. After allowing, as the study does, for the reinvestment of earnings on these investments, I suspect that the amount of income repatriated may be appreciably larger than seems to be implied in the projection.

Western Europe's imports from third countries

Next, it seems to me that the Brookings study may seriously underestimate the increase in Western Europe's imports from third countries and, therewith, the indirect benefits to the U.S. balance of payments from this source. I refer in particular to table II–8 on page 57. It will be seen that exports of the rest of world to Western Europe (given at the bottom of the table) amounted to $21 billion in 1961, or twice as much as rest of world exports to the United States. Yet the projections show a smaller absolute increase in the first than in the

second and a far smaller increase expressed in relative terms—19 percent in rest of world exports to Western Europe as against 45 percent in rest of world exports to the United States.

My doubts go back, of course, to the equations by which these figures are derived, but even superficially regarded, the disparity seems to me far too great. Recent historical experience would suggest a much larger rise in Western European imports from third countries. A table attached to my statement shows that real GNP in Western Europe rose by 33 percent from 1954–55 to 1961, or the same as the Brookings projection from 1961 to 1968, and was accompanied by a rise of 44 percent in Western Europe's imports from the rest of world valued at constant prices. I should think that we might reasonably expect a further rise of, say, 30 percent or $6 billion in these imports from 1961 to 1968 under the assumptions given for growth in the Western European economy.

This increase should be aided by a relaxation in the discrimination practiced in Western Europe against imports from Japan and other low-wage countries. It is hard to believe that prosperous countries, suffering from acute labor shortages, can hold out indefinitely against the pressures bound to be exerted by low-wage countries for fairer treatment. Negotiations next year under GATT and at the U.N. Trade Conference should mark some progress on this problem. By 1968, at least, it ought to be possible for a man in Paris to order a suit made up in Hong Kong just as one living in New York can do, or for an Italian importer to bring in Japanese cameras without forcing the Japanese to take Italian rice in exchange. Perhaps Western Europe will now experience the rapid growth in imports of labor-intensive manufactures which we have seen.

IV. CONCLUDING REMARKS ON ANALYTICAL ASPECTS OF THE STUDY

I have now noted various respects in which the Brookings study may tend either to overstate or to understate the extent of the improvement to be expected in the U.S. balance of payments. Without suggesting that these pluses and minuses would neatly offset each other in the final calculations, I should like to express again my concurrence with the main trends foreseen in the study under the assumptions given with respect to growth rates in this country and in Western Europe. You will note that I have not questioned these assumptions. Those pertaining to Western Europe seem to be reasonable. I think that it is also reasonable to stipulate the assumptions given for the United States—not necessarily as a forecast but as a basis for examining the various consequences which one or another assumed rate of growth would have for the balance of payments.

Alternative sets of assumptions and projections

It would have been interesting if the authors had explored the effects of other combinations of assumptions with regard to rates of growth in the United States and in Western Europe—that is, if they had paired a high rate for the one with a low rate for the other. Such combinations might also be considered plausible. A low growth rate here accompanied by a high rate in Western Europe would mark a continuation of the experience of recent years. On the other hand, it is occasionally suggested that this might now be reversed and that, perhaps about the time when the United States moves to a faster rate of growth, Western European expansion may slow down and become more susceptible to cyclical influences and other disturbances.

To consider these additional possibilities would, however, have required much more time and space, and Mr. Salant and his associates probably have logic on their side in proceeding as they have done. Even so, it would have been a desirable caution if the two sets of basic assumptions actually employed had been translated, in each case, into more than one set of balance-of-payments projections. This, too, would have made the presentation more cumbersome, but it would have served, far better than verbal qualifications, to alert the reader to the wide margins or uncertainty in the figures. The basis for the projections of capital movements seems especially fragile. I would note, among other things, the strongly qualifying remarks on page 126 with regard to the future course of interest rates here and abroad.

Need for better information on U.S. and foreign prices

The Brookings report properly stresses the handicaps imposed upon the analysis by the lack of satisfactory measures of foreign trade prices: "Until the price data are improved, quantitative projections of the competitive position of the United States can be little more than informed guesses—and this warning applies to our projections" (p. 91).

The members of this committee will be interested, I believe, to know that the National Bureau of Economic Research is trying, in a major project supported by the National Science Foundation and carried out with the cooperation of business firms, to point the way toward closing this gap in our information. The purpose of the new study is to devise indexes of change in the price competitiveness of the American economy in world trade. We hope to complete this project in the latter part of next year. In the meantime we should be glad to provide the committee with further particulars about the scope and methodology of the study, if that would be of interest.

V. OBSERVATIONS ON THE STUDY'S POLICY CONCLUSIONS AND IMPLICATIONS

So far, I have focused my remarks on the analytical aspects of the study. I should like to conclude with some brief and entirely personal observations on four policy issues.

Advantages and disadvantages of tying foreign aid

First, given the strains which have developed in our balance of payments, it has probably been unavoidable that we should tie foreign aid and also give preference to U.S. sources in military procurement for use abroad even at some extra cost in both cases. The Brookings study, though showing no enthusiasm for these measures and hoping that we can dispense with them later, argues persuasively that they are now helping to strengthen the balance of payments and that, without them, our Government expenditures abroad would be a more serious strain. I should like merely to add that the cost is not only to our budget but also to our competitive system and perhaps ultimately to our balance of payments also. Some provocative views on this subject are expressed in another new study, "Quiet Crisis in India," by Prof. John P. Lewis, also published by Brookings. Without necessarily subscribing to all that the author says, I am attaching to my statement an excerpt from this interesting study.

Role of fiscal policy and monetary policy

Second, I wish that the study now before us had said more about the relative role of fiscal policy and monetary policy as related both to domestic expansion and to external balance. The study occasionally seems to voice the hope that expansion will be encouraged by fiscal policy and thus strengthen the demand for credit and lead to some rise in interest rates, such as to discourage capital outflows (bottom of p. 253, for example). I should have expected the authors of the report to make a more definite plea for such a development. I think that they might indeed have done so, had they devoted more attention to short-term capital movements. The concept of a "basic balance," or "balance on basic transactions," is useful, but it should not lead one to leave aside the problem of short-term capital movements and the policy issues associated with it.

In my opinion, our tax system has become so burdensome as to compel us to rely unduly on monetary policy as the chief instrument—and not always a very effective one—for stimulating domestic recovery and growth. We had exceptional freedom to use the monetary instrument as long as our external position and the international status of the dollar were so uniquely strong. I do not see how we can continue to do so. Mr. Salant and his colleagues have well described how slow and difficult it is to make adjustments in merchandise trade and services. I fully agree. If at the same time we cannot use monetary policy to help shift international capital movements in the desired direction, we are sorely limited indeed in our ability to attain or maintain balance in our external accounts. I am not suggesting that the domestic economy should be sacrificed to the balance of payments. But I do suggest that a fuller array of policy instruments, including a less onerous and more flexible tax system and less compulsion toward easy money, is needed to meet both our internal and our external problems. To my mind, tax revision is now the most crucial issue in the battle for a stronger economy and for a stronger dollar.

Reform of the international monetary system

Third, the study is right, I am sure, in arguing that severe and protracted strains in balances of payments are to be expected, and that international liquidity must be adequate to finance such strains, so as to avoid excessive deflationary pressures on deficit countries. I am nevertheless surprised that the policy conclusions of this particular study have been brought to focus so strongly on the liquidity issue. Indeed, much more attention is given in the discussion of policy to what we should do after 1968 than to what we should

do to arrive there. We should be clear that the liquidity problem is unlikely to become serious unless and until we bring our international accounts more closely into balance. It is, of course, useful to make plans for that time. But one could not expect such plans to assist us materially at present, unless he were very sanguine about the readiness of other countries to enter into large new commitments for extending credit.

I do not think that the report reflects any confusion on this point in the minds of its authors. But it may contribute to confusion elsewhere on the part of some who seem inclined to think that the answer to our present balance-of-payments problem lies in the reform of our international monetary institutions. It is not that I disagree with what the authors say on the need to improve these institutions. I only wish that they had said it elsewhere instead of running the risk of seeming to relate it to our present international payments situation.

Proposal for a modified system of flexible exchange rates

Fourth and last, I am intrigued by the suggestion given at the end of the report, as a second-best alternative, for a modified system of flexible exchange rates, but I doubt that it would, in fact, provide that results anticipated. Many economists are attracted by the greater freedom for domestic policy which they believe a flexible exchange rate system would allow. It is instructive to note that some other economists tend to favor flexible rates for just the opposite reason—that is, that such a regime would compel governments to be more cautious in their financial policies lest the external value of the currency come into question. I suspect that the political judgment of the second group may be more nearly correct than that of the first. A floating or flexible dollar would add still another sensitive issue to economic and political controversy in this country. And domestic economic policy, instead of being set free, might well be more constrained than before.

To this dissent I would add one more word of caution. A small country may opt for a flexible exchange rate and hope not to provoke adverse reactions. But let the dollar—or the pound sterling, the German mark, or the French franc—fluctuate appreciably, and the chances are strong that other countries would take counter action, such as quantitative controls, to protect their markets. It is to be feared, therefore, that a flexible exchange rate system, even on the modified lines described in the Brookings report, would work counter to our other objectives for a more closely knit world economy.

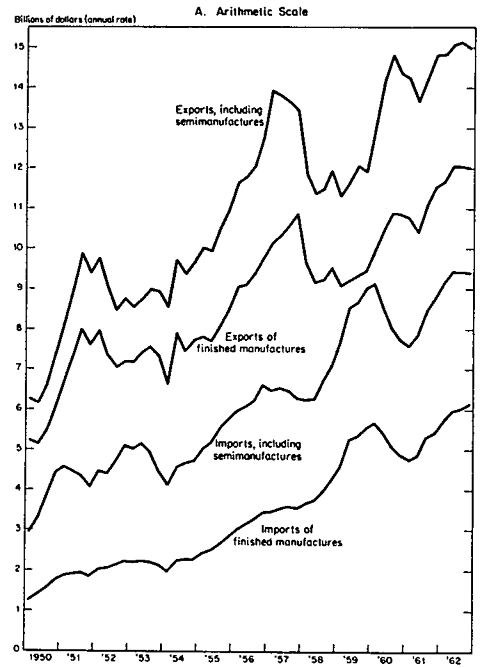
U.S. exports and imports by economic classes, annual averages for 1953–55 and 1960–62

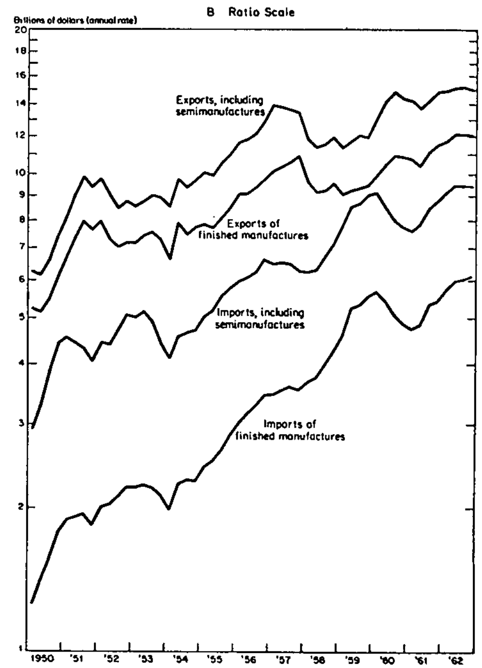
[Values in millions of current dollars]

	Total	Crude materials	Foodstuffs	Semimanufactures	Finished manufactures
I. Exports of U.S. merchandise, excluding military grant-aid:					
Value:					
1953–55	13,011	1,811	1,746	1,850	7,604
1960–62	19,982	2,455	3,061	3,288	11,177
Percentage distribution:					
1953–55	100	13.9	13.4	14.2	58.4
1960–62	100	12.3	15.3	16.5	55.9
Increase, 1953–55 to 1960–62:					
Value	6,971	644	1,315	1,438	3,573
Percent	53.7	35.6	75.3	77.7	47.0
II. Imports for consumption:					
Value:					
1953–55	10,785	2,624	3,242	2,589	2,330
1960–62	15,310	3,290	3,393	3,197	5,430
Percentage distribution:					
1953–55	100	24.3	30.1	24.0	21.6
1960–62	100	21.5	22.2	20.9	35.5
Increase, 1953–55 to 1960–62:					
Value	4,525	666	151	608	3,100
Percent	42.0	25.4	4.7	23.5	133.0

Sources: U.S. Department of Commerce—1953-55—WTIS January-December 1959; 1960-62—OBR April 1963.

U.S. Trade in Finished Manufactures and Semimanufactures





NOTE: Data are seasonally adjusted.

SOURCE: U.S. Department of Commerce.

U.S. foreign trade in research-intensive products [1]

[Millions of dollars, annual averages or annual rates]

	1926-35	1953-55	1956-57	1958-59	1960-61	1962	Percentage increase from 1953-55 to—	
							1960-61	1962
I-A. U.S. exports, including special category type II [2]								
Total exports, all products	3,338	14,307	19,300	17,067	20,163	21,052	41	47
Exports of research-intensive products	780	6,508	8,438	8,056	9,417	10,504	45	61
(Percentage of total)	(23.4)	(45.5)	(43.7)	(47.2)	(46.7)	(49.9)		
Construction, excavating, and mining machinery	40	492	845	695	768	828	56	68
Other industrial machinery	110	1,054	1,482	1,545	1,861	2,190	77	108
Electrical apparatus	83	869	1,023	1,003	1,072	1,260	23	45
Office machines and parts	33	93	122	139	260	329	180	254
Scientific and professional instruments	8	63	97	99	118	144	87	129
Photographic and projection goods	20	80	102	109	137	151	71	89
Agricultural implements	31	129	130	134	144	158	12	22
Tractors, parts and accessories	37	332	385	333	373	363	12	9
Automobiles, parts and accessories	277	1,347	1,499	1,281	1,240	1,362	−8	1
Aircraft, parts and accessories	8	745	1,047	878	1,282	1,440	72	93
Railway transportation equipment	13	110	127	157	150	157	36	43
Synthetic fibers and manufactures	5	223	248	250	307	328	38	47
Medicinal and pharmaceutical preparations	16	229	265	281	275	270	20	18
Chemicals and related products [3]	99	742	1,066	1,152	1,430	1,524	93	105
I-B. U.S. exports, excluding special category type II								
Total exports, all products	3,338	12,623	17,847	15,753	18,782	19,216	49	52
Exports of research-intensive products [4]	780	5,379	7,198	6,988	8,269	8,902	54	65
(Percentage of total)	(23.4)	(42.6)	(40.3)	(44.4)	(44.0)	(46.3)		
Electrical apparatus	83	635	786	807	842	916	33	44
Automobiles, parts, and accessories	277	1,081	1,334	1,116	1,170	1,221	8	13
Aircraft and aircraft engines	8	131	225	188	451	343	244	162
Chemicals and related products	99	727	1,050	1,135	1,413	1,504	94	107
II. U.S. imports								
Total imports, all products	2,868	10,821	12,949	14,310	14,821	16,259	37	50
Imports of research-intensive products	138	684	1,075	1,784	1,885	2,230	176	226
(Percentage of total)	(4.8)	(6.3)	(8.3)	(12.5)	(12.7)	(13.7)		
Industrial machinery	n.a.	107	145	152	228	283	113	164
Electrical apparatus	15	48	122	206	293	425	510	785
Office machines and parts	n.a.	10	30	42	83	85	730	750
Scientific and professional instruments	2	15	26	33	44	55	193	267
Photographic goods	4	23	37	46	58	75	152	226
Agricultural implements and parts	5	76	78	146	124	151	63	99
Automobiles and parts	2	64	241	699	503	515	686	705
Aircraft and parts	--	30	70	73	107	130	257	333
Synthetic fibers and manufactures	9	45	51	72	73	99	62	120
Chemicals and related products	101	266	275	315	372	412	40	55

[1] The selection of "research intensive" goods is that given for U.S. exports by Erik Hoffmeyer, "Dollar Shortage and the Structure of U.S. Foreign Trade," Copenhagen and Amsterdam, 1958, pp. 189–190.

[2] "Special category" goods of type II are selected items for which, under national security restrictions details are published by commodity but not by country. "Special category" goods of type I are those for which only totals are published, without distribution by commodity or by country, and are not included above. A list of the items in these groups is given in report FT 410 for January 1961, issued by the Bureau of the Census.

[3] Excluding medicinal and pharmaceutical preparations.

[4] Product groups shown are limited to those affected by the exclusion of "special category" items. Others remain as in part I-A of the table.

Source: Arranged from trade statistics published by the Department of Commerce.

Western Europe:[1] *Gross national product and imports from rest of world, excluding United States*

	GNP (billions of U.S. dollars)		Imports (millions of U.S. dollars)		
	At current prices and exchange rates	At 1954 prices and 1958 exchange rates	At current prices	Price index[2] 1954=100	At 1954 prices
1954	206.7	195.8	15,255	100.0	15.255
1955	225.2	207.5	16,731	100.0	16.731
1956	246.8	216.9	17,931	99.1	18,094
1957	261.6	226.3	19,045	99.1	19,218
1958	270.9	231.0	18.125	95.2	19,039
1959	278.7	241.7	18,641	92.4	20,174
1960	303.5	256.8	20,677	93.3	22,162
1961	330.9	268.4	20,783	90.5	22,965
1962			22,048	88.6	24,885
Increase from 1954–55 average to 1962:					
Value (1954 prices)		66.8			6,972
Percent		33.1			43.6

[1] European members of OECD, excluding Spain.
[2] Export unit value index of underdeveloped countries.

Sources: GNP and imports—OECD. Price index—U.N. Monthly Bulletin of Statistics (converted from 1958=100).

ANNEX

EXCERPT FROM QUIET CRISIS IN INDIA, BY PROF. JOHN P. LEWIS, PUBLISHED BY THE BROOKINGS INSTITUTION, WASHINGTON, D.C., 1962

* * * The *double tying* of loans, however—the insertion of a buy-American requirement into loans that, like most DLF loans to the Government of India, also are unmistakably reserved for large individually designated projects—demolishes supplier competition. For such loans deny the buyer freedom to maneuver in either direction. He has no discretion as to what he buys, and his choice of where to buy is limited in many cases quite literally to the two or three U.S. firms that are prepared to fill a large Indian order for highly specialized equipment within a stated period. Such double tying creates a high degree of monopoly power for a few American machinery and equipment manufacturers. Thus it is that the DLF buy-American move was not after all, "just what everyone else has been doing all along." The problem that this poses for Americans is less its effect on India or on the U.S. national image abroad than its importance for the U.S. own longer run national economic health. It seems clear that if the U.S. "basic" balance-of-payments deficit is going to be permanently narrowed, many American industrial exporters will have to resharpen their competitive talents. I am sure that it was not the intention of the DLF in instituting country-of-origin tying to buy a few protected markets in India and elsewhere for a few favored American manufacturers. But this, nevertheless, has been the effect, and it was a poor way to condition American exporters for the long pull.

In view of the current American balance-of-payments problem, it would be politically unrealistic—and perhaps irresponsible—to recommend complete abandonment of country-of-origin tying. But this much seems to me indisputable: *Double tying* should be strictly avoided. Comparatively little harm need be done in India by Eximbank dollar-purchase-tying as long as it is not project tied. And the suggested new special assistance could carry a buy-American clause, except for commodities where American procurement is clearly infeasible. But all definitely double tying should be abandoned—either by providing, within the framework of a nominal buy-American policy that all loans for uniquely specified projects be automatically exempted from that policy, or by reversing the policy but attaching special dollar-purchase strings to those loans that do not specify individual projects. If this change is made, a further, coordinated relaxation of country-of-origin tying could then be bargained out with other aiding governments. * * *

Representative REUSS. Thank you, Mr. Lary.

Senator DOUGLAS?

Senator DOUGLAS. Well, I want to thank all the members of the panel for their care and attention to this problem. In the terms of reference which we gave you, you were asked primarily to concentrate on assumptions, methods and conclusions of the Brookings study, and not primarily to address yourselves to questions of policy. But of necessity we have to concern ourselves primarily with policy, and only incidentally with methods. We deal with the latter only insofar as they may affect the former.

I would like, therefore, to start off with the question as to whether our existing gold reserve is adequate to meet the probable demands upon it during the next 5 years, prior to the time when 1968 comes. As I understand the situation, we have approximately a reserve of $15.5 billion in gold, and the 25 percent cover on Federal Reserve notes and deposit obligations of the Federal Reserve System come to approximately $12.5 billion. So that if this 25 percent cover is retained, we have a margin of only $3 billion in so-called free gold.

Now, I notice that Mr. Costanzo recommends that no change be made. But the query that I should like to address is this—in view of the probability that the so-called unfavorable balance of payments will continue for some years, is this $3 billion balance adequate? And in spite of the reluctance of at least two members of the panel to raise these questions at this time—is not this a matter that this country faces, and that therefore legislators cannot ignore?

Mr. COSTANZO. Senator Douglas, obviously the $3 billion in free gold would not take us very far at the rate at which we are running a balance-of-payments deficit at this time. For this reason, I feel that it is urgent that we face up to the balance-of-payments problem.

I do not accept the structural changes arguments—that the direction of our balance-of-payments deficit requires time, and that therefore we must seek interim solutions for financing this particular deficit.

My feeling is that if we get to the root of the problem, which I feel is in the monetary and fiscal policy area, that we would be surprised at how quickly the balance of payments would respond.

My own experience at the International Monetary Fund has been that when the right monetary and fiscal policy measures have been taken, the balance of payments is usually brought into equilibrium in periods of 6 months to a year.

There is a delicate confidence factor involved here which none of us can predict. Five years have already gone by; we do not have another 5 years. We have got to tackle the problem today. And if we do, we can bring this problem into balance within the next year or 18 months.

Senator DOUGLAS. Well, if I may reply to that—the deficit, of course, does not arise from an unfavorable balance of trade, but from what we used to call invisible items—not too invisible nowadays. To bring the balance of payments toward equality would require a complete change in our military policy, tremendous curtailment of our military assistance, great curtailment of economic assistance, limitations upon the amounts which dependents and servicemen can spend abroad, possibly bringing home the dependents; limitations of the amount of tourist expenditures; limitations on capital investments overseas, to which I am sure your bank and other banks would interpose very decided objections.

In short, is your proposal really realistic, in view of the political and economic situation in the world?

Mr. Costanzo. Senator Douglas, what I have in mind, I feel, would go a long way toward correcting our balance-of-payments problem. We should not concentrate on the individual payment items in the balance of payments; my main thesis is that we have been creating entirely too much money to finance our budgetary deficit.

Senator Douglas. You mean the money supply should not have increased as much as it has?

Mr. Costanzo. Yes, sir. What I have in mind is this—in the last 5 years we have run a budgetary cash deficit of something like $23 billion, and of that amount $22 billion has been financed as follows: $6.7 billion by the Federal Reserve System; approximately $9 billion by the commercial banks; and roughly $6.5 billion outside the country, by foreigners.

Now, this is a creation of money which has put pressure on a domestic demand for items which otherwise would have been released for exports and excessive liquidity in the hands of the financial market and banking system which has financed the increased capital outflow.

Senator Douglas. Mr. Costanzo, may I interrupt just a minute. I am puzzled by what you say. I have the monthly indicators for July here. It shows an increase in what they term money supply, namely, demand deposit and currency, and that shows an increase from $136 billion in 1956 to $150 billion in the first half of 1963, or an increase of $14 billion in 7 years, or an average rate of increase, eliminating geometrical factors, of 1.4 percent a year. Now, that is less than the growth rate of the country during this time, which is approximaely 2.5 percent. And I am really startled by the implications of your statement in which you say that we have been expanding the money supply too rapidly.

Mr. Costanzo. Senator Douglas, I was not referring to the money supply figure. I was referring to money creation expansion in the domestic assets of the Federal Reserve System. As I see it, at any given time there is a certain demand for liquidity on the part of the economy. But liquidity in excess of this demand is rejected by the economy and finds its way abroad through the various channels of trade and foreign exchange. Foreigners then sell these dollars to their central banks which in turn either hold the dollars or convert them into gold. Thus, the excess liquidity created by the Fed is taken out of the economy by gold sales.

Now, this I feel has been one of the problems. As we are selling gold, and the funds are flowing into the Federal Reserve, the policy has been to feed those funds back into the system. The trouble is they have not remained in the system, and for that reason (i.e., there has been no demand for this liquidity) our money supply figure has not gone up as rapidly as it has been fed by open-market operations. There has been a leakage of money through the gold outflow. In other words, the demand has not been there for that liquidity. We have attempted to feed it. But it has not stayed in the system; it has gone out.

Senator Douglas. I wonder if any other members of the panel would be willing to comment on the question which I asked—namely, whether as long as the 25-percent gold reserve is our requirement, is the margin of $3 billion adequate, and would you suggest the elimination of the 25-percent gold requirement.

Does anyone wish to speak to that?

Mr. PATTERSON. Senator—I would disagree with Mr. Costanzo's conclusions. I think the requirement should be removed. It seems to me that the dollar is stronger, there is less speculation against it, because it can be converted into gold by certain holders. Now, if this does not give strength to the dollar, we might as well get rid of the gold, exchange it for something useful. If it does give strength to the dollar, it is important that there be gold that is available. And there is not very much gold available any more. It does seem to me that the possibility of transferring dollars into gold does strengthen the dollar, and we therefore ought to make that gold available. I doubt if removing that requirement now, at a time of weakness, would really increase speculation against the dollar.

It seems to me that the rationale will be: if there is more gold available than there was before this happened, there is less reason to run against the dollar. I am encouraged in this supposition as to how the rest of the world would behave by the developments in the past week and a half after the decision to borrow from the International Monetary Fund. It has been said for some years that we must not borrow from the Fund in times of stress because this will show the world we are weak. So far as I can tell from the financial press, it did not have this effect at all. This did in fact relieve our position, it added to some of the resources available to us, and I think on balance strengthened the helpful speculative elements. So this recent development would encourage me to think we need not worry too much about removing the gold cover requirement.

Senator DOUGLAS. Does any other member of the panel wish to discuss this?

Mr. LARY. Mr. Chairman, I would agree with what Professor Patterson has said about the desirability of removing the 25 percent reserve requirement. And I should imagine most of us would regret that it has not been done a long time ago.

Senator DOUGLAS. You disagree?

Mr. LARY. I agree that it is unfortunate that we have this fixed requirement, and regret that it has not been eliminated long ago. It might have been easier to do than it seems to be at the moment.

I think that your rundown, Senator Douglas, shows that it is difficult to cure the balance of payments on an item-by-item basis. On that point I agree with what Mr. Costanzo has said. But I am wary about what seems to me to be the strong deflationary implications of the kind of remedy that he has proposed.

If a reduction in credit creation could be quickly translated, as he thinks it might, into an equivalent reduction in gold outflow, well and good. But the process of linking one with the other is rather remote and time-consuming. I do not see how one could realistically recommend a line of policy that would appear, if I have understood it correctly, to have such deflationary possibilities as I would draw from Mr. Costanzo's remarks. That is the reason why I would stress the desirability of promoting expansion through tax policy and budget policy in the hope that the demand for credit would be sufficiently strengthened to reduce the outflow of capital and thereby contribute to the solution of this problem.

I have in mind not only the recorded items, when I speak of capital outflow, but also these disturbingly large errors and omissions which

Mr. Lederer mentioned and which appear to have a very high capital content.

Senator DOUGLAS. Of course, if I may make one or two remarks on this question—it seems to me that the 25-percent gold reserve has largely a symbolic value. Nobody can obtain gold. The sole way in which gold can be obtained is in settlement of international balances under the gold exchange standard. The only function it performs is that it fixes a definite tether to the amount of credit—the maximum amount of credit which the Federal Reserve System can create.

It seems to me that this would have a very unfortunate consequence when we do not want to have production tied to a tether—we want production to be able to expand. And in the interest of stable prices, I have always thought that the quantity of the circulating medium should move at an approximately equal rate with the index of the real national income, or the gross national product.

Does anybody want to comment on that?

Mr. COSTANZO. Senator Douglas, I would certainly agree that over the long run we would probably need to take a look at this gold reserve requirement. My main preoccupation is again this confidence factor. If we remove it in a period of weakness, we run a serious risk. The risk is that the conviction will be increasing among investors throughout the world that we do not have a policy and program for dealing with our balance-of-payments problem, and we are seeking measures to gain time.

Now, I disagree with the statement of Mr. Patterson that the recent drawing on the Fund has had no effect on confidence in the dollar. I agree it has not affected the exchange markets. But the reason there is that in the short run exchange markets are made by exchange traders, and the exchange traders realize that at least for the time being, there is $500 million of exchange hanging over the market. So that while the short-term effect may be negligible, the long-term impact is to weaken confidence in the dollar.

Now, I cannot predict that if we remove the gold reserve requirement that this is going to provoke a capital flight. On the other hand, I think that equally it is very difficult for anyone to be sure it might not. But there is a serious risk here and it raises the question of how much longer we can go on with the kind of balance-of-payments deficits we have been running.

I repeat, we are already in the sixth year. How many more years can this go on before it will have an impact on confidence?

Senator DOUGLAS. Thank you very much.

Mr. Chairman, I think I have taken more than my 10 minutes.

Representative REUSS. Senator Miller.

Senator MILLER. I apologize for not having been able to be present during the testimony of the witnesses, but there was another important committee meeting I had to attend. However, I would like to ask this question of the panel. Anyone can answer, or all of the panel can answer.

Yesterday we were told that the assumptions, or one of the assumptions of the study group was that there would be in the neighborhood of $70 to $80 billion of inflation during the period covered by the report.

That, as I recall, is at the rate of around $9 or $10 billion a year. I asked the reason for the assumption and the answer given me was that

that has been pretty much the record over the last several years. And I believe that this is borne out by certainly the last two and a half years. I noted from Economic Indicators furnished us by the President's Council of Economic Advisers that during the first 6 months of this year we had inflation in the amount of $4.8 billion, comprising better than one-third of the gross national product increase.

Now, my question is in two parts:

One, do you gentlemen feel that that assumption that this will continue at that rate is a sound assumption, and secondly, do you think that the report of the working group of the Brookings Institution was remiss in not making a recommendation for some action to curb this, if not to eliminate it?

Mr. LARY. May I ask a question for clarification?

Does the $70 billion or $80 billion of inflation to which Senator Miller refers relate to the U.S. economy or Western Europe?

Senator MILLER. We are talking about the U.S. economy. The inflation, as I recall, has been running about $7 to $8 billion a year for each of the last 2 years. It is at a rate of $9.6 billion for this year. The working group's response yesterday was that this has been pretty much the pattern for the last several years, so they projected it forward and came up with a total inflation of around $70 or $80 billion during the period covered by the report, which would run around $8 to $10 billion a year.

I want to say that I recognize the validity of their pointing to the record during the last several years. However, I am interested in knowing what you gentlemen think, whether or not it is a valid assumption that this is going to continue at about this rate, or perhaps a little more; and secondly, regardless of your answer to that, do you think that the working group of the Brookings Institution was remiss in failing to make a recommendation to do something about this—either to curtail the inflation or to cut it out entirely, with a view to having this contribute to the balance-of-payments deficit solution?

Mr. COSTANZO. Senator Miller, I believe you are referring to the assumption of a 1½ percent per annum increase in GNP deflator, which roughly gives us your figure of $9 or $10 billion. I have no quarrel with that particular assumption. I think that that is roughly what we have had, and I think it is reasonable to assume that this is what we will get in the future. As a matter of fact, if we continue with the same monetary policies, I would be surprised if we will be able to keep within this 1½ percent. It may be more than 1½ percent.

Now, then, as to the policy aspect of it, frankly I would feel that we are fortunate indeed if we can keep the rate of inflation to 1½ percent per year. It would not be particularly disturbing to me if domestic price inflation were kept within this figure.

I am disturbed, however, that on top of that one and a half percent price increase in domestic inflation, we have this large balance-of-payments deficit. To me these are two aspects—that is, domestic prices and the balance of payments—of the same problem.

Ordinarily—the fact that we have relative price stability in this country is due to the balance-of-payments deficit. In other words, without the balance-of-payments deficit, there would have been greater pressures on domestic prices and the rate of inflation internally would have been greater. Therefore, I am not satisfied with the one

and a half percent, as long as we are running the kind of deficit we have been running in our balance of payments.

Senator MILLER. Well, may I ask this:

If you say we will be fortunate to not exceed one and a half percent inflation a year, then I would assume that you would think that we would be more fortunate if we could attain a lower rate of inflation?

Mr. COSTANZO. What I would say is that a rate of inflation of one and a half percent per annum with balance-of-payments equilibrium would be quite satisfactory.

Senator MILLER. Well, my question was not quite that, because I want to talk about the way this thing is now, and in the light of the committee's view that the balance-of-payments deficit is going to be with us for some time. In fact, I do not believe they anticipate it can be eliminated. They estimate there might be a $500 million deficit by 1968.

My question is, If you say we will be fortunate not to exceed one and a half percent, you are really forced to say we will be more fortunate if we do not go up to one and a half percent?

Mr. COSTANZO. Well, we should see to it that a greater portion of our budgetary deficit is financed from real savings and not the creation of bank credit. If we did that, I think that our balance of payments, as I stated previously, would come into equilibrium, and when all of that has happened, and we still have domestic price inflation of one and a half percent, I would not be particularly concerned.

Senator MILLER. Well, would you be concerned if we had a continued outflow of gold problem which, as I understand, is attributable in part to the continued diminution in the value of our dollar as a result of this inflation? In other words, what I say is, I cannot blame foreign creditors if they see the dollar slipping 1 percent a year, which is what happened in the last two and a half years, that I know of—I cannot blame them for asking for gold instead of our diminishing value dollars.

Now, that is why I suggest that, in view of your statement, we will be fortunate if we can keep this rate at no larger than one and a half percent. We ought to be more fortunate if we can keep it under that, and maybe still more fortunate if we can keep it stable. Do you agree?

Mr. COSTANZO. Not completely, because I feel that the lack of confidence in the dollar which is gradually creeping up is related more to our balance-of-payments deficit than it is to a concern over domestic prices in this country. I do not believe the trend in domestic prices is a factor in this lack of confidence. I think the principal factor is the external balance-of-payments deficit.

Senator MILLER. Well, would you agree with the statement made by the group yesterday that we can handle the balance-of-payments deficit situation and still not have an outflow of gold problem?

Mr. COSTANZO. Yes, sir, I would agree with that. I think that is possible.

Senator MILLER. Would you agree that it would be likely that we would not have an outflow of gold problem, notwithstanding the balance-of-payments deficit, if the purchasing power of our dollar remains stable?

Mr. COSTANZO. I would say that if it is possible to show domestic price stability to demonstrate our ability and determination to main-

tain balance-of-payments equilibrium, then under these circumstances you might have a situation where there is such confidence in the dollar that foreigners demand dollars for working balances and other purposes. I would say that kind of balance-of-payments deficit would not concern me, so long as we are only providing dollars that the world is demanding. The problem concerns balance-of-payments deficits in excess of such demand which results in dollars in the hands of foreign central banks which are converted into gold.

Senator MILLER. Would you not agree that foreign creditors would be more inclined to be content with holding dollars rather than asking for gold if the purchasing power of our dollar remains stable?

Mr. COSTANZO. That would be one factor.

Senator MILLER. Well, that would be a pretty important factor, wouldn't it?

Mr. COSTANZO. Yes, it is an important factor.

Senator MILLER. Shouldn't we make efforts, in view of the importance of that factor, to preserve the purchasing power of our dollar, rather than being content with a one and a half percent diminution every year?

Mr. COSTANZO. If we took measures to strengthen—let's say if we took measures, as I have indicated before, along the lines of greater emphasis on monetary and fiscal policy, my feeling is that the first impact of those measures would be on the balance of payments. In other words, the balance-of-payments gap would close first before it would have any appreciable result in terms of the domestic price index that we are talking about.

In other words, I would expect the first effects of these kinds of anti-inflationary policies to close the balance-of-payments gap, and not affect the one and a half percent increase initially.

Senator MILLER. I see.

Mr. LARY. May I make a comment about the one and a half percent price increase?

It seems to me that this figure is not beyond the range of the margin of error in our measurements of prices. I think you are acquainted with the report that the National Bureau prepared at the request of the Bureau of the Budget for a survey of our price indexes, and with the points made in that report concerning the imprecision in these indexes.

There is a strong feeling in many quarters that the indexes tend to be biased on the upward side, largely because of the technical difficulties in accounting properly for quality changes in products and for the introduction of new products.

Now, of course, my remark pertains more to the indexes themselves than perhaps to the Brookings Institution projections. I do not know whether the Brookings figure of 1½ percent relates to real prices, if we knew what they were, or to the index of prices.

Senator MILLER. Well, may I say on that point, it relates to the implicit price deflator, which is contained in the Economic Indicators.

Mr. LARY. Yes. On past experience, I would question whether that 1½ percent is really beyond the margin of error which one must take into account.

Senator MILLER. Well, when you speak of the margin of error, then, are you saying it could be 3 percent instead of 1½, or zero instead of of 1½?

Mr. LARY. The general suspicion, I think, among those who are more expert in this question than I am is that the bias tends to be in the upward direction.

Senator MILLER. If that is so, how is it we continue to have the outflow of gold problem? The real test, the real proof of the pudding is what happens to our gold. Foreign creditors may get the idea—granted there may be some bias involved in these figures—that in their judgment the dollar is going down in its value. This is really what counts, is it not?

Mr. LARY. Except I would say that many factors have contributed to the deficit in the balance of payments—a great many factors. And it is difficult to disentangle their separate effects. How much the price factor alone has contributed to it I would hesitate to say. The Brookings Report is very explicit on the deficiencies in our measurements of prices, especially in the international trade sector. I am especially suspicious of the unit value indexes of our exports.

As to reactions abroad, my impression—it is only an impression—is that European countries themselves are tending to look with even greater tolerance on a rate of 1½-percent price increase as being, shall we say, more or less normal, than we are in this country.

Senator MILLER. Well, my time is up. I appreciate your responses. I would like to merely make this point, which I made yesterday:

Assuming for the sake of argument that the implicit price deflator has some bias on the side of inflation, if you gentlemen or anybody else can furnish us with something better than the President's Council of Economic Advisers has furnished us here in this respect, I am certainly for it. But until we get something better, particularly in view of the outflow of gold problem, I think we had better be very careful that we do not fall into the frame of mind that things are all right because there is a bias involved here. If we can find something that does not have a bias, one way or the other, let's have it. But until that time arrives, I think we had better go on with what we have got.

Representative REUSS. Mr. Patterson, I have a number of questions for you.

I was glad that you devoted the time that you did in your paper to the problem of trade, and particularly our upcoming negotiations under the GATT with the Common Market.

I note that you not only share the somewhat pessimistic view of the Brookings Report about the result of our negotiations with the Common Market, what they are likely to be, but in your statement you indicate that the results may be even worse than that foreseen in the Brookings Report.

I would appreciate your spelling out a little bit your reason for your pessimism there—pessimism which I happen to share.

Mr. PATTERSON. I think my taking a bit more pessimistic view than the report stems from the possibility—maybe I should say probability—that the tariff that the low-cost producer previously had and which was the basis for calculating the amount of tariff reduction which must be made in order to remove new discrimination—that there may have been excess protection in that already.

Therefore, a negotiation procedure by which we lower the common tariff only to the level of the low-cost producer—which would be a tremendous reduction already—that may not be enough, because there

may already have been for that low-cost producer some excess protection. Since it is adequate to protect him, it may be adequate to protect him in all the rest of the Common Market.

Representative REUSS. You are simply restating the discriminatory feature of the Customs Union.

Mr. PATTERSON. Yes. That is the heart of the problem. And it seemed to me a great service was done in laying out this problem. My guess is, not having worked this out in detail, that there will be many commodities where the table they give underestimates the amount of reduction that will be needed in order to maintain no more protection than before.

Representative REUSS. You notice Senator Douglas prick up his ears at this phase of the discussion, because he, as you will recall, was the author of the Douglas amendment which I pressed in the House, unsuccessfully, to extend the tariff-eliminating power of the Trade Expansion Act, not just to the rather piddling group of commodities which it in fact now applies to, but to a large group of some 26 major commodities.

I note what you say here—that merely modest reductions in tariffs on a reciprocal basis between the United States and the Common Market can actually do our balance of payments harm rather than good, because what we would be doing would be to let foreigners in to increase their imports, but that which we got in return, even though percentagewise they were even-Steven across the board—that which we got in return would not let us into the Common Market.

This is a restatement, I take it, of your point that a strongly competitive country, such as say Germany, would be there to absorb whatever market seemed to be open to us as a result of tariff reductions.

Mr. PATTERSON. That is right. Even though the common tariff may be substantially cut below what it is, it is still more than enough to protect the low-cost producers.

I would like to say I am very sorry that amendment was not made into law. It would have helped for us to have that much more authority in the upcoming negotiations, I think.

Senator DOUGLAS. Blame the State Department.

Representative REUSS. In the light of what you say, the zero bargaining amendment, which unfortunately was not adopted, becomes particularly crucial to successful negotiations with the Common Market, and therefore you, I take it, share the disappointment of Senator Douglas and myself and some of the rest of us on this committee that the administration is not asking Congress for that authority now.

You see, it would not be too late. We are going into a trading negotiation, the effects of which are going to last until at least 1970, because it takes 5 years under the Trade Expansion Act to get tariffs down.

So this is a one-shot operation that is going to delineate our trade policy for the next decade or perhaps generation.

You would share our view that it is not too late even now to get ourselves in shape so that we can bargain more effectively in the GATT round?

Mr. PATTERSON. I do not know what is too late, Mr. Reuss, because that depends upon what the Congress and the administration can do.

I would say that it would be a very good thing, in my view, if that much authority were in the hands of Mr. Herter and his col-

leagues. And it would be a very good thing if that could be provided.

Senator JAVITS. Mr. Chairman, would the Chair yield at this point?

No one admires what Senator Douglas has done more than I in respect to this amendment.

Senator DOUGLAS. Let me say I got the idea from Congressman Reuss, so I have been traveling in borrowed plumage.

Senator JAVITS. Then let me say the Douglas-Reuss amendment.

I happen to have a particular affinity for the Senator. I am sure Congressman Reuss will forgive me. He and I have been so closely associated in so much here.

I would like to ask you this:

You would have a choice among amendments, given three possibilities—the "80 percent" provision, which is now part of the Trade Expansion Act; the EFTA amendment, which is essentially the Douglas-Reuss idea as originally drafted; and the third amendment, which happens to be mine, but which bears unmistakably the stamp of the Douglas-Reuss genius, which would provide the President special authority to negotiate tariffs down to zero. Which one appears to be more relevant under present conditions?

Let me just briefly say why I ask the question.

I think we are now historically beyond the point of negotiations based principally on the European Economic Community. I think if we are really to succeed, there would have to be an embracing GATT negotiation with very material representation by us of Latin America, assuming that a good deal of Africa is in a sense associated with the European Common Market. That is why I ask the question.

If the Chair would allow me to ask this—it seems to fit in.

Mr. PATTERSON. If I understand the alternatives you presented—I take it your amendment would include everything that the Douglas-Reuss amendment had, plus any other industrialized country?

Senator JAVITS. That's right.

Mr. PATTERSON. I would favor that. But I must say I do not see in logic how you stop with industrialized countries. It seems to me there are the products of the poorer countries of the world, semi-processed goods, on which we have quite high duties. And why do we limit the amount of authority that we give ourselves to reduce those tariffs?

Senator JAVITS. I can tell you why. The reason is that we have—we continue to adhere, from what I can see, and will continue to adhere. though it may not be valid much longer, to an unconditional most-favored-nation policy. If we do that, then we are deprived of the even greater freedom of 100 percent negotiation with everybody. At least I do not think you could ever get the Congress to agree to that. We should abandon that policy.

And even if we limited the most-favored-nation policy approach to those who apply it themselves—we don't even do that now—then I would think that your point would be valid. But so long as we adhere to the unconditional most-favored-nation policy in any tariff negotiation we undertake, there I think it would be extremely difficult to get the Congress to go any further than the outermost limit, the industrialized limit. That is the reason.

Representative REUSS. If I may comment on what my colleague, Senator Javits, has just said. Some day in the future some historian

is going to look back upon the period we are in and wonder about a situation in which in one year, in 1962, the United States deprived itself of its tariff bargaining power, depending on whether or not the United Kingdom entered the Common Market, an irrelevant consideration—and this year, 1963, and apparently in the years to come, we are going to let our GATT bargaining be affected by the existence of this unconditional most-favored-nation clause that you are talking about, so that we have to refrain from doing things that we otherwise would do in the direction of lower-tariff bargaining with non-Common Market nations, because it is said that if we extract a good bargain from them, and get one in exchange, we will have to pass the benefits of that bargain under the unconditional most-favored-nation clause on to the Common Market, and thus we bind ourselves and tie ourselves again.

Senator JAVITS. If the Congressman would yield, I feel that we have here a real problem for the administration. I do not claim for a minute that the previous administration was any bolder than this one in trade matters. There is no argument about that. I am only pointing out that the administration apparently is reserved, I think even timid about taking on the trade struggle. And yet when it has taken it on, it has generally won it.

And our Government being organized as it is, no matter what Senator Douglas or my distinguished colleague from the House or I might do, if the President says "We don't need it, but it will be nice if you give it to us and we will ask for it when we do need it," we are dead, we haven't got a prayer. But if the President should say, as I feel he ought to say, "We need it, we need it urgently, we need this authority, it is just as critical as anything in this whole balance-of-payments operation; we need the vigor and the initiative which it will give us in respect of our trade negotiations," then it would throw new heart and new spirit into the fight.

Again, don't misunderstand me. I do not think anybody's credentials here are any better than mine in terms of the bipartisanship of these foreign policy and foreign economic policy efforts. And I would say the same thing, whatever might be the party of the President.

In the face of everything that we are hearing and have heard, I do feel that a call ought to go out from the committee to the President to reevaluate his own disposition and that of the administration on this question, because if it were called for by the administration, which is in my opinion a really impossible position, on its authority, notwithstanding that its authority is so recent, then I think it is likely to win, as it has won before in respect to trade expansion.

I thank my colleague.

Representative REUSS. I have a short question of Mr. Lary.

You do not mention in your summary of policy recommendations, Mr. Lary, your view, if you have one, on efforts to restrict access to the American capital market by foreign borrowers, either along the lines of the administration's interest differential tax or along the lines of screening, or any other way.

Do you believe that some such approach is necessary or desirable as a shorter-term method of bringing our payments under control?

Mr. LARY. Mr. Reuss, I think we are all bound to be worried about the way capital outflows show a capacity for suddenly increasing.

The rise in new security issues last year, and again in the first half of this year, does seem to me to be a disturbing phenomenon and points to the need for careful consideration of ways of keeping that particular part of the balance of payments from repeatedly getting out of hand. Yet it is extremely difficult to devise an acceptable course of action.

I continue to feel that the most desirable way—and I am sorry to repeat—would be to use methods other than monetary policy of inducing expansion in this country, so that we could have a stronger domestic demand for capital and higher rates of interest, and in that way limit the outflow. I do not see how in the long run we can do otherwise.

But action on the other approaches to the problem of domestic expansion—namely, tax revision—seems to be very slow. And in the meantime, the rate of capital outflow has been creating quite a problem. I think it is in that light that one has to consider the proposal for an interest equalization tax that has been made by the administration.

That particular proposal does have the advantage of trying to use the market mechanism, the price mechanism, rather than direct controls. In that respect it is more consistent with our traditions, our ways of influencing the economy, than if a capital issues committee had been created, for instance. It seems to me that this particular feature is sometimes overlooked. This is not direct intervention; it is an attempt to use the price mechanism under circumstances where no other immediate remedy was at hand.

I think, however, that the proposal also illustrates another fundamental dilemma, of which there seem to be so many. That is, how difficult it is for the United States to take any specific action that has its bearing concentrated on the particular countries where one would like to concentrate it—in this case Western Europe—as distinguished from other countries, for instance, Canada and Japan, which themselves tend to be in balance-of-payments difficulties, and where also the feedback effect, as mentioned in the Brookings study, could be adverse to our merchandise exports.

So it is a very thorny issue. I must say I have great sympathy with the difficulty in devising an appropriate course of action, while feeling at the same time that something needs to be done.

Under the circumstances, I am not sure that this particular measure will be very effective, especially in view of the amendments to the proposals that have had to be made.

Representative Reuss. Thank you. Senator Javits.

Senator Javits. The hour of 12 o'clock has approached, Mr. Chairman. I do not know whether the rule applies to us or not.

I just have a question or two.

First let me apologize for not being able to be here all morning. We have so many committees meeting—we have sessions on the TFX investigation and everything else.

This is a very eminent panel, and the participants honor us by being here today.

I just have two questions I would like to ask. One relates to this gold cover for our notes—this rather expensive amount of gold that we have tied up in that reserve.

I gather that the witnesses have been asked about that. And I note that Mr. Costanzo, whom I know very well, who is our next-door neighbor in New York, has a feeling that until confidence is restored, or confidence in the dollar is assured, it would be a mistake to tamper with the gold reserve requirement.

He says, "until U.S. dollars are again beyond suspicion." I gather there is some difference of opinion on that in the panel. And the only question I would like to have your comment on, gentlemen, is the question of timing.

What is the advantage to be gained by the United States—from those of you who feel that this gold cover requirement is artificial today—what is the advantage to be gained in respect to the balance-of-payments effort and other efforts to stabilize our situation by taking this gold cover off now? And then perhaps we might turn to those who disagree and say: What is the disadvantage?

But I really think the burden is on those who say to take it off now. What is the advantage to be gained? May we have some comment?

Mr. PATTERSON. Yes, sir—I think it should be taken off as quickly as possible. I think it should have been taken off before now. It seems to me it is an anachronism. It seems to me if there is a case to be made for removing it—that is, if it serves no useful purposes and ties our hands, or acts as a tether, as Senator Douglas said—the sooner we get rid of it the better. And it is better to get rid of it when we have $3.5 billion excess than when we have $0.5 billion excess.

Today various devices are being used to delay the outflows of gold, which are ingenious and clever and very well done, but there is still a lot of pressure on gold. I would do it now just because it is easier to do it when you have $3.5 billion than when you have $0.5 billion.

Senator JAVITS. Do we have any other comments from the panel on the side of advocating its removal?

Mr. LARY. I would agree with the last comment by Professor Patterson, that it is better to do it now, preferably at the same time that other actions are being taken to strengthen the balance of payments. It might have been better to have done it, or proposed it, in the President's last message on the balance of payments along with other measures. Psychologically, if it is part of a package, it may be better than otherwise. In any event, I agree with Professor Patterson that we should not wait until the last moment to act.

Senator JAVITS. Mr. Lederer, would you wish to make any comment on this? I gather you did not take any particular position. I can understand why.

Mr. LEDERER. Well, I can only talk for myself. I do think Mr. Lary's idea has much merit. If you do it in conjunction with other strong measures to stabilize the balance of payments, then it will be all right. If, however, this would be taken as merely giving us more rope, more time, then it might be an undesirable action.

Done by itself, it might have exactly this kind of effect. But if you wrap it up with other measures to improve the balance of payments, then it might be all right, and desirable.

Senator JAVITS. Well, Mr. Costanzo, I would summarize the advantage then as being this is a propitious time, and we are now in the gravest kind of trouble, and that it would make an affirmative contribution to our total effort to deal with the balance-of-payments situation.

Would you give us your view on that?

Mr. COSTANZO. Senator Javits, I certainly feel that in the long run this probably should be removed. I feel, however, that there are real dangers in doing it at this time.

I agree with what Mr. Patterson has said, that it is going to be more dangerous the closer we get to the 12.5. But at the same time perhaps I am overimpressed with the psychological factor here. But there is not a day goes by, at least in my institution, where we do not get treasurers who handle substantial funds of large American corporations in international business who are not raising the question as to what is this business with the balance of payments, what are the dangers of exchange controls.

And I am sure that business sentiment, both in the United States and Europe, would be that if we remove the gold cover this is another evidence that we have no intention of dealing with this problem, that we are playing for time, and that all of our measures are one to push this further on.

First of all, I feel if we remove the gold cover, it would add nothing to our present problem. The balance-of-payments problem is with us. It gives us more time. It releases the gold with which to finance this deficit.

But again, I repeat, there is this confidence factor. I do not think any of us can predict as to how much the confidence factor would cost us.

I mean we release the gold. But it may require a great deal of that gold which we released simply to feed the deterioration in the confidence. And I do feel that we should make an attempt. And my hope is that we face the problem with determined policy action today so that we can reach the turning point not 3 years from now or 2 years, but that we reach the turning point within the next 12 months.

If we do that, we do not have to act now, and then we can face the problem rationally after the pressure is off of us.

Senator JAVITS. What about the converse of the proposition—that by releasing that much gold in a package to deal with the balance of payments, we evidence our absolute determination to defend the dollar, come what may, with our total gold stock—we are not tying any of it up, we are determined to defend it to the limit?

I only asked the question because I have such enormous respect for the practicality that you refer to; that is, you deal with people that handle the money. Is there any thought of that? Has that argument been made and rebutted in pragmatic circles?

Mr. COSTANZO. No. This is a factor. The world would then know that our full gold reserve is available for international payments purposes. But I still feel that the basic risk that investors are taking is not only whether or not they will be able to get gold for their dollars, but, more fundamentally, it is their concern about this balance-of-payments deficit problem, which despite the best intentions of the administration may force a devaluation or exchange controls. The longer this problem continues with us, the wider the spread in this conviction. Removing the gold reserve requirement at this time would simply help to convince people more than ever that we are still playing for time and that the risks of exchange control and our devaluation are increasing. Sooner or later investors will begin to take action to protect themselves against these eventualities.

There is some of this already going on. This is the kind of thing that can pick up speed pretty quickly.

For this reason, I feel that it is a measure that needs to be studied very carefully before we remove the particular restriction.

Another point I wanted to bring out is this.

The legislation, as it is written now, as I understand it, requires the Federal Reserve authorities to impose a penalty tax on the reserve deficiency, whenever it falls below 25 percent. The penalty tax in turn will have to be added onto the discount rate.

Now the possibility of an automatic increase in discount rate provided by law is also a factor of confidence in the dollar, because these automatic increases in the discount rate would of themselves stem the deterioration in our balance of payments.

Senator JAVITS. So could we say it is a matter of judgment as to which way would effectuate the greatest amount of confidence, and your judgment is that leaving it on is better from the confidence point of view?

Mr. COSTANZO. I think that is a fair statement.

Senator JAVITS. Now, just one other question—that is, the attitude of the panel on this tax equalization idea. Has that been asked?

Representative REUSS. Mr. Lary has commented rather fully on that. The other panel members have not.

Senator JAVITS. Could we have the point of view of the others?

Mr. PATTERSON. I do not have anything to say on that.

Mr. LEDERER. I have nothing to say on that.

Mr. COSTANZO. I felt, as Mr. Lary indicated here, that the best thing about the tax proposals was that at least market forces were left intact.

I take the point of view that our balance-of-payment deficit is a serious problem, and I would like to see something done. Now, to the extent that this measure, by increasing the cost of borrowing, would have made a dent on our deficit, I would have been inclined to be for it. However, I now have reservations because of these exemptions for Canada and possibly Japan; I am not quite sure how much of a net gain now remains.

Now, if the net gain is sufficient, I would be for it. If we watered it away, then I do not think it is worth it, because we are going to lose something because of the psychological factors I keep talking about.

Senator JAVITS. Thank you.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. Yes. I would like to say that this is another banner day. We have learned a great deal.

I would like to start with Dr. Lederer.

Dr. Lederer, I think this is an excellent warning against relying on the full prescription of the Brookings study, although you say, as we all agree, it is a competent job.

I especially like the fact that you emphasized the serious question, (a) about the assumptions, and (b) about the relationships which the assumptions would necessarily suggest.

For instance one that had not occurred to me at all, and I think should really be emphasized, is the notion that European rising prices and inflationary pressures would probably have the result of tending

to push up interest rates abroad, if only as a defensive measure, and, in view of the balance-of-payments relationship of our capital to theirs, might very well have the effect of pulling up our interest rates, which—you didn't mention this—might also have the consequence of tending to restrain our economic expansion and keep our GNP far below the growth rate which they are asked to project.

Isn't that a consequence of the situation too?

Mr. LEDERER. Well, there is, of course, a potential danger in the capital outflow, that the capital outflow could increase as a result of tightening interest rates, or higher rising interest rates in Europe, and that that could offset whatever increase in exports might possibly occur.

Senator PROXMIRE. This is another reason, it seems to me, and you did not mention it, why the interest equalization tax seems like a somewhat practical proposal as a temporary expedient—it is flexible, it can be adjusted. As Mr. Costanzo said, it does not interfere with free market forces, except, of course, to provide this recognized differential.

Mr. LEDERER. But it is, as you know, limited to some rather specific types of transactions. And it does not cover a great many other channels through which capital might flow out, including bank loans and direct investments and some other possibilities.

So it has a rather limited application.

Senator PROXMIRE. I am not saying this is the whole answer at all. But I can see this is at least one reason for giving it favorable consideration. And, of course, I enthusiastically support your statement that "It would not be advisable to rely primarily on developments which would tend to affect adversely the competitive capabilities of other industrialized countries" in view of our experience with them.

It seems to me Mr. Costanzo very vigorously expressed this viewpoint, too.

Altogether, the Brookings study is a sequence of taking pretty much overwhelmingly favorable assumptions to us, coming up with a situation in which our balance of payments problem is solved in 1968, indicating we can rely on international agreement, expansion of international liquidity, and assuming that this is satisfactory.

I assume that you feel that there may be some more basic policy changes on our part that may well be required.

Mr. LEDERER. You see, the international agreement which the study proposes, that is, the monetary reforms which the study proposes, are essentially designed to correct certain problems which may arise after we have achieved equilibrium in our balance of payments.

Now, that does not address itself to the problems of achieving that equilibrium itself.

Now, if it is taken, however—and there may be some people and commentators in the press who apparently have interpreted it that way—that such a reform in the organization of international monetary payments would give us more time to create, to advance our own equilibrium, or give us more time during which foreign countries would help us to come into equilibrium, then that is a dangerous assumption, because I am not so sure that foreign countries will take upon themselves the burden of running through a continuous inflationary development just so that we can balance our international payments.

Senator PROXMIRE. Particularly in view of the fact that this has not been their attitude to date, number one, and number two, that they have an unfavorable balance of trade right now—a favorable balance of payments, but an unfavorable balance of trade, which is the opposite side of our favorable balance of trade. Is that correct?

Mr. LEDERER. Yes. Well, of course, they have the choice of either accumulating more reserves or permitting an internal inflationary development. And between the two choices, I would think a good many of them might prefer to have the increasing reserves.

Senator PROXMIRE. Mr. Lary?

Mr. LARY. If I may comment on that, I would not fully agree with this as an interpretation of what has been happening in Europe in fact during the last 2 or 3 years. The European countries, especially the Common Market countries, have in fact been experiencing some rather considerable increases in prices. I think it is possible also to see some effects of these increases, with our own prices holding relatively more stable. The export surplus of the Common Market countries in the first quarter of this year was very much smaller than it was in the same quarter of 1962. It was reported in the press a few weeks ago as being $500 million less.

If one asks why we have not, therefore, had more of a lift to our balance of payments as a result, I think the answer is largely in the other area that we have been exploring; that is, the disturbing behavior of capital movements. It seems that what we gain on the one hand we lose on the other.

But, to repeat, it does not seem to me that the assumptions that the Brookings Institution study makes about price and GNP developments in Western Europe are contradicted by recent developments there. I would of course agree that Western European countries would not be likely to tolerate anything approaching hyperinflation. But, given their employment objectives, I am not sure they would not be content to live with the kind of price increases that are assumed in the Brookings study.

Senator PROXMIRE. As Mr. Costanzo has said:

> The French earlier this year responded quickly to emergent pressures on prices with ceilings on commercial bank credit. Until a different breed of men emerge in positions of leadership in the finance ministeries and central banks of Western Europe, a policy based on European inflation to bail us out would be a serious miscalculation.

It would seem to me that, although they have had much more inflation than we have—there's no question about it—the fact is they are in a position to adopt monetary policies that would have the effect of tending to restrain price increases.

One of the things that has been called to my attention is their very sharp increase in money supply. Their interest rates have been rising. Their prices have been going up—because the demand for goods has been rising rapidly, too, and of course they have been reconstructing their economies, and they have been advancing in all kinds of ways.

One of the interesting contradictions is that every one of these countries which has had a large increase in GNP has had a similar increase, a very substantial increase in the money supply. Now, this would suggest to me that they can, if they feel that the price increases are eroding the international position—and they depend on trade far more than

this country does—they can limit their increase in money supply, and the result would be an increase in their interest rate, our interest rate might follow, and their prices might stabilize, with, I think, unfortunate international consequences all around.

I would like to ask you another question in this regard, Mr. Lary.

In your statement you say:

> But I do suggest that a fuller array of policy instruments, including a less onerous and more flexible tax system and less compulsion toward easy money, is needed to meet both our internal and external problems.

Do you feel that we have relied on the policy of easy money in this country for the past several years to secure at least the degree of growth we have achieved?

Mr. LARY. I think that money has been easier than it would have needed to be if we had had a less difficult tax situation.

Senator PROXMIRE. Here we have the situation in which the money supply has grown far less rapidly than the GNP, much less. It is only in the last 10 or 12 months that the growth has kept pace with the GNP.

The 6 years before that, the money supply growth was only 1 percent. It was very small. And each year the relationship between money supply and gross national product would be tighter. Now it is true that interest rates did not rise, but that is because we did not have the kind of vigorous demand for expansion.

Anyway, don't you feel that if we are going to achieve anything like the kind of economic growth which this report is based on, 4.8 percent a year, we need both an expansionary fiscal policy and an expansionary monetary policy? If not, where are we going to get it?

Mr. LARY. I am sure you are correct that the supply of money would need to expand under the growth assumptions that we are talking about. I am only saying that I should like to see the positive impulsion come more through tax policy and budget policy, and depend less on simply making credit attractive. And under these circumstances I could see an expansion in the economy and in the money supply, along with a definite tightening of monetary conditions.

It is partly a question of timing. If this result came from a burst of private investment activity, we would regard it as normal that the demand for credit should strengthen, and that America should become a relatively more attractive place to invest in. I do not recommend that we proceed first by tightening credit. But I think we have to induce a line of development which will permit money to become less easy than it has been, if we are at the same time to meet our external problems.

Senator PROXMIRE. These are the two instruments we have—fiscal and monetary policy—that the Government can consciously and deliberately use to expand the economy.

We have been running deficits. We plan to run a big deficit probably next year. And the traditional or conservative reliance over the years has been the reliance not on deficit policies or reducing tax and increasing spending, but on the money route.

And you seem to feel that we should give far more emphasis to this new notion of reducing taxes and more Federal spending, and less reliance on expansion of the money supply. What I am saying is that we will probably need a combination of both, although I am far less inclined to go along with a loose fiscal policy.

Mr. LARY. I am not arguing in favor of a loose fiscal policy. I was referring to fiscal policy with particular reference to the structure of our taxes. There are two different aspects of this problem. One is the way in which we levy our taxes and the kinds of incentives or disincentives which those taxes give to the economy, and the other part of the problem is what the whole budget looks like.

I was thinking primarily of the urgent need for tax reform in the first sense. I think it is a matter of great danger to our external position that action on this point is so greatly delayed and the outcome still uncertain.

On the budget question, I would not presume to say now what size of deficit or surplus we ought to aim at. I would only say that, depending on the circumstances, the fact of running a budget deficit does not frighten me. It may be definitely required at particular times.

Senator PROXMIRE. Thank you very much. I would just like to ask one more question. My time is about up. I would like to ask Mr. Costanzo one question on his very able paper.

In your statement you say:

> There is no evidence of a shortage of international liquidity today.

Now, in the Brookings Report they point out that between now and 1968 there is every likelihood that such shortage would develop.

In view of the statistics in their report—and they seem to be pretty reasonable—how can you argue that there is likely to be no problem of international liquidity shortage?

Mr. COSTANZO. Senator Proxmire, first of all my statement is related to the state of international liquidity today. As to the situation in the next 5 years—I do not know where we will be 5 years from now. In the first place, there is no automatic relationship between international liquidity and the volume of trade. Any number of things can happen. The need for liquidity—the reserves of a country as a whole are usually related to the magnitude of anticipated deficits and the period of time it takes to correct them. Reserves, therefore, are related more to imbalances in balance of payments rather than to simply volume of trade.

In addition to that, I do not know what may happen in 5 years. It may be that the United States will run a surplus; or the United States may choose or other countries may choose to hold German marks or French francs. It is difficult to predict the precise situation in this respect 5 years from now. But all I say is there is adequate liquidity today.

The Fund itself disposes of adequate resources in terms of gold and hard currencies. There is another $6 million that can be borrowed if there is need for it. And the existing framework of the Fund is sufficiently flexible so that 5 years from now, if we do run into liquidity problems, provisions could be made for additional resources.

The Fund has already increased quotas a couple of times as I recall. So I do not see the need for any drastic overhaul. We have a mechanism, a mechanism that has proven itself. It has been efficient and effective.

World trade has expanded in the postwar period. The Monetary Fund has shown its flexibility to deal with problems as they arise. We can face these problems when they arise.

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Senator PROXMIRE. I understand Brookings implies there is a liquidity shortage today when they say that other countries will take restrictive actions to safeguard their balance of payments if our position improves. This suggests that the inadequacy of U.S. international liquidity is not offset by excess liquidity elsewhere, and consequently that there is currently a world shortage of international liquidity.

I might also say that it would seem to me that we need—we seem to need more leeway. The difficulty is that our adverse balance of payments is a favorable balance of payments for our friends and allies in the countries we want to strengthen.

We do not want to compete with them in the sense of defeating them. We want them to grow and expand, too. This increase in liquidity, in international reserves, would give more free play for economic growth on both sides, would give us 5 or 6 or 8 or 10 years, or give them, when the situation develops the other way, time to adjust without taking the kind of severe monetary action or restraining fiscal action, the kind of restraint that upsets economic growth and expansion.

Mr. COSTANZO. My answer to that, sir, would be that I have never known in my own experience a country with a balance-of-payments deficit where that deficit automatically corrected itself.

Sooner or later something had to be done. The sooner action was taken, the less the consequences, the smaller the adjustment that economy had to make. But the longer action was postponed, then the deeper the readjustments.

Now, I am not sure that to restore balance-of-payments equilibrium today the U.S. economy does require drastic monetary and fiscal policies.

I do not believe we need deflationary policies today. And another point, we are not arguing for sustained surpluses on the part of the U.S. economy to recoup the gold that has been lost.

I do not think that should even be our policy.

But even if the United Kingdom or Germany or France ran into trouble at a later stage, the International Monetary Fund would be able to handle these problems.

The problem arises only if we think in terms of the major countries going for long periods of 8 or 10 years without taking action.

Then obviously not only this liquidity, but I think no liquidity that we can work out will be enough. And the point to remember is that when we are talking about reforms of the international monetary system, we are talking about some countries being willing to become creditors.

No matter how complicated these systems may appear, they all boil down to the surplus countries providing the volume of credit needed to sustain the deficit countries over these long periods of adjustment.

Senator PROXMIRE. My time is up, Mr. Chairman. I would only say that we cannot very well follow the traditional policy of austerity and deflation, which is supposed to be the classical solution to an adverse balance of payments.

We cannot do that without not only having adverse effects on our own economy, but also perhaps kicking off a real depression. And that is why it seems to me that we need more time and flexibility so that we can indeed follow policies which will gradually correct the situation, do so in a more constructive and patient and careful way over a

period of a number of years, and not feel that we have to take action, as the Secretary of the Treasury told us we might have to take unfortunate action within 2 or 3 years.

Possibly the action would be adverse to our position as the leader of the free world.

Mr. COSTANZO. Well, we have already taken 5 years and are now in our sixth year. And to add another 8 years on that would bring us up to 14. Again we come to the basic question of what is a reasonable time in which to restore equilibrium.

Creditors would certainly want to know how the deficit country expects to restore equilibrium. The present concept within the framework of the International Monetary Fund is that 5 years is a reasonable period. But as a practical proposition, even within the Fund framework, a country can get considerably more than 5 years because of the technique of rollover of drawings.

The time it takes to restore balance-of-payments equilibrium depends on us. The problem will be with us so long as we fail to get to the heart of the problem. We still have time for an orderly solution. If we wait too long we risk losing our freedom of action.

Senator PROXMIRE. Thank you very much.

Senator DOUGLAS. We have already kept you gentlemen for an undue length of time. The discussion was so interesting that I am going to suggest that we have a second go-around, but that we limit ourselves to not more than 4 or 5 minutes apiece.

Senator MILLER. Thank you, Mr. Chairman. I would like to ask Mr. Patterson this question.

I understood in your answers to Senator Javits' questioning that you are of the opinion that we ought to take off the gold cover requirement, now. And you pointed out that in your opinion it would be better to do it now, when we have $3.5 billion above free gold, than to wait until we have only half a billion dollars of free gold. Is that correct?

Mr. PATTERSON. Yes.

Senator MILLER. Why do you think it is better to do it now rather than to wait?

Mr. PATTERSON. Well, I start off believing that no useful purpose is served by the requirement; that it is, as I said, an anachronism. It serves no useful purpose in today's world, this sort of requirement.

That being the case, it seems to me the sooner one takes it off, the better—partly because taking it off when we still have some leeway seems to me to give rise to less of an adverse speculative movement than if you had to take it off in a moment of desperation.

I will agree with my colleagues who have said that it would be desirable to do this along with some other things.

Senator MILLER. It is a matter of confidence, for example. In other words, the idea is if you do it now instead of when we are further down the line, perhaps the confidence factor that Mr. Costanzo has referred to will not be impaired.

Mr. PATTERSON. Yes. I should think it must be less impaired if we do it now.

Senator MILLER. Would you say it would have been better for us to have taken the requirement off a couple of years ago?

Mr. PATTERSON. Yes.

Senator MILLER. Would you say it would be better for us to take it off after we restore our balance of gold by another $2 or $3 billion?

Mr. PATTERSON. If I saw that as a likely possibility in the near future, I think I would delay it. I do not think this improvement is going to happen right away.

Senator MILLER. We are talking about confidence. I think you two gentlemen are together. At the beginning I thought perhaps you were a long way apart. But I believe now you are a lot closer together than I originally thought.

Now, my point is that if it is possible to strengthen confidence, rather than to weaken it by freeing our gold reserve now, rather than waiting until it goes down $2 billion, why not take some action to increase our gold reserve?

Mr. PATTERSON. Well, I am in favor of taking action to correct the balance of payments.

Senator MILLER. I am talking about the gold supply.

Mr. PATTERSON. Yes. But my view on this is that we are likely to lose more gold before we gain any. That being the case, we had better release what we have so we can use it to the purposes for which we have it.

If it looked as if in the near future, the next year or two, we were likely to run some surpluses and build up gold, I would say all right, let's wait, and then take it off. But I do not see it happening in the near future.

Senator MILLER. I don't either, the way we are going—although I hope some of the steps the President has advocated may reverse the trend.

We have an increase in short-term interest rates. There is increased activity on the part of the export trade. There is the tourism factor, the reciprocal tax, and some of these other items.

I am just wondering if you would be in favor of really doing something so you would not have to say it is likely that we are going to go down—so that you can say because we are doing these things it is likely that the stock will go up. Wouldn't you prefer to do that?

Mr. PATTERSON. I guess that would depend upon how we got in this happy state of affairs. I do not see us getting into that. I do not see anything that has yet been proposed that in the next 18 months is going to remove this deficit that is now running at the rate of about $3.2 billion per year.

It is not just a matter of sort of stopping or reversing a trend. We have to go quite a ways before we start accumulating gold again.

Senator MILLER. Well, do you agree with the group yesterday and with Mr. Costanzo, if I understood correctly this morning—do you agree that we can still have a balance-of-payments deficit problem and at the same time work the outflow of gold problem?

Mr. PATTERSON. Yes; I think——

Senator MILLER. In other words, it is not a sine qua non that if we have one we have the other?

Mr. PATTERSON. No; it is possible to have a balance-of-payments deficit with no outflow of gold.

Senator MILLER. Now, my question is, why can't we do something about that? Granted we are doing other things about balance-of-payments deficit; why can't we do something about the outflow of gold problem? And if so, can we restore the balance a little higher, so that we will have more confidence when we take off this gold requirement?

Mr. PATTERSON. Senator, here is where I think you see some very clever things happening now. I think the measures that have been taken, the short-term measures on the short-term capital side, the currency swaps, the selling of Treasury securities in foreign denominated currencies—these have been a very ingenious way, not of correcting the balance of payments, but of preventing a gold outflow.

I am not sure how much more we can go along this way. We have done a lot there already.

Senator MILLER. Do you have any suggestions for what more we can do?

Mr. PATTERSON. On the short-term problem, no I don't.

Senator MILLER. Do any other members of the panel have any suggestions?

Mr. COSTANZO. I have some, Senator Miller. I come back to what I said before and I do not think this would be deflationary. I feel that ultimately we are going to have to look at the liquidity the Federal Reserve System is feeding into the system. By that I mean the open market operations of the Federal Reserve System. They have been buying roughly $2.5 billion net of Federal Reserve securities in the market. This has been feeding a certain level of liquidity into the banks. This has made for credit expansion and in the end these dollars have returned to the Federal Reserve System where they have been exchanged for gold.

I believe a policy of expanding Federal Reserve credit at a rate of about 3 percent per annum to take care of growth, but permitting gold losses to have a natural tightening effect on bank liquidity would go a long way in closing our balance-of-payments gap without any serious jolt to the domestic economy.

The other thing I want to point out is this: if the economy needs liquidity, it has the means of creating it. If money gets tight here it will simply pull in liquidity from abroad.

This will bring capital in. As that happens, you will get an increase in money supply in this country in the same way the Europeans are getting an increase in money supply. Yes, money supply has gone up in Europe, but not because the central banks have been deliberately expanding credit.

They have been expanding money supply because they have been buying U.S. dollars. In other words, the increased money supply in Europe is based upon the increase in their gold and exchange reserves resulting from their balance-of-payments surpluses.

Senator DOUGLAS. Senator Proxmire?

Senator PROXMIRE. Yes. I would just like to ask this question of Mr. Costanzo. Mr. Lary in his very fine book has written that, because international transactions are so small relative to the U.S. gross national product, it would take a substantial deflation to produce a relatively modest balance-of-payments savings. Now, in view of your views, Mr. Costanzo, on restricting credit growth to produce balance-of-payments equilibrium, don't you feel that we would have to have a really pretty fierce deflationary effect to move our balance-of-payments problem through credit contraction? You would stop even a very modest increase in the money supply flowing from the policies of the Federal Reserve Board—which I think has been too modest in buying Government securities—you would even arrest that.

Don't you think such a policy is likely to have an adverse effect on our gross national product which is not a price worth paying for the higher questionable favorable effect in our balance-of-payments situation?

Mr. COSTANZO. It is because of the low ratio of trade to GNP that I do not have any hopes of our restoring balance-of-payments equilibrium through the trade account.

I look for the basic equilibrium to come in the capital accounts. This is the area where monetary policy can contribute quickly to balance-of-payments equilibrium. Funds now flowing to Europe would be pulled instead into the United States.

Senator PROXMIRE. Yes. But to get that equilibrium, you are going to have to follow monetary policies that are going to be very restrictive domestically.

Furthermore, you are in a position now where you cannot really expect much cooperation from our allies. When we increased the rediscount rate by one-half of 1 percent, it wasn't 24 hours before Belgium had done the same thing; other countries have not followed yet, but they have every reason to increase their interest rates. They have inflationary problems we do not have.

I will ask you if you can give us one study that contradicts either the Bell or the Gemmill study, both of which show that interest rate differentials are not very significant in capital flows.

We had the Secretary of the Treasury come forward with the Kenen study and the Cohen study, neither of which on the basis of an analysis of this staff stood up very well or really contradicted the argument that interest rate differentials are a minor factor in capital flows, and therefore in the balance-of-payments situation.

Mr. COSTANZO. I don't know. I am sure that the treasurers of the large American corporations could throw some light on this. My impression is that they keep a pretty sharp pencil on interest rates, at least as far as short-term money is concerned.

Senator PROXMIRE. Let me just point out that the Secretary of the Treasury stipulated to the fact that it is trade that accounts for most of capital flow, financing trade, and that, as Bell pointed out in his article, not only trade but speculation is more important than interest rate differential. And furthermore, our staff made estimates based on their findings, which indicated that only about 15 percent of the capital flow is interest-rate sensitive.

Mr. COSTANZO. Well, I certainly agree that the interest rate is not the only factor. There is also the question of just pure availability. In France today—money is not available. Money is tight. So I think that irrespective of interest rates, there is a certain amount of borrowing which is going to have to be done outside of France, thus, in spite of France's balance-of-payments deterioration on current account, they still have such a flow of funds on capital account coming in from the outside that they have sustained their balance-of-payments surplus.

I feel we exaggerate to some extent the impact on our domestic economy of some tightening of an excessively easy money policy.

Senator PROXMIRE. Thank you, Mr. Chairman. I want to thank the members of the panel very much.

Senator DOUGLAS. Before we formally close the record, I would like to address a query, not to the members of the panel, but to those who may read the record later. That relates to the question of the alleged need for a more liquid system of international payments.

The volume of world exports increased from approximately $74 billion in 1953 to $118 billion in 1961, or an increase of $44 billion in absolute terms, and 60 percent in relative terms.

At the same time, according to the figures in the Brookings Report on page 282, the official gold reserves of the world increased from approximately $52 billion to $61 billion, or an increase of $9 billion, or approximately 18 percent.

As a first approximation, we can assume that the need for currency reserves increases at roughly the same ratio as the volume of world trade—although in a way these two are related in a more complex manner. And the accumulation of international reserves was only made possible by the increase in foreign holdings of the two reserve currencies—the pound and the dollar.

Now, I have merely two questions. I am not going to ask the members of the panel to comment at this time.

Certainly, there is need for some expansion of world currency balances other than gold—as a matter of fact, the figures which I have been able to collect indicate that a decreasing proportion of the world's gold production each year goes into the gold reserves. In 1958–59 it was approximately 65 percent; in 1962, approximately 25 percent.

In practice, therefore, it seems to me you have got to expand the nongold reserves of the international system. And the question is whether this is to be done by national currencies or by international currencies.

If reserves are expanded by national currencies which are always subjected to strain, this puts a great check upon the monetary policies, the growth policies of the reserve-currency countries—in this case, Great Britain and the United States. It does not seem to me an accident that the growth rates of the two reserve-currency countries should be the lowest growth rates in the Western World; namely 2.5 and 2.2 percent over a period of time, as contrasted with the rates of 5 percent plus which the countries of Western Europe have had and enjoyed.

Therefore I have felt for some years that we should seriously consider the question of expanding international currencies through the creation of some kind of an international reserve system which would do for international balances what the Federal Reserve System is presumed to do domestically.

There are many problems of structure, because it could result in world restraint rather than world expansion; on the other hand, we do not want world inflation.

I wish if any of you have any thoughts on this subject—we have already taxed you too severely—if you would be willing to submit a statement for the record, it would be printed following this query of mine.

(No statements in reply to Senator Douglas' invitation to comment on this subject were received.)

ADDITIONAL MATERIALS

(The following letter was submitted for the record:)

WOODROW WILSON SCHOOL OF
PUBLIC AND INTERNATIONAL AFFAIRS,
PRINCETON UNIVERSITY,
Princeton, N.J., July 31, 1963.

Mr. JAMES W. KNOWLES,
Executive Director, Joint Economic Committee,
Washington, D.C.

DEAR MR. KNOWLES: At the end of yesterday's hearing, Senator Douglas invited us to submit any additional thoughts we might have. I would like to take advantage of this invitation to have the record note that I was most uneasy at what I interpreted to be something of a sentiment among some members of the committee that perhaps it would be in the U.S. interests to abandon most favored nation policy.

While adherence to most favored nation policy does reduce, in certain circumstances, our bargaining power in trade negotiations, history as well as theory makes it very clear that what is likely to be lost here is a very small price to pay for the advantages of a policy which has its purpose proscribing discrimination. There can be little doubt, I think, that if the United States were to abandon most favored nation policy not only would the general level of trade restrictions rise, with all that implies as to undesirable economic effects, but the resulting morass of discrimination, retaliation, and bitterness would also prove to be not in our national interest.

Sincerely,

GARDNER PATTERSON.

(By order of the chairman the following material was made part of the record:)

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
July 30, 1963.

Dr. WALTER W. HELLER,
Chairman, Council of Economic Advisers,
Executive Office of the President, Washington, D.C.

DEAR DR. HELLER: At the Joint Economic Committee's hearings on the Brookings Institution's report on the balance of payments, July 29, I asked Dr. Walter Salant whether the average annual growth rate of real gross national product of 4.8 percent between 1960 and 1968, which was a basic assumption of the study, was predicated upon a tax cut. Dr. Salant replied that the assumption had been provided by the Council of Economic Advisers and that the basis for it would have to come from that group.

I would appreciate knowing, therefore, whether the 4.8-percent assumed average annual real rate of growth was based upon a tax cut.

Please send a copy of your reply to Donald A. Webster, minority economist of the Joint Economic Committee, so that it may be included in the record of the hearings on the Brookings Institution report on "The U.S. Balance of Payments in 1968."

With very best wishes.

Sincerely,

JACK MILLER.

COUNCIL OF ECONOMIC ADVISERS,
Washington, August 3, 1963.

Hon. JACK MILLER,
U.S. Senate, Washington, D.C.

DEAR SENATOR MILLER: This is in reply to your letter of July 30, 1963, concerning the assumptions regarding U.S. economic growth used by Dr. Walter Salant and his colleagues in the Brookings Institution's study, "The U.S. Balance of Payments in 1968."

Your question is whether the assumed average annual growth rate of real

GNP of 4.8 percent, which the Council supplied to Dr. Salant, was "based upon a tax cut."

The answer is clearly in the negative. As the Brookings report makes clear, the assumptions regarding 1968, both for the United States and for Europe, are not forecasts. In the case of the United States, the projected level of GNP represents an estimate of what GNP would be if unemployment were at the level of 4 percent. The estimate generally corresponds to one which is contained in the Council's January 1962 annual report, which is likewise clearly explained to be a projection of potential GNP.

The reason for suggesting that Brookings should use a growth rate corresponding to a 4-percent level of unemployment was that we wished them to explore whether or to what extent our return to a satisfactory level of employment in the United States might be consistent with the restoration of equilibirum in our balance of payments. We are, of course, heartened by their conclusion that there need be no conflict between a prosperous U.S. economy and the achievement of balance in our international accounts.

It should be clear, therefore, that the assumed growth rate is not based upon the assumption of a tax cut. Rather, it is only a projection of the growth rate of which the economy is capable, not a forecast of what that rate will be. Moreover, it may be noted that the projection was developed at a time before any administration proposal for a tax cut had been made and before 1962 economic developments made it clear that getting back to full employment required major fiscal action.

It would be fair to say that the chances of reaching a 4-percent level of unemployment in the years immediately ahead without a major tax cut are dim. The year 1968 is far enough in the future to make it difficult to make any precise statement of the requirements for full employment in that year. But barring major changes in economic conditions, we would regard 4-percent unemployment in 1968 as most unlikely without a tax cut.

I should also note—as does the Brookings study, in footnote 8 on page 40—that some of the factors underlying the projection of the potential GNP in 1968 have been revised since the time the projections were prepared, in particular, the projections regarding the growth of the labor force. These revisions would require a slight scaling down of the 4.8-percent growth rate. In our judgment, the Brookings conclusions would be little altered had a slightly lower U.S. growth rate been assumed.

I am sending a copy of this letter to Mr. Donald Webster, as you requested.

Sincerely,

WALTER W. HELLER, *Chairman.*

Senator DOUGLAS. At this time, I want to thank you very much for coming here. We appreciate it.

(Whereupon, at 12:55 p.m., the hearing was adjourned, subject to call of the Chair.)