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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

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### PART 3

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THE INTERNATIONAL MONETARY SYSTEM: FUNCTIONING AND POSSIBLE REFORM

NOVEMBER 12, 13, 14, AND 15, 1963

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[1] Comments intended to be printed in the Joint Economic Committee's compendium of statements (released Nov. 10, 1963) on the Bookings Institution study "The U.S. Balance of Payments in 1968," but received too late for inclusion therein.

# THE UNITED STATES BALANCE OF PAYMENTS

## I.—The Existing Gold Exchange Standard

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**TUESDAY, NOVEMBER 12, 1963**

Congress of the United States,
Joint Economic Committee,
*Washington, D.C.*

The joint committee met, pursuant to notice, at 2:08 p.m., in room AE-1, U.S. Capitol Building, Hon. Paul Douglas (chairman) presiding.

Present: Senators Douglas, Proxmire, Pell, Javits, Miller, and Jordan of Idaho.

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

Chairman Douglas. The committee will come to order.

Ladies and gentlemen, we begin this afternoon some of the most important hearings that this committee has ever held; namely, on our balance of payments. These hearings will continue through the week.

This afternoon we are going to discuss the existing gold exchange standard. In this country we do not have the gold standard as an internal monetary mechanism. It would be impossible to convert Federal Reserve notes into gold. But gold, in conjunction with the dollar and with the pound, is used to settle international balance-of-payments deficits. We are very happy to welcome our two witnesses who have paid us the honor of coming to us: Professor Bloomfield, of the University of Pennsylvania, who I discovered to my pleasure was once a student of mine, and in whose intellectual development I am sure I did not play a very important part, and Professor Lutz, of the University of Zurich. We are very glad to greet you both and we appreciate your coming.

We are also happy to welcome Congressman Lloyd.

Representative Lloyd. Thank you.

Chairman Douglas. Our first witness is Professor Lutz.

## STATEMENT OF FRIEDRICH LUTZ, PROFESSOR OF ECONOMICS, UNIVERSITY OF ZURICH

Mr. LUTZ. I have submitted a written statement but I don't intend to read it.

(The complete statement of Mr. Lutz follows:)

### COMMENTS ON THE MECHANICS OF THE GOLD EXCHANGE STANDARD AND RULES OF THE GAME

(By Prof. Friedrich A. Lutz, University of Zurich)

When, in 1922, the Genoa Conference suggested the adoption of the gold exchange standard, it did so solely for the purpose of economizing gold. There was no thought of creating an international currency system of which the mechanics or rules of the game should, or would be different from those of the prewar gold standard. The experience with the gold exchange standard in the 1920's and after World War II, however, has revealed some very marked differences.

In discussing the way in which the gold exchange standard works I shall have in mind a standard such as we have at present. This means first that the key currencies on which the standard is based are only one or two; secondly, that countries on the standard may in certain circumstances alter their exchange rate; thirdly, that they have access to credit from foreign central banks and from the IMF. Thus their international liquidity includes not only the foreign short-term assets held by their central banks or treasuries, but also the willingness of other countries or of the IMF to lend to them in case of need.

(1) I shall begin with a minor point.

There are under the present system no gold points in the proper sense of the term. They have been replaced by official floor and ceiling rates for the U.S. dollar. Such rates have been established by all those countries which upon the reintroduction of currency convertibility at the end of 1958 signed the European Monetary Agreement. The signatories comprised all Western European countries except Spain. The rates have in most of the countries been set at 0.75 percent on either side of the parity with the dollar. This gives a maximum spread of 1.5 percent between the lower and upper limits, and is considerably wider than that (of only about 0.7 percent) between the gold points in the twenties. This widening is a step in the direction of a suggestion made by Keynes at the end of the twenties that the spread should be fixed at 2 percent.

The widening of the spread makes it possible in certain conditions to maintain, temporarily at least, substantial interest rate differentials between countries without causing shifts of short-term funds between those countries on such a large scale as could occur under the old gold standard. For when there exists a fairly wide margin within which the exchange rates can fluctuate, the central bank in the country with the relatively high short-term interest rates can, by intervening in the spot and forward exchange markets, make the difference between spot and forward rates so high, and thus make hedging against the exchange risk so expensive, that the volume of funds actually attracted is reduced to small proportions. This means that the money market of a country is better protected, as Keynes said, "from being upset by every puff of wind which blows in the money markets of other countries." (Keynes, Treatise on Money II, p. 125). But I think we must assume, as Keynes evidently did also, that this instrument is not one which can be effectively used to prevent the consequences of interest rate differentials which persist over long periods. Obviously, too, it is an instrument which is of no help at all in the case that the movement of funds is motivated by the expectation of currency devaluations or appreciations.

There are circumstances, of course, in which a country may want to attract foreign short-term funds by deliberately creating an interest rate differential in its favor. Thus it used to be considered normal for a country with a deficit in its balance of payments to raise its short-term rates above the rates in the surplus countries precisely in order to draw funds from abroad. For that situation a narrow maximum spread between the official selling and buying rates for foreign currencies might seem preferable. But this point is weakened by two considerations. First, as we see from the experience of the last years, the so-called normal situation may well be reversed. A deficit country may actually keep its interest rates below those of the surplus countries, so that short-term

funds flow in a direction contrary to the interest of both the deficit and the surplus countries. Secondly, a central bank can use the technique of operating in the spot and forward market just as well to attract short-term funds, if it so wishes, as to repel them.

I think, therefore, that the spread between the selling and buying prices of foreign currencies should be further widened still. But, as I remarked before, this is a minor point. I turn now to the more important ones.

(2) Under the gold standard a country lost gold only if it had an overall deficit in its balance of payments. Under the gold exchange standard a key-currency country can lose gold even when its balance of payments is in equilibrium. Let us suppose that the United States is in such a situation while, at the same time, Germany has a deficit and is losing dollars to the United Kingdom and Switzerland. The last two countries keep their international reserves almost exclusively in the form of gold whereas Germany does not. Hence the fact that they convert the dollars into gold has two consequences for the United States. First it loses gold, and secondly the ratio of foreign dollar balances to its gold stock is falling in the case that the gold stock is smaller than the foreign liabilities. These consequences have no justification in economic logic. There is no reason why the money market of a country in balance-of-payments equilibrium should be upset by balance-of-payments disequilibriums abroad. The case I have taken illustrates a basic property of the gold exchange standard. This is that the non-key-currency countries can cause a gold drain on the key-currency country and a reduction in the sum total of international reserves by shifting from dollar to gold, and vice versa. (In the illustration I have used the non-key-currency countries taken not singly but all together converted dollars into gold.) This is the most inconvenient aspect of the gold exchange standard. For the propensity to convert key-currency balances into gold tends to increase as the ratio of gold to these balances falls or, that is, as it becomes more difficult for the key-currency country to supply gold. There is thus merit in the suggestion that the principal non-key-currency countries should all agree to keep a fixed and identical proportion of gold and dollars (say 60 percent gold and 40 percent dollars). This proposal seems, however, to be unpopular with some of the European central banks.

(3) The willingness of non-key-currency countries to accumulate balances in the key-currency country means that the latter can continue to run a deficit in its balance of payments for much longer than can the former, for which a deficit means a loss of international reserves to the entire extent of the deficit. The gold exchange standard is thus, as it were, asymmetrical.

This is one of at least two aspects of the standard which has led some observers to conclude that it is an "inflationary" standard. For the fact that the key-currency country can remain in a deficit position for a long time may mean that the surplus countries accumulate international reserves at such a pace that, in the longer run at least, they cannot avoid expanding their money supply at a rate too rapid to be compatible with price stability. In order for the standard to be conducive to something approaching world price stability the key-currency country must keep the deficit in its balance of payments at just the right level. This is a level such that neither inflationary nor deflationary tendencies are created by an overabundance or shortage, respectively, of international reserves. Admittedly if this were to be considered a rule of the game, it would be one which the key-currency country would find it difficult to live up to. In other words, it is extremely difficult to make of the gold exchange standard what it was originally and ideally conceived to be; namely, a standard which would not be more inflationary than the gold standard was, but also not as deflationary as the latter might in certain circumstances be.

(4) Even if the key-currency country managed to run a deficit which would create exactly the "right" amount of foreign exchange, the gold exchange standard could not, in its present form—i.e., with its heavy dependence on one key currency—last indefinitely. For given the comparatively low level of new gold production, the ratio of gold to foreign short-term liabilities in the key-currency country would still fall continuously. But this would mean, as I pointed out before, that the non-key-currency countries would become progressively less willing to hold balances in the key-currency country as part of their international reserves.

A way out of this impasse, which has been suggested by a number of people, would be for the monetary authorities to hold balances not only in one or two countries but in many. If the circle of key currencies were thus enlarged, international reserves could expand without a worsening of the ratio of gold to

foreign liabilities in the present main key-currency country. Take the case where France has a surplus in the balance of payments while the United States is in equilibrium. At present such a surplus merely causes a shift of dollar balances from some other countries to France. International reserves do not increase. But were France willing to hold balances in nondollar countries, the surplus would cause these other balances to grow, so that international reserves would increase even though the United States had no deficit in its balance of payments, and though the owners of dollar balances did not add to these at the expense of their gold holdings. I believe that the gold exchange standard, if it is to survive, should, or must, be modified in this direction of an increase in the number of key currencies. Such a modification would, of course, create its own problems. One of these is connected with the present inadequacy in most continental European money markets of suitable short-term paper in which central banks may invest. Another is the confidence factor to which I shall return in a moment.

(5) Under the gold standard the rules of the game required that a country that lost gold should react by adopting a tighter monetary (and/or budgetary) policy, and the other way round if it gained gold.

Under the gold exchange standard the same rule ought to apply to all non-key-currency countries, a loss or gain of foreign exchange being treated as equivalent to a loss or gain of gold. But, because of the asymmetry of the gold exchange standard, this rule of behavior cannot apply to a key-currency country. As I pointed out already the only rule that seems to suit the role of such a country is that it should manage its deficit in such a fashion as to provide just the right amount of international reserves. And if there were more than one key-currency country, there would have to be some way of sharing round this responsibility.

It cannot be said that countries do actually keep to these rules. One reason why they do not is that they are more concerned with keeping up the level of domestic economic activity than they are with balance-of-payments considerations. It is much easier for a country to put the latter into second place under the present gold exchange standard than it was under the old gold standard. Two recent developments account for this change. The first is that countries have easier access to foreign credits from central banks and from the IMF. The other is the recognition by the code of international monetary behavior of the right to devalue. The benefit usually seen in these two developments is that they give countries with deficits in their balance of payments more time to correct those. But I am afraid that this way of putting things is often a euphemism for a system which allows countries with deficits to postpone the necessary measures unduly long.

While deficit countries are opposed to taking deflationary measures, the surplus countries are frequently just as reluctant to "import inflation"; and in times of widespread laxity in the field of monetary policy we must sympathize with their attitude. Their monetary authorities have often postponed applying what are called the rules of the game as long as they could. They have combatted the tendency toward an increase in their own money supplies caused by the surplus in their balances of payments until the pressure became so strong that, with the instruments at their command, they were powerless to resist it. Thus those countries which are the pacemakers of inflation drag the others along with them. The fact that they do not follow the rules of the game, or else follow them too late, leads to world inflation.

(6) Some people say that it is a rule of the game of the gold exchange standard that surplus countries should lend to deficit countries or to third countries (in, say, the "underdeveloped" group) in order to allow the deficit countries to reduce their own lending to such third countries. More generally they argue that countries with surpluses should always manipulate their unilateral transfers so as to offset their surpluses and in this way to finance the deficits of other countries. We have only to imagine an extreme case in order to see that if this procedure were really made a "rule of the game" the consequences would be disastrous. It is true that if all surplus countries lent amounts equal to their surpluses to the deficit countries, no shortage of international liquidity could arise, nor would any country ever get into a balance-of-payments crisis. But the fact that deficit countries could always rely on getting their deficits financed by the surplus countries would remove all incentive toward taking action to get rid of the deficit. Indeed each country would have an incentive to inflate more rapidly than other countries as a means of drawing on the latter's resources. Such a system would be extremely inflationary.

It is wrong also to argue that because a country has a surplus in its balance of payments it is a "natural" capital exporter and should therefore export long-term capital to the extent of the surplus. The latter is usually merely an indication of a cost level that is low relative to the cost level in other countries.

(7) There is a lack of symmetry in the gold exchange standard not only because a key-currency country can run a deficit in the balance of payments much longer than non-key-currency countries can, but also for another reason. A key-currency country, unlike a non-key-currency country, cannot very well devalue its currency, no matter how bad its balance-of-payments position becomes. The reason is that devaluation might wreck the gold exchange standard. The mere fear that the key currency may be devalued will cause a run on it. This cannot be entirely avoided even if the "esprit de corps" among central banks prevents them from joining in the run. For this "esprit de corps" will not go so far that when foreign commercial banks and individuals convert their key-currency balances into the currencies of their countries the central banks acquiring these balances will refrain from turning at least part of them into gold. This movement alone may cause a loss of gold for the key-currency country greater than its stock of free gold can cover. But even if this extremity is not reached, the fear of a repetition of the devaluation some time in the future will very likely undermine people's willingness to accumulate further balances in the key-currency country. The gold exchange standard can work satisfactorily only if there is absolute confidence in the key currencies.

The proposal for giving a gold guarantee on dollar balances held by foreign monetary authorities is to be seen in this light. It is true that such a guarantee might turn out to be very expensive for the United States, supposing that the additional balances which foreign monetary authorities acquired in consequence of a devaluation were actually used at some time to cover deficits in their countries' balances of payments. For this reason it is probable that giving a gold guarantee would be tantamount to freezing the gold value of the dollar at its present level. But this would not be disaster. It is, as I said before, a condition for the continued working of the gold exchange standard that the gold value of the key currency should be kept stable. Failure to grant a gold guarantee leaves doubts in people's minds of the determination of the key-currency country to maintain this stability. Here I have been talking in terms of a single key-currency country. The wider, however, the circle of key currencies is drawn, the larger will be the number of currencies which must carry the gold guarantee and the more rigid therefore will the exchange rate structure become. This consequence has its advantages and its disadvantages.

(8) Cooperation between central banks in the foreign exchange market has made great progress in recent years. But I think it should be limited to giving short-term assistance; e.g., for the purpose of offsetting the disturbing effects of flows of short-term funds.

I would not support the proposal that foreign monetary authorities should come to an agreement for funding a large part of their present dollar balances or, in other words, for converting them into medium- or long-term dollar securities. (Incidentally, this proposal implies an admission that the volume of international reserves now held by countries other than the United States is more than adequate rather than the reverse.) Funding would allow the United States to continue with a deficit in its balance of payments much longer. For the improvement in the U.S. ratio of gold to short-term foreign liabilities, and the reduction in the international reserves of the foreign monetary authorities, would both be factors favoring a new accumulation of dollar balances. But it is, to my mind, doubtful whether the removal of the pressure on the United States to correct its balance-of-paymens position would really be to its own advantage or to that of the rest of the world.

Cooperation between monetary authorities might conceivably go beyond their concerted action in the foreign exchange markets. They could, for example, try to coordinate their domestic monetary and budgetary policies so as to minimize the disequilibrating effects on balances of payments caused by the lack of synchronization of booms or recessions in the different countries. This type of cooperation would be aimed at eliminating some of the sources of disequilibrium in the "basic" balances of payments, and would thus tackle the balance-of-payments problem from a much more fundamental angle than would cooperation that is restricted to action in the foreign exchange market. This type of cooperation is, however, probably still a long way off.

The positive suggestions that emerge from this comment on the gold exchange standard are these:

(1) The maximum spread between buying and selling rates for foreign exchange should be widened somewhat.

(2) The number of key currency countries should be increased.

(3) The key currency countries should give gold guarantees on balances held in their currencies by the monetary authorities of other countries.

(4) The monetary authorities of the key currency countries, at least, should make an effort to coordinate their business cycle policies.

Mr. LUTZ. I would like to make a few comments on particularly two problems. The first one is the difference in the functioning of the gold standard as we knew it and the gold exchange standard as we have it now; the second one is the question whether countries keep to the rules of the game of the gold exchange standard.

In my written statement I have made some constructive suggestions as to how the standard could be developed but I am not now going to talk about the future of the international currency system.

Now, the first point I want to discuss, under the general heading of the difference in the functioning of the gold standard and the gold exchange standard, is the role of gold under the two standards. In both standards it plays the role of a means of payment for the settlement of international accounts; but does it still fulfill the function which it used to fulfill under the gold standard of setting a limit to the monetary expansion of the world?

Under the gold standard the money supply was tied to the amount of gold, which meant that if gold production was too small, the standard worked in a deflationary way; if it was excessive, it worked in an inflationary way, but the monetary gold stock always set a limit to monetary expansion in the world.

Is this still true under present gold exchange standards?

The facts seem to suggest that the answer is no. We had inflation in the world ever since the end of the Second World War. There were some interruptions, but on the whole the trend of prices was upward. It is quite clear that if we had been on a gold standard we would not have had this inflation. On the contrary, we would probably have experienced deflation because the production of gold added to the monetary stock less than was required to keep pace with the growth of world output. It is true, of course, that if we had been on the gold standard, gold production would have been bigger than it actually was and world output would probably not have risen as fast as it actually did, but nevertheless I think it is true to say that, under the gold standard, we would have experienced deflation rather than inflation. So it looks as though gold no longer sets a limit to monetary expansion in the world.

It is for this reason that some, in particular Professor Rueff in France, are of the opinion that the gold exchange standard is an inflationary standard. But I would say that gold acts as a limit to monetary expansion even under the gold exchange standard, although monetary expansion comes up against the limit later than under the old gold standard.

As long as the rest of the world is willing to accumulate dollars, gold does not act as a brake to the expansion of the supply of money; but sooner or later there will come a point at which the ratio of gold to foreign liabilities of the key-currency country is so adverse that other countries will cease to accumulate dollars; and then both begin to act as a brake on the money supply. We may approach this point. Up to now, however, the brake did not work.

The second point I want to make is that the gold standard was what I would call a symmetrical standard whereas the gold exchange standard is not symmetrical. This is for several reasons. First of all, under a gold standard a country loses gold only if it has a disequilibrium in its balance of payments. Under the present gold exchange standard this is still true for nonkey currency countries. But the United States as a key currency country can lose gold although it has an equilibrium in its balance of payments simply because some other country has a disequilibrium.

Assume, for example, that Germany has a deficit in her balance of payments and loses dollars to the United Kingdom and to Switzerland. Now the United Kingdom and Switzerland hold practically all their foreign exchange reserves in the form of gold, whereas Germany has approximately 60 percent gold and 40 percent dollars. If Germany loses dollars to these two countries, they will change them into gold and the United States will lose gold although its balance of payments is in equilibrium. This is a nonsensical result; it makes no sense that the money market in a country is upset simply because another country has a disequilibrium in the balance of payments. There is therefore merit in the suggestion which Dr. Posthuma, one of the directors of the Netherlands Central Bank, made to the effect that countries should keep an identical and fixed proportion of gold to dollars. He suggested 60 percent gold and 40 percent dollars. I think this is a very sensible suggestion, but I know that many European central banks don't like the suggestion.

The second asymmetry is that under the gold standard each country has to react in the same way when it has a deficit. This is also true for the nonkey currency countries under the present standard. But the key currency country can go on having a deficit much longer than the nonkey currency countries can, because the latter are willing to accumulate its currency. Under the gold standard, the United States would by now have lost most or all of its gold and the balance of payments would have been forced into equilibrium a long time ago.

Not only *can* the key currency country go on longer having a deficit than nonkey currency countries, but it *must* have such a deficit in the long run in order to supply the world with sufficient international liquidity in the form of dollars; this is so as long as gold production is inadequate.

Chairman DOUGLAS. You made a most significant statement. Are you saying in effect that the gold exchange standard has only worked because the United States has had a deficit in its balance of payments?

Mr. LUTZ. Yes, because otherwise the other countries would not have gained enough international reserves. If the international reserves consisted entirely of gold, they would increase by 2 or 3 percent a year. But world output or international trade increased by something like 6 percent a year. So international reserves which, broadly speaking, have to keep pace with the development of international trade or world output would have become very short without the deficit in the American balance of payments.

Chairman DOUGLAS. Excuse me for interrupting. Suppose, then, we were to balance our international payments as we are being urged to do. What then will happen to the gold exchange standard and what will be available to eke out the supply of gold? Perhaps I am anticipating your point.

Mr. LUTZ. For the moment, there is too much liquidity in the world although some individual countries may still be short.

So if the United States balances its accounts now, it would not mean that we would immediately get into a position of an overall shortage of international resources. But after some years it would be necessary for the United States to run a deficit again in order to provide the rest of the world with international resources, except if—and this is my positive proposal—the world could get itself to use also other currencies as key currencies. If we were to widen the circle of key currency countries, the United States could be in equilibrium and yet international reserves could grow by more than the monetary gold stock. If, under the present system, Germany has a surplus and France a corresponding deficit, the French pay dollars to Germany. The total international reserves remain unaffected. But if the Germans were willing to hold francs, the international reserves would grow by the amount of the francs the Germans are accumulating. But if the dollar is the only key currency, the United States will have to have a deficit in the balance of payments if international reserves are to prove sufficient.

Chairman DOUGLAS. You say we will have to have it. Why should we have to have it? Why should we be compelled to bear the full burden of international liquidity? Why should this be our sole task?

Mr. LUTZ. Well, of course, this country doesn't have to have a deficit. But I say if it doesn't, then there will be, sooner or later, a shortage of international liquidity except if other currencies are also used as key currencies.

Senator MILLER. Would the Senator yield for a question at that point?

Chairman DOUGLAS. Surely.

Senator MILLER. Professor Lutz, you say that gold output would be too low to permit the expansion of international liquidity. On what basis do you say that it is too low?

Mr. LUTZ. Well, I compare——

Senator MILLER. Or would be too low.

Mr. LUTZ. I just compare the increase in the monetary gold stock due to gold production with the expansion of, let us say, world output, or international trade which is perhaps a preferable yardstick.

Now, international trade expands at the rate of 5 to 6 percent, something like that, per year. The gold production adds to the monetary gold, at the yearly rate of something like 2 to 3 percent, if I remember right, in any case, a much smaller percentage than the one by which international trade expands. This means that if the gold were the only international reserve medium, deflation could hardly be avoided.

Senator MILLER. Do you say that for every $1 of increase in international trade, you would have to have a certain amount of additional gold supply? That it would be directly related to the expansion of international trade?

Mr. LUTZ. I wouldn't be as strict as that, but on the whole I would say if international trade grows, international liquid reserves must grow, too. Perhaps not by exactly 6 percent, if international trade grows at that rate, but not far short of that.

Senator MILLER. And the fact that international trade is a back-and-forth proposition with perhaps a turnover of several times a year would not affect your answer?

Mr. LUTZ. No. International reserves are required to pay for deficits in the balance of payments. Now, a deficit of, let us say, 5 percent

of the total exports of a country is, in absolute quantity, greater the larger that country's volume of exports is. Therefore, in order to have sufficient international reserves in 10 years to take care of a deficit, let us say, of 5 percent of exports, they have to be much bigger than they must be now, if trade continues to grow at the present rate. I don't know whether I made the point clear.

Senator MILLER. Yes, you have.

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

Professor Lutz, I am glad to join my colleagues in welcoming you to the committee, and, as I have been making this point which you are making constantly, I welcome such distinguished academic support for this thesis.

May I ask you this: Are you acquainted with the Federal Reserve System in the United States?

Mr. LUTZ. Yes.

Senator JAVITS. And will you describe for us the difference between how the Federal Reserve System builds up credit to meet an expansion of the American economy and how the world monetary system builds up credit for increased world trade?

Mr. LUTZ. The question is, how does the Federal Reserve provide the necessary backing for an expansion of credit by the commercial banking system?

Senator JAVITS. For expanded economic activity. In other words, in response to Senator Miller's question you said that the expanded economic activity of the world requires certain backing, and you say it has got to be in gold. Now, that isn't true in the United States. We have expanded economic activity and we are losing gold. As a matter of fact, we have suffered a decline in gold since the end of 1961 from $16.9 to $15.6 billion at the end of October 1963 and yet we have maintained a very stable price level. We have not had inflation. The money has not been debased.

Now, will you describe for us the difference between the mechanism at work in the United States upon which economic activity is based and the mechanism at work internationally which you have just referred to in your answer to Senator Miller's question?

Mr. LUTZ. Well, in the United States if the commercial banks expand credit they have to have reserves for the increased deposits which they create by expanding credit. These reserves consist of balances held by commercial banks in the Federal Reserve banks. Now, the Federal Reserve System has the power to add to these balances as it sees fit by open market operations, or it can increase the liquidity of the commercial banks by lowering the reserve requirements. If the Federal Reserve System believes that the right thing to do is to stimulate credit expansion by commercial banks, it strengthens the reserve positions of the commercial banks by the methods I have described. In the international field we don't have a central bank which can act in this way. Such a world central bank could perhaps be created, but for the moment we don't have it. Now the only way in which international reserves can increase is either by gold production or by an accumulation of dollar balances. And that requires a surplus in the balance of payments for those countries which accumulate these balances. The reserves cannot be provided by a world central bank, at least not yet.

Senator JAVITS. Now, the chairman very kindly corrected me out of his great knowledge, and I don't say that lightly at all because I have enormous affection and respect for him, that gold as a source of international credit is supplemented by holdings of dollars and other foreign currencies.

Chairman DOUGLAS. Holdings by other countries of dollars and pounds.

Senator JAVITS. That is exactly right.

Mr. LUTZ. Yes.

Senator JAVITS. Now, what I would like to question you on again is this. Assume that the United States takes herculean measures of many kinds, as it has already taken, and eliminates or substantially eliminates its international imbalance of payments. Then the world will not have available, let us say, more than what we would consider to be a tidy situation, $500 million, let us say, at the most a billion dollars in additional liquidity. Then what would happen, in your judgment, to the other countries of the world who are now getting the benefit of this imbalance which we are suffering and have been suffering for a very considerable number of years?

Mr. LUTZ. I want to make one point clear, first of all. If the United States has a deficit and this is partly financed by other countries accumulating dollar balances, I don't know whether one can say that this is of benefit to the other countries or to the United States. It is perhaps a question of judgment which way to put it. By getting its deficit financed, the United States draws on the resources of other countries; and this seems rather to benefit the United States.

If the United States really succeeded in removing the deficit, the reserves of other countries would cease to increase except by the amount of gold that comes in; this wouldn't do any harm for, let us say, 5 to 10 years because as I said before international reserves are at present very high, higher than necessary. I say, therefore, that the world could afford an equilibrium in the balance of payments of the United States for some years to come, without getting into trouble on that score. But at some time in the future the United States would have to start a deficit again in order to provide international liquidity unless we adopt another currency standard.

Senator JAVITS. Or unless we found some substitute for the need of gold accretion for that purpose.

Now, you assume a static situation regarding the average annual increase in world trade, do you not?

Mr. LUTZ. Yes.

Senator JAVITS. It should be the aim and objective of the world to materially accelerate that, should it not, due to the fact that the gap between the newly developing countries in terms of standards of living and the developed countries is widening rather than narrowing today?

Mr. LUTZ. I would agree.

Senator JAVITS. So we have to do better than we are doing now and that will the sooner bring our crisis toward an end, will it not?

Mr. LUTZ. Yes. The trouble with the gold exchange standard as we have it now is the paradox which is inherent in it. The paradox is simply this, that on the one hand America has to have a deficit in order to provide sufficient international liquidity. On the other hand, America can't go on forever having deficits because other coun-

tries will sooner or later cease to accumulate dollars. We have to overcome this paradox, and my suggestion is to "enlarge" the standard so that other currencies will also be used as key currencies. Then the burden could be lifted from the United States and shifted to other countries.

Senator JAVITS. How would we go about adopting a multiple currency standard?

Mr. LUTZ. I think the United States, once it achieved a surplus in its balance of payments, ought to acquire and hold not only gold but also foreign exchange—francs and marks and so on. If the United States started holding other currencies, the other countries are likely to hold other currencies also besides dollars, so the multiple currency standard might come into existence automatically once the United States has started the ball rolling. This is particularly true as the other countries might begin to regard holding dollars more risky, in view of the ratio of U.S. gold to liquid liabilities to foreigners, than holding the currency of a country which has no liabilities to foreign monetary authorities yet and has a big gold stock.

Senator JAVITS. Professor Lutz, I will defer any further questions in order to permit you to develop your thesis.

Mr. LUTZ. Well, I was talking about the various asymmetries in the gold exchange standard compared with the gold standard, and I pointed out that one of the asymmetries is that the key currency country can go on with a deficit much longer and even has to have a deficit in the long run for the reasons I have outlined, whereas this is not true for the nonkey currency countries.

The next asymmetry in the gold exchange standard compared to the gold standard is this: The key currency country cannot very well devalue its currency. Now, one can understand two different things under devaluation. One meaning is devaluation vis-a-vis other currencies; that is, lowering the dollar exchange rate vis-a-vis the pound sterling or German marks, and so forth. I think the United States could hardly devalue in this sense even if it wanted to because the other countries would follow.

They don't want to lose their competitive position in the world market and they don't want to make a loss on their dollar holdings.

The second meaning of devaluation is devaluation with respect to gold only, while all the exchange rates remain the same. Although there is nothing to prevent the United States from raising the gold price, such action would probably wreck the gold exchange standard. Raising the gold price has to be done by Congress. So the move would be discussed openly and immediately a run on the dollar would set in. People would turn their dollars into gold before the world price was raised. This would create a very difficult situation in the foreign exchange markets. And even if this could be avoided, the fact alone that the gold price has been raised would lead other countries to believe that the dollar is no longer safe. What happens once can happen a second time, and other countries would probably no longer be willing to hold dollars. Therefore, the key currency country can hardly devalue, whereas the nonkey currency countries can. This is another asymmetry in the present gold exchange st[illegible]ard which doesn't exist under the gold standard.

Of course, one could discuss the problem of the gold guarantee from this point of view, but unless I am asked, I am not going to say anything about it. I did so in the written statement that I submitted.

There is one more point I would like to make in this connection. I noticed that some American economists have suggested a widening of the gold points by which I think they mean a widening of the spread between the selling and the buying price for gold. Now, I don't know what the purpose of this suggestion is. If it is simply to allow a central bank, in this case the Federal Reserve, to operate in the market for foreign exchange so as to prevent short-term capital flows, what is necessary is to widen the maximum spread between the buying and selling rate for the dollar in other countries. The pound sterling can fluctuate at present between $2.78 and $2.82 per pound. Now, this spread could be widened still further and the central banks could then, by operating in the spot and forward exchange market, fight more effectively against, and maintain a higher interest rate differential between countries without, attracting short-term funds.

Now, I want to make a few remarks about the rules of the game. Have the countries kept them? First, we have to know what we mean by the "rules of the game." Take a nonkey currency country which has a deficit. It is possible for such a country to devalue. So if we include devaluation under the rules of the game then whatever a deficit country does—except perhaps imposing quantitative restrictions—comes under the "rules of the game." I think therefore we should consider devaluation an exception and not a rule of the game. In this case, the rule of the game would be that a deficit country somehow follows a more restrictive monetary or budgetary policy in order to attract funds and create or increase the export surplus of its country. And the answer to the question whether nonkey currency deficit countries have kept to these rules is that they occasionally have done so. But very often they have not.

The United Kingdom, for instance, has often acted according to the rules of the game. At one time it had a bank rate of 7 percent, which is an extraordinarily high bank rate, for the sole purpose of protecting the balance of payments. Other countries, for instance France before 1958, did not keep to these rules and went on inflating in spite of the deficit in the balance of payments. They borrowed from the IMF, from other sources, and finally had to devalue. And the reason for such behavior is that countries quite understandably do not want to deflate if they have a deficit in the balance of payments. What happens to economic activity at home is for most countries of greater importance than what happens to the balance of payments.

Take now the surplus countries. They don't keep the rules of the game either. The best example is Germany in that respect. Germany had a surplus in the balance of payments for 10 years and is beginning to once again. The rules of the game would imply that Germany would have followed an expansionary monetary policy in the last decade. It has not done so. On the contrary, Germany followed a very restrictive monetary policy because it did not want to "import inflation."

A surplus in the balance of payments for Germany means creation of money at home. This makes the banks liquid. They could engage in credit creation. This would be inflationary. So, because Germany, more than any other nation, is afraid of inflation, the monetary authorities did not follow the rules of the game but tried to offset the internal increase in liquidity by open market operation and raising reserve requirements in order to prevent this inflation. And only

when the Bundesbank no longer had the power to offset the inflationary effect of the balance-of-payments surplus did it desist from this policy and returned to a sort of cheap money policy; but, I repeat, its actions were forced by circumstances and were contrary to its wishes.

So neither the deficit countries—I am now talking about non-key-currency countries—nor the surplus countries have constantly kept to the rules of the game. The former because they wanted to avoid deflation; the latter because they wanted to avoid inflation. And then, of course, there is no force which will remove the surpluses or deficits in the balance of payments. So the standard doesn't work very well because the nations, for understandable reasons, don't stick to the rules of the game.

What can be done I just don't know because I am sure that countries will always act in that way. The countries will always look first at the domestic scene. And as long as they do that they will not follow the rules of the game. This is what happened in the last 10 years; and the result is that the deficit countries blame the surplus countries and the surplus countries blame the deficit countries for the situation, yet they are both at fault. The gold-exchange standard will always be a clumsy standard and I don't see how this clumsiness can be overcome if we maintain the standard. However, it is not my task to talk about the pros and cons of other standards, such as for instance a regime of flexible exchange rates.

Chairman DOUGLAS. Thank you very much.

Dr. Bloomfield, you may proceed.

## STATEMENT OF ARTHUR I. BLOOMFIELD, PROFESSOR OF ECONOMICS AND FINANCE, UNIVERSITY OF PENNSYLVANIA

Mr. BLOOMFIELD. Mr. Chairman, I am sorry I did not have a copy of my statement prepared in time for the committee to see it beforehand, but I had it typed up last night and with your permission I would like to read it now.

To some degree I handle a slightly different phase of the problem than Dr. Lutz did, but I think that some of it covers ground that he did. And I hope you will also forgive me if there is perhaps a little bit more history in this statement than is customary for most statements, but I was guided in large part by the questions put to me by the committee.

The essential features of the present international monetary system may be described very briefly as follows. The currencies of the member countries of the International Monetary Fund are pegged in terms of gold or dollars, and thus indirectly tied to each other, with members being obliged to maintain their exchange rates within a maximum margin of 1 percent on either side of parity. Exchange rate parities are not rigidly fixed, but can be periodically altered by members under circumstances of "fundamental disequilibrium."

The official monetary reserves of member countries are held, in varying proportions, in gold and foreign exchange, almost exclusively dollars and sterling. With these reserves, monetary authorities can intervene in the foreign exchange market to maintain their exchange rates within the specified spread around parity. Member countries

have, in addition, assured drawing rights to a certain amount of the Fund's pool of currencies and conditional drawing rights to larger sums.

The special role in the system of the dollar and sterling as key currencies stems from their widespread use in international payments and, in the case of the former, from its convertibility into gold at a fixed price for foreign and international monetary authorities. During the past decade the proportion of dollars in aggregate official monetary reserves has risen sharply under the impact of continuing U.S. balance-of-payments deficits.

All of the leading currencies are today freely convertible into other currencies for current account transactions from the viewpoint of nonresidents of the countries concerned, and to a very substantial degree from the viewpoint of residents as well. Most countries, including the industrial ones, maintain certain restrictions on capital movements, especially outflows of capital by residents. But such restrictions, which are explicitly sanctioned by the Fund Agreement, have been progressively reduced by the industrial countries in recent years so that there is in fact a fairly high degree of freedom of capital movements.

In addition to the existence of the Fund, the code of rules it has established, the aid it provides, and its use as a forum for international contacts and consultation, there has in recent years developed an elaborate network of formal and informal arrangements between the leading countries designed to strengthen the foundations of the system, and especially the position of the key currencies, and further to promote international monetary cooperation.

The international gold standard that prevailed over a large part of the world from 1880 to 1914 had some similarities to, but also marked differences from, the present system with which it is often compared and contrasted. The leading currencies were defined in terms of gold, and central banks—or treasuries or other official agencies where central banks did not exist—stood ready to buy and sell gold at fixed prices in terms of local currencies, with a narrow and sometimes variable margin between the buying and selling prices. While exchange rates were kept within the gold points mainly by the action of private gold arbitragers most of the central banks or other official agencies held some foreign exchange mostly sterling—along with gold in their monetary reserves with which from time to time they intervened in the foreign exchange market to keep exchange rates inside the limits of the gold points. While foreign exchange holdings constituted a much smaller proportion of total official monetary reserves than today, it would not be incorrect to say that the pre-1914 system had many of the elements of a gold-exchange standard, with Great Britain being the dominant reserve center and the pound sterling being used as the major means of international payment.

From 1880 to 1914 the exchange rates of the various gold-standard countries remained fixed within the narrow limits of the gold points, despite the absence of any exchange restrictions on current or capital account or of direct import controls. Only a trifling number of countries was forced off the gold standard, once adopted, and devaluations of gold currencies were highly exceptional. Yet all this was achieved in spite of a volume of reserves that, for Great Britain and a few other leading countries, was amazingly small, and in spite of only a mini-

mum of international monetary cooperation and a complete absence of international agreements or commitments on monetary matters such as exist today. Despite occasional shocks to the system and occasional threats to the continued convertibility of certain of the leading currencies, widespread confidence existed in the continued stability and convertibility of the leading gold currencies, with the result that private short-term capital movements were mainly equilibrating in character and sudden or large-scale conversion into gold or transfer to other centers of foreign exchange held by monetary authorities were kept to a minimum.

It is often said that the successful operation of the pre-1914 gold standard depended upon the fact that monetary authorities played the so-called rules of the game according to which domestic policies were supposed to be subordinated to the requirements of external equilibrium, even if necessary at the expense of undesirable deflationary or inflationary pressures at home. Thus, central banks were supposed to raise discount rates and reduce their domestic assets when they were losing reserves, that is, to contract credit, and to lower discount rates and increase their domestic assets when they were gaining reserves, that is, to expand credit. In this way central bank action was supposed to reinforce rather than to offset the self-adjusting tendencies of balance-of-payments deficits and surpluses upon interest rates, the money supply, money incomes, and prices, and thus upon capital movements and the trade balances. While admittedly convertibility into gold at a fixed price was the dominant objective of central banking policy, the statistical evidence, such as it is, does not give strong support to the view that the rules of the game were systematically played, or that economies were frequently subjected to alternating waves of deflation or inflation because of the requirements of external balance. Admittedly, the self-adjusting mechanism of the balance of payments, to the extent that it did come into play, had more scope to operate than it does today, but there is little clear-cut evidence that its functioning was systematically strengthened and accelerated by central bank action.

Whatever might have been the importance in actual fact of the rules of the game before 1914 and under the revived gold standard of the late twenties and early thirties, the drafters of the Articles of Agreement of the International Monetary Fund were determined that member countries would not, as far as possible, be forced to pursue deflationary policies productive of large-scale unemployment and decline of real output in order to protect existing exchange rates or be forced, if they could avoid it, to acquiesce in persisting deflationary or inflationary pressures arising from, or coexisting with, balance-of-payments deficits and surpluses, respectively. Thus, although the Articles of Agreement accepted the general principle of exchange rate stability and, after an undefined transitional period, removal of exchange restrictions on current account, members were to be free to alter their exchange rate parities in case of "fundamental disequilibrium," subject only to Fund concurrence if the proposed change exceeded 10 percent of the initial par values. The Fund was authorized to make its resources available, under adequate safeguards, to member countries in payments deficit, thus providing them with the opportunity to correct the imbalance without resort to measures destructive of national or international prosperity. The right granted to members to impose

controls over capital movements, even in the posttransitional period, was similarly adopted to insure, among other things, that an autonomous interest-rate policy by a member aimed at the achievement and maintenance of domestic economic stability would not run the risk of being counteracted by disturbing movements of capital provoked by differing interest rates abroad or other developments.

As we all know, however, things have not worked out quite as expected. With the notable exception of the widespread exchange devaluations in September 1949, exchange rate adjustments have been quite infrequent, in large part because member countries have displayed relatively little enthusiasm for this instrument as a means of correcting large or persisting payments imbalances, because in the early postwar years tightening or easing trade and exchange controls usually proved a more attractive alternative, and because other measures, not involving seriously adverse effects upon output, such as disinflation of excess demand, often proved adequate to the task. Besides, experience has shown that anticipation of exchange rate adjustments, as well as actual exchange adjustments of leading currencies, have unleashed massive speculative movements of short-term funds which have magnified existing payments imbalances and undermined confidence in the continuance of the whole exchange rate structure. In particular, it is increasingly recognized that a devaluation of the dollar, apart from the losses that it would inflict upon foreign holders of dollars, would greatly weaken if not destroy their continued willingness to hold dollars, lead to large-scale conversions of existing foreign dollar balances into gold—which would wipe out a large volume of international liquidity—and probably destroy the gold-exchange standard itself. Similar considerations would apply, though with less force, in the event of a devaluation of sterling.

Finally, with regard to private short-term capital movements, experience has shown the difficulty of curbing speculative or other large-scale movements of such funds even with exchange control and suggests that the difficulty would be especially great in the absence of some measure of control or supervision over current-account transaction as well. During the past few years, therefore, as the leading industrial countries have, in keeping with the Fund agreement, dismantled their exchange restrictions on current account and accepted the obligations of article VIII, they have also permitted a very substantial degree of convertibility on capital account as well.

Now, it is clear that if, under the present international monetary system, the leading countries are to resort to exchange rate adjustments only in extremis; if payments imbalances are to be prevented as far as possible by monetary authorities from exerting undesirable deflationary or inflationary pressures upon domestic economies or if authorities do not want to be forced to pursue undesirable deflationary policies to correct such imbalances or to adopt other measures prejudicial to domestic or broader international objectives; and if, finally, reimposition of exchange restrictions is virtually ruled out under article VIII of the Fund agreement and a retreat to exchange control over capital movements would be considered a retrogressive step, then at least three basic requirements must be satisfied if the system is to work at all satisfactorily under these restraints in the future.

First, there must be some alternative means for correcting large and sustained payments imbalances so as to keep countries' inter-

national accounts in reasonable equilibrium over a period of years, and some means for helping to keep the emergence of such imbalances to a minimum.

Second, there must be available to individual countries adequate reserves or access to credit arrangements to enable them to finance deficits on basic account while needed measures, consistent with domestic goals, are being taken to correct them; to help discourage speculative attacks, especially on the key currencies; and to enable the financing of such speculative and other large-scale short-term capital movements as do occur. Third, as a counterpart to the other two conditions, there must be the closest consultation, cooperation, and as far as feasible coordination of policies among the leading countries of the system. All three of these conditions are of course closely interrelated. They do not of course exclude the possibility that other requirements may also be needed. Special additional measures and rules may still be needed to protect the key currencies. In the context of the present-day situation, moreover, it need hardly be mentioned that the early elimination of the present payments deficit of the United States is a categorical imperative.

The comments that follow will be confined exclusively to the approximately dozen economically advanced countries upon which the satisfactory future functioning of the present international monetary system or some variant thereof will primarily depend. This does not of course mean that the pressing economic problems of the underdeveloped countries are of no importance. But they are problems of a special order requiring special treatment and they will not be solved by the mere provision of additional liquidity. In any case, the balances of payments of most of these countries are presently subject to some measure of control by exchange and direct trade restrictions.

So far as concerns the supply of international liquidity, there appears to be general agreement that it is adequate today and in the immediately foreseeable future for the problems at hand, especially if allowance is made for the recent increase in Fund quotas, the formal arrangement between the Fund and 10 member countries enabling the former to borrow up to an aggregate equivalent of $6 billion of the nations' currencies in case of need, the reciprocal currency or swap arrangements between the United States, on the one hand, and 10 countries and the Bank of International Settlements, on the other, and other less formal bilateral undertakings between central banks for the provision of aid in the case of need. But there is considerable concern as to the adequacy of international liquidity in the future as the volume of international transactions grows and as the U.S. payments deficit, which has been the main source of liquidity in the recent past, is gradually eliminated. Numerous plans have been advanced to meet the problem of future liquidity needs and some of them would be consistent with the gold exchange standard in its present or somewhat modified form. The problem is currently being examined by representatives of 10 of the leading Fund members and by the Fund itself, and will be discussed at another session of these hearings.

I propose, rather, to confine myself to a few comments on the other problem posed earlier, on which there has been far less discussion. What is to be the means of correcting large and sustained payments imbalances that will inevitably arise in the future within the framework of a convertible fixed exchange rate system, in its present or a

somewhat modified form, where the leading countries are anxious to pursue policies aimed at domestic stability at high levels of production and employment? In short, can some new set of "rules of the game," analogous to but differing in kind from the old, be formulated for payments adjustment under such a system? While the provision of more adequate reserves would permit more time for the orderly correction of imbalances without sacrifice of basic domestic and broader foreign goals, in themselves additional reserves would provide no escape from the responsibility of maintaining reasonable balance-of-payments equilibrium for individual countries over a period of years. And it is highly doubtful that any new arrangements for additional liquidity provision would permit a country to avoid that responsibility.

Now, let it first be noted that many payments deficits reflect cyclical or random forces that tend to cancel out over a period of years, or transitory influences that disappear of their own accord, so that with adequate reserves the countries affected would be able to ride out such deficits even without corrective measures. Let it also be noted that under certain circumstances even resorting to the old-fashioned rules of the game, far from being disruptive to internal stability, would actually be conducive to it. Thus, if a country's payments deficit were attributable to domestic inflation, disinflationary measures acting on excess demand would not only help to promote domestic stability, with little or no sacrifice in terms of real output and employment, but also help to contribute to the elimination of the payments deficit. Similarly, a payments surplus associated with internal recessionary pressures would justify measures of domestic expansion, with desirable effects on both the internal and the external situation.

Regrettably, the combination of external-internal circumstances that have faced the leading countries in recent years have not been mainly of this sort. Rather they have reflected the coexistence of persisting payments deficits with recession or a high rate of unemployment—the United States—and of persisting payments surpluses with internal inflationary pressures—continental Western Europe. Efforts to correct the internal situation by expansionist and anti-inflationary policies, respectively, would tend to make the payments imbalances worse, while efforts to correct the payments imbalances by deflationary or expansionist policies, respectively, would tend to make the internal situation worse. It is in such circumstances that monetary authorities, under a fixed exchange rate system, tend to face their most painful dilemma. And, unless the deficit country is provided with ample reserves, the pressure upon it to correct its payments imbalance is likely to be greater than the corresponding pressure on the surplus country.

Finally, let it be noted that in many cases it may be very difficult, if not impossible, fully to offset the domestic effects of prolonged payments imbalances, even with the greatest official determination to do so. The more dependent a country upon foreign trade, and the less effective its stabilization tools, the more difficult will this be. Even the countries of continental Western Europe in recent years have been unable, fully, to restrain the inflationary pressures generated in substantial part by their continuing payments surpluses, and to some extent, and in part because of deliberate policy decisions, have yielded to them. But to the extent that the traditional mechanism of adjustment has thus been able to work, its effects in reducing the payments surpluses have been slow in coming.

Having made these qualifications, we are still left with the problem with which we started: how to correct persisting imbalances in the future that are not merely a reflection of domestic inflation or deflation in a regime where exchange rate adjustments, policy measures disruptive of domestic goals, or direct controls over the balance of payments are not considered acceptable? It would be impossible here to list all of the possible kinds of corrective actions that could be taken. The recent experience of the United States in moving toward the elimination of its deficit, which has had as its counterpart the surpluses of continental Western Europe, indicates some of the range of possibilities. What has already been done, and what is planned for the future, have recently been summarized in President Kennedy's balance-of-payments message to Congress on July 18 and in the statement of Secretary Dillon before this committee on July 8.

The measures already taken, some in cooperation with our European friends, have had the effect, despite some temporary setbacks, of progressively reducing the deficit. The additional measures currently planned should help further to restore balance. They indicate the potentialities of selective action on various items in the balance of payments and of more general actions that would not be seriously inconsistent with domestic or broader foreign goals. On the other hand, some of these measures already taken have been inherently undesirable and it is hoped that they will be abandoned as quickly as conditions permit. They have been forced on us by the urgency of our payments problem and our special responsibilities as a reserve-currency center. And it is to be hoped that we and other countries, if faced with a similar position in the future would, with more adequate reserves, not have to resort to some of the measures that we have taken. But the broad strategy of many of the long-run measures that we have taken and are currently planning—especially an increase in the competitiveness of our economy—should facilitate payments balance and be entirely consistent with this country's basic domestic goals.

The fact that in many of the advanced countries government transactions bulk so large in the balance of payments indicates the possibilities of direct action on the volume of such transactions as a means of working to correct sustained payments imbalances. In all countries, too, there is scope for other selective action on various items in the balance of payments. Some corrective actions also tend, with adequate time allowed, to occur spontaneously by the response of export and import competing industries to the challenge of increased competition that is adversely affecting the balance of payments. These include changes in product design, better service and credit terms, selective price adjustments, modernization of plant, and shifts to related lines of production. These competitive responses could be strengthened by the Government, if need be, by tax incentives, export credit schemes, and export promotion drives, or related measures.

There are also possibilities of closer cooperation between the leading countries in reducing the size of imbalances to begin with, and of keeping such imbalances as do develop within more tolerable limits, by regular consultation, mutual cooperation, and, where possible, coordination of policies. The OECD Committees, for example, have done much through their regular consultations and exchange of information, to obtain a better understanding of the interactions and international ramifications of the policies of the different members

and to work toward a closer harmony of objectives and policies. The most notable successes achieved thus far, through the discussions of the OECD and BIS, have been registered in the area of coordinated operations in the foreign exchange market to curb speculative and other large-scale movements of short-term capital and in a somewhat better coordination of national interest-rate policies. But much might still be done, and can be done, without sacrifice of basic national goals, in such areas as development assistance, commercial and fiscal policies, a more appropriate burden sharing of the costs of the mutual defense of the free world, long-term capital movements, and even wage-price policies.

It is impossible to formalize all this in terms of any simple or unique set of rules of the game applicable to deficit and surplus countries in view of the differing circumstances under which troublesome and widely dispersed imbalances might arise in the future, the differing structure of the balance of payments of the countries in which such imbalances occur, and a host of other considerations. As a general principle, however, the correction of such imbalances should be regarded as a joint responsibility of both deficit and surplus countries, calling for action on both sides, and should be the occasion for close consultation, cooperation, and coordination of policies where feasible. So far as the handling of the present imbalance between the United States and Western Europe is concerned, I believe that this principle has been reasonably well accepted. The International Monetary Fund, through its credit extensions and its contacts and consultations with all of its members, should also in the future be able increasingly to exert a disciplining effect upon the policies of members whose payments are in major imbalance.

Of course, even such actions, along with some fortification of international liquidity that would permit greater time for orderly adjustment of large and sustained payments, may not be enough. At times some basic domestic objectives may temporarily have to be sacrificed in the interests of the international equilibrium, as indeed to some extent they have in various countries. It may be that on some occasions the stubborn undervaluation or overvaluation of a currency may have to be corrected through an exchange adjustment, disturbing though such an adjustment might be for the international community at large if the currency involved is an important one. But these and other unattractive features and dilemmas of the present system would have to be weighed against the pros and cons of some quite different set of alternative arrangements, such as a system of flexible exchange rates.

Thank you.

Chairman DOUGLAS. I want to thank both of you gentlemen for these two very brilliant papers. They are very fundamental.

I am going to ask Senator Proxmire if he has any questions.

Senator PROXMIRE. I concur with the chairman. These are two very enlightening and helpful papers on this complex and difficult subject.

Dr. Lutz and I understand that Dr. Bloomfield agrees, you seem to feel that at the present time it would be a vain act on the part of the United States to devalue the dollar. We could do so but from a realistic standpoint, if we do, it will be followed by virtually immediate and parallel devaluation by other countries. This is very startling to me. I have opposed devaluation, as have other Members of the Congress under present circumstances, and as the President, of

course, has. But this is the first time I have heard top economists say that it would have no effect, no real effect, that there might be some difficulties for a few months but that it would just be followed by an adjustment by the countries in the very near future.

Mr. LUTZ. It is quite true it would not have any real effect as far as the balance of payments is concerned because I am quite sure that the European countries would follow suit and the exchange rates would stay as they are. But, of course, as the gold price would have been raised, that would mean that the reserves of this country would correspondingly increase. Suppose the gold price were raised by 100 percent. That would mean that the gold stock in terms of dollars would now be worth double what it was worth before.

Senator PROXMIRE. I understand that. What I am getting at is the fact that as far as the balance of payments is concerned, this devaluation would not have a substantial effect. I was a little bit persuaded that because of the very small revaluation by West Germany about 2 or 3 years ago it might be possible that some of the surplus countries might not follow, at least for a while, but you seem to feel that the dollar is so dominant that they probably would. Is that correct?

Mr. BLOOMFIELD. It would probably destroy the willingness of foreign countries to hold dollars any longer. That willingness has already been severely strained in recent years, and if we devalued I think, apart from the losses which it would inflict upon foreign holders of dollar balances, it would certainly induce them to convert a substantial part of their dollar balances into gold, thereby wiping out a large stock of international liquidity and probably bringing on the downfall of the gold exchange standard itself.

Senator PROXMIRE. That would be very undesirable.

Now, Professor Lutz, you indicated that key-currency countries may promote world price stability by adjusting their deficit positions to parallel the growth of world trade or international economic growth. I think that you recognize what a fiction this is, in view of the fact that our deficit position is beyond our control really, in the second quarter this year it is one of the worst we have had, although we were struggling, as Senator Javits said, manfully to try to overcome it. So that certainly is a hopeless way to try to affect the international price level. Am I correct?

Mr. LUTZ. I quite agree with that. Although it would be desirable that the key currency country should have a deficit exactly of the size that provides the international community with enough international reserves, it is almost impossible for a key currency country to live up to that condition. One of the reasons is that the deficit is not simply the affair of that country alone; it is a two-way affair because some other country has a surplus. So the size of the deficit does not depend simply on what the deficit country does but also on what the surplus countries do.

Senator PROXMIRE. And rightly or wrongly in our democracies our paramount concern is the economic welfare of our own people. A deflationary policy might or might not seem to have wisdom to many people in international affairs today, but it would be politically impossible even if we thought it was wise, is that correct?

Mr. LUTZ. Yes.

Senator PROXMIRE. Now, Dr. Bloomfield, you answered this question in part but it seems to me that your answer may be construed by many as just postponing the evil day. The question is: What steps can the key currency countries take to promote international price stability while following whatever policies seem wisest to expand their own economies or to restrain inflation? You gave three or four alternatives.

In the first place you said there are alternative means. In the second place you said adequate, more adequate national reserves. And in the third place you said close consultation with other countries and cooperation with other countries.

Now, isn't it true that one of the virtues that the classical economists saw in the gold standard was that it had a degree of economic discipline, that if a country followed inflationary policies it had to pay the price and was soon required to adopt fairly conservative fiscal and monetary policies? There would be automatic corrections—now, what you are advocating is an expansion of international reserves that it seems would weaken and loosen that discipline and lead to a situation in which we can pretty much predict that we are going to have an increased or continued international inflation.

Mr. BLOOMFIELD. Well, I would agree, sir; if you increase international liquidity by some fantastically large amount, you always face the risk that certain countries might be removed completely from any sense of discipline, might inflate, and thereby run constant balance-of-payments deficits which would be financed by this allegedly unlimited supply of extra reserves.

Senator PROXMIRE. As we look at just the industrial countries of the world, we see that, maybe with the exception of the last few months, we have had an experience of substantial inflation, certainly over the last few years. Maybe this is the price we have to pay for the economic growth that we have enjoyed, but there has been sharp inflation in most countries and substantial inflation certainly in European countries, even some inflation here.

Mr. BLOOMFIELD. Well, this has not been, sir, as far as I can make out, because of any marked lack of discipline on their part. I would say the surpluses which Western Europe has undergone in recent years, as I believe I indicated in my statement, were in substantial part due to the balance-of-payments surpluses which they were experiencing. I can think of maybe only one or two cases where there were deliberately inflationary policies. And with regard to the other point you raised—if I may complete the point—I wanted to bring out that a very large amount of liquidity might indeed weaken discipline but I do not think that under any arrangements that might be made in the calculable future for increasing reserves any country would be completely freed from a certain amount of responsibility for its balance of payments, and that the reserves which we would hope for it to get would not be forthcoming unless there were a certain standard of performance on its part.

I would agree with Professor Lutz that the multiple currency standard scheme is one of the possible and likely ways in which liquidity might be increased. But even more so do I envisage the possibility that the International Monetary Fund may further liberalize its lending policies, its resources might be further enlarged, and that more and more of the addition to liquidity in the future might come from

the International Monetary Fund itself. And I am quite sure that in granting aid to individual countries, the International Monetary Fund will make every effort to insure that the borrowing countries exercise the necessary discipline with the use of the reserves which they get.

Senator PROXMIRE. Would both you gentlemen agree that a tax cut substantially increasing the deficit of our Government, at least temporarily, by, say $11 or $12 billion, would have an adverse effect on our balance of payments?

Mr. BLOOMFIELD. Well, sir, I am not——

Senator PROXMIRE. On the basis of your experience? I want Dr. Lutz to answer this, too. You go ahead. You start.

Mr. BLOOMFIELD. Well, I was going to say I don't want to pose here incorrectly as a tax or fiscal expert. I would say that from the longer run point of view the tax cut would be a measure that I think would contribute substantially to an improvement in our balance of payments to the extent that it increases investment, modernizes plant, raises the level of our productivity and ability to compete in the world markets.

On the other hand, I would concede that perhaps in the short run it might to some degree have a less than satisfactory effect upon our balance of payments, but I do not expect it would be one of any major importance because the propensity to import in this country is very small and any increase in income immediately brought about by substantial tax cuts would only spill over to a relatively small degree in increased imports.

I look upon the tax cut mainly from its long-run advantages.

Senator PROXMIRE. I call your attention to one simple fact.

The studies I have seen indicate that in periods of economic expansion the balance of payments has become more adverse, because our imports have increased more than our exports. There is a natural economic classical explanation of this in that our prices tend to rise in times of economic expansion and drop in times of depression.

In recent years, certainly the best periods for our balance of payments, with the exception of the last 3 months because of the announcement by the President of the interest equalization tax, the best periods have been in periods of recession and our worst periods have been in periods of economic expansion.

Mr. BLOOMFIELD. Well, traditionally the U.S. balance of payments has deteriorated in times of prosperity and gotten better in times of recession, and I would say in large part because the initial impetus to world expansion or contraction came from the United States. We were leading the rest of the countries from the time point of view, that is, we expanded or contracted first and that expansion or contraction gradually spilled over to other countries.

Senator PROXMIRE. I don't mean to say I am in favor of depression and against prosperity, but I do mean to say we ought to be realistic and honest in appraising the effects of the policies we take.

Dr. Lutz?

Mr. LUTZ. I think what matters now is the short run. It is certainly true that a country which has a very rapid rate of growth will even without any increase in prices import more, whereas exports will not increase as fast because the increase in demand at home will make it possible and easy for export industries to sell more at home. On the whole, I think the tendency is unfavorable for the balance of payments. Of course, it depends also what happens abroad at the same

time. I would say rapid expansion in the United States would by itself certainly tend in the direction of a deterioration of the balance of payments but, if at the same time foreign countries expanded just as rapidly or even faster, that wouldn't be true.

Senator PROXMIRE. I was assuming conditions were about the same so that there would be a fair basis for comparison.

I would like to ask just one more short question if I may, although my time has expired.

Professor Lutz, you are a professor at the University of Zurich and your country has been characterized by very low interest rates and at the same time a favorable balance of payments. And I am wondering if in your judgment it is possible to have an expansionary monetary policy with reasonbly low interest rates and at the same time cope with the balance-of-payments situation with other policy instruments.

What I am getting at, frankly, is that I am very concerned with the reverse policy which our Secretary of the Treasury seems to be espousing, of loose fiscal policy and tight monetary policy. I feel much more congenial with the latter. It is more conservative. We have much more experience with it.

Mr. LUTZ. It is true Switzerland has low interest rates. And the balance on current account has a great deficit now. But large amounts of capital come in in spite of the fact that the interest rate is lower in Switzerland than in other countries. The capital comes in, but not in order to take advantage of the higher interest rate because such an advantage does not exist. The funds come in because their owners think Switzerland is a safe haven for money.

Senator PROXMIRE. Switzerland is what? Safe?

Mr. LUTZ. Safe. For foreign capital.

Senator PROXMIRE. This confirms my view that the interest differentials are not very important in capital flows.

Mr. LUTZ. Well, I wouldn't——

Senator PROXMIRE. Trade is important. Safety is important. Speculation is important. The interest rate is of some importance but it is only one of a number of considerations.

Mr. LUTZ. If there is some trouble in the world, money flows to Switzerland, and as there is some trouble somewhere all the time, money comes to Switzerland almost continually.

Chairman DOUGLAS. Can you tell us where it comes from?

Mr. LUTZ. The countries from which the funds come change. They are the countries where political or economic troubles exist or are expected. But the circumstances are peculiar and don't exist in other countries.

Senator PROXMIRE. Thank you.

Senator JAVITS. Gentlemen, I would like to first get the areas of agreement between you. You do agree that there is an inherent limitation in the expansion of world credit or trade on the basis of the present international gold exchange standard?

Mr. BLOOMFIELD. Well, I am not sure, Senator Javits, that I would fully agree with that. I would say that certainly we cannot expect gold production itself to provide enough liquidity for the future, and it is quite probable that we will not be able to rely upon substantially further increased holdings of dollars or sterling to contribute to it, but there are many other possibilities of increasing liquidity even

within the framework of the present or slightly modified system. One, as I mentioned before, would be an enlargement of the facilities of the International Monetary Fund and the one which Dr. Lutz had advocated so brilliantly is the multiple reserve currency standard which is something that the authorities of this country also seem to be leaning to.

So I do not mean that the gold exchange standard itself is necessarily doomed to disappear. Maybe we should allow it to disappear. Professor Triffin and others, for example, would want it to disappear. But its liquidation is not inevitable in the foreseeable future.

Senator JAVITS. Could you relate the International Monetary Fund mechanism you just described to the proposal for flexible exchange rates which is favored by some academic economists?

Mr. BLOOMFIELD. I would say with flexible exchange rates the need for reserves becomes very limited or even nonexistent, and probably the need for the International Monetary Fund itself might have to be reconsidered under such a framework, but I do not personally favor such a regime.

Senator JAVITS. Would you like to comment, Dr. Lutz?

Mr. LUTZ. I agree.

Senator JAVITS. Secretary of the Treasury Dillon said, in testimony before us a few months ago, that we can't take in this country more than a year or two of deficits in our international balance of payments on the order of magnitude which we have been experiencing up to now, around $3 or $4 billion a year. What would be your comment on that?

Mr. BLOOMFIELD. Well, I would be inclined to agree with the Secretary for the following reason, that if we have deficits of such continuing scope, it might almost become impossible to induce foreigners to continue to add to their dollar balances unless, perhaps, we gave them, as we have in effect been giving them, marginally some sort of an exchange guarantee on their additional dollar holdings.

Mr. LUTZ. I would agree with that.

Senator JAVITS. Now, assuming that we cannot maintain deficits on our international payments for 2 or 3 years at the present rate, we must look to the results of the investigation by the Paris Club of Ten and the International Monetary Fund to really give us some pretty hard answers, must we not? They are going to report within a year. We certainly need pretty hard answers from them by the time that year expires.

Mr. BLOOMFIELD. Well, I do not think they are going to give an answer to the problem of the U.S. balance of payments as such. This is not what they are committed to do. Their own view is very clear on the subject. They want us to eliminate our deficit as quickly as possible, but, in terms of the need for international liquidity, I think that the world will survive for another year until their report comes out.

Senator JAVITS. Would you say that it would do us any good if we made more of our gold reserves available and freed it of the 25-percent reserve requirement for our currency?

Mr. BLOOMFIELD. I think that would have a very important psychological advantage. I see no reason for locking up part of our gold stock when the only purpose of our gold stock is to be available for use. It will not solve our balance-of-payments problem, of

course, but I think it might, to some degree, add to the confidence that foreigners have in the dollar.

Senator JAVITS. In other words, that if they want gold they would be assured that there is lots of it.

Mr. BLOOMFIELD. That is right. And that the gold will be available for use.

Senator JAVITS. That is what I meant, with respect to central bank claims.

Mr. BLOOMFIELD. Yes.

Senator JAVITS. Now, can you see any advantage in this interest equalization tax that Secretary Dillon has been pushing in order to deal with the balance of payments?

Mr. BLOOMFIELD. Would you want me to answer that?

Senator JAVITS. Both of you.

Mr. BLOOMFIELD. Well, my personal feeling is that, under the present circumstances and recent circumstances, when foreign bond flotations in the New York market have jumped spectacularly, this was an important emergency measure. I might have some questions from the longer run point of view as to the desirability of the United States taking such a measure, but, from the immediate point of view, I am very sympathetic with it and think it was almost an inevitable measure.

The only alternative would have been the much less attractive one of some kind of direct control over capital movements. The proposed measure at least provides the advantages of a sort of marketplace solution to the problem of excessive long-term American capital outflows.

Senator JAVITS. Of course then there is also the alternative of voluntary restraints.

Mr. BLOOMFIELD. Well, there would be that alternative.

Senator JAVITS. Through some form of Capital Issues Committee.

Mr. BLOOMFIELD. Capital Issues Committee, but that, perhaps, might not be quite as effective.

Senator JAVITS. I would not wish you to comment, Professor Lutz, on domestic legislation. So I won't even ask you the question. But I would like you to comment on the virtue or value of releasing some part or all of the 25-percent required gold reserve against Federal Reserve liabilities.

Mr. LUTZ. I think it ought to be done, of course. If there were reasonable expectation that the balance of payments would come into equilibrium next year, it would be better to wait until then because it is better to abolish these requirements in a position of strength than in a position of weakness. Nevertheless, I think that the requirement should be abolished right away, although some bankers abroad may think that, if the United States gets rid of this requirement now, it is a confession that the authorities in this country think that the dollar is weak. So if it could be done in a position of strength it would be better than to do it in a position of weakness.

Senator JAVITS. Now, there has been some weakness——

Mr. LUTZ. But still I would do it now.

Senator JAVITS. You would?

Mr. LUTZ. Yes.

Senator JAVITS. There has been some discussion about the fact that we ought to withdraw our offer to buy gold at $35 an ounce

and leave only our offer to sell it at that price. Would you have any comments on that?

Mr. LUTZ. I must think about that.

Senator JAVITS. In other words, right now we have got a guaranteed price for gold. The theory is to let the speculator in gold take his chances. We will sell it for $35. We won't commit ourselves to buying it at that price.

Mr. LUTZ. But then I think the foreign central banks wouldn't take it any more if they can't get rid of it at a fixed price.

Senator JAVITS. In other words, we would be defeating our own aim in the sense that a guarantee is more important to our creditors than it is to the speculators. Is that correct? That is your judgment.

Mr. Bloomfield, what about yours?

Mr. BLOOMFIELD. I am inclined to agree with Dr. Lutz.

Senator JAVITS. So that would be a misguided remedy.

Mr. BLOOMFIELD. I would think so.

Senator JAVITS. Now, in the minute I have left, may I have a restatement from each of you as to what you would do, precisely what you would do about this question of a deficiency in international liquidity which you both see. You may have different views as to its timing or when it will really be an emergency, but let us have your respective remedies clearly on record, if that is not too frontal a question. I think it is important for us to get the very essence of your thinking when you are kind enough to come and give us your very important points of view.

Mr. BLOOMFIELD. Well, I would say that the timing of this will depend, of course, upon how quickly we eliminate our deficit. My own prescription would be some consideration of a further liberalization of access to, and an increase of the resources of, the International Monetary Fund. That is to say, instead of merely having automatic access to the so-called gold tranche, perhaps also to give automatic access to the first credit tranche, and also to increase Fund quotas and borrowing potential if need be.

Secondly, I would think this could be combined and would not be inconsistent with some extension of our present system into a multiple-currency standard such as Professor Lutz has so eloquently advocated. But my own personal preference, sir, would be to work as much as possible through the International Monetary Fund.

Mr. LUTZ. Dr. Bloomfield has already given my views. As far as international liquidity is concerned, I would say there is no lack of it except perhaps for the United States. The first problem is to get rid of this deficit in the American balance of payments. I think if the United States got rid of this deficit, there is still enough liquidity around to carry us along for several years. Later on the problem arises what to do about a further increase in liquidity. Gold production is not sufficient. And my solution always was that one should widen the circle of key currency countries so that balances could be held in other countries where the gold stock is not yet mortgaged by foreign liabilities. In such countries we would start from zero, the ratio of foreign liabilities to the gold stock would be zero or at least very small, and it would go a long way before the ratio in these countries would become as high as it is now in the United States. So

international reserves could increase for many years without any deficit in the U.S. balance of payments.

Senator JAVITS. Would you put any ceiling on the proportion of gold reserves which other countries should have in that case in order to maintain stability?

Mr. LUTZ. I would think that the suggestion of Dr. Posthuma is quite reasonable: that the countries should keep 60 percent gold and 40 percent foreign exchange.

Senator JAVITS. And that would result in reducing gold reserves, for example, in a country like France.

Mr. LUTZ. France, United Kingdom, Switzerland. France has about 20 percent dollars, if I am not mistaken, but the United Kingdom has only 5 or 6, and Switzerland also has only 5 or 6.

Mr. BLOOMFIELD. And this suggestion would be particularly helpful to this country.

Senator JAVITS. Thank you very much, Mr. Chairman.

Senator PELL. Gentlemen, I have one question and it is perhaps too elementary to impose upon you, but I have often been struck by the fact that half our gold comes from the Union of South Africa and about a quarter each year from the Soviet Union; also by the fact that the increase in our share of world GNP each year outstrips the growth of gold reserves.

I was wondering if you had given any thought to the basic question of looking many years ahead as to whether we should gradually come to adopt some other unit of exchange, perhaps like Schacht's unit of production, or some other unit of exchange. What we are talking about now, in general, is the next 2 or 3 years. We don't generally think in terms of the next 20 years as we should.

Mr. BLOOMFIELD. The only possible alternative I would see would be to get rid of gold altogether and adopt a flexible exchange rate system. But given the traditional world propensity for gold and the mystique of gold, I cannot think of any other commodity or unit of account which in the foreseeable future would be able completely to take the place of gold.

Senator PELL. Professor Lutz?

Mr. LUTZ. I think I agree with this. The alternative of flexible exchange rates always attracted me because it removes the problem of international liquidity from the scene. It solves the problem by simply abolishing it because if you have flexible rates, you don't need international reserves.

But I know from my contacts with European central bankers there is not the slightest hope that a system of flexible rates will be introduced because all central bankers are, for quite understandable reasons, strictly in favor of fixed exchange rates. There is no chance of introducing flexible rates now.

Now, as far as the standard you suggested is concerned, I can't imagine how we could get the countries to agree on some imaginary standard which is not tied to something everybody can understand, like gold. Theoretically one could do it, I am sure, but I don't see how it can be done in practice. Of course, it is quite true one can run an international currency system without any gold at all and still have fixed exchange rates. This is quite possible.

Senator PELL. Thank you very much. I have no further questions.

Senator MILLER. Gentlemen, I might confess a little disappointment in your suggestion that we free the extra $12.5 billion of gold that we have to back up our currency. You indicate that the reason for that is to give foreign creditors confidence that we are going to pay them gold.

We have had testimony on this before. I certainly favor Professor Lutz' approach on timing, so that we don't start doing it right now, but we do it from a position of strength. But what is going to happen when our gold runs out?

Either one of you.

Mr. BLOOMFIELD. What will happen when our gold runs out?

Senator MILLER. Yes. You are going to free the $12.5 billion of gold now. At the rate we are going, won't the gold run out?

Mr. BLOOMFIELD. I would say that before we reached that stage we would doubtless have closed the wicket. Apart from the fact I don't envisage such a complete drainage of our gold, should we for some unforeseen reason face a situation like that, we would probably simply close the wicket.

Senator MILLER. What do you mean "close the wicket"?

Mr. BLOOMFIELD. Stop giving out gold.

Senator MILLER. Well——

Mr. BLOOMFIELD. Go off the gold standard, whatever you want.

Senator MILLER. Then you would say we should devalue our dollar, I suppose.

Mr. BLOOMFIELD. Or just let the dollar float. I don't see that the actual release of gold from this 25-percent requirement would make any difference to the basic situation at all other than its effect on confidence from the viewpoint of the rest of the world. We are not keeping our gold for internal reasons. The only purpose of our gold is to meet balance-of-payments deficits and we want the world to be absolutely sure that, if necessary, we will go below that 25-percent point to defend the dollar.

Senator MILLER. You don't think it serves a useful function in limiting the amount of dollars that we can print then?

Mr. BLOOMFIELD. No, sir; I do not.

Senator MILLER. Well, may I just carry this colloquy on a little further. If we are really looking for confidence on the part of the foreign creditors, foreign holders—why go about it this way? Why not give them so much confidence in our dollar that they don't want gold?

Mr. BLOOMFIELD. Well, we are trying to do that, sir, by our efforts progressively to eliminate our balance-of-payments deficit. We are doing precisely that.

Senator MILLER. Well, I understand from Dr. Lutz that even if we got the balance-of-payments problem licked we could still have an outflow of gold problem. Didn't you so testify?

Mr. LUTZ. I did.

Mr. BLOOMFIELD. I agree thoroughly.

Senator MILLER. Then I come back to my proposition that perhaps we ought to not only work on the balance-of-payments deficit, which is all very fine and I am 100 percent for it, but also give the foreign creditors confidence in the dollar.

Now, the fact remains that we have had inflation. We are having inflation right now. And it has been a case of the dollar going down

1 percent or more a year. And I for one can't understand why we should be critical or surprised at foreign creditors wanting payment in gold instead of dollars or wanting to turn in dollars for gold. It would seem to me if we really want to do a job on confidence, what we should do is do a job on our own dollar instead of letting it continue to decline in its value.

Mr. BLOOMFIELD. Well, I would feel reasonably sure that, to the degree inflation has taken place in the past in this country, the mere fact that we would have or have not a gold reserve requirement would not have anything to do with foreign confidence or lack of confidence in the continuance of inflation. Foreigners know that the way we manage our affairs is not guided by the need to keep the 25-percent reserve requirement, and that the existence of such a requirement as such does not per se restrain us from any inflationary splurges we might wish to engage in.

Senator MILLER. Wouldn't it be better to work on confidence in the dollar rather than to work on confidence in having gold available if they want to cash in dollars for the gold?

Mr. BLOOMFIELD. Well, I——

Senator MILLER. Why not just avoid the problem altogether by giving them enough confidence in the dollar so they don't want gold? Maybe they really would rather have dollars.

All right, Dr. Lutz.

Mr. LUTZ. You see, I don't think that the fact that there has been inflation all over the world, including this country, and that the actual purchasing power of the dollar is now less than it was 15 years ago is a reason for foreign countries to want gold instead of the dollar, because the purchasing power of an ounce of gold has fallen just as much as the purchasing power of the $35 for which you can buy it.

The reason why people want gold instead of dollars could only be that they expect that gold will recover its purchasing power because the gold price will be raised sometime in the future. This is the reason why they want gold, not the fact that the purchasing power of the dollar has declined. The purchasing power of gold has declined just as much as the purchasing power of the dollar.

Senator MILLER. Well, you talk about a 15-year range. I would rather talk about a short range because our problem has been a relatively short-range problem. We are worrying about an outflow of gold from this country 1 year to the next and we have had a pretty bad 4 or 5 years. What you have to say would impress me if other countries were having a similar amount of diminution in their value.

Mr. LUTZ. They do.

Senator MILLER. But it is my understanding that some of the other currencies in the world are not undergoing the same problem of devaluation or of the decline in value that the American dollar has, which is one reason why people are asking for payments in gold rather than holding on to our dollars.

Mr. LUTZ. All the currencies in the world have declined in purchasing power.

Senator MILLER. Did the Swiss franc decline last year?

Mr. LUTZ. Oh, yes.

Senator MILLER. How much, sir?

Mr. LUTZ. Four percent.

Senator MILLER. Four percent?

Mr. LUTZ. Three to four percent, yes.

Senator MILLER. How about the West German mark?

Mr. LUTZ. It declined also. Last year was a bad year for all of them.

Senator MILLER. How much did that decline?

Mr. LUTZ. The purchasing power of European currencies declined much more than that of the dollar. The price level in this country was stable whereas that of the European countries rose. It is this, I repeat, not the decline in the purchasing power of the dollar, but the feeling that the gold price may be raised, which make foreign countries want gold instead of dollars. This is a different matter. Don't you think so?

Mr. BLOOMFIELD. I would agree.

Senator MILLER. I would like to ask you a question on your recommended solution of multiple-currency standards. In item No. 4 of your statement, you suggest a problem in this connection when you say the monetary authorities of the key currency countries should make an effort to coordinate their business cycle policies. I must say the theory here is very intriguing and perhaps it could be implemented. I am wondering how practical it would be to implement it, for example, to try to obtain a coordination of business cycle policies or to try to obtain a coordination, let us say, of amounts of inflation of currencies when we are dealing in a competitive economic structure of world trade, when this country, for example, and others affected are democracies. I can understand how this could be done in a dictatorial situation. I am wondering how practical it would be in the present framework of the governmental systems we have and economic systems we have today.

Mr. LUTZ. Of course, as I say in my paper, the coordination of monetary policies is certainly still a long way off, but if you look at Europe, the beginning of such coordination is already discernible. There is a strong tendency to coordinate monetary policies in the six countries of the Common Market. It hasn't taken shape yet to the extent to which it will take shape some day in the future, but they have the idea and they meet regularly for the purpose of coordinating their monetary policies with a view also of reducing the disequilibrium in the balance of payments. I can imagine in some future time that such coordination could be expanded to the Atlantic community, but I think this is still a long way off.

Senator MILLER. In other words, you are talking about a theory which might be applied some time in a long-range view, a span of 10 to 20 years, something like that?

Mr. LUTZ. Yes. At least.

Senator MILLER. Thank you very much.

I have one more question. That wicket answer of yours intrigues me, Professor Bloomfield. At what point would you close the wicket?

Mr. BLOOMFIELD. I cannot answer that question, Senator Miller. I don't know.

Senator MILLER. Well, I don't want——

Mr. BLOOMFIELD. I would say we are still a very far way from closing the wicket. We still have over $15 billion worth of gold and I can't envisage any closing of the wicket for a long, long time off.

Senator MILLER. Well, it has been going out pretty fast; $900 million last year, $900 million the year before, $2 billion each of the 2 previous years. And our balance-of-payments deficit, as Senator Javits has pointed out, is no better. If anything, it is going to get worse this year.

Mr. BLOOMFIELD. I am thoroughly confident that we will bring our balance of payments into equilibrium long before any thought would ever have to be given to closing the wicket.

Senator MILLER. Well, I am glad to get that measure of confidence.

Now, if that is so, why can't we do that before we get down to the $12.5 billion level? I recognize that the gold down at Fort Knox is collecting mold and dust and all of that, but it seems to me it exists as a discipline and that rather than giving foreign creditors the feeling of confidence in our management of our fiscal affairs by reducing or eliminating that $12.5 billion, it seems to me if we could adhere to it, we would give them confidence in our ability to discipline ourselves from a fiscal standpoint, which I think is quite important for a so-called leader of the free world to exercise.

Mr. BLOOMFIELD. Well, the size of our gold stock certainly exerts a discipline upon our balance-of-payments policies without any question at all. I think the only difference between you and me is that I question to what extent the existence of our legal reserve ratio as such exerts a discipline upon our fiscal responsibility or lack of it. But I certainly would agree that our gold stock has a disciplining effect upon how far we can allow a balance-of-payments deficit to progress, and I am not advocating, I hasten to say, that the reduction in the reserve ratio should necessarily be taken now. I am saying that if we did it at an appropriate time, I do not think it would be a disastrous move but an even desirable one.

Senator MILLER. Well, my time is up but I would like to follow on with just one brief question which ties in with this same problem.

Professor Lutz pointed out that surplus countries don't want to take inflationary action. Deficit countries oppose deflationary measures because of internal domestic pressures.

Now, is it not possible that where we would have, let us say, a deficit country like our own, that the internal pressures, domestic pressures, opposed to deflationary measures might not be changed or at least offset by outside pressures which result from our being a deficit country, so that maybe for the time being you have internal domestic pressures which are opposed to deflationary measures, but maybe the pressures from the outside might be built up to such an extent that our domestic pressures will change?

I am thinking in terms of, for example, the outside pressures of outflow of gold and a possible devaluation of the dollar which could cause a great amount of internal hardship and cause pressures domestically to change to prevent continued inflationary measures, to force deflationary measures or to force an equilibrium policy.

Mr. LUTZ. Well, that is possible, of course. If the deficit in the balance of payments continues and if foreign countries are no longer willing to accumulate dollars to finance part of this deficit in this way, then there are only two possibilities left. Either raising the gold

price and therefore adding again to the reserves so that the deficit can continue for a long time still, or putting on some deflationary pressure. It may come to that. We hope that it won't but it may.

One further point: To Europeans the American position does not seem so desperate as one sometimes gets the impression when one talks to the people over here. If you consider that the British live with foreign liabilities which are three times as high as their gold stock and that they have lived with this situation for 15 years and are still alive, I think that a situation in which the foreign liabilities held by foreign monetary authorities are not even 100 percent of the gold stock yet, but below that, is not yet desperate.

Senator MILLER. Thank you very much.

Chairman DOUGLAS. Senator Jordan?

Senator JORDAN. Yes. I have a press story under a Paris dateline dated November 4, in the New York Times, in which Robert V. Roosa, Under Secretary of the Treasury, said that the United States had its balance-of-payments problem clearly under control. Do you share that optimism?

Mr. BLOOMFIELD. Well, of course, I haven't had the advantage of seeing the latest figure. I do know that last summer—in the second quarter of the year—there was a disturbing deterioration in our deficit position, but from what I know, in large part I believe because of the announcement of the interest equalization tax, there has since been a marked falling off in American purchases of foreign securities. I happen to know Mr. Roosa and I am sure that if he made that statement he must have some statistical information which I do not have at my disposal, and I am prepared to accept his judgment and I hope that our deficit continues to remain under control.

Senator JORDAN. Professor Lutz, do you care to comment on that?

Mr. LUTZ. The last figure I had seen is that the American deficit in the third quarter runs at an annual rate of $2 billion. In the second quarter it was around five or something like that?

Mr. BLOOMFIELD. Four, I believe.

Mr. LUTZ. Four. So this is a very significant reduction. It is apparently due to a reduction in capital exports. The reason for the decline of capital exports is the new interest equalization tax, or perhaps it is better to say it is the uncertainty which this interest equalization tax created.

Now, if the tax itself is enacted, I am not so sure that the capital export will stay so low. I don't know. It depends on how big the tax will be. But I am pretty sure that it was uncertainty in the third quarter which made the capital exports come down so quickly, and it depends upon the size of this tax whether the capital export will continue to remain low.

Senator JORDAN. If the interest equalization tax were enacted, the capital outflow might be expected to begin again.

Mr. LUTZ. It depends on how big the interest differential remains and whether the tax will make up for it.

Mr. BLOOMFIELD. Of course, foreigners borrow in the United States not merely because of interest rate considerations, but because we have a wider and broader and much more open market than they have at home. So I myself would say that even with the passage of the tax, the mere interest rate consideration may not be enough to bring

about the magnitude of decline that we might expect on the basis of interest rates alone. But I am hopeful that the proposed tax certainly will have some effect in reducing our export of capital.

Senator JORDAN. Now, a general question. What likelihood do you think there is of the foreign creditors calling for payments of their claims in gold?

Mr. BLOOMFIELD. Calling for——

Senator JORDAN. For payments of their claims in gold.

Mr. BLOOMFIELD. What do I think of the likelihood of foreigners calling for their payments in gold?

Senator JORDAN. Yes.

Mr. BLOOMFIELD. Well, I don't see any immediate reason to expect any larger rate of conversion into gold than has been taking place in recent years. On the contrary, the rate has been somewhat less in recent years because of the arrangements which we have made through our swap deals and our sales of Treasury securities denominated in foreign currencies with which we have been able to mop up some of the excess dollars that foreigners might otherwise have converted into gold. The possibility of a larger rate of conversion into gold would depend upon confidence in the dollar, and this in turn will depend upon the prospects and pattern of our balance of payments in the immediate future.

Senator JORDAN. Then you would say that the present trend is away from an accelerated conversion?

Mr. BLOOMFIELD. I would say that I do not see any prospect in the foreseeable future of any accelerated rate of conversion into gold, barring some quite unexpected deterioration, further deterioration in our balance-of-payments position, and even under those circumstances we might still not have to face the problem of an accelerated conversion into gold.

Senator JORDAN. Would you agree, Professor Lutz?

Mr. LUTZ. Well, it is certainly true that what I called in my paper the esprit de corps of the central banks is very highly developed and I don't think they would change the percentage of their dollar holdings to gold. They just don't do that kind of thing.

What might happen, of course, is that foreign commercial banks may turn their dollars into their own domestic currency. Then these dollars would end up in the central banks of those countries and the central banks then would convert, let us say, 60 percent of those dollars into gold.

So if the private foreign funds are repatriated, the outflow of gold would increase. Whether the private funds are repatriated, is not simply a question of faith in dollars, but also of the economic situation at home.

Swiss commercial banks, for instance, if there were an expansion of economic activity at home, could sell their dollars in order to get the cash at home that is required for credit expansion. This might happen. This has nothing to do with the position of the dollar itself, but it would have the effect that the outflow of gold would increase.

Mr. BLOOMFIELD. I might also have added that through our operations in the forward exchange market we have helped to some degree to keep private foreign banks and individuals holding their dollars

rather than turning them over to their central banks. This is part of the combined strategy which we have along with swaps and sales of foreign currency securities.

Senator JORDAN. Thank you, Mr. Chairman.

Chairman DOUGLAS. Congressman Lloyd?

Representative LLOYD. No, thank you, Mr. Chairman.

Chairman DOUGLAS. I hope you won't feel inhibited in the future.

Representative LLOYD. Thank you.

Chairman DOUGLAS. There is one correction I would like to make for the record. I think it has been implied that our price level has been increasing more rapidly than price levels in other countries. The record shows that the index of wholesale prices was 100.3—1957–59 equals 100—in the week of October 15 of this year, and that, if you take the commodities in the Consumer Price Index, they were 5 percent above the average of 1957–59. The U.S. News & World Report in its issue of October 28 of this year brings figures together from the International Monetary Fund, United Nations, Department of Labor, and so forth, and I shall ask unanimous consent that these be printed in the record.

(Excerpts from the article referred to follow:)

[Excerpts from an article in the U.S. News & World Report, Oct. 28, 1963]

WORLDWIDE INFLATION: WHAT IT MEANS TO U.S.

An old problem—inflation—is cropping up more and more. Key countries in Europe, Asia, Latin America are battling a price spiral. Why the flareup? What are the effects on the United States? Here's a report from world capitals on a growing worry.

Mounting inflation is becoming a problem in many parts of the world.

In more and more countries—in Europe, Asia, Latin America—price increases are threatening to get out of hand.

You find that situation today in France, where the danger is runaway prices. Serious problems of inflation are plaguing Italy, Holland, Sweden, and Denmark.

Prices still are fairly stable in Britain, West Germany, and Belgium, but fears are growing that the inflation fever now seen in other European countries may spread.

Japan is caught up in a strong wage-price spiral. Elsewhere in Asia—in India, Indonesia, Korea, the Philippines—inflation troubles have grown more severe.

In Latin America, where inflation is an old problem, the situation has worsened in some key countries.

* * * * * * *

First, three broad conclusions:

1. Forces pushing up prices vary. In Europe, it's a strong boom, with men and machines pushing against capacity. Among many Latin-American countries, inflation is feeding on a bloated money supply growing out of government deficits. In Asia—except for Japan—experts blame inflation mostly on overambitious development programs.

2. In places where inflation is most severe—in Asia and Latin America—hardships are widespread. The middle class often is hardest hit. Social unrest, strikes are on the rise.

3. Inflation has shaken public confidence in governments in many places. Lack of confidence often is accompanied by a flight of capital. In Italy, for example, businessmen have sent about $1 billion worth of capital out of the country this year, according to Swiss bankers. Some of this money has returned in the form of tax-privileged foreign funds. But much of it is staying out of the country.

| | Living-cost rise in latest 12 months | Living-cost rise since December 1958 [1] |
|---|---|---|
| North America: | | |
| United States | Up 2 percent | Up 6 percent. |
| Canada | do | Do. |
| Europe: | | |
| Austria | do | Up 16 percent. |
| Belgium | Up 3 percent | Up 6 percent. |
| Denmark | Up 6 percent | Up 22 percent. |
| Finland | Up 5 percent | Up 16 percent. |
| France | Up 6 percent | Up 24 percent. |
| West Germany | Up 2 percent | Up 12 percent. |
| Italy | Up 7 percent | Up 15 percent. |
| Netherlands | Up 3 percent | Up 12 percent. |
| Norway | do | Do. |
| Spain | Up 7 percent | Up 21 percent. |
| Sweden | Up 2 percent | Up 15 percent. |
| Switzerland | Up 3 percent | Up 10 percent. |
| United Kingdom | Up 1 percent | Up 11 percent. |
| Latin America: | | |
| Argentina | Up 17 percent | Up 289 percent. |
| Bolivia | Down 1 percent | Up 31 percent. |
| Brazil | Up 77 percent | Up 515 percent. |
| Chile | Up 49 percent | Up 144 percent. |
| Colombia | Up 34 percent | Up 54 percent. |
| Dominican Republic | Up 8 percent | Up 14 percent. |
| Mexico | Up 2 percent | Up 8 percent. |
| Peru | Up 5 percent | Up 39 percent. |
| Venezuela | Up 1 percent | Up 5 percent. |
| Asia: | | |
| China (Formosa) | Up 2 percent | Up 43 percent. |
| India | Up 4 percent | Up 14 percent. |
| Indonesia | Up 117 percent | Up 944 percent. |
| Japan | Up 8 percent | Up 27 percent. |
| South Korea | Up 35 percent | Up 79 percent. |
| Pakistan | Up 5 percent | Up 16 percent. |
| Philippines | Up 6 percent | Up 15 percent. |
| Middle East: | | |
| Iran | Down 1 percent | Up 43 percent. |
| Iraq | Up 4 percent | Up 18 percent. |
| Israel | Up 8 percent | Up 30 percent. |
| Africa: | | |
| Ghana | No change | Up 21 percent. |
| Morocco | Up 4 percent | Up 13 percent. |
| South Africa | Up 1 percent | Up 6 percent. |
| Oceania: | | |
| Australia | do | Up 8 percent. |
| New Zealand | do | Do. |

[1] Rise is measured through latest 1963 month—in most cases June or July.

Source: International Monetary Fund; United Nations; U.S. Department of Labor; other official sources.

IN EUROPE: FULL EMPLOYMENT

Shortages of labor are singled out for much of the blame for rising prices in booming Europe. Everywhere in major countries there are more jobs than workers. Example: In Switzerland there are only 142 unemployed—and 6,700 vacant jobs.

In a tight labor market, unions are in the driver's seat. Businessmen, with order books full, meet union demands and pay even more to hold workers.

Result: European wages generally have been rising by 8 to 10 percent a year. In Italy, pay increases have been running higher—16 percent last year. Pay hikes have been running at least double the increase in output per worker—adding to costs and putting upward pressure on prices.

Where competition has prevented price increases—as in consumer goods such as appliances—higher wage costs have squeezed profits. You hear that complaint from local and U.S. firms operating in Europe.

The upward spiral in factory wages has brought similar demands from farmers. As food prices have mounted, factory workers have demanded still higher pay, adding new inflation pressure.

Dutch workers, in the past, have held down wage demands. Now, tiring of moderation, these workers are demanding wage parity with other Common Market nations—notably Germany, where wages are 20 to 30 percent higher. A rash of strikes has broken out in Holland.

Governments in Europe, more and more, are beginning to crack down on inflation.

France, becoming alarmed at price trends, is cutting back on spending to reduce its budget deficit. New curbs on credit have been imposed. Ceiling prices have been ordered on such foods as beef, fruits, vegetables, cheese, cooking oil.

Italy, too, has moved to curb prices—though efforts are milder than those made in France.

Many economists in Europe doubt that France, Italy, other countries on the Continent will take the drastic—and unpopular—steps needed. Effective curbs would slow business expansion, bring unemployment. "What these countries would like is to avoid runaway inflation and get back to creeping inflation," says one European economist.

Impact of inflation is beginning to show up here and there in Europe.

German and Belgian exporters, whose prices have risen more slowly, have been able to expand shipments to France and Italy. Italian exporters, on the other hand, have seen their shipments to Germany decline for the first time since World War II.

IN LATIN AMERICA: OLD STORY

In this part of the world, inflation is old hat, almost chronic in many countries.

But problems have grown more serious in recent months in such countries as Brazil, Chile, Argentina, and Colombia.

Impatient for progress, economists say, many Latin-American nations attempt development programs that can't be paid for out of savings, taxes, and loans from abroad. Deficits in spending programs are covered by borrowing from central banks—with the effect of ballooning the money supply.

What's it like to live where inflation is almost a way of life?

Argentina illustrates some of the effects:

Walk down the Calle San Martín in Buenos Aires any weekday and you will see many Argentines swapping their extra pesos for U.S. dollars. The reason: In 18 months the peso has declined 80 percent compared with the dollar.

Savings deposits pay 8 percent interest annually. But there are relatively few depositors. Why? Money put into an account will lose buying power, on average, at the rate of 20 percent a year.

Jewelry stores in Argentina do a booming business as people get rid of paper money for gold and gems. Land and real estate are another popular inflation hedge. Those Argentines who do buy life insurance keep adding more every year to keep death benefits abreast of rising prices.

Mortgage loans are available usually at 30 percent annual interest—for a term of only 5 to 7 years. Consumer loans, for appliances and furniture, carry annual interest of 36 percent.

Businessmen run into many of the same problems—high cost of credit, profits that steadily lose buying power, all the headaches that go with trying to produce and sell when money values are changing almost daily.

One U.S. businessman puts it this way: "We have to make forecasts on how much inflation to expect and set our policies accordingly. It's amazing how often we are right. But it's a strain."

IN ASIA: RAMPAGING COSTS

Japan is going through wage-price inflation similar to Europe's. Wage rates rose 12 percent last year and a 9- or 10-percent hike is expected this year. Living costs in July were 8 percent above a year earlier.

The Japanese Government now is at the crossroads. Political leaders facing the national election late this year or next spring want an immediate cut in taxes and heavy spending. Central bankers and the Finance Ministry want to tighten up to prevent more inflation. Experts in Tokyo doubt that harsh restrictive measures will be taken until after the election.

Indonesia is caught up in rampaging inflation. Cost of living has more than doubled in the past year.

Public confidence in the currency is at a new low. A man with cash has one objective: Get rid of it for something that will retain its value.

Servants will not work for cash alone—part of the payment must be in rice and cloth. Many Government workers check into their offices in the morning and then spend the rest of the day on jobs in private industry to make ends meet.

Businessmen are finding that they usually have to pay bribes to get documents. The asking price is high for import and export papers.

In India, inflation is bringing growing bitterness, frustration, and concern among middle class city dwellers.

You find much the same problem in the Philippines, where rising prices are bringing uncertainty and confusion in business and mounting labor strife and lack of confidence in the Government.

NO END IN SIGHT

And so it goes in many parts of the world.

Inflation forces, gaining new strength, are raising problems for individuals and for businesses.

And, as the experts see it, there's no early end in sight.

Chairman DOUGLAS. In brief, in terms of living costs, it shows that the increase in the United States since 1958 has been less than in every country in the world except Canada and Belgium which have the same increase.

Now, the question I would like to ask is really based on this. Under the old gold standard, prices of commodities internationally traded tended to an equality because if the price level of country A was higher than country B, exports moved from B to A, gold from A to B, the price levels in A would decline and in B would rise and there was consequently an equilibrating tendency. The Swedish Economist Cassel developed the thesis that, with a paper money standard, exchange rates would adjust themselves so that there would be approximately equality of purchasing power in commodities internationally traded.

Now, I would like to ask whether the present gold exchange standard, when combined with controlled domestic price levels and with exchange rates which tend to be permanent over long periods of time, permits such an adjustment and tendency toward equilibration, or whether you can have permanent disequilibriums.

Mr. BLOOMFIELD. Well, if I understand you, Senator Douglas, I think about all we can say is that the price of an individual commodity moving into international trade will be the same in all markets after allowance for transportation and tariff costs. I don't think that this can be applied to any general group of commodities as a whole. I think rather in terms of individual price equalization for internationally traded goods. And if the Casselian theory was correct under a paper exchange system, and many people don't think it was, it would be correct under a gold standard or gold exchange standard.

Chairman DOUGLAS. Would it be if price levels were domestically controlled and if the movements of gold were either frozen or compensated for?

Mr. BLOOMFIELD. Well, it probably wouldn't—it would probably be even less true under those circumstances.

Mr. LUTZ. I would say that, as Dr. Bloomfield has already pointed out, internationally traded goods, of identical type, must have the same price in the world market no matter what monetary policy is followed by the countries concerned. So that if you looked at price indexes only of internationally traded goods in two countries, they would always have to show the same price increase whether the balance of payments were in equilibrium or not.

If, for instance, a country engages in inflation and as a result costs rise in that country, then the commodities which the country exports will have the same price in that country as in other countries, but the country, nevertheless, will experience a decline in exports. It is a bit difficult to make this quite clear without the help of diagrams. Costs

have risen in the inflating countries and they therefore tend to lose foreign markets. The countries that have not inflated would increase exports, but prices for identical internationally traded goods, although higher, would remain the same in both groups of countries. The country which has inflated will get a deficit in the balance of payments and it may then be forced to deflate again.

Chairman DOUGLAS. I didn't make myself clear. Certainly you have an equality of prices of commodities internationally traded but prices are affected or were affected, in the case of the old gold standard by the movement of gold. Now if gold moves but is not allowed to affect the domestic price level, does the equilibrating mechanism operate, and what effect does this have on permanent exchange rates?

Mr. LUTZ. I think the answer is this: Let's take as a practical example the case of Germany with her large surplus in the balance of payments for 10 years and with gold and foreign exchange moving in all the time.

Now, the Germans did not do what the rules of the game really required them to do, that is to say, to inflate. As a result their balance-of-payments surplus continued year after year and they had a "fundamental disequilibrium" in their balance of payments. And as long as the Germans did not inflate and the deficit countries did not deflate, the balance-of-payments surplus did not disappear. Such a surplus continues until the deficit country has lost most of its foreign exchange and is forced to deflate or the surplus country is forced to inflate.

Chairman DOUGLAS. Prior to that time will there not be a readjustment of exchange rates?

Mr. LUTZ. That is up to the Germans whether they want to do it, because they buy foreign currencies at a fixed price. If the central bank continues to buy the foreign exchange at this fixed price, the exchange rate would not change. If they decided not to buy it any more, then of course the exchange rate would change and the mark appreciate.

Mr. BLOOMFIELD. Dr. Lutz and I, if I understand him correctly, seem to disagree on one fundamental point, although otherwise we are quite close in agreement. He seems to imply that under the present system that countries should follow the old rules of the game in a sense. Unless I misunderstand him, he implies that Germany should inflate and that we should deflate.

Now, it was exactly the point of my statement that countries today do not want to do this. They do not want to be subjected to the harshness of the so-called rules of the game. And that this is why I posed the particular problem of what alternative mechanisms we have to enable balance of payments to be kept in reasonable equilibrium without the need for subjecting individual countries to waves of inflation and deflation, if they can't or don't want to adjust their exchange rates, and if they are not allowed or don't want to impose exchange restrictions. At the end of my statement I gave a few possibilities of what might be done and I drew them largely from the experience of this country in recent years. Not all of them have been what I would regard as highly desirable means of equilibrating the balance, but under the circumstances necessary.

Chairman DOUGLAS. Well, if these alternatives which you suggest were not adopted by nations individually or collectively, will you not have to establish equilibrium by adjusting the exchanges rates?

Mr. BLOOMFIELD. Well, I am assuming also that for reasons which both of us pointed out, certain countries, the key currency countries, cannot properly alter their exchange rates. I concede that situations may arise where a disequilibrium may be so persistent and so intractable that some exchange rate adjustment may be necessary, but if you are going to have a system of fixed exchange rates or quasi-fixed exchange rates, you have to try to find some mechanism other than too frequent alterations of rates or too frequent subjection to inflationary or deflationary pressures and policies as a means of equilibrating the balance of payments.

Now, this may be asking for an impossible task, I don't know, and the only possible alternative would be going on to a flexible rate system which I do not personally favor.

Chairman DOUGLAS. If you say that the key currency countries, Great Britain and the United States, can't devalue, shouldn't the surplus nonkey currency countries, namely, France and Germany, appreciate, send up their exchange rates?

Mr. BLOOMFIELD. I would say in certain cases they may have to, and Germany and Holland, as you know, in 1961 did exactly that. I don't think it was particularly happy because of the disruption it caused in foreign exchange markets, but if we had to make a choice of some exchange adjustments, I fear that we would have to throw it onto the surplus and nonkey currency countries under the postulates of our present arrangements.

Chairman DOUGLAS. Without wishing to be a monetary chauvinist, I suggest this is a very good argument for our Secretary of the Treasury in his dealings with the other nations in the International Monetary Fund.

Mr. BLOOMFIELD. But I don't want to make myself unpopular with my central banking friends abroad.

Chairman DOUGLAS. I think this is altogether too much of a tendency on the part of America. We don't want to make ourselves unpopular with the central banks abroad, and without being chauvinistic, I would say that this reluctance should be overcome. [Laughter.]

Senator PROXMIRE. I am impressed and pleased with the emphasis which you gentlemen have put on the effect of just the announcement of the interest equalization tax, the fact that we had an improvement in the seasonally adjusted annual rate of deficits from around $5 billion to about $2 billion between the second and third quarter, you say, on the basis of the announcement. I am particularly happy about this because it was on February 1, before this committee in this room, that Governor Mitchell, the new appointee to the Federal Reserve Board, suggested such a tax in his paper, and I want to read his remarks very briefly. It will take me less than a minute to read.

> The United States has the largest and most accessible capital market in the world, and it ought to be kept free of exchange restrictions. It is proper and desirable that capital-poor developing countries should utilize this market to meet a portion of their enormous needs for foreign capital. It is not so clear, however, that it is either necessary or desirable for advanced countries, with balance-of-payments surpluses, to have recourse to our capital market on the recent large scale while they restrict and hamper entry of outside borrowers to their own capital markets. If these countries are unwilling to open their capital markets, possibly we should look toward tax measures that might help to remedy this unbalanced position. In general, we need to explore the possibilities of various tax measures that might, consistent with our obligations as an international good neighbor, and with the status of the dollar as a world reserve

currency, discourage capital movements that appear to flow uphill to countries that are already capital rich. (Hearings on the January 1963 Economic Report of the President before the Joint Economic Committee, p. 385.)

Now, I think this was the genesis of the interest equalization tax. It would seem to this member of the committee that, in view of the improvement in capital flow as a result of the announcement of the interest equalization tax, we can now think in terms of a monetary policy in this country which is consistent with our economic needs, that is, reasonably expansionary monetary policy, together with an interest equalization tax that protects us from the consequences that some say might flow from such a policy such as a flow of capital abroad.

Do you feel this is a sound position, that it is reasonable for us to adopt this kind of policy, and that it will have a—can have both a favorable effect domestically as well as not contributing to our balance-of-payments problems?

Mr. LUTZ. I think so, yes.

Senator PROXMIRE. Do you think so?

Mr. LUTZ. It depends to a degree on——

Senator PROXMIRE. This is most encouraging to me and I think perhaps also to the chairman of the committee, because we both contended that we have to have our two big instruments of economic policy pulling in harness. That is, monetary policy and fiscal policy pulling together. If we have a tax cut and have interest rates pushed up so that we don't have an adverse balance-of-payments situation, you have them working against each other and you are slamming on the brakes and stepping on the gas at the same time so that all you get is a deep deficit and no expansion. Your views are most encouraging.

I have just one question for Professor Lutz. I understand that you favor a capital issues committee to ration foreign calls on the U.S. capital market. Could you explain why?

Mr. LUTZ. Well, this is simply another and perhaps more effective way of achieving the same result. The interest equalization tax would then not be necessary.

Senator PROXMIRE. This is an alternative.

Mr. LUTZ. Yes. I admit that the interest equalization tax is more compatible with a market economy than the system which, for instance, the Swiss follow. The Swiss license foreign loan issues in the Swiss market. The central bank in Switzerland has to give its permission. It is simply an alternative to your way of doing things.

Senator PROXMIRE. As a Member of Congress it would seem to me that the capital issues committee would be subject to the kind of pressures we often find ourselves subject to. They might permit a flow of capital to a particular country or particular concern in a country under strong pressure whereas the interest equalization tax would be more objective and more neutral and therefore perhaps more satisfactory.

Mr. LUTZ. Of course, it is possible that political influence would play a role if you had a capital issues committee.

Senator PROXMIRE. Particularly I think it would be more sensitive in this country than in some other countries because of the importance of our foreign aid and the importance of our country as a——

Mr. LUTZ. Owing to her neutrality Switzerland has not the same grave problems of foreign policy as this country has, so that con-

siderations of foreign policy play no role in determining whether a foreign country or corporations of foreign countries should be permitted to float a loan on the capital market.

Chairman DOUGLAS. Happy is the country in which problems of foreign policy are relatively unimportant.

Senator Jordan?

Senator JORDAN. No more, thank you. I appreciate this fine contribution that these gentleman have made.

Chairman DOUGLAS. This was a very stimulating afternoon. We want to thank you gentlemen. I may say that under the direction of Dr. Pollack we have issued a joint committee print which will not be released until this coming Sunday, bringing together some of the salient facts and some of the salient theories on our balance of payments. That will be made available for the press and for others, provided it is not published until Sunday.

We want to thank you gentlemen very much for coming.

The hearings will recess until tomorrow morning at 10 o'clock when we will discuss short-run measures to strengthen the dollar.

(Whereupon, at 4:35 p.m., the hearing recessed to reconvene at 10 a.m., Wednesday, November 13, 1963.)

# THE UNITED STATES BALANCE OF PAYMENTS

## II.—Short-Run Measures To Strengthen the Dollar

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**WEDNESDAY, NOVEMBER 13, 1963**

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

The joint committee met, pursuant to recess, at 10:05 a.m., in room AE-1, U.S. Capitol Building, Hon. Paul H. Douglas (chairman) presiding.

Present: Senators Douglas, Javits, and Miller. Representatives Reuss, Curtis, and Widnall.

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

Chairman DOUGLAS. The committee will come to order.

We are going to consider this morning the question of shortrun measures to strengthen the dollar and, more particularly, whether the gold reserve requirements, now imposed upon the Federal Reserve System as regards note issue and other obligations should be maintained, modified, or eliminated.

We asked the Federal Reserve Board to prepare a statement of the present law and administrative regulations and the conditions under which these might be modified, and we have the reply here which will be available to everyone.

I am going to ask that the reply of Mr. Martin be made a part of the record at this point.

(The communication is as follows:)

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
OFFICE OF THE CHAIRMAN,
*Washington, November 5, 1963.*

Hon. PAUL H. DOUGLAS,
*Chairman, Joint Economic Committee,*
*Washington, D.C.*

DEAR MR. CHAIRMAN: This is in reply to your letter of October 21, 1963, in which you asked for certain information regarding the 25 percent gold certificate reserve requirements specified in section 16 of the Federal Reserve Act, with particular reference to action the Federal Reserve might take if the reserves should fall below the required amounts.

Paragraph 3 of section 16 provides that each "Federal Reserve bank shall maintain reserves in gold certificates of not less than 25 per centum against its deposits and reserves in gold certificates of not less than 25 per centum against its Federal Reserve notes in actual circulation." The Board of Gover. has authority, under section 11(c) of the Federal Reserve Act, to suspend these

requirements in order to provide time for corrective adjustment, should the reserves fall below required levels. Section 11(c) also requires the Board to impose a graduated penalty tax on Reserve banks experiencing a reserve deficiency. The Board could comply with this requirement by imposing a nominal penalty tax, so long as System holdings of gold certificates did not fall below 20 percent of Reserve bank liabilities on Federal Reserve notes outstanding. For any deficiencies of reserves below this level, the law requires the imposition of a tax graduated upward from 1½ percent per annum. The discount rate of any Federal Reserve bank so penalized would have to be raised correspondingly. The text of section 11(c) follows:

"SEC. 11. The Board of Governors of the Federal Reserve System shall be authorized and empowered:

* * * * * * *

"(c) To suspend for a period not exceeding thirty days, and from time to time to renew such suspension for periods not exceeding fifteen days, any reserve requirements specified in this Act: *Provided*, That it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified: *And provided further*, That when the reserve held against Federal Reserve notes falls below 25 per centum, the Board of Governors of the Federal Reserve System shall establish a graduated tax of not more than 1 per centum per annum upon such deficiency until the reserves fall to 20 per centum, and when said reserve falls below 20 per centum, a tax at the rate increasingly of not less than 1½ per centum per annum upon each 2½ per centum or fraction thereof that such reserve falls below 20 per centum. The tax shall be paid by the Reserve bank, but the Reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Board of Governors of the Federal Reserve System."

This suspension authority, together with the penalty tax provisions, was part of the original Federal Reserve Act, as enacted in 1913, except that in the original act the reserve requirements were 40 percent against notes and 35 percent against deposits, and the higher tax rate became mandatory when a Reserve bank's reserve against notes fell below 32½ percent. The reduction from a 40 percent requirement against notes and 35 percent against deposits to 25 percent in each case was made by the act of June 12, 1945 (59 stat. 237). Since you have expressed an interest in the origin of the gold cover requirement, I am attaching material on its legislative background and intent prepared by our staff.

The Board has exercised its authority under section 11(c) to suspend reserve requirements on three occasions. On November 7, 1919, the Board authorized Governor Harding to suspend reserve requirements of the Fedral Reserve Bank of New York for a period not exceeding 10 days. On March 15, 1920, the Board suspended reserve requirements for all Federal Reserve banks for 10 days. On March 3, 1933, the Board suspended reserve requirements for all Reserve banks for 30 days. None of these suspensions was renewed.

Penalty tax rates have been established at varying levels over the years under section 11(c). They have always been graduated according to the size of the deficiency, but three different beginning rates have been fixed. From the inception of the System until 1933, the rate on the first five percentage points of deficiency in reserve requirements was 1 percent per annum. On March 13, 1933, the Board cut the beginning rate to one-tenth of 1 percent per annum. This rate prevailed until June 30, 1945, when the Board adopted a higher rate schedule, following enactment of the legislation lowering reserve requirements to 25 percent. That schedule has continued unchanged up to the present time, as follows: one-half of 1 percent per annum when either the note or deposit reserve ratio falls to between 25 and 20 percent; 2 percent upon deficiencies below 20 percent down to 17½ percent, 3½ percent upon deficiencies below 17½ percent down to 15 percent, and an additional 1½ percent for each 2½ percent further decline in either reserve ratio below 15 percent.

In round numbers, the System's gold certificate reserves stand at $15 billion, to cover $18 billion in deposits and $31 billion in Federal Reserve notes. (A table is attached showing actual figures for October 30, 1963, but round figures will simplify the discussion at this point.) If there were a continued loss of gold reserves to the point where they were about to become insufficient to cover note and deposit liabilities (that is, if they fell from $15 billion to $12 billion), the Board could suspend the requirements to permit time for corrective adjustment. While the initial suspension is limited to 30 days, unlimited renewals are au-

thorized, and, although no single renewal may be for more than 15 days, no overall limit is imposed on the duration of successive suspensions. If a reserve deficiency should prove unresponsive to corrective measures, the Board could, therefore, continue a suspension for as long as necessary to permit enactment of remedial legislation.

As long as a reserve deficiency were confined to what we may call the first "layer"—the reserves required against deposit liabilities—the only action required by law would be the imposition of a tax against the Federal Reserve banks. Under a longstanding interpretation of section 11(c), the tax need not be added to the banks' discount rates until the reserve deficiency penetrates into the second "layer"—the reserves required against Federal Reserve notes. For the System as a whole, therefore, reserves could fall from their present level of $15 billion to $8 billion before any increase in discount rates would be required by the act. Under the present schedule of penalty rates, if reserves fell all the way through the first "layer" (down to $8 billion), the annual taxes on the reserve deficiency (using $18 billion as the figure for deposits) would be something under $300 million a year. Payment of these taxes would diminish net earnings of the Federal Reserve banks and reduce by an equal amount their payments to the Treasury as interest on Federal Reserve notes, which amounted to $800 million in 1962. It should be understood that the total payment to the Treasury would not change; it would simply be divided into two parts adding to the same total, one part labeled "tax on reserve deficiencies" and the other labeled "interest on Federal Reserve notes." In the example, the total payment would still be $800 million, but $300 million would be in the form of a tax and $500 million would represent interest on notes.

If reserves continued to fall, so that a deficiency occurred in the reserve against Federal Reserve notes, with a consequent additional penalty tax for that deficiency, the statute would require the Reserve banks to "add an amount equal to said tax" to the rates they charge on advances to borrowing member banks. While the statute is not at all clear on the mechanics of imposing this added charge, perhaps the most reasonable method would be to raise the discount rate by the same number of percentage points as the penalty tax rate on the note reserve deficiency. For example, if the gold certificate reserves fell to 20 percent of Federal Reserve notes—or to about $6 billion—the penalty tax under present rates for the note reserve deficiency would be one-half of 1 percent (or $10 million). Adding the penalty tax rate to the present discount rate of 3.5 percent would result in a discount rate of 4 percent. Again, it should be understood that the Board could establish a different penalty tax rate in this case; the statute simply requires that it be "not more than 1 per centum per annum." The statutory minimum penalty tax rate would come into effect only if reserves fell below this point.

It seems reasonable to conclude that if this country's gold losses should continue to the point where the Reserve banks were unable to comply with the 25-percent statutory reserve requirement, there is ample authority under the present act to meet the situation without disrupting the economy or the international payments mechanism, and to provide time for Congress to consider legislative action.

In response to your question about the arguments for and against keeping the gold reserve requirement, I doubt that I can add anything more to the testimony your committee has already received. In my judgment, no change in the requirement should be undertaken at this time, because the risks of such an undertaking outweigh the benefits to be gained. The principal risk in such a move under current conditions is that the public might interpret it as a sign of weakness portending failure in the Government's efforts to maintain the value of the dollar. I see no need to run this risk, because the gold cover requirement does not pose any obstacle to the use of our gold reserves in defense of the dollar, and the best way to deal with worries on that score is to lay before the public a full explanation of what the statute requires and the procedures for meeting its requirements. I appreciate this opportunity to contribute to that end.

Sincerely yours,

WM. McC. MARTIN, Jr., *Chairman.*

21-415 O—63—pt. 3——4

### Attachment A

*Application of Federal Reserve gold certificate reserve requirements, Oct. 30, 1963*

[Dollar amounts in millions]

| | |
|---|---|
| 1. Combined Federal Reserve deposit liabilities | $17,810 |
| 2. Combined Federal Reserve note liabilities | 31,442 |
| 3. Total Federal Reserve liabilities subject to reserve requirements | 49,252 |
| 4. Total Federal Reserve gold certificate reserve | 15,310 |
| 5. Less: 25 percent reserve requirement on Federal Reserve notes and deposits | 12,313 |
| 6. Equals: Excess gold certificate reserves | 2,997 |
| 7. Plus: 25 percent requirement on Federal Reserve deposits (deficiencies in this requirement necessitate no discount rate increase) | 4,453 |
| 8. Equals: Total gold certificate reserve releasable without mandatory discount rate increase | 7,450 |
| 9. Plus: Difference between 25 percent and 20 percent requirement on Federal Reserve notes (deficiencies in this range require only a small discount rate increase) | 1,572 |
| 10. Equals: Total gold certificate reserves releasable without substantial mandatory discount rate increase | 9,022 |

### Attachment B

#### LEGISLATIVE BACKGROUND AND INTENT OF GOLD RESERVE PROVISIONS OF FEDERAL RESERVE ACT

The House report on H.R. 7837, 63d Congress, the 1913 bill which became the Federal Reserve Act, contains the following statement regarding the purpose of imposing reserve requirements on the proposed central banks:

"In a general way the committee believes that requirement of a fixed reserve is not a wise or desirable thing as viewed in the light of scientific banking principle. It believes, however, that in a country accustomed to fixed reserve requirements the prescription of a minimum reserve may have a beneficial effect * * *."[1]

Since the "real bills doctrine" formed the theoretical basis for the original Federal Reserve Act, the members of the House Banking and Currency Committee evidently believed that limiting central bank credit expansion to the discounting of eligible paper would provide a sufficient check on monetary expansion, and that imposition of gold reserve requirements would be inconsistent with the "real bills" principle. However, because the precedents of reserve requirements for national banks and for various foreign central banks suggested that there might be a problem of public confidence, the committee members were willing to recommend gold reserve requirements. Other legislators, and the majority of the National Monetary Commission, were strong supporters of the idea that the central bank's liabilities should be restrained by the level of gold reserves.

According to the House report on H.R. 7837, the Federal Reserve Board's power to suspend reserve requirements was based upon a similar provision in the National Bank Act of 1864.[2] Under this latter provision the Comptroller was required to notify a bank with a reserve deficiency to "make good" the deficiency. If after 30 days the deficiency still continued, the Comptroller could, with concurrence of the Secretary of the Treasury, appoint a receiver to wind up the business of the bank.

Section 22 of H.R. 7837 was taken almost word for word from this section of the National Bank Act. Hence, in this early version of the Federal Reserve

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[1] U.S. Congress, House Committee on Banking and Currency, "Changes in the Banking and Currency System of the United States," Rept. 69 to accompany H.R. 7837, 63d Cong., 1st sess., 1913, p. 71.

[2] Ibid., p. 46. See sec. 5191 of the Revised Statutes for this provision in the National Bank Act of 1864.

bill the Board would apparently have been required to close a reserve deficient Reserve bank and appoint a receiver therefor if such bank should fail to make good its required reserve after receiving 30 days' notice from the Board to eliminate such reserve deficiency.

In later versions of the bill, the Board's power to close a Reserve bank was replaced with the mandatory requirement to impose a graduated tax on any bank with a reserve deficiency. Such a change would seem to shift the emphasis of adjustment from the mechanism of temporary suspension of requirements to the process of tax and discount rate increases and consequent restraint upon monetary expansion.

The provision of a penalty for reserve deficiencies appeared to be drawn from European central bank regulation, most specifically the German central bank.[3] Inclusion of a penalty is confirming evidence that the congressional authors of the act were not prepared to follow unequivocally the real bills doctrine with its attendant implications that Federal Reserve discounting of real bills would automatically provide the right amount of money. This conclusion is a logical consequence of the provision which requires a reserve deficient Reserve bank to respond to the penalty tax by raising the interest and discount rates which it receives on such real bills. The Congress evidently envisioned that the tax-induced increases in discount rates would reduce Federal Reserve credit, which, in turn, would eliminate the reserve deficiency while reducing bank reserves and the money supply.

The language of the act as enacted could be interpreted as suggesting that the effects of the penalty were expected to apply to individual Reserve banks, encouraging asset transfers or liquidation of liabilities only by the particular Reserve bank affected. Study reveals, however, that penalty provisions were included in early versions of central bank bills, including the Aldrich bill which proposed one centralized monetary institution, and hence there are grounds for presuming that the deflationary consequences of the penalty tax were expected to be nationwide in scope.

Chairman DOUGLAS. We are very happy to welcome two gentlemen this morning, Professor Charles P. Kindleberger of MIT and Mr. J. Harvie Wilkinson of the State-Planters Bank of Commerce and Trusts of Richmond, Va.

Mr. Kindleberger, we appreciate your coming down from MIT. We will be very happy to hear from you first.

## STATEMENT OF CHARLES P. KINDLEBERGER, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. KINDLEBERGER. Thank you, Senator.

The adjustment mechanism for restoring equilibrium in the balance of payments of the United States under present gold-exchange standard arrangements was discussed at yesterday's hearing, and proposals for major changes in the system—devaluation, flexible exchange rates, massive additions to international liquidity—will be considered tomorrow and the next day. I deal with a series of devices employed or proposed for the short run while basic forces are working themselves out. These devices have been referred to by Under Secretary of the Treasury Roosa as the "perimeter defenses" of the dollar.

May I first, however, express the conviction that the present system, for all its drawbacks, is by and large satisfactory, and in fundamental respects superior to the systems envisaged in most proposals for major reform. The system is evolving, and should continue to evolve. In the end, I suggest, we will arrive at a system in which exchange rates are fixed, large cumulative deficits and surpluses occur while deep-seated corrective forces take time to produce adjustment, and that

[3] Owen, Robert L., "The Federal Reserve Act," New York, Century Co. (1919), pp. 12–14 and 19–24.

these deficits and surpluses are financed to a large extent by private short-term capital movements in an integrated world money market, responding to interest-rate changes. This will require international collaboration to set the general level of short-term interest rates; departures from that level will be dictated by balance-of-payments needs; and heavier reliance will have to be put on fiscal policy for domestic stability and employment, because interest-rate changes are preempted by external requirements. (This latter will make more urgent speedy and effective action by the Congress in fiscal matters.) Some financing of cumulative deficits and surplus will doubtless continue through changes in official reserves of gold and foreign exchange. In this connection, as anticipated by Treasury officials, the gold exchange standard should become more symmetrical, with the United States holding foreign currencies as well as gold, while foreign countries hold gold and dollars.

If the task is to finance fairly large cumulative surpluses and deficits through movements of private capital, such capital movements must be stabilizing and not destabilizing. This means first that foreign holders of a given currency must know that the authorities of that country adhere to the goal of balance-of-payments correction, even though they are unwilling to permit large-scale deflation to achieve it; and that the authorities have the resources and the institutional arrangements at hand to meet any temporary loss of confidence by the market.

CENTRAL BANK COOPERATION

In the first place I would put central-bank cooperation of the type implied by the Basel Agreement of March 1961, the adjustment of the Canadian dollar in June 1962, and the flurry in sterling in February 1963. In a crisis of confidence, the ancient rule of Walter Bagehot is still good: Discount freely and tidy up afterward. Foreign central banks must buy dollars without limit, in a crisis, or the Federal Reserve system foreign currencies. Even with its special credit arrangements of 1961, the International Monetary Fund is not used in the thick of a crisis, but serves later as one means of regularizing positions. Precise rules and limits are a handicap. As in the military field, mutual support must not falter under attack.

FORWARD OPERATIONS

Forward operations have a place in the armory of defensive weapons. These require a modicum of central bank cooperation, although the initiative is generally one sided. The authorities of a currency under attack can buy time by selling foreign exchange forward, rather than spot, either to match bear speculators in the forward market, or even to induce such a discount on forward foreign exchange rates as encourages interest arbitrage, buying the local currency spot and selling it (that is buying foreign exchange) foward. Some experts regard official forward operations as capable of more than a contribution to the defense of a currency under temporary pressure. One view holds that interest rates in short-term money markets can be separated on a persistent basis by adjusting the forward discount or premium to the desired interest differential. Another claims that an outflow of short-term capital, or presumably even a deficit in the balance of payments can be offset without loss of gold or exchange re-

serves by selling foreign currencies forward without limit; old contracts coming due can be swapped forward, and new ones entered into with the cumulative total rising without limit. Neither of these claims is valid in my estimation. The subject is complex and cannot be dealt with effectively in summary. On the first point, however, if uncovered funds move in quantity between money centers, interest rates will be equalized without regard to the forward discount or premium, and if they do not, an interest rate differential will persist without the need for official operations. On the second point, there is almost certainly a limit beyond which the exchange market will want to hold spot foreign currency rather than forward contracts. When such limit is reached, the authorities will have to make delivery under old contracts as they mature rather than swap them forward. Forward operations are useful in short-run crises, to space out pressure in time. Moreover, they should be used outside of crises to keep the institutional machinery in being. They represent no panacea.

### GOLD OPERATIONS

In my judgment, the U.S. authorities are overly concerned about gold losses—possibly because of the undue sensitivity of the press—and should be willing to pay it out in the short run without elaborate arrangements to conceal small loses. Moreover, I see no need for the 25-percent gold cover against the liabilities of the Federal Reserve System. If, as is widely believed, it would be difficult to change the legislation because of the protracted debate which would be touched off, including the insistence on testifying of the large numbers of people with idiosyncratic views on money and gold, I am content to go along with Chairman Martin and take no action if the 25-percent level is breached, but pay the penalties under existing law. It would be a uesful gesture of the readiness of the United States to defend the dollar by paying out gold to repeal the obsolete provision for internal gold cover, but, provided the Congress understands what is intended, the issue is not a vital one.

Chairman Douglas. Well, I do not wish to interrupt, but is that not a pretty wide assumption?

"Provided the Congress understands what is intended"—and also provided the popular opinion in the country would permit Congress to act in this fashion.

Mr. Kindleberger. Well, sir, as I understand it, this issue has arisen in the past and it was thought by the leaders of Congress, as well as by the administration, that it would be desirable to repeal the gold cover, but it was felt that a number of people, in a vociferous minority, would, in fact, so delay and draw out the question of a change in the law that it could not feasibly be done.

Chairman Martin, in his speech to the American Finance Association last December, at the meetings in Pittsburgh, did say that the Federal Reserve System was faced, under the law, with certain penalties if the percentage was breached, and he indicated that the Federal Reserve System was prepared to see that breached.

I would prefer to see the law changed. This would seem to be highly desirable.

But if the leaders of Congress think it is impossible to change the law, then I think that Chairman Martin's view of the matter might be allowed to take effect.

Chairman DOUGLAS. Thank you.

Mr. KINDLEBERGER. I realize that this is a serious matter.

Representative REUSS. If I may append a footnote, I do not know to what extent we are writing history here, but I am not aware of the fact that the failure to press the repeal of the 25-percent gold reserve provisions of the Federal Reserve Act was due to the leadership in Congress.

My impression is that it was due to the other end of Pennsylvania Avenue.

Mr. KINDLEBERGER. You may be right, but my position in the matter has been primarily one of a remote receiver of gossip and I have no inside knowledge on the matter at all.

There is some sentiment for widening the gold points—a move in the direction of flexible exchange rates. I choose not to comment on this since flexible exchange rates are to be discussed tomorrow. It is worth pointing out, however, that if a large role is left for private stabilizing speculation, there is something to be said for the suggestion last year of Harry Johnson, intended ironically, no doubt, to narrow the gold points rather than widen them.

The Brookings report recommended a large sale of gold for foreign exchange to demonstrate to the world the confidence of the United States in the adequacy of its reserves and its relaxed attitude toward gold. This perhaps would work to convince speculators and even foreign central banks that a scramble for gold was not likely. But it might alarm others who are impressed by the ratio of gold to short-term liabilities. In this field of game theory, like poker playing, coups are possible but may also backfire. My instinct is to leave it alone.

The same may be said of suggestions for squeezing the private gold holders. Such holding is illegal for American citizens, abroad as at home. Professor Machlup has proposed that the United States announce a series of reductions in the price of gold in the future. Some economists would try to enlist all central banks in an agreement to buy gold at $35 an ounce or the equivalent only from each other and licensed mines, and to let the price in the private market go above or in the long run fall below the official price. The essence here is that the authorities should not provide gold to the market at higher prices, nor buy it at lower, and that a two-price system be developed. Something of this sort was attempted in the fall of 1960 when gold was not supplied to the London private market which went to a price of $40 an ounce. Since that time, however, the tactic has been adopted of discouraging gold speculation by holding the private price close to par with the official.

A squeeze might work, or again it might backfire. My recommendation would be to let the speculators wither on the vine. It costs say 5 percent of earnings foregone, plus storage charges to hold gold. A gold hoarder of 10 years' standing has lost one-third to a half of his capital in that time, and will lose more as time goes on, since the prospect of an upward change in the general price of gold is virtually out.

GUARANTEES

One proposal to preserve confidence in the dollar, to maintain the dollar holdings of foreign central banks, and to stop any tendency of foreign central banks to switch dollars into gold is to furnish guaran-

tees to dollar holders that in the event that the dollar were to depreciate the value of their holdings would be restored to present levels. Apart from the possibility that such a guarantee would backfire and stimulate fear, the technical difficulty of limiting such a commitment is almost insoluble. A guarantee limited to foreign central banks is of no use, since in periods of crisis dollars are dumped on the market and foreign central banks purchase them in Basle-type operations. Even American citizens could get a gold guarantee in this way by exporting capital. There can be no quarrel with the principle that cooperating foreign central banks must not suffer by reason of cooperating. The heavy losses of the Bank of Belgium and the Netherlands Bank at the time of British devaluation in 1931 are examples of what must be avoided. But rough justice after the event is the need, rather than a precise legal contract before. Such burden sharing is already established by the precedents of lend-lease, Marshall plan, rescue operations, et cetera. I submit that the Congress should be aware of a very general obligation not to let cooperating foreign central banks suffer by reason of that cooperation, in the event that the dollar should ever be devalued as a result of a crisis, but further than this it is neither necessary nor useful to go.

## SWAPS

One device worked out by the Treasury and Federal Reserve System for tactical defense is "swaps" or an exchange of dollars for foreign currency. These are generally for a limited period, often associated with forward operations, and occasionally replaced by credits, which are about to be discussed. Swaps create instant gross reserves, even though the net reserve position is unchanged. They are not very different from foreign central bank support of a currency. It is almost the same, that is, whether on the one hand the Federal Reserve and the Swiss National Bank swap $100 million for roughly 400 million Swiss francs, and the Federal Reserve System supports the foreign exchange market by paying out the francs while the Swiss hold the dollars; or, on the other, the Swiss National Bank supports the dollar by buying $100 million against francs. But the little difference is important. In the first case, the United States owes the Swiss Swiss francs; in the second case, only dollars. Like forward operations, where the U.S. authorities end up with an obligation denominated in foreign currency, reversible swaps are a form of limited exchange guarantee.

Three-month swaps are useful therefore to provide support in a shortrun pressure. Like forward operations again, they are of no help in meeting the steady drain of a balance-of-payments deficit. But again the institutional arrangements which may be needed in a crisis must be kept in readiness by occasional use in the long run.

Outright swaps, where one country exchanges its currency for foreign exchange without provision for reversal at the end of a stated period may be worth considering as a longrun means of adding liquidity on an informal ad hoc basis, more readily effected than modifying the articles of agreement of the Fund. But liquidity needs are the subject of another hearing.

One important device is the arrangement of potential swaps in advance, as was done last summer between the Federal Reserve and the Bank of England up to $500 million. This provides explicit advance

support for crisis. It is important, however, to regard it as an addition to and not a replacement for the implicit commitment to assist in crisis involved in Basle-type arrangements.

### CREDITS

Forward operations and swaps have tended to be of relatively short duration. The Treasury and the Federal Reserve have obtained some shortrun help by borrowing foreign currencies outright on longer terms such as 15 months. It is hard to see how these fit into a total program. Shortrun crises can be met by Basle-type arrangements, forward operations, swaps, as well as short-term capital inflows and gold outpayments. There is no need to borrow at intermediate term for them. Fifteen months is too short to finance the cumulative deficit in the balance over a longer period of the duration necessary to cure a structural disequilibrium. It is understandable that the creditors will want to take a new look at the position after a while, and possibly to claim repayment in gold if they believe that the deficit is not mending. But such countries should realize that the present international payments mechanism calls for slow, rather than rapid adjustment of deep-seated disturbance, and that short maturities to finance a cumulated deficit, on top of demand obligations, create too many occasions of possible crisis. Foreign currency loans to finance the cumulative deficit are desirable, but maturities should run to 3 to 7 years. Provision should be made for prepayment or refunding in advance of due dates if the creditor country's balance of payments turned quickly adverse, or if the deficit disappeared sooner than anticipated.

### PREPAYMENT OF DEBTS TO THE UNITED STATES

The prepayment of intergovernmental debts to the United States owed by surplus countries has been not a shortrun defensive measure but a way of buying time by financing the cumulated longrun deficit. In retrospect, it appears that the United States may have scaled down foreign obligations a little too precipitously in the settlements after World War II and the Marshall plan, but prepayments of such amounts as were consolidated into loans have been helpful. This means of financing the deficit is coming to a close as the surplus countries are paying off the last of their debts.

### TRANSFERRING U.S. ASSETS TO SURPLUS COUNTRIES

A similar device which might increase the amount of time, or the cumulated deficit which the United States can run would be to transfer to the surplus countries not receipted debts of their own, but other assets, such as the debts of other countries, if all parties agree, or even commodities. As part of the overall effort to correct the payments balance, this country is examining the sharing of burdens in military defense, and assistance to underdeveloped countries. Some part of the deficit is attributable, however, to the accumulation of a defense stockpile of commodities in the interest of the Atlantic community. There might be merit to a new sharing the burden of holding these stocks by transferring a portion of them to our European allies against payment in dollars.

### THE POSTHUMA PLAN

Professor Posthuma of the Netherlands Bank proposed some time ago that various central banks, including the Federal Reserve System, undertake to agree on a common ratio of gold to foreign exchange. The purpose was to prevent changes in the gold stock of a reserve country with balanced payments when its balances were transferred between countries maintaining different proportions of gold and exchange; and to put all central banks in the same position in a time of devaluation. In particular, it would eliminate all incentive for central banks to have their ratio of gold to reserves inch up so as to be in a better position to meet devaluation of a reserve currency. The difficulty with the proposal is that details are hard if not impossible to work out, with provision for all kinds of contingencies, seen and unforeseen. No simple mechanical scheme is universally acceptable, and an elaborate agreement is not worth the trouble. It is understood that Professor Posthuma has been revising his initial scheme in the direction of providing for settling deficits, rather than holding reserves, using fixed proportions of gold, foreign exchange, and local currency. But this again seems unduly mechanical. The success of the European Payments Union in correcting trade stagnation should not blind us to the fact that an automatically functioning exchange market is an improvement on a contrived one.

When the U.S. balance of payments has been corrected, the question will arise whether subsequent temporary disequilibriums should be settled by the deficit country paying out existing claims on the surplus country, or the latter acquiring claims on the former. There is no difference in the net reserve position, of course, but gross reserves are higher if new claims are acquired rather than old claims extinguished. Central bank cooperation will be needed to work this out, based upon the system's need for liquidity. In my judgment, no mechanical rule is called for.

### INTERNATIONAL MONETARY FUND

Most international trade economists welcome the action of the U.S. authorities last summer in arranging for a line of credit with the International Monetary Fund. Such credits should be used for emergencies, and not to meet a cumulated deficit. But it is well to explore in advance the nature of the use this country might make of the Fund, and so let destablizing speculators know that this country has a variety of devices to beat off a shortrun attack.

In short, the perimeter defenses should be used mainly in a crisis of confidence, although it is necessary to keep them operational between time; major reliance must be put on central bank cooperation, which seems to be working well; more attention should be paid to funding the cumulated deficit which piles up while our structural disequilibrium is being corrected, on terms which are less confining than the piling up of foreign demand liabilities or even short-term debts. Longrun deficits and surpluses should be financed mainly by private stabilizing capital movements, whilst guarding against destabilizing shifts of funds. I believe that the U.S. deficit is in process of correction, at long last, through price rises in Europe. This mechanism of adjustment—ultimate price rises in the surplus countries—

may make for large cumulative deficits and certainly will entail coordination of international monetary and payments policy in future.

Some may regret the loss of sovereignty in the monetary and foreign exchange field. But sovereignty is being lost in various spheres—trade, defense, monetary policy, etc.—and it is useless to weep over it as over the loss of U.S. foreign policy innocence. The household has lost the capacity to feed, clothe, protect itself, and so have the village, town, region, and state. It is sensible to expect growing interdependence of countries and in economic and political fields. It is difficult to see how independence of monetary, fiscal, payments, and other economic policy can be preserved.

Chairman DOUGLAS. Thank you very much.

We are very happy to welcome you, Mr. Wilkinson, and will you proceed with your paper.

## STATEMENT OF J. HARVIE WILKINSON, JR., CHAIRMAN OF THE BOARD, STATE-PLANTERS BANK OF COMMERCE AND TRUSTS, RICHMOND, VA.

Mr. WILKINSON. Thank you, Senator.

Under existing law, the Federal Reserve banks are required to maintain a gold certificate reserve equal to at least 25 percent of their combined note and deposit liabilities. As you know, gold certificates are nothing more than warehouse receipts for gold stored in the vaults of the Treasury.

At September 30, 1963, the United States had only $2.9 billion in excess gold reserves. Conservative projections of growth in Federal Reserve note and deposit liabilities indicate that this "excess" will be fully employed to meet the 25 percent requirement by sometime in 1970.

Not only does our gold stock serve as a reserve for our domestic money supply, it also is used to finance our international trade deficits. Since 1957, our balance of payments deficit has been averaging approximately $3 billion a year. During this same period and because of this deficit, we have sold almost $6.5 billion of gold, and our short-term liabilities to foreigners have increased by about $11 billion.

When our Federal Reserve System was created by Congress in 1913, it was required to hold a 40 percent gold reserve against its notes and a 35 percent reserve against its deposit liabilities in either gold or lawful money. Because of increases in the note and deposit liabilities of the Federal Reserve banks, the actual reserve ratio had decreased from 91 percent in 1941 to 49 percent by the middle of 1945, and it appeared that it would drop below 40 percent by the end of that year. At that time, Congress reduced the ratio to the present level.

In requiring a gold reserve originally, we expressed a fundamental need to put some impersonal restraint on the Government's power to create money. As the actual ratio approaches the required reserve ratio an alarm bell is sounded which requires that the Nation evaluate its position and take remedial action. This is America's position today.

In 1945, when the bell began tinkling, we silenced it by reducing the reserve requirement. The entirely different set of economic circumstances which we now face raise serious questions as to the wisdom of

congressional reduction of the gold certificate reserve ratio from its present level. I do not feel that we will enhance confidence in the dollar by escaping legislatively from the disciplines which we as a nation must face. We must as a nation now salute the fundamental questions that have brought us to the need for even considering a congressional change in the reserve ratio.

The other alternative is for the Board of Governors of the Federal Reserve System to use its statutory power as it has done three times before—in 1919, 1920, and 1933—to suspend the gold reserve requirement. At the same time, it would be forced to press for corrective action in other areas of government and the economy so that the suspension could be lifted by an improvement in the actual reserve ratio. The bell tinkles insistently now—and now is the time to take prompt, affirmative action.

We are using or contemplate using many techniques to protect our remaining gold supply such as currency swaps, the informal Group of Ten and direct Treasury borrowing abroad. These are constructive palliatives but mere palliatives and do not reach to the heart of the issue. They are time buyers.

Meanwhile, we are making every effort to attract foreign tourists to our shores. We are trying, through GATT, to increase the attractiveness of our exports to foreign buyers. We are attempting to encourage the formation and broadening of foreign capital markets so that foreigners will reduce their dependence upon our own. We have taken some steps through tying aid to American exports to reduce the adverse impact of our foreign aid and military assistance programs on our balance of payments. The protective techniques are doing all that they can do, and our other efforts will not take effect soon enough to be of any determinative value.

The tax cut now being considered by the Congress is a constructive step which can stimulate our domestic economy and which, if financed properly, i.e, out of savings, can have an indirectly favorable effect on our balance of payments deficit. Our domestic economy has been plagued by slow growth. Low corporate profits have slowed investment in new plant and equipment and, in the face of a growing labor force, have resulted in a smaller number of new job opportunities and in high unemployment. The President has taken a step in the right direction with the tax program and I favor it under several conditions.

First and foremost, the President should propose to the Congress a joint resolution limiting Federal expenditures for each of the next 3 years to the 1962–63 level. It is vitally important that while we actively seek a deficit by cutting taxes, we proclaim firmly to the world that our pursuit of domestic growth will be restrained by fiscal prudence. What better way to proclaim to the world the national will than for the executive which spends and the legislature which appropriates to commit themselves jointly to fiscal discipline? Lacking a publicly pronounced commitment we create an air of doubt and skepticism.

Secondly, the increased deficit resulting from the tax cut must be financed in a noninflationary manner. This means that pressure must not be brought to bear on the Federal Reserve System to ease our monetary position any further. For too long now we have followed

an easy money policy in the mistaken belief that this will encourage growth in our economy. History tells us that in any vigorous economy, good business means higher interest rates. The only thing that we have accomplished so far is to make this country a good place to borrow but a poor place to invest, both for foreigners and U.S. citizens. The impact of increased Federal demand for funds in the market will put upward pressure on interest rates, making investment here more attractive and thereby decreasing the capital outflows which we have been experiencing.

Finally, unless and until we can increase the margin between our exports and imports, we must reduce the intolerable burden which we have placed on our trade balance by reducing our expenditures abroad. Some important and constructive steps have already been taken in this regard, but more must be taken. Although political considerations are involved, the economic health of our country is paramount. Domestic and international confidence in the dollar is vital to the economic war which we are now fighting. At all costs, confidence in the dollar must be maintained. What is needed now is not conversation but commitment adequate to the task of restoring confidence in the dollar. Thus far, we have used salves and ointments to attempt to correct the curvature of our financial spine. We must now face up to the fact that the need is for a strong brace of fiscal prudence and discipline.

In essence, then, my position is this:

1. We should leave unchanged the present gold reserve requirement. To change it—or to even talk of changing it—is to suggest that we seek to escape our own self-imposed discipline. There is already statutory authority and precedent for a temporary suspension of the requirement by the Federal Reserve Board if a further decline in our excess gold reserves makes such an action necessary.

2. In his special message to the Congress on July 18 the President said:

> * * * early enactment of the comprehensive tax reduction and revision program * * * is the single most important step that can be taken to achieve balance abroad as well as growth here at home.

If the President and the Congress will commit themselves, by joint resolution, to the need for a limit on Federal spending, I will wholeheartedly agree with the President on the need for tax reduction.

3. The increased deficit resulting from the tax cut must be financed from savings and not through the creation of additional credit.

4. The Federal Reserve System should be encouraged to allow the rediscount rate to be a true penalty rate. This, plus the impact of a properly financed deficit, may well raise the rate structure, but not drastically, and thereby reverse the outward flow of dollars.

5. We should significantly reduce our foreign aid and dollar military expenditures abroad by demanding that those allies who have been made strong by our aid now assume their fair share of the burdens we have been carrying almost alone.

6. We should continue the long-term constructive efforts already set in motion to redress our adverse balance of payments. The following are representative:

(*a*) Submit guideposts for reasonable wage increases.

(*b*) Government influence to moderate price and wage increases.

(*c*) Stimulate investment through depreciation guidelines that are more liberal.
(*d*) Tax credit for new investment.
(*e*) Furtherance of foreign travel in the United States.
(*f*) Outright encouragement of exporters to increase their exports.
(*g*) Program of export promotion, e.g., trade fairs, etc.
(*h*) Increase in exportation of agricultural surpluses, preferably for payment in dollars.
(*i*) Export credit insurance and loan guarantees.
(*j*) Lift foreign restrictions on dollar imports.
(*k*) Favor foreign military acquisition in the United States.
(*l*) Encourage the development in Europe and Japan of broader capital markets.

In that same July 18 message, the President declared:

> I want to make it equally clear that this Nation will maintain the dollar good as gold, freely interchangeable with gold at $35 an ounce, the foundation stone of the free world's trade and payments system.

It is unthinkable that it would ever be otherwise, but I firmly believe that we must do more. We must act while we can still take the initiative. We must act firmly and courageously now.

In the remarks that follow, I will enlarge on these points.

## IN ELABORATION

Now that I have sketched briefly an outline of my position, let me proceed to a more detailed discussion of the situation.

As I have already pointed out, our excess gold reserves now stand at $2.9 billion. Based on a conservative projection of the recent past performance of member banks' net demand deposits, time deposits, and Federal Reserve notes in circulation, one finds that the resulting increases in Federal Reserve liabilities will absorb this excess gold sometime in 1970. This projection assumes a static gold supply over this period, and our recent history would indicate that we cannot hope to keep our gold supply at even its present level unless we take decisive, corrective action promptly.

However, this is not the only service which we require of our gold stock. It also serves—even more fundamentally—as a means of financing our balance-of-payments deficit. The President correctly postures this Nation in the eyes of foreigners when he says, "I want to make it equally clear that this Nation will maintain the dollar good as gold, fully interchangeable with gold at $35 an ounce, the foundation stone of the free world's trade and payment system." With our excess gold at the lowest level since 1945 (just prior to the time when the Congress lowered the reserve ratios to the present level), the worry is that our foreign creditors might wonder if, to put it politely, the foundation stone is cracking under the strain.

## WHY ARE WE IN OUR PRESENT POSITION?

Before I comment on the gold reserve requirement directly, let me come up the path which has led us to this problem.

At home, our economy has been beset by the slow-growth complex. The symptoms included in this syndrome include a moderately slow rate of economic growth and a relatively high rate of unemployment.

There is a distinct and direct relationship between these problems which, in turn, are related to rising production costs, declining corporate profits, and a low rate of business investment. Unemployment, also, has a high structural factor.

Internationally, we have experienced a payments deficit in 12 of the past 13 years. During the last 5½ years the deficit has been about $17.5 billion, or an average of somewhat over $3 billion a year. We have met this by selling about $6.5 billion of gold and by increasing our short-term liabilities to foreigners by about $11 billion. For 1962, Government statisticians report a payments deficit of $2.2 billion. If substantial debt prepayments by foreign governments to the U.S. Government and some other special intergovernmental transactions are taken out, last year's deficit amounted to $3.6 billion. The figures so far available suggest that the deficit for this year will still be in excess of $3 billion before special transactions.

Before proceeding further, it is well to note that our balance-of-payments figures are presented in a manner similar to that of a company's statement of current assets and liabilities; i.e., they show the changes in those assets during a specific period. If we look at the situation as a complete balance sheet—that is, all of our assets and liabilities on foreign account—we see that the assets of the United States, including gold, and our subscription to the International Monetary Fund, add up to about $100 billion—twice our liabilities to foreigners (including foreign investments here) of almost $50 billion. Our problem is one of American liquidity since most of our foreign assets are long-term investments whereas our liabilities, although substantially less, are much more liquid and more volatile. A substantial portion of our liabilities are, in effect, payable to foreigners on demand. Any further loss of confidence in the dollar could only decrease the willingness of foreigners to hold dollars and cause them to demand payment in gold.

## WHAT ARE WE DOING ABOUT IT?

On the international scene, there has been increasing communication and rapport among the central bankers of the Western World. Various types of currency swaps have been effected; the Group of Ten has been formed to combat speculative raids on the dollar; the Treasury has resorted to direct borrowing abroad; we have arranged to draw upon the International Monetary Fund.

In addition to these financing techniques, we are working through GATT to reduce tariffs on our exports, thus making them more attractive to foreign purchasers. A program of export insurance has been worked out. We are encouraging foreign countries to develop their own capital markets. We are attempting to attract foreign tourists to our shores. We are taking toddling steps to reduce our foreign expenditures for military and economic aid. Some progress has been made in offsetting our foreign military expenditures and foreign aid by bilateral agreements for the recipients to buy military hardware and other goods in the United States.

Natural economic forces are also working in our favor internationally. Our foreign industrial competitors are now coming face to face with the problems that we encountered during the earlier postwar years. Labor difficulties and demands for wage increases have accom-

panied their newly acquired prosperity. As a result, the costs of living in Western Europe and Japan during the last 3 years have been increasing at an annual rate near 5 percent while our consumer price index has moved up at an annual rate of less than 1½ percent during the same period. Also, the rate of increase in our costs of production has slowed in recent years. There are indications that labor is beginning to understand that wage increases cannot long outpace gains in productivity without seriously injuring our competitive position. We are all beginning to understand that our costs must be kept in line if we are to find long-range solutions for our problems.

A tax cut program has been proposed by the President and is now being considered by the Congress. It is felt that a tax cut will stimulate the economy in all areas. Specifically, it is hoped that it will result in expanded production, thereby reducing unemployment and increasing the likelihood that investment in new plant and equipment will increase.

In our postwar economy, corporate profits have lagged well behind the rest of the economy. The Office of Business Economics of the U.S. Department of Commerce in a comparison of 10 key economic indicators between the years 1951 and 1961 reported that corporate before-tax profits increased only 12 percent while gross national product jumped 58 percent, disposable personal income 60 percent, and dividends 67 percent.

Several factors have been responsible for this unsatisfactory performance. As we achieved general and relative stability in the price level, the artificial and unhealthy stimulus of inflation was removed. At the same time, domestic competition intensified and competitive pressure from abroad was being stepped up. Thus, it became increasingly difficult for U.S. producers to pass on increased costs by raising prices. Meanwhile costs, especially those represented by wages and taxes, continued to move up steadily. The result was the well-known profits squeeze. This condition, by holding down employment in the face of a growing labor force, has pushed up the rate of unemployment, has discouraged business investment, and has aggravated the deficit in the balance of payments. Although I will go into more detail later, I feel that the tax cut is a step in the right direction toward the solution of these problems if it is properly financed and a major condition is met.

All of this proves that we are aware of our problems and that some steps are being taken to solve them. I would suggest that we have not as yet sufficiently saluted the two fundamental problems and that more is yet to be done. But of this more later.

### THE GOLD RESERVE REQUIREMENT

Now that we have come up the economic path to our present status, let me proceed to the question under consideration—the gold reserve requirement. As you are aware, in the Federal Reserve Act of 1913, Federal Reserve banks were required to hold a gold reserve of 40 percent against notes, and a reserve of gold and/or lawful money—a term removed when the act was amended in 1945—of 35 percent against deposits. Despite the elimination of the right of an American citizen to turn his currency in for gold, the above reserve requirements were in effect until 1945. As I have already indicated, by that

time the actual gold coverage of Federal Reserve notes and deposits which had been as high as 91 percent in 1941, had declined to 49 percent. Projections based on past experience indicated that by the end of that year, the increase in Federal Reserve note and deposit liabilities would have reduced the gold coverage to 39 percent. As a result, Congress reduced the ratio to 25 percent and made it uniformly applicable to both notes and deposits. This requirement is in effect today.

It is well here to examine briefly the reasons for a gold reserve requirement. Over the many centuries of mankind's existence, he has struggled to find an absolute store of value which was also capable of either acting as or supporting a medium of exchange. Gold has become imbedded in the consciousness of much of mankind as the single substance most closely approximating an absolute store of value. I believe in Washington this is currently referred to as the "Puritan ethic." Even this is relative because from the time of the "king's bite" to the day of managed inflation man has had only a relative store of value—albeit the best yet devised.

It is of basic social, economic, and political significance that man has felt in modern times the need to put some arbitrary and impersonal restraint on Government's power to create money. Generally speaking, as the supply of money increases its value tends to decrease. Governments are ever inclined to spend money. In the elemental societies lacking a bond market, the recourse is to the creation of money through the printing presses or through the banking system. It was in this effort, first, to prevent the ultimate worthlessness of money and, secondly, to sound a bell of alarm and concern that the Congress enacted a required percentage of gold behind its currency, both paper and deposit.

Until recent times it has often been pointed out that this gold reserve requirement is meaningless as an instrument for preventing monetary expansion because the amounts of "excess" gold on hand have been sufficient to support a vast increase in the money supply. It must be noted, however, that the advantage that should be claimed for the requirement is not that it will prevent undue monetary expansion. Rather, it is that the requirement will halt such expansion at some point once it has gotten underway. In the case of the United States, external gold drains, if allowed to persist until they have consumed all of the Nation's excess gold, will require some corrective action in order to prevent a violation or a sustained suspension of the gold reserve law.

It is interesting to note that we in America by virtue of the suspension of domestic gold convertibility have in one sense substituted external compulsions—in the form of foreign claims on our gold—for internal compulsions. The latter would have forced our monetary authorities to act in restraint had there been a movement on the part of our citizens to call for gold. This would have reflected distrust in the future value of the dollar as a result of a continued and excessive increase in the money supply. Domestic lack of confidence can still be felt if our citizens liquidate their investments here and increase them abroad. In any event, it is this external compulsion with which we are now face to face.

It might also be pointed out here that the substitution of the external compulsion through the abandonment of domestic gold convertibility in essence aligned America with other nations which looked

upon gold principally as a source of international liquidity (although we also retained the domestic reserve requirement as a means of controlling the expansion of our money supply). In other words, a nation's gold reserve provides a means of financing a balance-of-payments deficit while internal policies are adjusted to international requirements. With excess gold reserves approximately equal to 1 year's balance-of-payments deficit, it is obvious that this cushion is fast disappearing and that some additional steps need to be taken.

### THE ALTERNATIVES

The Secretary of the Treasury and the Chairman of the Federal Reserve Board have already said that our entire gold reserve will be used to meet our international obligations. If this is to happen, then either Congress must be asked to lower or to remove the existing reserve requirements or the Federal Reserve Board must, using the power given it by the Congress, suspend the requirements. There are precedents for both actions. As mentioned earlier, Congress lowered the requirements in 1945. In 1919, 1920, and again in 1933 the Federal Reserve Board suspended the gold reserve requirements.

I believe that the psychological climate is sufficiently different now from that existing in 1945 to question the wisdom of congressional action at this time. Surely, with the Federal Reserve possessing the power to suspend reserve requirements—and by such an act inevitably evoking further and additional corrective measures—the effort to evade such measures by legislative fiat would be regarded askance by holders of dollars abroad when the dollar is now under pressure as it was not in 1945. Our ability to eat from the menu we served up so freely to Europe in the immediate postwar years would be brought into question.

While I admit that there are many techniques, such as lowering the reserve requirements that commercial banks maintain with the Federal Reserve banks (thus reducing the Reserve banks' deposit liabilities) and changing the basis on which the gold reserve requirements are computed, these are no more than palliatives, and I would submit that we have had enough of such palliatives already. Having rejected congressional action at this time as unwise, we are left with the alternative of the Federal Reserve Board's suspending the reserve requirements. By definition, this would be temporary and would mean that sufficiently strong and immediate action would then have to be taken to correct the situation. The course of wisdom for America is to take these corrective actions now and preserve, and hopefully enhance, our roughly $3 billion excess reserves as working balances for international trade deficits. To take action in the atmosphere of a suspension of the gold reserve requirements would most likely require more stringent domestic measures than need now be applied for constructive results. To repeat, the action which needs to be taken must be taken now.

Parenthetically, I feel that if reduction in or removal of the gold reserve requirements were to take place it would have to be done at a propitious time. Such a time would be when we had a confluence of forces such as an economy in upswing, our Federal expenditures under control, our budget approaching balance, our international payments problem nearing resolution, the dollar not under pressure

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internationally, and hopefully some such event as reflected by the Russian entrance into the foreign exchange market with gold for large purchases of foreign currencies, some of which would be dollars. Obviously, now is not such a time.

WHAT WE MUST DO

The President of the United States, in his special message to Congress on July 18, stated:

> Full implementation of the program of action I have outlined today should lead to substantial improvement in our international payments. The rate of Government expenditures abroad will drop by $900 million over the next 18 months, and the combined effect of the increase in short-term rates and the interest equalization tax should equal and will probably exceed this figure. Gains of this magnitude—approximately $2 billion—will give us the time our basic long-term program needs to improve our international competitive position, and increase the attraction for investment in the United States.

This is the right idea, but it has not yet been carried far enough.

I have gone into some detail as to the measures which have been taken already and to which the President referred on July 18. While I recommend these efforts and feel that they are constructive, they will not of themselves cure. Some are merely financing mechanisms to handle our international deficit. They only temporarily alleviate the symptoms. Others will take time to become effective. Any impression that the United States is seeking an escape from balance-of-payments disciplines through expansions in international liquidity could seriously strain international confidence in the dollar.

First, the maintenance of relatively stable wages and prices is essential so that we may capture a larger share of the trading markets of the world and improve our already favorable trade balance. The efforts of our Government to encourage the visits of foreigners to our shores and to broaden the interest of the American businessman in seeking export markets, all contribute to improving our international trade position. By reducing taxes, we immediately reduce the businessman's direct costs and enhance his competitive position abroad. But stability can only be achieved by accepting fiscal discipline, which brings me to my second point.

We must brake the rise in Federal expenditures. I believe it is of paramount importance for the President to propose to Congress a joint resolution limiting the total of Federal expenditures for each of the next 3 years to the 1962–63 level. Because the executive branch spends and the legislative branch appropriates, it is important that such a statement of the national will be made jointly. Then we have committed ourselves to the discipline. Lacking that, the omnipresent fear abroad, and at home, will be that we shall seek the first excuse to escape from the expenditure discipline.

Third, we must allow our short-term rates to rise to the extent necessary to curb the outflow of funds. Parenthetically, this action, if accompanied by other fundamental steps, will not have to be as drastic as some fear.

I have already mentioned the tax cut as a positive step in the right direction. However, there is a reverse side to this coin that must be recognized. The tax cut means an increased Federal deficit which must be financed by the Treasury. The Treasury's increased demand for funds would normally put upward pressure on our rate structure.

We need to understand that interest rates are only a very small factor in the expansion of investment by businessmen. If our economy is healthy and growing, the expected return from increased investment in plant and equipment would be considerably greater than the cost of the funds so invested. Because of easy money policies this country has been a good place for both foreigners and our own citizens to borrow but a poor place in which to invest. A rise in short-term rates which would be a natural effect of the defiicit could reverse the situation.

The immediate answer to such a proposal is that this rise would mitigate the constructive effect of the tax cut on our domestic economy. I believe the mitigation would be slight indeed. The tax cut is much more fundamental.

Fourth, as an American, I am willing to run the risk of any further disagreement within our western alliance by simply telling our allies very bluntly that we are not going to continue to maintain at our expense Armed Forces and foreign aid at the risk of continued imbalance in our external payments. I am in no position to make the judgments as to which allies we should so address. And even at the risk of losing some, I am persuaded we must do so.

These are actions which taken today can be effective. Delayed in the taking they are impotent. Strength exercised on the initiative of the strong is power. Strength standing against international panic is sapped into weakness. The good efforts we have made so far to secure short-term improvement in the balance of payments will prove futile unless they are accompanied by fiscal, monetary, and debt management policies which are effective in maintaining stability in costs and prices and in providing attractive outlets for productive investment in the domestic economy. Over the longer run, these objectives must be realized if the Nation is to reestablish a sustainable payments position. In the short run, strict orientation of policies to these objectives is imperative if international confidence in the dollar is to be preserved.

We can, if we exert the national will, turn this situation to our lasting benefit, seize the initiative, and develop a posture which becomes the wearer of the mantle of financial leadership of the free world. However, we can do this only if we declare unequivocally that we will no longer "tinker." Instead of conversation, we need commitment which may be defined as the President's statement of July 18 plus every single requisite supportive action to give credence to that statement. The restoration of our balance-of-payments equilibrium must be elevated to the highest order of national priority. I feel strongly that these actions would restore this equilibrium.

We live in a very complex economic society. Millions of people in the world, both American citizens and foreigners, have an enormous stake in the purchasing power of the dollar. Their willingness to continue accumulating dollars is dependent upon their confidence in that dollar and in the economy which backs it. If that confidence declines further, we are in trouble. We must pay whatever price is necessary not only to maintain that confidence at home and abroad but to increase it.

If we can restore confidence in the dollar and make our country more attractive for foreign investors, we may be able to coax out of hiding the estimated $2 to $3 billion of gold now being hoarded and

experience an inflow of gold, rather than the steady ebb to which we have grown so accustomed.

In the last analysis, in judging the strength of a currency, one considers the strength of the economy back of that currency. The strength of the American economy actually and potentially in its ability to support the dollar in undreamed of strength is almost beyond belief if, but only if, we conduct our affairs as prudent men.

Finally, a word about the need for increased international liquidity. Should the hoarded gold come out of hiding and should the dollar regain its international stature, the velocity of international transactions will increase markedly and possibly obviate the pressure for ever-increasing discussions on international liquidity problems. "A dollar good as gold" will stop the "shell and pea" game with dollars and alleviate any worries about the adequacy of international liquidity for some time to come.

In setting a gold reserve requirement, we have provided for an alarm bell to alert us to monetary problems. The bell is tinkling now as it did in 1945. We silenced it then by reducing the reserve requirement. We can silence it altogether by removing the reserve requirement. We would not thereby eliminate one whit the danger it foretells. Alternatively, we can sit and wait until the tinkling grows louder and the Federal Reserve Board is forced to suspend the requirement. Now is the time to listen. We must remember that our gold is ebbing away because foreigners are unwilling to hold ever-increasing amounts of dollars.

The President has already said:

> At the same time, we do not pretend that talk of long-range reform of the (international payments) system is any substitute for the actions we ourselves must take now.

Our slow economic growth and our balance-of-payments deficit are but symptoms of curvature of our financial spine. The salves and ointments proposed so far may ease the pain temporarily, but the pain will return. What I am suggesting is the firm brace of fiscal discipline, displayed proudly and strongly to the world.

Chairman DOUGLAS. Thank you very much, Mr. Wilkinson.

I am going to ask a very primitive question but one which, I think, has real bearing.

I hold in my hand a Federal Reserve note for $5, and on it there is printed these words:

> This note is legal tender for all debts, public and private, and is redeemable in lawful money at the U.S. Treasury or at any Federal Reserve bank.

Now, I make a practice, when a new Secretary of the Treasury or his representative appears before us, of presenting such a note to him and asking him to redeem it in gold.

He always declines and, generally, when I say, "Well, I want it redeemed in lawful money," offers another Federal Reserve note in return for the Federal Reserve note which I gave him, and then when I present the second Federal Reserve note to him, he offers a third Federal Reserve note, and so on.

Now, I have not yet had the opportunity of presenting one of these notes to a Federal Reserve bank, and there is a Federal Reserve bank in Richmond, is there not?

Mr. WILKINSON. That is right.

Chairman DOUGLAS. I wonder if you would act as my agent and present the $5 bill, which I send to you, at the Federal Reserve bank in Richmond and say that I asked for $5 in gold?

Mr. WILKINSON. It would be a positive pleasure to do that, sir, but considering the expense in postage I want to give you $5 of mine so I will not be in debt to you.

Chairman DOUGLAS. Now, let me ask you this:

Do you think you can get gold?

Mr. WILKINSON. No, sir; I cannot get gold.

Chairman DOUGLAS. Well, this raises the whole question.

Since the Federal Reserve notes are not redeemable in gold or, indeed, a silver certificate is not redeemable in gold, I would like to ask what is the practical use of this 25-percent gold requirement?

Mr. WILKINSON. Senator, as a practical matter, insofar as exchangeability goes and the availability to Citizen Jones to get his hands on it, the value of that reserve is zero.

Chairman DOUGLAS. Now, that is a very frank statement.

Mr. WILKINSON. Right. Now, may I follow through a bit on that?

Chairman DOUGLAS. Surely.

Mr. WILKINSON. The value of it comes in the form that, like it or not, out of man's long and tortuous history he has come to regard the existence of a gold reserve requirement as a form of restraint, and if we were simply by congressional action at this time, in the atmosphere as I see it, to cut away that gold requirement we would be deemed by the citizenry in this country, many citizens in this country, and many people abroad, to be escaping a discipline.

Chairman DOUGLAS. Well, I take it your answer is that there is no practical purpose in maintaining this reserve but only a traditional and irrational purpose.

Now, should public policy be based on tradition and irrationality?

Mr. WILKINSON. Sir, you know well enough yourself, Senator—God bless you—you know well enough that rationality has its outer perimeter, and it is not very far.

Chairman DOUGLAS. Well, should one continuously accede to it or should one make some effort to transform irrational tradition into rational practice?

Mr. WILKINSON. I would be perfectly willing, under the set of circumstances which I can theoretically conceive, to consider the removal of gold as a reserve against Federal Reserve notes.

Even the Bank of England creates a statutory requirement for pound sterling notes and the House of Commons ups it any time that it needs or any time that the need seems to exist.

But I just do not believe for 1 minute, in the atmosphere that we are faced with in this country today, that we can by legislative action, without real peril, remove the reserve requirement or lower it.

You cannot get away from that, whether it is irrational or not.

Yes, if you and I were in a blueprint world, you are correct. We do not live in a blueprint world, however.

Chairman DOUGLAS. Well, the next question is, granted that you have to live in a somewhat irrational world, and no one knows this better than a politician—and we are frequently condemned because we realize that we live in an irrational world—should not there be some efforts to make reality, as I have said, conform more closely to reason rather than mere tradition?

Mr. WILKINSON. This is conjecturing to an extreme degree, but I should rather suspect that, as the events are evolving in the world, particularly in the Western World plus Japan, I would rather guess that in time that would come about through increased awareness of the sheer futility of this.

But I think to attempt to bring it about—if you will pardon my boredom of repetition—at a time such as we are in now would create a tremendous problem for the Nation.

Chairman DOUGLAS. Well, that is an interesting statement. It offers hope for the future, if not for the immediate present.

What has been happening, of course, has been the steady decrease in the fortunes of gold. Originally, gold and silver were used as coins as the medium of exchange, and then they became the reserves for paper money, and the ratio which they formed on paper money diminished from 100 percent——

Mr. WILKINSON. Right.

Chairman DOUGLAS (continuing). To a smaller figure, and then the creation of checking accounts and demand deposits appeared, checking accounts presumably convertible into money and the money convertible into gold, and a huge superstructure of the monetary media was being built up on a relatively small base of gold into which both credit and money, as it was then called, were convertible.

There then appeared a period of money panics which created great instability. Finally we took the step of moving from a gold standard to a gold exchange standard, in which neither credit nor currency was redeemable in gold for internal purposes, but where gold was still the primary agency for settling international balances.

Since the supply of gold was not thought sufficient for this, the dollar and the pound have been added, insofar as they were held by other countries, as a supplementary international reserve.

Now, if the supply of free gold should turn out to be insufficient to handle the volume of international payments, would you or would you not favor a reduction in this domestic reserve which certainly performs no useful function?

It is a vestigial remainder, one might say.

Mr. WILKINSON. Yes, I think that is correct. But it would seem to me that once you started reducing it along the lines you projected or conjecture about, unless we have taken the measures which, not in our view—we, as Americans, might hold a very different view from the foreigner who holds our dollars and can command our gold—unless we are operating internally in a fashion that is acceptable to the foreign holder of dollars we do a dangerous thing. Let's be frank about it, sir, we have lost to a degree the power of initiative.

To what extent we can retake it is really the heart of this whole question.

Chairman DOUGLAS. I thank you.

My time is up, and I will ask Mr. Curtis to take over.

I will merely say that I am not certain that the $5 has been returned.

Mr. WILKINSON. It has not, but I am counting on catching you on your way out, and I will return it.

Chairman DOUGLAS. Congressman Curtis?

Representative CURTIS. I would like to pursue this. I am not willing to abandon rationality as quickly as you and Senator Douglas seem to.

Senator Douglas posed this problem to you as a private citizen, and what you have said is true. But if you were a foreign government, is not there some difference in regard to this redemption?

Mr. WILKINSON. Oh, surely.

Representative CURTIS. Well, let's explore that. I want to let our minds go just a little bit further.

If it is true that there is more than irrationality—and if it actually has rationality to a foreign government—then, as our citizens relate themselves to a foreign government and through that exchange come back to the government, it has a direct bearing also on the full faith in the credit of the United States that is set forth in the dollar.

Would you comment on that? Is that not really what preserves the value of the dollar?

Mr. WILKINSON. Well, the confidence internally and externally in the dollar is what preserves it.

Representative CURTIS. Yes, but I am relating it to the gold reserve, the very syllogism that Senator Douglas presented to you as a private citizen.

Mr. WILKINSON. That is right.

Representative CURTIS. And where we know that our private citizens do not have the same right——

Mr. WILKINSON. That the foreigners do, that is right.

Representative CURTIS (continuing). That the foreigners do.

Mr. WILKINSON. That, of course, is to be regretted in some ways, but is a fact of law with which we are faced.

Representative CURTIS. That is right.

Mr. WILKINSON. You are correct, that the American citizen can protect himself in part by selling dollars and buying pounds and francs and buying foreign investments.

I was just looking at France. She has been picking on us a bit lately. Maybe we can comment on her.

I notice her gold holdings go up each week, each month in 1963, and that fascinates me a little.

There are certain other central banks and governments whose gold holdings remain quite stationary. It seems to me that somebody is trying to pull at us a little by this conversion of dollars into gold.

Now, it is one thing though to say that even if the dollars continue to flow, the French, the West Germans, and other central banks and the others who hold the dollars will act rationally and will cooperate with us; that is, not convert to gold. That is one thing, but they have a pressure leaning up against them, and it is the enormous pressure of their private citizens holding dollars and their private citizens can come in to them, turn those dollars in, and cause the central bank to build its holdings of dollars up and up and up, and there is a limit to which the central banks are going to hold them.

They are going to call for gold.

Representative CURTIS. All I wanted to do was to bring this full question right out into the open.

I am sorry that Senator Douglas left, after posing such a very narrow part of this problem, because I would like to have had the benefit of his further counsel on it.

I think that we are still dealing with a great deal of rationality, whether we agree with this or not.

Now, I am going to make a general comment for the benefit of either one of the witnesses who might want to answer.

I have been listening and reading papers on this subject for some time, and I must confess to a great confusion when I get into this field of monetary policy. But I have about concluded that the problem lies in the fact that there are two basically different schools of thought in respect to monetary policy. One school, which I would dub the neutralist, believes that money should be used as our primary economic weight and measure—weight of values in relation to goods, savings, and services. They believe that under the monetary policy our money should not be used to achieve other economic results, desirable as they may be, because of the great need to have, in an economic system, as realistic a weight and measure as we can.

There is another school of thought which very clearly feels, and has stated it many times, that monetary policy should be used to bring about economic growth or have a bearing upon employment or unemployment.

Those same people are advocating that we not adhere to a neutralist policy in our own domestic monetary policy. Furthermore, they seem to be the very ones who are arguing that an international medium of exchange should not be kept neutral in this sense and—perhaps the word "manipulate" is loaded, but I view it as a manipulation—they believe it is all right to manipulate in this field.

I wonder if you would agree with me that there is this very fundamental difference in these two schools, because I would like to know if I am in error.

Mr. KINDLEBERGER. Mr. Congressman, the distinction with which I am more familiar is that between the people who want to use monetary policy for domestic reasons and take their eyes off the international use of interest rates for regulating the international balance of payments, and those who say in our present world, where international money markets have become more integrated and where money is seeking the highest rate of return on an international basis rather than a national basis, that monetary policy can no longer be used for domestic purposes of stability——

Representative CURTIS. Yes, but can I interrupt you to carry it further? They are the very ones who do that.

Now, as I understand Mr. Martin's testimony over a period of years in the Federal Reserve System, he is seeking to create a money supply that conforms with the economic activity going on, not trying to change the economic activity. As he says, he is trying to lean against the wind.

I regard that as a neutralist policy, for they are trying to preserve money as a measure of economic values.

Now granted, this group—and I am well aware of them and they are predominant in many respects today—does want to use monetary policy just as you say. They are the ones, not the neutralists, who are now arguing that, because of other circumstances, monetary policy is not particularly effective in creating economic growth or hitting at unemployment.

They are "activists," if that is the proper term, and it is their arguments that seem to get the press attention and discussion. I know there are neutralists in the international field, and I would judge, by Mr. Wilkinson's paper, that he seems to be what I would define as a "neutralist" both domestically and internationally.

So, carry it from there.

Mr. KINDLEBERGER. Well, I have a hard time seeing what the distinction would be between an activist and a neutralist internationally, unless it is that a neutralist would let the rate of short-term interest adjust the international position.

Representative CURTIS. In other words, let the marketplace operate——

Mr. KINDLEBERGER. Except, sir, to the extent that you say you are getting a short-term capital outflow, then you have got to move into it and raise your interest rate or to the extent that you are getting too much of a short-term capital inflow you may want to lower it.

Representative CURTIS. Who is "you"?

Mr. KINDLEBERGER. I am thinking of the Federal Reserve System and the Treasury, as the monetary authorities of the country.

Representative CURTIS. Exactly, but are they doing it? Are they appraising the economic forces that apply, or are they doing it to try to change the economic forces?

There is the difference between the approach.

Mr. KINDLEBERGER. I see the distinction that is there, that is, whether they are responding to economic forces or leading them.

Representative CURTIS. Trying to create them.

Mr. KINDLEBERGER. Well, the line that I would take would be that the important distinction may be between the people who want to use the monetary policy on the domestic side, either the activist or the neutralist position on the domestic side, and those who would want to worry about it in the international sphere. I would have thought that as the world gets more and more unified, as corporations keep their funds, say, in Euro-dollars in London or wherever, you have a large floating mass of funds moving fairly stably, we are going to find that monetary policy can no longer be conducted on a national level. What this means in my judgment, sir, is that we have to move monetary policy to the international level to find the appropriate level of the short-term interest rate which fits the Atlantic Community, if you want to put it that way, or fits the major international capital markets rather than the one most appropriate for a given country. That means if you are trying to shape domestic conditions, then you have to rely more heavily on fiscal policy rather than monetary policy because monetary policy will be preempted by the international side.

Representative CURTIS. I go to the next point—and, of course, this is a field I feel a great deal more at home in—fiscal policy, particularly tax and debt questions where I have been a neutralist. I think taxes are to raise revenue and to meet the affirmative policies of government as expressed by expenditure policy.

The affirmative policies must be made, but tax or fiscal policy is being perverted, in my judgment, the same way that monetary policy already has been. We are going to create some real damage in fiscal policy if we move there. But it is quite interesting to me that these activists in monetary policy, having, as I regard it, corrupted the system or done their best to, now find that people are aware of their techniques. As a result, they aren't as effective now in manipulating economic events through trying to influence the value of money and are moving over into another field to see if they can manipulate that. I make this prediction, that they can manipulate taxes up to a point until people become aware of how taxes are being manipulated to bring

about economic results, and then they will find fiscal policy is deadened and doesn't have that reaction because people are one jump ahead of them.

At least there—getting back to what I was trying to project—thinking over all these papers, I am convinced that the fundamental argument should be developed that we must go back to our own monetary policy. What do we want to do with money? Let those who want to be activists in this argue their point out, and let those who believe in the neutralist theory that money should be a measure of value without tampering with measures if you really want to use it, argue their case. But this has never received full debate that I have seen. It is almost a begging of the question of those who say, "Of course we will use monetary policy to stimulate economic growth." "Everyone agrees," they said. Well, everyone doesn't agree. Let them go back and argue their case and win their case first.

I see my time has run out but I will come back, I hope.

Representative REUSS (presiding). Mr. Wilkinson, in your presentation you put a large share of the blame for slow growth and high unemployment in this country on low corporate profits. That is a correct understanding of your testimony, is it not?

Mr. WILKINSON. I put part of it on that, yes.

Representative REUSS. Would you be good enough to look at the most recent Economic Indicators with me, the October 1963 issue, at page 7, which is devoted to corporate profits. Do you have that?

Mr. WILKINSON. Yes, I do.

Representative REUSS. The top year is 1952 and it goes down to the third quarter of 1963. I notice corporate profits before taxes in 1952 were $36.7 billion. Today in 1963 they are at the rate of $51 billion. That is almost a 40-percent increase in that period, is it not?

Mr. WILKINSON. That is right. You, of course, are assuming that the second quarter profits in 1963 are going to turn out annualized. If you look back——

Representative REUSS. That is correct. That is the most recent figure.

Mr. WILKINSON. Right. But if you take annual rates you will find it is $48 billion, the annual rate.

Representative REUSS. That was the rate in the first quarter.

Mr. WILKINSON. Right.

Representative REUSS. Then I would like to have you turn your eye to the last column there, the one called "Profits plus capital consumption allowances," which is sometimes referred to as "cash flow."

Mr. WILKINSON. Right.

Representative REUSS. And there in 1952 cash flow was $29.6 billion, and in the most recent quarter of 1963 it is $58.9 billion. That is practically a 100-percent increase over that period from the top of the page to the bottom of the page, is it not?

Mr. WILKINSON. Yes, that is right.

Representative REUSS. Now, taking a look at the graph on the top of the page, and looking at the lines for profits before taxes, for profits after taxes, and for undistributed profits, let me ask you if the following is not true. Is it not a fact that for about 2 years prior to January 1961, all those three items were going rather steadily downward?

Mr. WILKINSON. That is correct.

Representative REUSS. That includes profits before taxes, profits after taxes, and undistributed profits. Is it not a fact that following January 1961 all three items have been going upward rather steadily?

Mr. WILKINSON. That is correct, yes.

Representative REUSS. And January 1961 was the month that John F. Kennedy was inaugurated, was it not?

Mr. WILKINSON. Yes. That is correct.

Representative REUSS. Well, isn't it a fact, then, that while there may have been downtrends in profits under an earlier administration, profits before taxes and after taxes both have been going rather steadily upward for the last close to 3 years?

Mr. WILKINSON. You are reading political implications in my remarks.

Representative REUSS. No, no. I am not. I am just asking whether it isn't——

Mr. WILKINSON. I have none.

Representative REUSS (continuing). Whether it isn't a fact that for the last 3 years since January 1961——

Mr. WILKINSON. That is right.

Representative REUSS (continuing). Corporate profits before and after taxes have been increasing.

Mr. WILKINSON. Yes.

Representative REUSS. And I am wondering, therefore, whether, in the light of all of the information we obtain from page 7 of the Economic Indicators, one can really assign a major share of the responsibility for our low rate of growth and our high rate of unemployment to corporate profits. I am wondering whether overall lack of demand in the economy is not a more important factor.

Mr. WILKINSON. Well, of course, this, Mr. Reuss, is representative of very much the same sort of division of thought to which Congressman Curtis referred when he delineated the two schools of the activists and the neutralists on this.

I have no question in my mind that the demand side of the equation as an upward pull is very powerful in the development of corporate profits. On the other hand, I do not visualize that such demand pull can be soundly generated through a continuous easy money supply or continuing budget deficits. I think that the demand pull comes not only through earned income, national income, personal income, the spending stream, but obviously it is enormously supplemented by consumer credit as adding to the pool of spendable money.

Representative REUSS. I wasn't so much asking you, Mr. Wilkinson, as to your preferred methods of dealing with demand——

Mr. WILKINSON. Right.

Representative REUSS. I was just asking for your observation on whether overall demand, or the lack of it, has not been in large measure responsible for high unemployment and slowed growth in recent years.

Mr. WILKINSON. Well, we have not had enough demand within our own country and internationally to consume all the production we can turn out.

Representative REUSS. Well, I think that is a very good answer and responsive to my question.

Mr. WILKINSON. Yes. Right.

Representative REUSS. Mr. Kindleberger, let me ask you a question.

Mr. KINDLEBERGER. Yes, sir.

Representative REUSS. I go right along with you in your banner of "Down with isolation, let's become interdependent and internationalist," but then I find, in order to join the crusade, I have got to be for high interest rates and apparently the same meager additions to the money supply in this country in the future that we have had in the recent past, and I would ask you, why is this necessarily so? Why can't I join your crusade toward international interdependence and away from isolation, which I dearly want to join, but why can't our club stand for monetary policies in the great countries of the free world which will contribute to their domestic full employment without inflation, and why shouldn't other countries at a time when we have both a slow rate of growth and high unemployment on the one hand, and a balance-of-payments deficit on the other, use fiscal methods to combat inflation rather than raise their interest rates without limit?

Why isn't that a more proper direction of internationalism?

And secondly, Why wouldn't it be a better way of ordering the free world if there were some reforms made in the international monetary mechanism, so that countries could pursue somewhat different monetary policies, depending upon their domestic situation, and let short-term capital gallop around, which is what it does under convertibility, but at the same time insulate countries against being the innocent victims of this great good of convertibility?

In short, can't one be a good fellow and an internationalist, as you are, and as I would like to be, without depressing the domestic economy by high interest rates and tight money?

Mr. KINDLEBERGER. Well, this is clearly what we are all trying to achieve. The difficulty, I think, is how we weight different objectives and how we view different mechanisms.

For example, there are some people who get out of this dilemma by adopting flexible exchange rates, and this happens in my judgment to do too much damage to the international payments system.

Representative REUSS. I am with you. I happen to agree.

Mr. KINDLEBERGER. I should have thought that this way of isolating countries so they can pursue an independent monetary policy is one which does a little too much damage. So I——

Representative REUSS. Right. Let's throw that out. We both wouldn't accept that. But why not isolate a country by either or both of these two methods: by getting other countries to stop being monomanic about monetary policy and use fiscal policy as a means of fighting inflation; and secondly, to get moving with a new international monetary mechanism which would give countries a breathing spell of 5 or 6 or 7 or 10 years, so that these long-term adjustments can take place, and they don't meanwhile have to undergo large-scale unemployment at home because it is said that they must keep the money supply tight and interest rates high?

Mr. KINDLEBERGER. Well, on the first point I agree fully. I think I did say that monetary policy would become a matter of international negotiation. The interest rate would become something which was not determined separately, but would reflect to some degree adjustments by all countries.

The Germans happen to like very high interest rates. If they try to lower them, they are fearful they will get more inflation.

Representative REUSS. Right. But why don't we urge the Germans to be internationalists, too, and to use fiscal methods—that is, taxing

more and spending less—if their problem is inflation, rather than raising their interest rates ad infinitum?

Incidentally, for the record, the Germans have been somewhat better in this department recently.

Mr. KINDLEBERGER. I agree.

Representative REUSS. But we are talking a hypothetical case here.

Mr. KINDLEBERGER. Well, in my view I think we may have some difference as to how effective we think interest rates are and in which direction. I happen to think that low interest rates don't stimulate a great deal.

Representative REUSS. I agree with you. But high interest rates can retard growth.

Mr. KINDLEBERGER. Exactly.

Representative REUSS. And whether a man is unemployed because there was a bad fiscal policy or a bad monetary policy isn't of much difference to him.

Mr. KINDLEBERGER. I agree.

Representative REUSS. He needs a job.

Mr. KINDLEBERGER. I would certainly like to see European interest rates come down rather than ours go up. On the other hand, all I am saying is if you have freedom in short-term capital movement, you are going to have to settle the rate internationally rather than nationally. I don't see that it is possible to insist that our needs must be met and not theirs. We think one thing about the appropriate level of interest rates here. They think something else. We are going to have to compromise, that is all I am saying, and that compromise is unhappy.

Representative REUSS. Why? You act as if there has to be one international going interest rate.

Mr. KINDLEBERGER. I think that is in fact coming, sir, just as for practical purposes in the short-term market there is one rate here.

Representative REUSS. Why is that such a great thing, though? That is my point. Why not let the countries of the free world pursue somewhat different domestic interest rate policies, and then protect against the resulting short-term capital movements by an improved monetary mechanism which will give much longer credit facilities than are now available, much more automatic, and larger amounts? Why penalize people who are moral, prudent, virtuous, and don't do anything wrong?

Mr. KINDLEBERGER. The difference as I see it is a technical one. It would be impossible. If in fact people in the United States who have money supplies, say corporations with balances, contemplate holding balances which they don't need in the short run, time deposits, in the market where they can earn the highest rate of return, then in fact these markets are joined and they are going to have one interest rate or an approach to this. You approximate it, unless you take steps to prevent it. One step would be to have the exchange rates flexible, which would mean people would hesitate to put funds abroad because they would run an exchange risk.

Another method would be foreign exchange control. I am not saying I advocate the unification of money markets. I am saying the unification of money markets is a fact which we are moving toward as the horizon of corporations which hold money is being lifted to the international scene.

I know one corporation which says, "We don't keep any money abroad, even though we could get one-half percent higher, because we think it is unpatriotic." But there are a lot of other corporations—and a lot of American money is held abroad because money markets are growing together. This is just taxonomics. I am just asserting this is a fact of life, that the international money market is fusing as exchange risks become regarded as less and less important. We are reapproaching the kind of unification of the international money market you had under, say, the sterling standard of 1913.

Representative REUSS. My time is up, but I would conclude by summarizing our colloquy here to give you a chance to disagree if I summarize it wrongly.

You would agree that though international money rates in the free world will tend to approach identity, it should be the object of free world policy to see that that identity is at as low a level as possible by inducing countries to use fiscal means to combat inflation, if their domestic inflation is what is bothering them, so that countries which need to expand can have the benefit of an interest rate structure which will not retard other ways they are pursuing of getting full employment.

And secondly, you would agree, I take it, that to the extent that interest rates don't attain complete identity through the free world, and I don't think you suggest that they would attain absolutely complete identity, an improved international monetary mechanism, which can give to the leading countries of the free world a longer time to adjust, and a method of financing themselves for a longer time in larger amounts while they are adjusting, is something that we ought to try to bring about.

Mr. KINDLEBERGER. Yes, sir. I think I might take a certain exception to how much of a change in the system would be required to do this. I think the system is working fairly well now.

I think I disagree with Mr. Wilkinson that we need more steps now. I think what we need—I expressed before this committee a statement some time ago, I think, which said, "Don't do something, stand there." I think we are adjusting. I think we are coming along.

Representative REUSS. Thank you very much.

Senator Javits?

Senator JAVITS. Gentlemen, I had a question that I would like to ask of Mr. Wilkinson, if I may. I notice that you have a prescription for dealing with the international imbalance of our payments which is very disturbing to our country, and I note that your prescription is as follows: First, the maintenance of relatively stable wages and prices; second, a brake on the rise in Federal expenditures; third, short-term rates to rise to the extent necessary to curb the outflow of funds; fourth, the tax cut; and fifth, telling our allies very bluntly that we are not going to continue to maintain, at our expense, armed forces and foreign aid at the risk of continued imbalance in our external payments.

Now, Mr. Wilkinson, suppose you tell them that very bluntly and they do nothing about it. Then what would you do?

Mr. WILKINSON. Well, I think our expenditures for military purposes in Europe are the greatest in France and in Germany. I believe that they are more afraid of the Russians than we are and that I would simply say we are going to keep the striking power but we will bring

it back to these shores and we will exercise it from here, and you may be sure for whatever our word has traditionally been worth we will exercise it under the same circumstances as have been said time and time and time again before the world.

I may be wrong, but the last figures I saw indicated, Senator—and you would know this in a minute where it would take me a week to find it—that the Germans and the French and some of the other Western nations would have to increase their military defense expenditures by roughly 25 percent to be carrying the burden in relation to national income comparable to ours. I don't see why they shouldn't do it. They are on their feet.

Senator JAVITS. Well, of course, their national income is lower than ours.

Mr. WILKINSON. That is right. But I was speaking of percentage.

Senator JAVITS. But economic well-being, after all, must be viewed in the context of the per capita income in a given country.

Mr. WILKINSON. That is right.

Senator JAVITS. Now, it is a fact, therefore, that you would be prepared to pull our forces out. Great powers can't bluff. You would actually be prepared to pull our forces out on balance-of-payments grounds if these countries would not take up the slack.

Mr. WILKINSON. Because balance-of-payments deficits lead into the cancer, the eating out, of our great economic strength.

Senator JAVITS. And would you say that this was so, even though the Joint Chiefs of Staff or the National Security Council might say that our defenses would be materially jeopardized?

Mr. WILKINSON. Well, Senator, you are now leaning up against me the weight of quite considerable authority whereas I was speaking as an individual citizen against any other individual citizen. It is clear to me that that is a high political question to be resolved at the highest levels. I am trying to focus on the fact that this balance of payments is eating at our vitals.

Senator JAVITS. I think the balance of payments is critically important and I think I was one of the very early ones to make that point very strongly.

Mr. WILKINSON. You were.

Senator JAVITS. I will say, however, in all fairness to you that I think it is an oversimplification just to tell them very bluntly that we are pulling back our forces. What happens then?

May I ask you another question: What is your attitude about the proposed interest equalization tax which attempts to deal with the drain attributable to the outflow of long-term investment funds?

Mr. WILKINSON. It seemed to me that the interest equalization tax was a perfectly doable and bearable step at the time it was taken. If you carry it to its ultimate in principle, you have then set up a form of capital control. If you regard it as really temporary and take, as I hope we will—and the President seems to feel we will—concomitant steps to buttress our position so that that tax can be lifted in time, I think it is a bearable burden.

I think it is a step in the wrong direction if carried to the ultimate.

Senator JAVITS. Well, do you prefer that to some form of capital issues committee in a major capital market like New York?

Mr. WILKINSON. I think I do, but were it necessary to continue to raise that tax and carry on these restrictive measures on capital move-

ments abroad further through the tax medium, I am inclined to think, strange as it may seem, I would shift to the capital issues control technique.

Senator JAVITS. Would you say, therefore, if we passed it at all, we should pass it for a limited period, say 2 or 3 years?

Mr. WILKINSON. I feel that very strongly, because I think it will also, hopefully, bring into force other measures correcting the basic problem.

Senator JAVITS. So that it should not be a permanent tax.

Mr. WILKINSON. That is correct.

Senator JAVITS. Now, about exports, which we must encourage, of course. Do you see any connection between the encouragement of exports and the world's credit base about which there is so much discussion now? That is, we had testimony, for example, yesterday that you have to look to the problems of world credit and liquidity if you really want to measurably expand the trade of the world.

Mr. WILKINSON. No.

Senator JAVITS. You don't see that.

Mr. WILKINSON. I don't see that.

Senator JAVITS. May I ask you this: Do you think, in order to stimulate exports from the United States, we should give some special tax concession to new exports which, for example, other countries do in order to stimulate exports?

Mr. WILKINSON. I have not examined the question, Senator Javits, and therefore I wouldn't like to express an opinion. I think it is an intriguing idea and I think that really one facet of that point you raise would be to have the other countries reduce their tax subsidies, for indeed that is what they are.

Senator JAVITS. Well, of course, our difficulty, sir—and I didn't mean to corner you in respect to this question on Western defense costs. It is quite difficult to get other countries to do things, and so, in the first instance, we have to think about what we can do ourselves.

Mr. WILKINSON. Right. Let me make this observation, if I may. You gave me no impression you were trying to corner me. I think that the more that Americans express their views—I assume the Western World's ambassadors are pretty alert and if they find a rising sentiment of opinion in America that fact is reported—and I think that makes their countries perhaps in a more negotiable frame of mind.

Senator JAVITS. Well, I think that is true. I think that really the way we get the best result is by putting ourselves in the posture where we help ourselves, and those measures of self-help at the same time bring out from others cooperative measures.

Mr. WILKINSON. Right.

Senator JAVITS. That is why I speak of more intense competition for exports because that is the kind of a measure which makes people a lot more willing to talk.

Mr. WILKINSON. Right.

Senator JAVITS. Now, I would like to, if I may, turn to that part of your ideas which relate to the 25-percent gold cover requirement for our currency and deposits. I notice that as a banker you feel that this would be a very inopportune time to free that gold and in that respect you are in direct difference with Professor Kindleberger who sits next to you.

Now, if you haven't given it before I arrived, could we have some reaction from you now that you have heard and seen his argument on that matter?

Mr. WILKINSON. The atmosphere which exists today in which there is increasing questioning of the dollar seems to me to make it an inappropriate time to try to escape from the discipline which in one form or another we must salute if we are going to bring the balance of payments into approximate balance. Indeed, I think Professor Kindleberger would agree that they are either going to be in surplus or deficit somewhere all the time in the very nature of things. But our basic trade position is out of balance by about $1.5 billion. So I would suspect that we very definitely would make a mistake to say to the world or imply or let the world have a hint that we were unable, unwilling to face any discipline, and so, therefore, we just say "Eliminate the gold cover."

Senator JAVITS. Professor Kindleberger, would you want to answer?

Mr. KINDLEBERGER. I can't agree with that at all. It seems to me that the discipline afforded by the internal gold requirement is absolutely minimal as compared with the discipline we have already established for ourselves in the gold crisis of 1960 under the Eisenhower administration, the balance-of-payments task force established by President Kennedy, the President's message last July. It seems to me we don't need this particular bell which is referred to in the previous testimony simply because we already have enough others. Moreover, it is not a bell but if it makes any clang at all, it is a mere ball and chain around our leg. It is getting in the way of paying out gold to those foreigners who want it to establish the confidence that we will in fact support the dollar.

To the extent that foreigners believe that there is some inhibition on our ability to support the dollar, then they may take panic and this is quite the wrong posture to be in.

I would have thought that this is a most archaic, obsolete requirement. Let me say this. If as I envisage, and I think the Treasury envisages, we are going in the future to include foreign currencies in our reserves as well as gold, and if we regarded the first tranche of our quota with the IMF as equivalent to gold, we certainly ought to amend the gold requirement to include these liquid international reserves as internal backing. But this, of course, it seems to me, is going in the wrong direction. The gold requirement now is inadequate, obsolete, archaic, serves no useful purpose, and I would dispense with it.

Senator JAVITS. Well, would it also be part of your thinking that the dollar is in enough jeopardy in terms of international confidence that we ought to mobilize and have liquid, as it were, our weapons to deal with that confidence, to wit, all our gold?

Mr. KINDLEBERGER. I accept the second part of your statement but I would submit, sir, that with respect to the present jeopardy of the dollar, the literature in Europe is beginning to suggest that it is the Europeans that are in jeopardy. I don't know how many of you have seen the article by Mr. Lamfalussy, the Belgian economist and banker, in Lloyd's Bank Review for October which starts talking about can Europe stand the forthcoming deficit? Under Secretary Roosa suggested signs the other day that the tide is changing.

I would suggest we do need to mobilize all our resources and have them ready, but I would think the jeopardy is lessening rather than increasing.

Senator JAVITS. And, of course, this is all attributable to our very efforts to overcome the imbalance in international payments because it is that very imbalance which represents the world's liquidity margin.

Mr. KINDLEBERGER. Yes. And an effort which I think is appropriate to say has had very little relationship to the limit set by the internal gold requirement. Certainly the alarm started possibly late. Possibly we were unwise not to have seen in the 1950's, the new shape of the balance of payments of the United States. As early as 1959, however, it was clear what was happening and action was begun then long before the final dollar of internal gold cover was threatened.

Senator JAVITS. I would like to ask you one other question. I am very intrigued by your suggestion, in connection with the international imbalance of payments, that we might consider transferring some of the defense stockpile of commodities to other nations in the Atlantic community in view of the fact that we have a common reason for the stockpile. Why shouldn't they carry some of that load where we have a lot of frozen money?

Mr. KINDLEBERGER. Well, sir, this idea occurred to me because of the fact that they might in fact prefer tangible commodities to——

Senator JAVITS. To a call on gold.

Mr. KINDLEBERGER. To a call on gold. We have had difficulty, at previous times, you know, with the tricky subject as to what inventories, let us say, of food the British should carry during World War II. The availability of stockpiles of defense materials in a period of crisis is awkward. I think we now have the feeling that our stockpiles are getting too high, too onerous. I am afraid that the administration and Congress have used defense stockpiles from time to time as a way of baling out commodities in difficulty. I would have thought that there might be some gain for them and for us in exploring this possibility. I am only suggesting exploration because I am not in any position to carry the thing further. They might like to turn in a chunk of dollars for a chunk of commodities.

Senator JAVITS. It is a very interesting idea and it has been brought to me before. Some efforts are being made by people I know to work out a practical proposal, but it is a most intriguing idea and to have you pick it up was very interesting confirmation to me of what I had already heard.

Thank you, Mr. Chairman.

Representative REUSS. Senator Miller?

Senator MILLER. Professor Kindleberger, you took issue, at least in part, with Senator Javits' discussion or comment on the jeopardy of the dollar.

Mr. KINDLEBERGER. Yes, sir.

Senator MILLER. Do I take it from your answer that you recognize that the dollar is in jeopardy or you recognize that confidence in the dollar has been going down but that it is your opinion that the confidence, the degree of the downgrading of the confidence of the dollar is diminishing?

Mr. KINDLEBERGER. Yes, sir.

Senator MILLER. In other words, you would probably go along with Mr. Wilkinson that the confidence in the dollar needs to be restored.

Mr. KINDLEBERGER. Oh, yes, sir; very much. I should have thought, sir, if I may say so, that the second quarter figures of the balance of payments which appeared during the summer and which showed such a sharp outflow of long-term capital exaggerated the position fairly sharply, that the fundamental forces were beginning to turn and that, as so often happens just as the turn occurs, the short-run circumstances show things worse. We were lulled into a false sense of security by the events of the Suez crisis of 1957–58. I think we may have been lulled into a sense of undue alarm by the balance-of-payments position of the second quarter of 1963. But I don't want to lean my professional reputation too much on that.

Senator MILLER. Why would it be undue? In other words, I am reading your paper in which you say "possibly because of the undue sensitivity of the press" with respect to the gold losses. What is undue about the sensitivity of the press?

Mr. KINDLEBERGER. Well——

Senator MILLER. With respect to our gold losses?

Mr. KINDLEBERGER. Well, I would like to make a point that I have felt for a long time. Let me single out my favorite newspaper, and that of many, the New York Times. The New York Times gives a front-page headline each time the cost of living index rises one-tenth of 1 percent, which strikes me often as being no movement at all, and it also gives headlines——

Senator MILLER. Pardon me. Strikes you as what, did you say?

Mr. KINDLEBERGER. This strikes me as being misplaced concreteness, I will put it that way. It is excited about things which are really trivial and features them unduly in the news. I cite on the one hand the fact that it gives a front-page headline to an increase in the cost of living of one-tenth of 1 percent. For example, we have had 20 headlines in the last 5 years that the cost of living is rising, where I would have said the most important thing about the cost of living is that it has been stable. All these rises have been so exiguous, so tiny. Similarly, a gold outflow should not make the headlines if there has been a larger decline, let us say, in foreign balances owed by the Federal Reserve System or by the New York banks or an acquisition of foreign currencies by the Federal Reserve System. Newspapers take one item of the balance of payments and single that out for headline discussion. And all I am saying is that it gives a misleading picture of what is happening in the foreign exchange market during the week to headline gold. Gold is tangible. Gold, therefore, gets the headlines. And I would have thought one wants a more rounded picture of what is happening—particularly since when we lose $10 million worth of gold and foreign balances go down $20 million we have gained.

Senator MILLER. Do you think that this situation in which we find ourselves where we need to restore confidence in the dollar is attributable to the——

Mr. KINDLEBERGER. Oh, no.

Senator MILLER. To the undue sensitivity of the press?

Mr. KINDLEBERGER. No. All I am suggesting is that the fact that any change in gold or even a nonchange in gold gets a headline in the press means that the Treasury, it seems to me, goes to some lengths to arrange it so that from time to time the Government stock looks unchanged. I think they are being unduly sensitive but I say they may

be responding to an undue sensitivity on the part of the press. I would rather see us be prepared to pay out gold more readily than to attempt to fudge the books a little bit, if I may put it in that indelicate way, which strikes me as being a mistake.

Senator MILLER. Well, what I am trying to find out is just where this loss of confidence in the dollar comes from. What is the cause of it? Now, I thought possibly you thought it was due to the press but now you say——

Mr. KINDLEBERGER. No, no.

Senator MILLER. You say it is not.

Mr. KINDLEBERGER. No.

Senator MILLER. Why is it that you two gentlemen talk about restoring the confidence in the dollar? Mr. Wilkinson in four different places in his paper talks about restoring the confidence in the dollar. What is wrong with the dollar that there shouldn't be confidence in it? What is the economic indicator that causes you to say this?

Mr. KINDLEBERGER. Well, I would have said, sir, that it is our basic balance of payments which has showed too large a deficit over too long a time, and this is the real reason. And by the way, one should headline, then, an increase in foreign balances in New York just as much as a decrease in gold because each of these is offset by the basic balance. But——

Senator MILLER. In other words, you are saying that it is the deficit in the balance of payments rather than the outflow of gold that is causing the loss of confidence in our dollar.

Mr. KINDLEBERGER. That has done it in the past; yes.

Senator MILLER. Do you agree, Mr. Wilkinson, that it is the balance-of-payments deficit rather than the outflow of gold which is causing the loss of confidence in our dollar?

Mr. WILKINSON. One is, Senator Miller, but the extension of the other because the continuing adverse balance of payments to which Mr. Kindleberger refers and the resulting lack of confidence causes foreigners to take gold in exchange for dollars and move gold out. So it is just the extension of that. It is the same.

Senator MILLER. We have had testimony before the committee that you could have a deficit in the balance of payments, a continuing deficit in the balance-of-payments situation, without an accompanying outflow of gold if there were sufficient confidence in the dollar. Now, you do not agree with that?

Mr. WILKINSON. Yes, I do. I think you could have a continuing deficit in the balance of payments if there were confidence in the dollar greater than now exists, but the nature of the deficit, what brought it about, whether it is a temporary movement of short-term funds around the world or whether it is due to greater commitments abroad than our current trade and service balances will support, that would have a lot to do with whether you could continue to have one. How does this deficit come about? And is it in the process of likely correction? If it is not, then I don't think you can have continuing imbalance of payments without an outflow of gold. If it is something that is being corrected and you see that your basic measures are being taken and the Nation is not trying to sort of weasel its way around and out of something but is saluting the problem, I think you can get somewhere with it.

Senator MILLER. Well, then, the immediate problem seems to be to restore the confidence in the dollar by stopping the outflow of gold and in turn stopping the balance-of-payments deficit.

Mr. KINDLEBERGER. I should have reversed them, sir.

Senator MILLER. Well, either way you have it.

Now let me ask you this. I would like to find out just why we are continuing to lose our supply of gold. What is the reason? I have been told that there are differing requirements in central banks for a certain relation or ratio between gold and currencies and all of that. But when you talk about confidence in the dollar, it seems to me that maybe one reason at least is that the holders of our short-term liabilities in these foreign countries have an idea that the dollar is slipping and they would rather have gold.

Now, is that so?

Mr. WILKINSON. That is correct.

Senator MILLER. Do you agree?

Mr. WILKINSON. That is my feeling.

Mr. KINDLEBERGER. For the most part, of course, it is the central banks that are acquiring the gold rather than private individuals and I do refer to the fact they have been inching up in their ratio of gold to total reserves. The Posthuma plan was designed to meet that situation. I happen to think that really what is needed is confidence rather than any mechanical plan.

Senator MILLER. Why wouldn't this inch upward their holding of dollars? It would be very——

Mr. WILKINSON. He said inching up their holdings of gold.

Senator MILLER. Yes. But I say why wouldn't it be better if they were inching up in their holdings of dollars?

Mr. KINDLEBERGER. Senator, I don't think that is very relevant. I say the proportion of dollars in reserves really isn't the issue and I think that is where we are unduly sensitive to this proportion. I think——

Senator MILLER. The point is that the gold continues to go out and has been going out rather rapidly. We hope it isn't going to be so bad this year, but it has been very severe: $900 million last year, about the same as the previous year, and considerably more than that in the preceding 3 years. There is no point in talking about taking away the $12.5 billion in gold reserves for our currency unless we see a dark cloud sitting out here, so I take it we are very concerned about the outflow of gold. The question is, Why are these foreign creditors asking for gold unless their confidence in our dollar has been diminishing? And Mr. Wilkinson, I take it, agrees that their confidence has been diminishing, which is why they have been building up their gold reserves, gold supplies; right?

Mr. KINDLEBERGER. Yes.

Senator MILLER. This confirms what I have been maintaining for sometime, and as Congressman Reuss pointed out, at page 7 of the Economic Indicators, what the corporate profit picture has been since President Kennedy took over, I think it only fair to point out that probably what businessmen are most concerned about is corporate profits after taxes, and I note that from 1961 on up to the mid-term this year, corporate profits after taxes have increased some $5 billion. That might sound fairly good were it not for the fact that over on page 35 I perceive that starting at the end of fiscal year 1961—so we are clearing 1961 there—the national debt has gone from $289.2 to $306.5 billion, so it has increased $17.3 billion. In other words,

we spent $17.3 billion more than we took in while we were getting $5 billion more after taxes in corporate profits.

And then on page 2, where gross national product is shown, if you relate the increases in gross national product in terms of 1962 prices, we find that we have $21.5 billion of inflation during this period of time.

So I just would like to suggest that this all ties in with the loss of confidence in the dollar while we are incurring this inflation and that it perhaps puts the increase in corporate profits in a little better perspective.

I presume, Mr. Wilkinson, that some of those corporate profits would contain elements of inflation, would they not?

Mr. WILKINSON. That is true.

Senator MILLER. My time is up.

Representative REUSS. Mr. Kindleberger, Mr. Pollack of the staff has asked whether you would be good enough to spell out—perhaps in a letter or a supplemental paper which could then be made part of this record, because I assume it is a little complicated for your immediate answer—a few implications of what you said about gold points. Specifically, one, what is the relationship of today's gold points to the gold points of the old gold standard? I interrupt myself to say we will give you this in writing.

Two, what does widening the gold points have to do with the permissible range set up by the IMF of exchange rate variation?

And, three, why would this widening be a move in the direction of flexible exchange rates? Couldn't exchange rates remain exactly as at present?

We will write this out in a letter to you and would appreciate it if you could file with us some spelling out of your points there.

Mr. KINDLEBERGER. I should be delighted to Congressman Reuss.

(Subsequently the following communication was received from Mr. Kindleberger:)

NOVEMBER 18, 1963.

Senator PAUL H. DOUGLAS,
*Chairman, Joint Economic Committee,*
*Congress of the United States,*
*Washington, D.C.*

DEAR SENATOR DOUGLAS: At the conclusion of the hearing before your committee on Wednesday, November 13, 1963, Acting Chairman Reuss put to me three questions which I believe were raised by the staff of the committee. These questions and my answers, for what the latter may be worth, are as follows:

1. What is the relationship of today's "gold points" to the gold points of the old gold standard?

Under the old gold standard, the gold points represented that disparity of an exchange rate between two gold-standard currencies from the mint parity, calculated by dividing the gold content of one currency by that of another, which would just make it pay to buy gold in one country and pay the costs of transferring it for sale to the other. The costs of transfer included handling charges levied by the central bank or Treasury, if any, plus freight, insurance, assay fee, etc., and interest on the money tied up. These gold points were determined to a considerable extent by conditions in the freight, insurance, and similar markets; they were of course affected by the rate of interest.

Today's "gold points" represent for the most part practices of central banks. Foreign central banks still are obliged to pay the one-fourth percent handling charge which the U.S. Treasury charges for purchases and sales of gold—selling gold at $35.0875 and buying it at $34.9125. This charge establishes the minimum range within which their currencies move against the dollar. The maximum is fixed by a ruling of 1954 under the articles of agreement of the International Monetary Fund which calls on members to support their currencies

against gold (or dollars) within a range of 1 percent either side of their exchange parity. Most foreign countries have in fact supported their currencies by buying and selling them against dollars within a narrower range, typically about three-fourths percent either side of parity.

Little, if any, private arbitrage of gold takes place currently. But the costs of shipping gold between New York and London, estimated at 12 to 14 cents an ounce, set limits on the fluctuations of the London gold price expressed in dollars. This can go as high as $35.20 without drawing gold from New York, and as low as $34.80 without inducing movements to the United States. Within these limits, however, foreign central banks with gold in New York and London are likely to buy in one market and sell in another to earn a small profit or to adjust the geographical position of their stocks.

"2. What does widening the gold points have to do with the permissible range of exchange-rate variation?

If a widening of the gold points were desired, the most effective means would be for the U.S. Treasury to increase its gold handling charge. If this increase were to go beyond 1 percent, the ruling under the Fund's articles would have to be altered. If it went to 1 percent, if the Fund's regulation were not altered, and if Fund members all observed the Fund ruling, the present range of exchange fluctuation which is based on the Treasury's handling charge of one-fourth percent and an exchange agio in various countries, but not the cost of shipping gold, would not be widened greatly. At present the effective range of fluctuation of sterling—roughly $2.82 and $2.78—is about three-fourths percent either side of parity.

3. Why would a widening of the gold points be a move in the direction of flexible exchange rates? Could not exchange rates remain exactly as at present?

If the United States were to increase its handling charge for gold to say 2½ percent—which I do not recommend—and if the International Monetary Fund were to widen its range of permitted deviation from parity by this amount or more, it would still be possible for foreign countries to stabilize their exchanges against a given currency, by buying and selling that currency within selected limits. But it would not be possible to do so against gold unless some other country than the United States were willing to buy and sell gold within a narrower spread. If, as at present, the United States remained the principal country with a statutory commitment to buy and sell gold against its currency, the U.S. dollar could vary within a 5-percent range around the fixed relation to gold, and so would every other currency. But it would still be possible for another central bank to fix narrower limits, stabilize its own currency more narrowly in terms of gold, and make it possible for other countries to do so.

In replying to these questions, I should like to acknowledge the aid of an unpublished memorandum by Robert Z. Aliber.

Sincerely yours,

CHARLES P. KINDLEBERGER.

Representative REUSS. Thank you. Mr. Curtis?

Representative CURTIS. I want to follow up a little bit on the point which Mr. Reuss started and Senator Miller has continued. I have a note on your paper, Mr. Wilkinson, where you were giving us the various increases in corporate before-tax profits and gross national product. Senator Miller has emphasized that the corporations are concerned about profits after taxes.

I would point out that what they are concerned about in investment is profits per investment dollar. That is what bears on the incentive to invest.

Mr. WILKINSON. Rate of return on capital.

Representative CURTIS. Yes. And I was going to ask whether we had the additional figures. You give these other percentage increases, but what has been the percentage amount of capital invested, the increased amount? One of the points we made in our minority views to the Joint Economic Committee report on the President's Economic Report this year was the decline in the return on investment per investment dollar, from about 14 percent—I think we used 1947–51 as a base—to around 9 percent now. Do you have any comments on that?

Mr. WILKINSON. I am quoting from the monthly review of the Federal Reserve Bank of Richmond, October 1963:

> In the 1957–62 period while hourly rates were growing at an annual rate of more than 3 percent (exclusive of most fringe benefits), the rate of return on equity capital was declining by 2.6 percent per year. This followed a 10-year period in which the divergence had been even greater.

Representative CURTIS. To me here is the key issue, and it lies behind a good bit of why our investments have been going abroad. The administration wants to put an excise tax on investment abroad—as if that would stop it. I think the forces of anything flowing toward a freer climate, whether human beings or investment dollars, are going to get there. The best way to keep them in our own country is to free our own climate rather than to try to erect a type of Berlin wall.

I want to get to what I think is another basic question. So much of the discussion in this whole field has been without distinction between the Government sector and the private sector. Mr. Wilkinson, again you point out in your statement that our problem is one of American liquidity since most of our foreign assets are long-term investments, whereas our liabilities, although substantially less, are much more liquid and more volatile. This is a point I have maintained ever since this balance-of-payments problem began.

Our investment portfolio abroad is excellent and we get a tremendous return from it. It is a great thing. This business of trying to interfere with that portfolio is going to cause trouble for the future in my judgment, as far as balance of payments is concerned. This is one of the affirmative aspects. But I am led to this question: The problem also lies in the fact that the United States operates, thank goodness, primarily through the private sector, not the governmental sector. These other countries abroad are much more heavily oriented toward operating through the governmental sector in actual economic endeavors, but even where they have a private sector, they have for years imposed all sorts of restrictions on investments of their own people.

There is a lot of State trading that goes on and one of the basic problems is whether we can use the political mechanism. Should we use the political mechanism to assist in this or should our position be to try to encourage these countries abroad to withdraw their political government from these economic areas and emphasize the private sector more? What disturbs me is that the United States, having grown great on the emphasis of the private sector, is now trying to imitate the countries abroad which have relied on the governmental sector.

Surely it is a problem, because we cannot control our investments abroad through political fiat. We rely on the marketplace and have traditionally done so. Other countries haven't. And now we are coming in through monetary policy, and fiscal policy, through the development of a protective tariff, which is what this amounts to as far as stocks and bonds that would come here for sale are concerned.

This lies at the base here and is a basic policy.

Should monetary policy be neutral in our own country, and if we decide that it should be, then shouldn't it be as neutral as we can make it in international affairs? I don't know that we can, but that is the question.

The second major policy question involves a balance between the Government and the private sector. I find very little discussion in all

the papers, although there have been lots of articles written on this subject, hitting at what to me are the key points.

Would you comment, Mr. Kindleberger?

Mr. KINDLEBERGER. You have raised a very large topic.

Representative CURTIS. Yes.

Mr. KINDLEBERGER. I would agree fully that it would be desirable, for example, to have, let us say, capital markets in Europe loosen up, become more responsive to private initiative. To a certain extent, the markets in, say, Germany, France, Switzerland, are moving in this direction a little bit and the Treasury has pushed them in this direction as a means of trying to take pressure off the New York capital market.

I think more can be done and I would certainly urge it to be done.

On the other hand, Senator Javits did say it takes two to play this game. I am a little unhappy about Mr. Wilkinson's reply to his question whether we should stimulate tax concessions for export because Europeans do this. I think that I would urge that we try to get the Europeans to stop. He suggested we couldn't do this because that is out of our control. But I would have agreed that it is much better for us to try to get them to move in the direction we think is the correct one than to employ methods they use, and I happen to be for freeing the markets where the market performs a good job.

Representative CURTIS. Well, I am glad to hear that. I have a question in my mind of whether for those reasons I want to see markets develop abroad. One of the other great assets that we have in our society in the balance of payments is the fact that we do have the only really developed capital market, and we gain revenue, although I don't know exactly how much, from providing the services available in this market. But here is another approach of the Kennedy administration, to hit at that very thing. It almost looks as if they hit at the strengths of our system—our trade balances and our private investment portfolio. This great mechanism of a capital market here is bringing in real money, or earned money, to our society.

Those are the things that are being attacked in our desire to hit at this basic balance of payments which I think is an economic problem and not, as has been developed here, one of press reporting or the fact that you see the indicators such as gold flow. That is to me just an indicator of what is going on. It is fundamental economics that must be examined.

I might even go back to the basic point I raised in this line of questioning, that of percentage return per invested dollar. Why will the dollar be invested here or anywhere? Doesn't it relate to the return on capital? And yet we keep saying, well, corporate profits have increased. Well, that is great but on what basis? What is the basis on which the profits apply that give us this important figure of per investment dollar?

My time has expired.

Representative REUSS. Mr. Wilkinson, I am under the impression that you have an engagement quite shortly, is that right?

Mr. WILKINSON. I have to leave in a few minutes.

Representative REUSS. Senator Miller, did you have any further questions?

Senator MILLER. Yes. I would like to ask Mr. Wilkinson this question. You premised your approval of a tax cut on the fact that we have expenditures held in line at the 1962–63 level.

Mr. WILKINSON. Right.

Senator MILLER. Plus the fact that any deficit that might occur from this will be financed out of the savings.

Mr. WILKINSON. Outside the banking system.

Senator MILLER. Through the purchase of Government bonds.

Mr. WILKINSON. Outside the banking system, that is right.

Senator MILLER. Now, it has been forecast that an $11 billion tax cut in 1964 and 1965 will indeed perpetrate practically an $11 billion deficit, maybe get a little kick in revenue during one of those years. But we are going to be in a deficit situation anyhow, I am told. Now we come along and we are going to make it worse with the tax cut.

Do you really think we can get $11 billion out of savings to finance that tax cut?

Mr. WILKINSON. Yes. I would not think that was beyond the achievable. I think it would be very difficult but we are possibly on the verge of excess capital in construction, in building, at the moment. I believe that your social security, government pension fund, private pension funds, and others would have enormous money to invest. I also think that if you were to have this joint resolution—it has to be joint—it would help. The executive spends but the Congress appropriates. And at times they have been at odds. One will appropriate more money than the other asks for and at other times they won't give them as much as they ask for.

If you have as strong an assertion of the national will in that area as I suggest, I think you would see a great deal of fixed interest investment come out of hiding and be willing to go in there, contrasted with equities. It would be such a ringing declaration of a great nation.

Senator MILLER. Well, may I say I do like your idea of the joint resolution. It can't do any harm. It might do some good.

Let me ask you this further question. Let us say that for fiscal 1964 we are going to have a $6 or $7 billion deficit regardless of the tax cut. Now we come along and we have a tax cut which superimposes, let us say, $5 or $6 billion more on top of that. You have already said that the tax cut is OK with you, provided that the deficit attributable to the tax cut is financed out of savings. Would you care to step further and say, "Provided also that any other deficit that may accompany the tax cut which would exist regardless of the tax cut also be financed out of savings?" So that, in the example I put to you, the $6 or $7 billion deficit that we would have regardless of a tax cut would also be financed out of savings as well as the extra $5 or $6 billion on top of that that would come from a tax cut?

Mr. WILKINSON. Senator Miller, I had in mind that the total deficit would be financed out of savings. I would never have the Government default on an obligation, so I would finance it wherever I could, but that in turn would be such a smack in the face to the American people that they would see very quickly what the financial and economic realities were. The deficit has got to be financed.

Senator MILLER. Otherwise we just print the money.

Mr. WILKINSON. Well, of course; right.

Senator MILLER. May I say I thoroughly agree with you on that point.

Now, the thing that bothers me, however, is that if the tax cut has for its purpose the provisioning of extra money to stimulate the economy, and we come along and take your suggestion to finance that tax cut by taking out of the private economy the money necessary to finance it, where does that put us ahead? We are taking the money out of the private economy which otherwise is going to stimulate the economy. We are going to put it in here to buy Government bonds so that we will have a tax cut which will give some extra money to stimulate the economy. It looks like we are going around in circles.

Mr. WILKINSON. No. The stimulation of the economy of the type I envision would come from business plans for capital expenditure and for expenditures in the public sector of such breadth and dimension that I think there you would receive your economic stimulation. The money you think of being sucked out of the economy to finance it, or the savings, also continues in circulation because if individual X pulls it out of his personal spending stream and invests it, he continues to receive interest on his investment and the debtor spends the money he invested. The pension funds and the private funds as well as corporate funds that are now already in existence for investment are annually increased and are perfectly enormous. I do not envision a conflict there.

Senator MILLER. Well, it seems to me that the money that would be used out of these pension trusts to buy bonds would otherwise be used to finance some spending programs, otherwise they couldn't bear interest from the borrowers. I just can't quite get the difference you are driving at.

If you take that money out and put it in Government bonds, you are in effect going to lend it to Uncle Sam to, in turn, give a tax cut to people to invest in plant expansion and the like, whereas if you leave it sitting right there in the trust funds where they are right now, aren't they going to lend it out to businesses to invest and have their plant expansions?

Mr. WILKINSON. Yes. Businesses, many of them, not all—and this is one of the problems in the private sector of the economy—have enormous capital funds today that they are not employing in the industries of which they are a part. They have become fourth or fifth—we have so many—banking systems. They are lending great amounts of money. Your total gross private domestic investment increases at a pretty substantial rate each year as you will see from page 8 of Economic Indicators, and I would suspect that the aggregate of private domestic investment would certainly be able to absorb the financing of this deficit at bearable rates, and the minute that you had an easier money market in which to do it, you would call those bonds and refund at a lower rate. That is the way it has worked throughout history.

Senator MILLER. Well, let me ask you this. If you suck out $11 billion from this private capital to finance the tax cut, isn't that going to have a tendency to increase the interest rates?

Mr. WILKINSON. I think it would inevitably increase interest rates somewhat but probably where I would disagree or have a divergent view from Mr. Reuss, for example, is that I don't think that the increase in rate would be of the dramatic proportions that would stymie

business recovery because, as I tried to say in my presentation, the more fundamental thing is encouragement of the private sector through the tax cut, and I think that that upward surge of confidence would more than offset the increase in rate that might be involved in financing such an upsurge plus a Government deficit.

I think that it is utterly impossible for any one of us to sit here and say interest rates would go up a half or a quarter or an eighth or three-eighths, but I do feel that that is secondary to the benefits that would flow from a tax cut, but to have a tax cut without financing this out of savings in my opinion is just "asking for it."

Senator MILLER. Well, I couldn't more thoroughly agree with you on that. However, I was a little disappointed that instead of advocating not only the savings financing of any deficit and also advocating the resolution to hold expenditures, that you didn't couple with that an advocacy of cutback in spending to make room for the tax cut so that the tax cut would in the first place meet the qualifications of being meaningful by having a stable dollar, and second, so that you wouldn't be pulling this $11 billion out of private investment capital and possibly having an increase in interest rates.

Mr. WILKINSON. Senator Miller, I suppose that when as a citizen you have been trying your damnedest to give voice to something and it never occurs, you are inclined to try another tack. I am very discouraged about getting reductions in Federal expenditures, and I believe if we can redress it the other way around, of taking this terrible tax burden off of our people, corporate and personal, lightening it—you never take it off, lightening it—then I think you obviously make the debt that we have thus far more bearable. So I have decided after some 15 or 20 years of working that street to try another one. But I know that the primrose path that smells so sweet in this tax cut is full of thorns.

Senator MILLER. Indeed it is full of thorns. But let me encourage you, Mr. Wilkinson. The 15 years sounds like a long time but it might be well worth it if we still adhere to the kind of fiscal and monetary policies which will see to it that we don't have a short term of euphoria followed by another 1932. And I think that you can take some courage, probably more from Congressman Curtis than you can from me, about what the Houses of the Congress have been doing with some of the $98.8 billion budget. I am just wondering if you think it is practicable to recommend or continue to recommend a cutback in spending at least relative to increased revenue. I am not just saying let's say revenue goes up $5 million next year. That doesn't mean we have to stay with the same budget we had this year. I am talking about relative to income, cutting back spending or holding spending in line to the extent that we do make room for the $11 billion tax cut. Would you prefer to see that happen?

Mr. WILKINSON. Yes. It is beyond the realm of credibility that a $98 billion expenditure can't be cut.

Senator MILLER. Thank you very much.

Representative REUSS. Thank you.

Tommy?

Representative CURTIS. I would like to make this request, Mr. Chairman. I have some questions I prepared. I don't want to burden these witnesses too much, but I would be very happy if I

could supply those questions to both of you and if you would be kind enough to supply answers. Then I could have it put in the record.

Representative REUSS. Without objection.

Mr. KINDLEBERGER. I shall be delighted to, sir.

Mr. WILKINSON. I will certainly try.

(Subsequently the following communications were received in response to a letter dated November 14 from Congressman Curtis:)

MASSACHUSETTS INSTITUTE OF TECHNOLOGY,
DEPARTMENT OF ECONOMICS AND SOCIAL SCIENCE,
*Cambridge, Mass., November 19, 1963.*

Congressman THOMAS B. CURTIS,
*New House Office Building,*
*Washington, D.C.*

DEAR CONGRESSMAN CURTIS: Your letter of November 14 setting out certain questions reached me only today, and I hasten to reply. Herewith are your questions and my answers:

1. It is often said that U.S. balance-of-payments deficits have tended to dampen inflationary forces in this country while tending to contribute to inflationary pressures in the reserve-accumulating countries abroad. Sometimes the United States is said to be "exporting inflation." Is this view essentially correct? Would the United States have experienced greater inflation in recent years had it not been for our continuing balance-of-payments deficits?

Answer: It is true that a deficit in the current account in the absence of capital movements is deflationary. When the deficit is in the basic balance, however, or in overall balance, the answer to your question is not given as easily. The outcome depends upon what would have happened to the capital if it had not flowed abroad. Assume a current account surplus of 100 but an export of capital of 200 units, so that the balance is in basic deficit by 100. If the capital would otherwise have been invested at home and used up local resources, the deficit may be regarded as deflationary, since either domestic investment or full transfer of the capital outflow would have put greater pressure on domestic resources. On the other hand, if the alternative to the capital outflow was merely an increase in liquid savings in the United States, the fact that a part of the capital outflow was transferred through the payments mechanism could be regarded as expansionary.

The preferred answer, in my judgment, is that a deficit in the basic balance, or in the overall balance, deriving from a current account surplus but a still greater capital outflow, is "relatively deflationary."

2. What are the advantages and dangers involved in extending the gold exchange standard to embrace additional strong currencies which would then be held as reserves just as the dollar and the pound are held today? Might not such a multiple key currency system be inherently unstable? A multiple currency system has been said to have an inflationary bias even greater than the present system. Is this so?

Answer: I agree that a system of multiple key currencies might be unstable, provided there was an inadequate degree of cooperation and coordination among the monetary and fiscal policies of the key-currency countries. But I do not see that increasing the number of key currencies raises the chances that the gold-exchange standard will be unstable. The instability of the gold-exchange standard stems from the practice that a key-currency country adapts its international monetary and fiscal policies to changes in its gross reserve position, rather than to changes in its net reserve position, i.e., taking into account changes in its liabilities as well as changes in its assets. If the new countries added to the list of key currencies are unable to learn from the experience of the present key-currency countries, and are obliged to repeat their mistake in ignoring the increase in liabilities until late in the day, it would be more unstable. If, on the other hand, they can profit from the lessons of recent history, it should not be. Adding to the number of key currencies might, in fact, increase the stability of the system by insuring that mistakes of policy, such as responding to changes in gross rather than changes in net reserves, are smaller, the more widely the reserves are divided.

3. Prof. Fritz Machlup has said that a system of fixed exchange rates under which equilibrating actions exclude deflationary measures and under which surplus nations are obliged, or feel obliged, to purchase the currencies of deficit nations at fixed prices, is inherently inflationary on balance. Do you agree?

Answer: I agree with Professor Machlup that a system of fixed exchange rates with adjustment made largely through inflation in the surplus countries is inflationary on balance. So, too, however, is a system of adjustment through depreciation of the exchange rates of deficit countries. In a world where the deflationary pressure is unemployment which is politically excluded, it is hard to see that there is any system of adjustment which does not lead to net inflation on balance. Only if technical progress proceeds rapidly and leads to lower prices is there a chance of halting the upward movement of prices. If the upward movement of prices can be kept slow, however, mild upward price pressure throughout the world is preferable to some combination of unemployment and/or balance-of-payments maladjustment.

4. Are the currently existing exchange rates among the major industrial nations equilibrium rates? If some major currencies are undervalued, would not an upward valuation of these currencies be desirable? Wouldn't revaluation of undervalued currencies be less disturbing to the system than devaluation of the dollar?

Answer: In my judgment the present set of exchange rates is on the verge of becoming, with recent price movements, an equilibrium one. This was not true in 1959 or 1960, and at that time I favored an upward movement of the undervalued rates, rather than a depreciation of the overvalued ones. In retrospect, however, the churning about of short-term capital movements which the March 1961 appreciation of the deutsche mark and the Dutch guilder produced seems to have reduced the appeal of discontinuous adjustments of exchange rates on a frequent basis, though these may sometimes be unavoidable. When adjustment is necessary, there is much to be said for some appreciation of the undervalued rates, and some depreciation of overvalued rates, both in relation to gold, so that the average price of gold in all currencies is unchanged.

I agree that if a change were required in the dollar vis-a-vis the deutsche mark, French franc, Dutch guilder, Austrian schilling, Spanish peseta, and Japanese yen, it would be better to alter the several European currencies than to devalue the dollar and require decisions on the part of monetary authorities throughout the world, such as would be required if the dollar and/or sterling were devalued. But I believe that the early undervaluations of the Swiss franc and Italian lire are well on their way to correction, and I expect this path is being followed by the other European currencies named.

Thank you for the opportunity to comment on these important questions.

Sincerely yours,

C. P. KINDLEBERGER,
*Professor of Economics.*

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STATE-PLANTERS BANK OF COMMERCE & TRUSTS,
*Richmond, Va., November 21, 1963.*

Congressman THOMAS B. CURTIS,
*New House Office Building,*
*Washington, D.C.*

DEAR CONGRESSMAN CURTIS: I am pleased to attempt to answer the questions contained in your letter of November 14. I appreciated the opportunity of appearing before your committee and hope that the attached answers to your questions will be of some assistance to it and to you.

I would be remiss if I did not mention to you my feeling of admiration for the obvious efforts you have made to inform yourself on this very complex question. Such matters do not have obvious political significance but are of vital importance to our country and I feel that you are performing a real service in your attempt to understand the situation.

With very best wishes, I remain,

Sincerely,

J. HARVIE WILKINSON, Jr.,
*Chairman of the Board.*

QUESTIONS FROM CONGRESSMAN THOMAS B. CURTIS AND RESPONSES BY J. HARVIE WILKINSON, JR., CHAIRMAN OF THE BOARD, STATE-PLANTERS BANK, NOVEMBER 21, 1963

Question. It is often said that U.S. balance-of-payments deficits have tended to dampen inflationary forces in this country while tending to contribute to inflationary pressures in the reserve-accumulating countries abroad. Sometimes the United States is said to be "exporting inflation." Is this view essentially correct? Would the United States have experienced greater inflation in recent years had it not been for our continuing balance-of-payments deficits?

Answer. Inflation within a given country is subject to influence by fiscal and monetary policies. The American unfavorable balance of payments is, in many ways, but the end result of the inflation which we have experienced in this country in the last decade and a half and the burden of international commitments which we have undertaken. These commitments have been far in excess of our favorable trade surplus. Inflation has tended to make us less competitive internationally and made it difficult for us to increase our trade surplus.

Inflation in any given country can be greatly affected by fiscal and monetary policies. Thus, the countries receiving dollars and treating them as part of their reserve base could have offset the inflationary implications of a swelling of their reserve monetary base.

I do not think it is possible to state in a simple response that the United States would have or have not experienced greater inflation in recent years had it not been for our continuing balance-of-payments deficits. These payments deficits did not become critical until 1958, and we had substantial inflation before then. There are many factors at work, and we do well not to try to find too simple a diagnosis lest we fall to the error of treating symptoms rather than the disease itself.

Question. What are the advantages and dangers involved in extending the gold exchange standard to embrace additional strong currencies which would then be held as reserves just as the dollar and the pound are held today? Might not such a multiple key currency system be inherently unstable? A multiple currency system has been said to have an inflationary bias even greater than the present system. Is this so?

Answer. The strength of every currency (including those classified as "additional strong currencies") rests basically on the economic strength back of the currency and on the adoption by the nation in question of sane fiscal, monetary, and wage policies. Any national currency is subject to and greatly influenced by the given nation's political policies. Until a higher degree of political unity evolves in the Atlantic community, it is likely that strong currencies will turn weak and weak currencies will turn strong. Accordingly, the use of any given multiple currency system inevitably has in it these weaknesses. Neither man nor nation can escape from discipline, but the discipline of nations is harder to effect than the discipline of the individual. All nations at one time or another try to escape discipline. Any effort toward a multiple currency system has inherent in it an inflationary bias, and hence needs the ingredient of gold. Any multiple currency units should be utilized only as a small fractional part of the reserves of all countries until we have accumulated some experience in this area.

Question. Prof. Fritz Machlup has said that a system of fixed exchange rates under which equilibrating actions exclude deflationary measures and under which surplus nations are obliged, or feel obliged, to purchase the currencies of deficit nations at fixed prices, is inherently inflationary on balance. Do you agree?

Answer. I have not read Professor Machlup's treatise wherein set forth and do not feel qualified to respond.

Questions. Are the currently existing exchange rates among the major industrial nations equilibrium rates? If some major currencies are undervalued, would not an upward valuation of these currencies be desirable? Wouldn't revaluation of undervalued currencies be less disturbing to the system than devaluation of the dollar?

Answer. If every major currency except the dollar were valued upward, this would be the mechanical equivalent of devaluing the dollar. While nations are loath to undertake upward revaluation because of the deflationary pressure it puts on their exports, there has been in recent years an upward valuation of one or two strong currencies.

I do not feel in a position to state that present exchange rates among the major industrial nations are equilibrium rates. No relationships among rates will last indefinitely unless identical political, fiscal, and monetary policies are pursued by individual nations—often in concert and, it is to be hoped in the case of the Atlantic community, increasingly in concert.

Representative REUSS. I want to express the appreciation of our committee to both Mr. Kindleberger and Mr. Wilkinson for their help this morning, and we will now stand adjourned until this time tomorrow morning in this place.

(Whereupon, at 12:35 p.m., the committee was recessed, to reconvene at 10 a.m. on Thursday, November 14, 1963.)

# EXHIBITS

## LETTER FROM SENATOR DOUGLAS TO LEADING BANKERS AND REPLIES RECEIVED THERETO

JOINT ECONOMIC COMMITTEE,
*Washington, D.C., October 31, 1963.*

DEAR SIR: I am sorry to learn through the staff of the Joint Economic Committee that you will be unable to participate in person at our hearings on November 13.

Both Senator Javits and I have been anxious to get some expression of views from leaders in the banking community upon the arguments for and against modification or repeal of the legal 25 percent gold certificate reserve requirements against Federal Reserve liabilities. The inquiry by our committee does not involve consideration of immediate legislation, but is intended to broaden public understanding of the role of the legal cover today as compared with the earlier period when it was enacted in 1913, and a consideration of what factors might influence the timing of action to modify or repeal the present legal requirements if such change should seem desirable.

Although you will be unable to discuss the matter with the committee in person on the date suggested, we would, nonetheless, welcome an expression of your views. Such a statement, even though taking the form of a brief letter, would make a valuable contribution to the record of our hearings.

We recognize that the subject is regarded by many people as an extremely sensitive one, but we believe also that a better general understanding of the issues may make the problem easier to solve should the need become more urgent.

Faithfully yours,

PAUL H. DOUGLAS, *Chairman.*

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MORGAN GUARANTY TRUST CO. OF NEW YORK,
*New York, November 12, 1963.*

Hon. PAUL H. DOUGLAS,
*U.S. Senate,*
*Washington, D.C.*

DEAR SENATOR DOUGLAS: I regret that my schedule makes it impossible for me to participate in person at your committee hearings on November 13. However, in response to your request, I am pleased to submit a brief written statement of my views regarding the present legal requirement that Federal Reserve notes and deposits be backed to the extent of 25 percent by gold certificates.

This requirement, in my judgment, is illogical in the context of the monetary system that has evolved in the United States. Back in the early 1930's when this Nation stopped coining gold and took it out of circulation, it in effect abandoned the notion that gold should function as the critical limiting factor on the size of the domestic money supply. I for one do not regret that decision, since by my reading of history this country's experience with the gold standard was not very satisfactory. The record shows that it did not prevent wild fluctuations in the value of money or in economic activity. The system of discretionary monetary management that replaced the gold standard has imperfections also, but I am confident that it affords better promise of facilitating the fulfillment of the Nation's economic objectives on a continuing basis than would any return to arbitrary rules.

The present gold-certificate requirement is an untidy remnant of the country's gold-standard days. Adhered to strictly, it would deny our authorities all flexibility in the exercise of monetary policy if U.S. gold holdings fell to a point where they were equivalent to only 25 percent of Federal Reserve notes and deposits. This would be a most unwholesome situation. If economic recession happened to be a threat at such a time, Federal Reserve officials would be prevented from taking their customary contracyclical steps. In a favorable economic situation,

monetary authorities would be precluded from accommodating further growth. In both instances, the consequences could be harsh in terms of employment and general well-being.

To relate that the United States moved away from gold domestically some 30 years ago is to tell only half of the full story. Equally important is the fact that we stayed on it internationally, declaring our readiness to buy and sell gold at a fixed price in transactions with foreign governments and central banks. This was simply a practical recognition that there was no full substitute for gold in the settlement of international balances among nations, a condition—let me emphasize—which continues to hold true in 1963. In a very real sense, the gold policy devised in the 1930's represented an acknowledgment of the need to narrow the utilization of gold to its most important, and most effective, use.

Requiring a reserve of 25 percent in gold against Federal Reserve notes and deposits tends to negate this intent and in so doing weakens the position of the United States internationally. At the present time, approximately $12 billion worth of the Nation's total gold stock of $15½ billion is set aside for legal reserve purposes, technically leaving only $3½ billion free for settling international balances. I think there can be no doubt that the dollar would enjoy better status throughout the world if the entire U.S. gold stock were clearly earmarked for making international settlements. Repeal of the 25 percent requirement would accomplish this realistic restatement.

While I am persuaded that elimination of the reserve requirement is desirable in principle for both domestic and international reasons, I would be inclined to defer the initiation of repeal action until such time as the country's balance-of-payments situation is firmly secured. I feel this way because of the furor that would almost certainly be created by congressional consideration of the step. You will recall, I am sure, the emotional excitement occasioned 2 years ago merely by the introduction of Representative Multer's repeal proposal. In the main, the promise of repeal should be reassuring to foreign governments and central banks, but it might also be misunderstood by others, including some Americans, and this could produce unfavorable shortrun consequences. These considerations will be relevant, however, only so long as the country is experiencing payments pressures. Once the tide turns, I would favor proceeding with repeal.

The necessity for early congressional action on this matter is lessened because of the power which the Federal Reserve Board presently possesses to suspend the gold-certificate requirement. I do not regard this as an adequate substitute for repeal over the longer term, in part because the language in the Federal Reserve Act which specifies the penalties that would accompany suspension is not as clear as it should be and in part because each finding by the Federal Reserve Board that suspension was necessary would tend to create an atmosphere of emergency. I view the alternative of divorcing gold from its illogical link to the domestic money supply as a far sounder resolution. But the suspension powers do constitute an important safety valve for the time being. On balance, I prefer to rely on them, rather than on repeal, until the payments situation improves decisively.

I first publicly advocated repeal of the 25 percent reserve requirement in a speech delivered in November 1960, at that year's annual meeting of the Investment Bankers Association. Because that talk contains a somewhat fuller development of my ideas on national gold policy than does this letter, I am enclosing a copy of the full text.

Sincerely yours,

HENRY C. ALEXANDER,
*Chairman of the Board.*

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TEXT OF ADDRESS BY HENRY C. ALEXANDER, CHAIRMAN OF THE BOARD, MORGAN GUARANTY TRUST CO. OF NEW YORK

OF MEN AND MONEY

Mr. President, distinguished guests, members, and friends of the Investment Bankers Association of America, thank you for inviting me to your annual seminar in the sunshine. The beauty of the ladies present adds greatly to the brilliance of the day. For one who toils in the tame confines of commercial banking, usually in the shadowy canyons of Wall Street, this is, indeed, a pleasant opportunity—one to be enjoyed in pleasant surroundings with friends who

are stimulating and lively both day and night, completely characteristic of the investment banking profession.

Thanksgiving is 4 days behind us. A national election is 3 weeks behind us. A new year and a long, long future are just ahead of us. I have no doubt that your deliberations here during the next few days will explain the past and show us the light and the way for the future.

I can suggest this because for many years I have had it stressed to me that this is a working convention. The officers of our bank who attend it year after year and who return to their desks in a state of trembling exhaustion—from what, I am not sure—emphasize the hard work that is done here. In all events, membership in the IBA is cherished by our bank. We value our membership as a Government securities dealer and as a municipal securities underwriter and dealer. But we also have a sentimental reason for holding this affiliation dear.

It preserves a link in spirit, though unfortunately not in profits, with the days when J. P. Morgan & Co. and the Guaranty Co. were full participants in the investment banking business. I trust it is no violation of the Banking Act to recall, with some wistfulness, that those were exciting days. For sheer, agonizing drama, packed into a short space of time, I doubt that there is another process in the business world to compare with an important piece of underwriting. It has the careful buildup, the mounting tension, the moment of truth when the books are opened, and then the quick unraveling of the plot—either glorious success or sudden death. It all has a format as classic, in its own way, as the theater of the ancient Greeks. But, for those of us in commercial banking, that particular kind of excitement ended some 26 years ago, in the early days of a "Deal" that was then called "New."

Going back to dwell on that period hardly makes, I fear, a cheery thought for many of us on this Florida morning; but there is a point to be drawn from those days and the ones that followed which has some meaning for the present.

Then we were in the first stages of a political era in this country which was to last in all for 20 years, and which was to carry, among its other trademarks, the stamp of being generally hostile to business. Not surprisingly, this climate produced in most businessmen a defensive reaction that was equally hostile. One does not have to be a deep scholar of history to see that a prolonged period of such cross-purpose in our society was a bad thing. Without trying to apportion the blame, I believe most people will agree that an atmosphere that set Government against business, business against Government, was a costly misfortune for all groups in this country.

That 20-year era was followed by 8 years in which the atmosphere was different. There was a turn away from the direction of constantly more Government intervention in the lives of people and in the work of business. It was a turn toward the firm road of free enterprise.

Now again the Nation prepares for a change in national administration. By earlier rules, perhaps, this would call for a hasty return to old battle stations, for a quick resumption of old stances and the invocation of old slogans. I hope we have outgrown those rules. I hope no future Government in this country will regard its mission as one of punishing business. I hope no generation of businessmen will automatically and instinctively lapse into a persecution complex about Government.

The majority of businessmen, I believe, hoped that Vice President Nixon would be elected. I know I did. The electorate has rendered its decision—a close one indeed. Those of us who supported the Vice President might well follow his example of graciousness in reaction to the outcome. I don't doubt that we, or some of us, shall find things to criticize in the new administration. But let's not rush to dig into the back corners of the closet for the uniforms marked "opposition," the ones we put away 8 years ago. Let's not, as businessmen, wall ourselves off, or sulk in our tents. Let's keep the lines of communication open. The great problems facing this country don't permit any group, however disappointed, to withdraw from the search for sensible solutions, to pout on the sidelines. I would add that those problems also do not permit any group—though defeated at the polls—to be put in the penalty box.

Among the most urgent of these problems is the problem of money. For, if you go down the list of our great national objectives—the preservation of peace, the protection of the free world, the making of a better life for our people and for those in other lands—not one of these ideals will be within our grasp unless we keep our economy strong, and that means keeping our currency sound.

This, I realize, does not sound like an heroic challenge. It is not romantic, not very exciting. The task I outline lacks the glamor of new frontiers, but

it does possess the hard truth of old realities, the bedrock—not the shifting sands—upon which we can build the enduring structure of our Nation's great future.

Many speeches have carried the message about the need to keep our money sound. But today this message is being proclaimed, in terms more eloquent than all the speeches, by that ancient commentator, gold. As the poet said,

> "Gold! Gold! Gold! Gold!
> Bright and yellow, hard and cold."

When gold speaks, men listen. When gold moves, men watch. Lately we have been treated again to glimpses of the fascination this substance holds, the purposes it serves, the myths it inspires. There are facts about gold and there are fancies, folklore, and fables. Which is which is not always easy to know, but we must know more.

Gold is in many ways a distinctive substance. It's pleasing to look at, bright without being flashy. It's easy to identify, impossible to counterfeit. Man tried for centuries, but he doesn't even try any more. Gold doesn't deteriorate with time. It doesn't shrink or expand with changes in the weather. It's always been scarce enough to be much craved and sought after and never to be for long in surplus. Even today, after man's quest for it over the centuries, the total store of gold held for monetary purposes in all the free world amounts to some 36,000 metric tons. At the U.S. Treasury's official price of $35 an ounce, it is worth about $40 billion. That's less than half of what our Federal Government spends in a year. You could stack all of it solidly in a room 40 feet long, 40 feet wide and 40 feet high—a space no larger than a small ballroom.

The amount of new gold mined annually has been rising. Free-world production is running about a thousand tons a year, something over a billion dollars at the official rate. The output of the Soviet Union and its satellites is a secret, but we do know they are important producers. This despite the fact that Communist doctrine ridicules the metal and Lenin is said to have promised that one day the public washrooms of Moscow would be plated with it.

Here in the United States we have never lacked respect for gold, though in normal times our appetite for it has tended to be somewhat restrained. It was not restrained, however, in the frantic days of 1933, when the great depression was deepening and faith in all currencies was failing. The public demand for gold was so great that the Government slammed the lid on domestic convertibility and temporarily embargoed shipments abroad.

Franklin Roosevelt, in the first days of his administration, used the emergency powers of a World War I law to do this. Such drastic action was justified only by the grimmest of necessity. Over the next 9 months, in helter-skelter fashion, laws were passed, directives issued, market maneuvers undertaken, and the gold clause in contracts abrogated. There were mistakes, and there were injustices. But, improvised though it was under the gun of panic or near panic, the gold policy which emerged from those days has proved workable and is with us still. It has enabled the dollar to become the fixed point about which nearly all the free world currencies now array themselves in a monetary solar system.

The important thing about 1933, in retrospect, is not that we went off gold, but that we stayed on it in a different way. We stopped coining gold and took it out of domestic circulation. But, for legitimate monetary purposes, we declared our readiness to buy and sell gold at a fixed price in transactions with foreign governments or central banks. In narrowing the utilization of gold, we were following a trend which the other major financial countries had begun as they worked their way back from the chaos of World War I. Those countries, holding much less gold than we did, but nevertheless wishing to tie their currencies somehow to gold, looked for ways to economize their supplies of the metal. For the most part, they stopped minting coins of gold—a practice Winston Churchill described as "unwarranted extravagance." The place for gold, this line of reasoning holds, is not in people's pockets or under their mattresses but in the official holdings of governments and central banks for use in the settlement of international balances.

That reasoning is the core of our gold policy today. That is why none of us is allowed to own gold in this country, and why we shouldn't be allowed to hold it abroad. To satisfy considerations of taste, custom, or utility, incidental use of gold is permitted in the arts, in jewelry, in ceremony, in dentistry, and in industry. Taken all together, these applications don't claim enough gold to threaten the adequacy of the world supply available for official monetary purposes.

A threat is posed at times, however, by two other uses to which gold is put; hoarding and speculating. By drawing gold into private hands, those uses work against the policy adopted by this country and most others of conserving gold in official holdings.

Some countries, in deference to local custom or other considerations, allow the private buying and selling of gold under certain conditions, even though they have the same general policy of economizing their gold reserves as we have. These are the so-called free markets in gold, about which we have heard a great deal recently. The best known is the one in London. It has been open since 1954, after being closed for nearly 15 years during and after World War II. Other markets, varying in degree of organization and formality, include Paris, Zurich, Brussels, Amsterdam, Frankfurt, Beirut, Hong Kong, Macao.

The supply of gold to these markets comes from new production (including sometimes that of the Soviet Union), from hoarders who have grown tired of hoarding, from speculators who have decided it is time to sell, and on occasion from governments or central banks which enter the market for one reason or another. The demand comes from hoarders and speculators who are on the buy side, from people who are uneasy about their currency, and—again on occasion, when the price is low enough—from governments or central banks.

The price gold brings in these markets tends to fluctuate, sometimes rather violently. In the first few years after World War II, gold sold often at well above $50 an ounce in the markets then open. This didn't attract much attention in the United States—nothing at all like the run up in price in London last month. The London market, because of that city's historic financial role and its prestige, draws more notice than the others. This explains why there was concern recently at seeing gold quoted there as much as $5 above the official price maintained by the U.S. Treasury.

Concern was proper, but not principally over the brief appearance of $40 gold in London. After all, the appetite for gold is a capricious thing, like all human appetites, and sudden flareups or fallbacks of demand in thin markets can produce sharp swings in price. More troublesome is the question whether such markets will in time draw into private pockets and strongboxes significant quantities of gold that are needed for official holdings. This involves, also, the question whether the official reservoirs should, in an effort to discipline such markets, pour their gold into pipelines that may lead to the great sinkhole of hoarding and speculation.

Certainly the United States, which has not seen fit to allow private trading in gold here, would have nothing to gain, and conceivably a good deal of its gold to lose, in undertaking to stand astride the foreign markets and keep the price there pegged. That is not the way to defend the dollar. We must defend it at home with sound monetary and fiscal policies, with wise monetary and fiscal management, and with the strength of our economy. The dollar is not up for trial by the whims of the world's gold markets.

We hear criticism of our officials for letting some speculators pay $40 for gold in London rather than presenting them with gold to which they were not entitled and charging them only $35. The Treasury's stated policy toward premium prices for gold in foreign markets has quite properly been one of flexibility and noncommitment. It has been neither open mouth nor open faucet. The Treasury is free to stay out of those markets or to find ways of going in if it believes that course best for our national interest. What the Treasury's day-to-day decisions in this regard have been, I, of course, do not know. Neither does any other private citizen, although that fact has not prevented the tipsters, the inside dopesters, and the oracles from being busier than ever.

The free markets for gold are not this country's responsibility. Nor do they provide, as is sometimes supposed, a bridge by which we may hope one day to return to a gold standard of full domestic convertibility such as we had prior to 1933. There is no bridge that will take us safely back there. We ought to face that fact squarely.

Too much lipservice is paid to the notion of "getting all the way back on gold," always with the reservation that we should do it "when the time is right." This ritual has become a sort of loyalty oath by which to prove one's belief in sound money. It shouldn't be. Sound money is well-managed money, honestly managed money, wisely managed money; and we will get it by having sound, honest, wise monetary authorities and sound, honest, wise fiscal and economic policies. We will not get it by submitting to the automatic, unreasoning operation of a gold coin standard with full convertibility here at home. For all the reverence still paid to it, did that standard actually work so well? It was supposed to

stabilize, but we had the wild boom of the 1920's and the deep depressions of the 1890's and the 1930's.

We cannot and should not move all the way back to gold. But it is essential that we retain in our monetary system, as indeed we do, the discipline that gold exerts through its flow from country to country. Man, in his history, has tied his currency to many substances. None of them has been perfect; when the imperfections of one have become too troublesome, he has moved on to another. If ever—and this does not seem a near probability—but if ever our present system for settling international transactions becomes an obstacle to true economic progress, then a new system will have to be devised. It might or might not involve a breakaway from dependence on physical masses of metal. But of this we can be sure: if currencies ever are to have their base not in some metal but in a code of rules, then those rules must have the firmness of metal and must provide a discipline equal to that now imposed by the movement of metal from country to country.

Though we cannot put gold back on its past pedestal, we most certainly cannot ignore its present message. Gold is still the stern voice of monetary discipline. For some time now it has been proclaiming the need to keep our money sound and to put our balance-of-payments position in order. The message was read sooner and more clearly in the weekly charting of our official gold outflow than in the erratic price movements of the foreign gold markets.

We have been losing gold at a brisk rate; not to speculators, not to nervous hoarders, but to governments and central banks of countries that have piled up dollar claims against us. They have continued increasing their dollar holdings, still showing confidence in our currency. But, as our negative balance of payments keeps providing them with dollars, they inevitably cash some of them for gold.

Thus our massive gold supply—still nearly half the free-world monetary total—buys us time in which to cure the stubborn imbalance in our international transactions. It buys us time, but it will not buy us an eternity; we must press vigorously on with every sensible measure to correct soon the deficit in our foreign payments.

We can be heartened that our Government is going at the job with determined measures, and we must trust that the new administration will carry the work forward. The directives issued by President Eisenhower this month, to minimize the balance-of-payments impact of Government operations abroad, dramatize both to our own people and to our allies the earnestness with which we view the problem. This will reinforce our continuing efforts to persuade our prosperous partner nations to carry a larger share of our joint burdens in military preparedness and economic assistance. Persuasion in these delicate matters will take time and persistence, as was evident in Europe last week. But our case is a valid one and should be successful in its outcome.

The efforts we ourselves are making will also add weight to our argument when we press for removal of barriers that still discriminate against our exports. It also will help explain why we may have to "tie" an increasing proportion of our foreign-aid grants and loans to the purchase of American goods. This "tying" of aid is not an attractive idea for us, and we should drop it as soon as other countries cut the "ties" which effectively bind their grants and loans. Right now we must employ every appropriate means to strengthen our payments position.

To our country's credit, we find no serious advocacy of trying to solve our problem by taking the dead end road of devaluation, making our gold worth more by writing up its price and writing the dollar down. That course would not buy time, it would only buy trouble. Other countries, to protect their exports, would devalue with us; all faith in currencies would be jeopardized; the gold-poor, underdeveloped countries would be further impoverished; and we would present the Soviet Union with a huge gift in the appreciated value of its considerable gold holdings. It would be silly, and it would be immoral.

No, we are nowhere near the point that would even call for consideration of such an extreme move. We can defend the dollar with sensible policies, underpinned by the bedrock of a sound economy. We have to work from the bedrock up; move forward with our technology, get rid of growth barriers in our tax structure, sharpen our competitive abilities in world trade, walk the straight line of monetary and fiscal integrity.

Alerted by the warning signal of gold, we are tidying up the house of our financial policies. While we are doing so, let's straighten a few pieces of old furniture.

Our gold policy now prohibits residents of the United States from owning refined gold in this country. That policy should be extended to prohibit the holding of gold anywhere by U.S. residents.

The purchase of gold abroad is, in practice, a privilege of rather limited availability. The means and the mechanisms required for its exercise make it so. And the exercise of it runs counter to our basic national gold policy. It can have very unfortunate side effects. When people living here buy gold in foreign markets, observers abroad tend to exaggerate the significance. The buying of speculators or eccentrics is likely to be mistaken for signs of concern among responsible investors.

Sealing up this gap in our gold policy would in no way interfere with the freedom of all residents to change their dollars into any foreign currency, to spend or invest their dollars anywhere in the world. Maintaining freedom of currency exchange is essential to the defense of the dollar; allowing a relatively few individuals to own gold overseas is not.

Along with protecting our store of gold, we should make clear—to our own people and to the world—what our gold is for; namely, for making international settlements, not for redeeming our currency and deposits. Requiring a reserve of 25 percent in gold against the notes and deposits of the Federal Reserve banks makes our gold supply for international payments only about one-third of our total gold holdings. Nearly $12 bililon worth is set aside as a reserve against something it cannot be used to redeem.

As far back as the early 1930's, monetary scholars were questioning the wisdom of central bank reserve requirements expressed in gold or foreign exchange, and this line of questioning has recently been revived. Such requirements illogically make a country's domestic money supply a charge against its international reserves.

Repeal of the 25-percent gold-backing provision would be a logical step in the further improvement of our international monetary framework. So that it will be clearly understood as such, it probably should wait until our balance-of-payments position shows more clearly the results of our buckling down to the basic problems. In that favorable setting, repeal of the gold reserve requirement will be seen for what it is—a change to a more realistic statement of the strength of our gold position.

As I cautioned at the outset, this talk has been mostly about money. Why do I, and why do so many others these days, place so much stress on sound money? It is not out of concern for the cold, inanimate gold lying heavily in dark vaults, but rather for the meaning of money in the lives and welfare of people—all people. Such temporary inconvenience, or even hardship, as the maintenance of sound money may entail is small compared with the painful, long-lasting hardships that are wrought by unsound money. Most of us remember the early 1930's, when currency after currency was left to wander in stormy seas with only drifting lights to steer by. We remember those days as a period of worldwide financial chaos; but, more than that, we remember the long lines at bank windows and soup kitchens; the silent factories; the still ships; the idle, anxious people.

Our well-being as individuals—all 180 million of us in this country—our jobs, our homes, our opportunities, will be directly affected by what we as a ntaion do about our money. Put in its proper place, money is not man's enemy, not his undoing, not his master. It is his servant, and it must be made to serve him well. As bankers, Mr. President, this must always be our first concern with the substance in which we deal. This must be our perspective when we speak of men and money.

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THE FIRST NATIONAL BANK OF BOSTON,
*Boston, Mass., November 13, 1963.*

Senator PAUL H. DOUGLAS,
*Chairman, Joint Economic Committee,*
*Congress of the United States,*
*Washington, D.C.*

DEAR SENATOR DOUGLAS: In response to your letter of October 31, I am very glad to attempt to express my views on the subject of modification or repeal of the legal 25-percent gold certificate reserve requirements against Federal Reserve liabilities. In my opinion a reasonable case may be made for either side of this question, even though I am aware many people feel very strongly on one side or the other. Without attempting to straddle the question I would point out in support of a change the fact that this would not be the first such move as evi-

denced by the reduction from a higher figure to 25 percent in 1945. I understand at the present time only Switzerland and Belgium in Europe require the holding of significant gold reserves against domestic liabilities so that we would in no sense be adopting an extraordinary posture to reduce or eliminate our requirements. Additionally one effect would be to raise the gold backing of foreign dollar balances, thus giving evidence of our determination and ability to maintain convertibility. Since the reserves of our commercial banking system are entirely separate there should be neither inflationary nor deflationary effects so far as domestic money supply is concerned. Lastly, it is illogical and confusing to hold the gold reserve against the domestic money supply which it cannot be used to redeem.

As against the foregoing arguments justifying a change is the fact that removal would not, in itself, solve the balance-of-payments problem, but might actually create in some minds the illusion that we could, with complacency, continue with such a deficit for a considerable period. It is also conceivable that removal would merely result in additional gold losses if some dollar holders interpreted the change as an invitation to conversion or as an admission on our part of concern about the dollar.

In the opinion of many responsible observers the most important point is the restraint upon the expansionary powers of the monetary authority such requirements provide. The possibility of indefinite expansion of the note and deposit liabilities of the central bank developing at some future date is deeply disturbing to this group. Similarly the necessary debate in the Congress and the multiplicity of conflicting views which undoubtedly would be expressed would be of concern to people in this country, and perhaps sufficiently alarming if viewed from abroad to develop some tendency to a flight from the dollar.

I find both sets of reasoning to have considerable validity and, therefore, it is difficult to assume a clear-cut position. Even though in my own group of associates within the bank there are differences of opinion, I would nevertheless answer your question by expressing a preference for a change or reduction. It would seem to me most unfortunate at some later date to be forced to make any changes in an atmosphere of emergency, or to find that failing to make such changes had pointed out a weakness then beyond our ability to cure. In other words I am not persuaded that the present limitation will, in fact, act as a definitive protective point beyond which we will not allow ourselves to go, but rather that it serves as a limited deterrent only. Therefore I would choose to move only as a result of deliberate and timely study such as that your committee is giving to this general question.

Sincerely yours,

L. D. BRACE,
*Chairman of the Board.*

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MANUFACTURERS HANOVER TRUST CO.,
*New York, N.Y., November 19, 1963.*

HON. PAUL H. DOUGLAS,
*Chairman, Joint Economic Committee,*
*Congress of the United States,*
*Washington, D.C.*

DEAR SENATOR DOUGLAS: I would like to say, in response to your letter, that the initiative of the Joint Economic Committee in holding hearings on the role of the 25-percent, gold-cover requirement for Federal Reserve liabilities is a constructive one.

Making clear to the world that the United States is willing and able to use all its resources to defend its currency is necessary. There should be no doubt anywhere that the Nation's gold reserve is fully committed to backing the dollar internationally. Relevant to this commitment, of course, is the fact that the Federal Reserve System is required to maintain a reserve of 25 percent of its liabilities in gold, a requirement which the law allows the Board of Governors to suspend.

Many people, including myself, have been very reluctant to see the 25-percent, gold-cover provision eliminated, because it remains one of the fixed points generating balance-of-payments discipline. Now, however, faced with such slow progress toward balance, a new danger looms: a drop in gold reserves close to the 25-percent cover level may create doubts as to what would happen if and when the level is actually reached. President Kennedy has said that all the Nation's gold is available to back the dollar, and Chairman Martin has publicly

gone over the procedure according to which the requirements would be suspended if necessary. Now, obviously it would have been better either to have corrected the payments imbalance before we were even this close to the 25-percent level or to have reexamined the law earlier, but, as in the case of repairing the farmer's leaky roof, there never seems to be a good time. Now is hardly that time. We shall instead have to extend and enlarge, as we can and as we need to, our arrangements to minimize conversion of dollars into gold by foreign central banks, while we redouble our efforts to correct the deficit. If we run up against the 25-percent limit before that time, we shall have to count on Chairman Martin and the Federal Reserve Board to see us through via the suspension route. In the meantime, our intentions should be made clear to all. Later, in a calmer time, we can take another look at the law. At that time the strong arguments for modifying or eliminating the provision can be better appraised and action taken.

Best wishes.

Sincerely yours,

GABRIEL HAUGE, *President.*

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FIRST NATIONAL CITY BANK OF NEW YORK,
*New York, N.Y., November 12, 1963.*

HON. PAUL H. DOUGLAS,
*Chairman of the Joint Economic Committee,*
*Senate Office Building, Washington, D.C.*

DEAR SENATOR DOUGLAS: I regret that my trip abroad will prevent my appearing before your committee in response to the invitation of you and Senator Javits, extended through Mr. William H. Moore before my departure, to express my views with respect to the problem presented by the existing statute on the required gold cover against Federal Reserve note and deposit liabilities.

I appreciate the opportunity to file this letter with your committee for consideration in your present review of this matter.

First, may I repeat for your record my comments on this subject included in a recent speech I made before the Independent Natural Gas Association in New Orleans on September 16, 1963. After pointing out that we still have a basic balance-of-payments deficit of about $3 billion annually which continues into 1963, I said in part:

"Now this cannot go on forever. Time is running on. We still have about $16 billion in gold but about $12 billion of this is required by present statute as cover against Federal Reserve note and deposit liabilities. The Secretary of the Treasury and the Chairman of the Federal Reserve Board have said that our entire gold reserve will be used to meet our international obligations. This is as it should be, but Congress has not passed such a bill, and the adverse psychological effects of any prolonged debate in Congress over the enactment of such legislation would further damage confidence in the dollar. We know that the Federal Reserve Board has the power to suspend this gold reserve requirement for short periods, and to renew such temporary suspension, but doing so would be contrary to the intent of the legislation involved. Nevertheless, I am satisfied that the Federal Reserve would use these emergency powers, if necessary. In any event, removing this restriction on use of our gold would not solve our basic problem but merely give us more time to deal with it."

I would like to make a further comment with respect to the 25-percent gold cover provision. I agree, and I think most economic opinion is in accord, that our gold reserves today should be available in full to support the strength of the dollar as a reserve currency, to maintain its acceptance as an integral part of the world monetary reserve, to make the so-called dollar exchange system work, as it has, postwar, as a monetary base for our expanding world economy. While I am in accord with the desirability of long-range studies on the adequacy of "international liquidity," the main problem today comes down to the creditworthiness of deficit countries. Potential credit supplies—from private sources as well as governmental and international agencies—are great.

The gold clause was put in the Federal Reserve Act at a time when we were on a gold coin standard. In that sense it is obsolete. I favor ultimate repeal but would not favor this action at the present time. There are two considerations that I would advance.

First, the fact of the existence of gold reserve requirements has made us more alert to the necessities of getting down to the business of rectifying our balance-of-payments problem. Repeal of the gold reserve requirements at the present juncture could have unfortunate psychological repercussions, leading us to feel

that we can—and others to suspect that we will—relax efforts to get the balance-of-payments deficit in order. In other words, we should defer consideration until we succeed in bringing our balance of payments into approximate balance.

In the second place, repeal of the gold reserve requirements will leave a need for an effective alternative "braking system."

We live in a different world from that of 1913 when the Federal Reserve Act was adopted. Nevertheless there remains for gold a function of cautioning the Federal Reserve and Treasury against inflationary indulgences. W. Randolph Burgess once wrote of the need for a statistical equivalent for gold. Perhaps we have it through the sensitivities of people to price inflation and the consequences of excess Government deficits.

But I question whether this is enough. While we can allow the gold reserve to decline to help cover balance-of-payments deficits, the unique position of the dollar in the international monetary system demands that we hold, and act to protect, a substantial gold reserve. If we had no legal gold reserve requirement, we would have a practical need as opposed to a legal requirement. We would have to educate ourselves as to a normal level required to support unqualified confidence in the dollar. This fits the pattern pursued by most other countries that have stable currencies. They have conceptions of figures which represent, for them, safe working minimums of gold and foreign exchange reserves.

The present gold reserve requirement yields a calculation of $12 billion of gold required to be held. Probably this is around the dimensions of the gold stock that we should normally wish to hold. Twelve billion is about a quarter of the total reserves of monetary gold inclusive of a crude estimate of Soviet holdings.

Thanking you for the opportunity of being heard, I am,

Respectfully yours,

GEORGE S. MOORE, *President.*

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THE CHASE MANHATTAN BANK,
*New York, N.Y., November 18, 1963.*

Hon. PAUL H. DOUGLAS,
*Chairman, Joint Economic Committee,*
*Congress of the United States,*
*Washington, D.C.*

DEAR SENATOR DOUGLAS: I am writing you in response to your request for an expression of my views on the question of possible modification or repeal of the legal 25-percent gold certificate reserve requirements against Federal Reserve liabilities.

I personally believe the Nation's full gold supply should be available for international purposes. My position on this question is a matter of public record. I might add that my view was reinforced by the extensive discussions of this problem which I participated in during the deliberations of the Commission on Money and Credit, and that I am in general agreement with the analysis and recommendations on the gold reserve requirement contained in the Commission's report.

At the same time, I feel I should point out that there is a wide difference of opinion on this law within the financial community—indeed, even within our bank. It is argued that the gold certificate reserve requirement provides a necessary element of discipline to bring about an early correction of any deficit in our balance of payments. I would certainly agree that our Nation must do what is required to maintain a viable balance in our international payments. However, I do not think that the gold-cover requirement is essential to this end, though I respect the views of those who believe that it is.

It is my understanding that the present gold cover can be suspended for an indefinite period if such action should prove to be necessary. I also understand that both the President and the Chairman of the Board of Governors of the Federal Reserve System have announced that our full gold stock stands behind our international liabilities. This may be all that needs to be done at present. However, I would see some reason to repeal the present law if a propitious moment presented itself.

I want to thank you for this opportunity to present my views on this matter to the Joint Economic Committee. Your committee is performing a most important function, and doing so with increasing effectiveness. Thus, I am always glad to do whatever I can to help in the task of broadening understanding of the complex and technical economic problems which confront the Nation.

Sincerely,

DAVID ROCKEFELLER, *President.*

## MATERIALS SUBMITTED BY SENATOR JAVITS DURING THE HEARINGS

### COMPILATION OF STATEMENTS RELATING TO REMOVAL OF 25-PERCENT GOLD RESERVE REQUIREMENT

*Secretary of the Treasury Dillon, June 1961*

"I don't think there is any advantage (in the gold cover). The advantage is all with removing it."

*Per Jacobsson, late Managing Director, International Monetary Fund, December 13, 1960*

"A great number of countries have seen fit to abolish cover requirements in terms of gold because gold is mostly no longer needed for internal purposes, but only for the settlement of international obligations. For my part, I think it would be all to the good if the maintenance of the 25-percent gold cover rule, as well as the 4¼ percent interest rate limitation, could be removed simultaneously. I am sure that opinion abroad would regard the simultaneous removal of these two limitations with approval, and that such steps would thus contribute to a strengthening of confidence in the dollar."

*Roy L. Reierson, vice president, Bankers Trust Co.*

"Hence a corollary of this proposal is the reduction or elimination of the present 25 percent gold reserve requirement; I happen to agree with Mr. Reuff that this in itself would not be of great consequence, although I recognize that there are a good many students of the subject who think differently."

*Sir Oliver Frank, chairman of the board, Lloyds Bank, Ltd., 1959 annual report*

"The $12 billion of gold—nearly one-third of the entire gold stock of the free world—at present locked up as backing for Federal Reserve notes and deposits should be set free for effective use. There are those who would oppose such a step on the ground that it might aggravate fears of inflation among the American public. It is, of course, for the American authorities to decide where the balance of advantage lies * * *.

"If the United States were to liberate their $12 billion of sterilized gold * * * this step would not lack precedent and would be quite in line with a natural process of evolution in the management of money. Nor are the advantages of such a step related solely to the fact that the United States happens to be losing gold at present. Both sterling and the dollar are important reserve currencies. Over a period, international exchange reserves will have to grow steadily if world trade is not to be hampered by a shortage of liquidity. Since the gold component of the reserves (assuming an unchanged gold price) will expand only very slowly, we must look to a continued growth in the foreign exchange component. This means that the short-term liabilities of financial centers like London and New York will tend constantly to expand in relation to their gold holdings. Hence it is very important, for the preservation of world confidence and the prevention of disruptive flights of hot money, that those liabilities should have the effective backing of all the gold that can be mustered for use."

*Edward M. Bernstein, former Director of Research, International Monetary Fund*

"The time is long past when the monetary authorities could regard the gold reserve as an objective measure of the proper quantity of money. In fact, a gold reserve requirement may hamper the monetary authorities in making monetary policy * * *. It may be helpful to abolish gold reserve requirements entirely, retaining the obligation to retain the present gold value of the dollar and to keep exchange rates within the limits prescribed by the International Monetary Fund."

*Isaac Witkin, president of General Cocoa Co., Inc.*

"I propose * * * repeal by Congress of the requirement of a 25 percent gold reserve against outstanding Federal Reserve notes and certain other deposit liabilities. (It is believed that the Federal Reserve bank now has the power to suspend this requirement). Since no holder of a Federal Reserve note can obtain a single gold dollar in redemption thereof, the reserve of gold is a myth.

The gold standard disappeared long ago. The gold backing of currency is at best token or symbolic."

*Bank for International Settlements, 33d Annual Report, 1963*

"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 settling international balances."

*Richard H. Timberlake, Jr., associate professor of economics at Florida State University, letter to the New York Times, November 20, 1960*

"Neither should we think that the 25 percent requirement is sacrosanct. It is only a legal requirement that Congress can change at will. In fact, the gold requirement is incompatible with the existence of a central bank, and we might well question why we should have any requirement or hold any gold at all * * *.

"Not only could we reduce our own real costs of perpetuating a superannuated myth, but we could also at one stroke show the free world that we are willing to promote liberal and open policies in international affairs."

*Prof. O. K. Burrell, University of Oregon*

"The requirement is an anachronism, a holdover from before 1933. No one can seriously contend that this requirement has in any way restrained Federal Reserve policy * * *. The ratio is not a restraint because the Federal Reserve need not fear the consequences of a conversion into gold * * *. Because the maintenance of the international integrity of the dollar is so essential to the security of the free world, it is reasonable to expect that this minimum requirement will be eliminated. Its elimination would not in itself be either inflationary or deflationary."

*Congressman Abraham Multer, House of Representatives, September 12, 1962*

"To repeal the law requiring a gold reserve has certain positive advantages. We would replace a legalistic myth with reality. We would be freed from juggling around reserve percentages to meet conditions which might arise. We would simplify the economy's financial structure. And in time of potential war with a power possessing vast gold deposits, we would strengthen our economy in the world, add greater flexibility and mobility, and increase our chances of survival and success for the United States * * *.

"To those who argue that history tells us that every country without a gold reserve has collapsed economically, I say they confuse gold with manipulation of the economy.

"Our gold reserve is subject to the same manipulation as our economy. Irresponsible Government officials can manipulate either. Thus far in our country in our generation that has not been done. We must be alert to be sure it is not done. Gold, however, is not the brake on such conduct * * *.

"Only if our entire gold stock were needed to meet the 25 percent gold requirement could this requirement be said to impose a limitation on the money supply. At the present time our gold reserve is substantially more than the minimum established by law."

*Kenneth Crawford, Newsweek, July 23, 1962*

"Whatever else is or isn't done, the United States should free the $12 billion required for Federal Reserve backing. Some of our leading bankers have long advocated this. It would make Fort Knox more formidable."

*Richard Mooney, New York Times, June 20, 1961*

"Dr. Walter W. Heller, Chairman of the President's Council of Economic Advisers said that it (the gold reserve requirement) was 'more of a symbol than a reality' and that its repeal would not affect the country's economy."

*John Gerrity, Weekly Bond Buyer, July 30, 1962:*

"In less tense political times, when the climate on the Hill is more serene than it is today, I have no doubt that many Republicans will support the President in this. After all, you must remember, it was Senator Bob Taft who led the fight to cut the reserve ratio from 40 to 25 percent."

"Every American official of notable stature—the President, his Secretary of the Treasury, his principal economic advisers, the Governors of the Federal Reserve Board, and Members of Congress who devote much of their energies

to money matters—are in general agreement that the reserve ratio is not very useful and that in time it should be abolished.

"When and how to abolish it, however, is quite a different matter."

*Henry C. Alexander, chairman, Morgan Guaranty Trust Co.:*

"As far back as the early 1930's monetary scholars were questioning the wisdom of central bank requirements expressed in gold or foreign exchange, and this line of questioning has recently been revived. Such requirements illogically make a country's domestic money supply a charge against its international reserves.

"Repeal of the 25-percent gold-backing provision would be a logical step in the further improvement of our international monetary framework. So that it would be clearly understood as such, it probably should wait until our balance-of-payments position shows more clearly the results of our buckling down to the basic problems. In that favorable setting, repeal of our gold reserve requirement will be seen for what it is—a change to a more realistic statement of the strength of our gold position."

*Prof. Robert Triffin, Yale University:*

"I would be very much in agreement with the proposal (to eliminate the reserve ratio) for obvious reasons * * * I do not (recommend) removal * * * when the dollar is under suspicion. This is the kind of measure that would be taken at the time when the dollar is absolutely unquestioned * * *. Most countries abandoned that requirement many years ago * * * and have never reestablished it * * *. There are very few countries which have any limitations of this sort today."

*Excerpts from Money and Credit, "The Report of the Commission on Money and Credit, 1961"*

Pages 233–234:

"The U.S. position as a world banker can be strengthened by a number of measures, some of which are unilateral in character, while others involve international agreements. The steps which can be taken unilaterally are discussed first.

"The requirement that the Federal Reserve banks hold gold reserves equal to one-quarter of their note and deposit liabilities tied up nearly $12 billion U.S. gold at the end of 1960, leaving a "free gold" stock of less than $6 billion available for international settlements. This requirement was adopted originally to limit the ability of the Federal Reserve System to expand its notes and deposits. In fact, the gold holdings of the Federal Reserve System generally have been large enough so that the requirement has not imposed an effective constraint on the expansion of Federal Reserve notes and deposits. When it appeared in 1945 that it might prove to be a constraint, the requirement was reduced without any apparent adverse internal or international effects. The elimination of this requirement in the United States would not pressage U.S. devaluation or U.S. inflation and would merely signify the abandonment of an archaic law.

"The Commission believes that the threat of a confidence crisis would be greatly reduced if it were generally recognized, both here and abroad, that all of the U.S. gold is available to meet our international obligations. Any doubts about the U.S. policy should be removed by elimination of the gold reserve requirement at the earliest convenient moment so that all of the U.S. gold stock is available for international settlements."

*Excerpts from "International Payments Imbalances (and Need for Strengthening International Financial Arrangements)," Report of the Subcommittee on International Exchange and Payments to the Joint Economic Committee, 1961*

Page 21:

"* * * the United States should discourage destabilizing outflows of short-term capital, speculation against the dollar, and speculation in gold by the following action:

"A. By the United States unilaterally:

"* * * Eliminate the present 25-percent gold cover against Federal Reserve notes and deposits, so that official and nonofficial holders of dollar liabilities will have no doubt that the entire U.S. gold reserve stands back of the dollar in international transactions."

*Excerpts from "International Payments Imbalances and Need for Strengthening International Financial Arrangements," Hearings Before the Subcommittee on International Exchange and Payments of the Joint Economic Committee, 1961*

Pages 41–42:

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

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

Pages 64–65:

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

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

Page 241:

"An Action Program to Strengthen the International Monetary System," by Harry G. Johnson, University of Chicago.

"A. Unilateral action by the United States:

"(1) Abolish the legal requirement that the Federal Reserve System hold a minimum gold certificate reserve of 25 percent against its note and deposit obligations."

Page 243:

"Measures to Strengthen International Monetary Arrangements," by Peter B. Kenen, associate professor of economics, Columbia University.

"The following are the measures I would recommend to strengthen the international position of the dollar and the international monetary regime:

"* * * Modifications in Financial Arrangements:

"* * * (a) Immediate elimination of the 25-percent gold cover requirement to remove whatever doubts may remain concerning our capacity to combat speculation."

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[From the New York Times, Sept. 24, 1963]

## SWEDISH BANKER BIDS UNITED STATES USE GOLD TO DEFEND DOLLAR

(By Edward Cowan)

A prominent Swedish banker recommended yesterday that the United States make more of its gold available to defend the dollar by loosening or severing the tie between gold and the domestic money supply.

At present, about $12,275 million of the Treasury's $15,583 million of gold is legally obligated as backing for the money supply.

By reducing or abolishing this so-called gold cover, said Rune Hoeglund, executive vice president of the Svenska Handelsbanken, the United States would increase the amount of gold available for sale to foreign governments and thereby strengthen confidence in Washington's willingness and ability to sell gold for dollars.

Convertibility of dollars to gold at the present price of $35 an ounce is the keystone of the present international currency system. The willingness of other governments to hold large amounts of dollars as reserves for their own currencies depends on their confidence that the dollar will remain "as good as gold."

### SALE IS RESTRICTED

Federal law restricts the sale of gold by the Treasury to transactions with foreign governments and central banks and international organizations, such as the Interantional Monetary Fund. The Treasury stands ready to sell gold to such buyers, and to buy gold from anyone, at the statutory price of $35 an ounce, less a handling charge of one-quarter of 1 percent.

Mr. Hoeglund expressed his views in an interview before boarding a plane for Stockholm, his home. He had spent a week in New York as chief of Sweden's delegation to the International Management Congress.

The Svenska Handelsbanken is the largest commercial bank in Sweden. Its assets of 8,365 million kronor ($1,673 million) account for about 30 percent of all commercial bank assets in the country. It has 427 offices.

Looking ahead some 5 years, Mr. Hoeglund envisaged the emergence of a surplus in the U.S. balance of international payments. In recent years there has been a persistent deficit; that is, an excess of dollars moving into foreign hands over dollars returning to American ownership.

INTO CENTRAL BANKS

Many of the dollars going abroad have found their way into foreign banks, which have used many of them to buy gold from the Treasury. As a result, the Treasury's gold stock has declined by $7 billion in the past 6 years.

Mr. Hoeglund said a surplus in U.S. international accounts could mean the reappearance of a dollar shortage in Europe—a problem that troubled Europe through the first postwar decade. The possibility of such a shortage has led the Treasury, some experts in this country, and some foreign governments to recommend that the major powers explore establishing new international monetary arrangements.

Mr. Hoeglund offered several reasons for expecting that this country would develop a balance-of-payments surplus. A slower rate of wage and price increases here than in Europe, he said, is gradually giving American goods a stronger competitive position in world trade.

He also anticipated a steady increase in returns on U.S. business investment abroad. Still another factor, he said, is the probable enlargement of European markets and the relaxation of restrictions, forcing many borrowers to come to New York.

CAPITAL FROM EUROPE

Moreover, he continued, favorable business prospects in this country may attract capital from Europe and are likely to diminish American business investment abroad. Mr. Hoeglund said that among the Americans he met at the Management Congress there was almost a unanimous feeling of optimism about the near-term prospects for the U.S. economy.

The question of the "gold cover" is one the administration may have to come to grips with fairly soon. In the spring of 1961, Treasury Secretary Douglas Dillon called off at the last moment hearings before a House subcommittee on a bill to repeal the nexus between gold and the money supply. The bill was introduced by Representative Abraham J. Multer, Democrat, of Brooklyn.

At that time, the Treasury felt conditions were too unsettled for a full-scale debate on these controversial issue.

In these 2½ years since then, events have pushed toward confrontation of the question. The gold supply has shrunk and the money supply has increased.

Since 1945 there has been a statutory requirement that gold back up at least 25 percent of Federal Reserve note and deposit liabilities. As of last week the liabilities stood at $49,100 million. Hence $12,275 million of gold was legally obligated.

The actual ratio of gold available to the Federal Reserve as backing dipped to a new low last week of 30.8 percent. When the Multer bill was about to be considered the ratio was 38 percent.

Inasmuch as the Treasury and the Federal Reserve try to avoid pressing for monetary legislation in a crisis atmosphere, they may have to reopen the issue with Congress soon. They could recommend either reducing the 25 percent ratio or ending it entirely.

There is an alternative, however. The Federal Reserve has the power to suspend the 25 percent requirement. The Reserve and the administration might decide that criticism from some Members of Congress might be preferable to an extended, public debate about the strength of the dollar and the soundness of administration policy.

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[Except from a publication of the Committee for Economic Development]

THE INTERNATIONAL POSITION OF THE DOLLAR, MAY 1961

GOLD POLICY

It has long been the policy of the United States that gold should be used as a means of international settlement, not as a part of the domestic money supply or for private hoarding. The only significance of our gold holdings is as an

international reserve. Nevertheless, the Federal Reserve banks are legally required to maintain gold holdings equal to 25 percent of their total note and deposit liabilities, a requirement which now amounts to $12 billion. This requirement gives rise to frequent references in discussions of the international liquidity position to the "free" gold holdings, the excess of gold stock over the 25-percent requirement.

This legal requirement can be temporarily suspended. The President has pledged that "the full strength of our total gold stocks and international reserves stands behind the value of the dollar for use if needed," thus making it perfectly clear that the legal reserve requirement would in fact be suspended if necessary. Nevertheless, it would be advisable to remove any lingering doubts that may remain by repealing the present legal requirement. This action should further strengthen international confidence in the dollar.

Internationally, the position of the United States implies that gold should be held only in official reserves, and not by private holders. Although some countries prohibit their nationals from holding gold, as does the United States, others do not. Private holdings are large, and at times they have absorbed a considerable part of new gold supplies. International reserves would be strengthened, and the opportunity for capital flight into gold reduced or eliminated, if private holdings were prohibited by all countries.

The recent order, prohibiting citizens from holding gold abroad, corrected the anomalous situation under which U.S. residents could hold gold abroad but not in this country. The principal disadvantage of the order is that it may be difficult to enforce. Nevertheless, we believe that extension of the prohibition is worth while.

Those who are tempted to hold gold against the possibility of a rise in price should bear in mind that the price of gold, like other prices, could conceivably move down as well as up, and that a reduction in the U.S. Treasury's buying price has been seriously suggested.[1]

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[From the Commercial & Financial Chronicle]

*Letter to the editor:*

## The Gold Myth and the Dollar Dilemma

William Stix Wasserman maintains we are held in bondage by mythical essentiality of gold, whereas a nation's wealth is actually based on its productivity; economist and investment banker proposes series of practical steps to increase free world's liquidity and liberate our economy from gold chains.

For hundreds of years, sea exploration was retarded because most men believed that the earth was flat, and that should they venture too far to sea they would certainly encounter disaster at the earth's rim.

Today, men are held in equal bondage by the myth that gold is essential to their wellbeing, and that without it their money would lose value in an avalanche of inflated paper. Nothing could be further from the truth. A nation's wealth is based not on its gold supply but its productivity. Two examples of staggering force have occurred within our lifetime to prove the truth of this basic maxim. At the height of the depression in the early thirties when 12 million unemployed walked the streets and this country was in the direst economic straits it has ever been in, our banks and Treasury were bulging with gold. Conversely, despite the opinion of the majority of the banking world that Germany could never go to war because she had no gold, Hitler built the greatest war machine in the history of mankind. Dr. Schacht convinced him that production alone was the real source of wealth, and that if he could put the German people to work he need not worry about gold.

In both cases solutions to the problems of the times lay in a fresh appraisal and a new economic approach. Our chief problem is one of liquidity where a diminishing gold supply is called upon to finance an ever increasing volume of business at a time when our balance of payments is adverse.

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[1] "Memorandum of Comment, Reservation or Dissent," by Allan Sproul, in which Messrs. Clark and Heinz have asked to be associated: "I do not think that the suggestion that there might be a reduction in the price at which the U.S. Treasury buys gold needs to be taken seriously, nor that anyone tempted to hold gold instead of dollars would take it seriously."

### OUR CONTEMPORARY BANK CURRENCY

It cannot be stated too often that the currency of our times no longer consists of gold or silver, or even a large number of paper dollars, but rather credit or bank currency in the form of checks. Almost all of our major business transactions are conducted on the basis of check or bank deposits. In the long run the Federal Reserve maintains the value of the dollar by regulating the total amount of bank credit outstanding in relation to the amount of goods and services available. Gold has ceased to have any bearing on the problem except as it effects Federal Reserve policies, which must be governed by the necessities of maintaining a balance between the country's credit needs on the one hand and a stable balance of international payments on the other. Today these are in conflict.

Domestically we require low interest rates and easy credit. Internationally, to prevent further gold losses, we require tight money and high interest rates to attract foreign balances and to create a psychological climate of confidence by showing we mean to defend our gold position come what may. If the dollar was intrinsically weak there would be some justification for the latter course, but to defend the dollar at the expense of our economy by creating a condition of lessened rather than increased production (tight money always hampers production) seems completely absurd in view of the other steps available.

Logically, we might ignore our gold losses and permit our reserves to dwindle to the vanishing point secure in the knowledge that the intrinsic strength of our currency would eventually maintain its trading value. However, this might create a world panic. The psychological hold of gold on people's imagination is so great that pure logic must be abandoned and a more gradual approach substituted, embodying the retention of gold and acknowledgment of its mystique, while at the same time loosening its strangle hold on the economy.

### THE DOLLAR'S INHERENT STRENGTH

Most people fail to realize the great inherent strength of the dollar. They become panicky at our continuing gold losses because they are unaware that we have been trading dollars and gold for the ownership of at least half the fuel resources of the free world, for oilfields in Arabia, Libya, and Venezuela, for refineries, pipelines, and filling stations throughout Europe, Asia, and Africa; for the ownership of at least half the automobile factories of Europe; for a dominant position in the telephone manufacturing companies of England, France, Holland, and Germany; and for ownership in countless other industries where American industry has established profitable subsidiaries throughout the free world.

If the total income of these investments were returned to the United States instead of being used for expansion, a large part of our balance-of-payments problem would be solved. Or, if we decided to curtail our economic and military aid and call in part of our $20 billion of Government loans abroad, the problem would disappear. But neither of these actions is feasible.

What constructive steps can be taken to increase the free world's liquidity and free our economy from its golden chains without upsetting world confidence? Ideally, individual gold speculation should be outlawed, and the tremendous supply now in private hands returned to the central banks to increase their liquid resources. To date, gold has been a one-way street with the advantage to the hoarder. He could always exchange his gold for a usable currency at a rate never below his purchase price and often considerably above. Consequently, most of the free world's newly mined gold has not gone to the central banks but rather into individual hands, for hoarding.

To be sure, to persuade the governments of Europe to prohibit private purchases of gold will be no easy matter. London has for centuries been its leading marketplace and it will be difficult to induce the British Government to pass laws that will diminish London's importance in this respect. In France one will encounter formidable opposition from a people long accustomed to regarding the hoarding of gold as their chief protection against a currency continually devalued. The Swiss, who earn an important part of their living by acting as custodian of the world's private fortunes, and who view private property in all forms as sacrosanct from government interference, will not welcome these measures. Therefore, as a workable compromise the following steps are suggested:

A CONSERVATIVE COMPROMISE

(1) An agreement between the central banks of the free world that all their dealings in gold will be restricted to transactions among themselves. They will not buy from or sell to private banks or individuals any gold whatsoever, with the exception that the purchase of newly mined gold will be permitted providing it is made from certified mining companies. The mining companies, in turn, will be permitted to sell only to the central banks. Present individual gold owners will be given a grace period to exchange their gold at present rates for the currency of their choice. This will leave the free markets of London, Zurich, and Paris intact, but without government support.

(2) In the event of the refusal of the central banks of London, France, and Switzerland to cooperate in respect to the above, the announcement on the part of the President should be made that the United States reserves the right to lower its buying rate for gold should such action be deemed advisable.

(3) Abolition of the present statutory note cover requirements, whereby some $12 billion of Treasury gold must be kept on hand as a reserve for our combined deposit and Federal note liabilities.

(4) The greater use of free world currencies as an acknowledged part of the central bank's reserve.

(5) Curtailment, by taxation if necessary, of the use of so-called "Euro-Dollar" transactions. "Euro-Dollars" consist of money borrowed on short-term from American banks by both European and Canadian banks, who have used these credits to help finance European speculation against the dollar as well as the boom on the European stock exchanges. Part of these funds have been used for long-term industrial credits and could easily help provoke a liquidity crisis, since their withdrawal would present serious problems. Their existence is one of the main reasons for the present imbalance of the American exchange position. It is estimated that more than $5 billion is currently being utilized to maintain the present "Euro-Dollar" position.

The steps outlined above, by denying the private speculator access to the gold reserves of our central banks, would remove the most potent threat to the free world's exchange position. The central banks at this point would be exempt from outside pressures. Gold movements would take place only in response to the coordinated economic planning of the central banks, whose basic interest must be to promote exchange stability and economic growth.

In the long run, exchange stability depends on confidence. In the 19th century, the British pound was supreme despite the fact that the Bank of England gold reserves were meager, and that there were often adverse balances of trade and payment. The world knew that Great Britain was the world's leading industrial nation, that she had great invested wealth abroad, and most importantly, had wise economic leadership. Wisdom begins at home. We must teach the American people how strong the dollar really is. Part of our dollar weakness has resulted from our own ignorance and unjustifiable fears in regards to our budget position and balance of payments. Today, America is the world's greatest producer. Our wealth abroad is estimated at close to $100 billion, an enormous sum in comparison with the few billions of adverse balances that have created so much alarm. With a realistic solution to our liquidity and gold problems, we need no longer be inhibited in following a policy of expansion, which is so essential for our own and the world's well-being.

WILLIAM STIX WASSERMAN.

NEW YORK CITY.

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[From the Christian Science Monitor, May 16, 1961]

BILL FILED TO RELEASE GOLD FROM MONEY BASE DUTY

TREND OF THE ECONOMY

(By Nat White, business and financial editor of the Christian Science Monitor)

A final step in the commitment of the United States gold to meet its balance-of-payments obligations may soon be taken. It all depends on Congress.

This is the pending proposal in Congress, H.R. 6900, introduced by Representative Abraham J. Multer, Democrat, of New York, chairman of the House Banking Committee, to repeal the law requiring a 25-percent gold base for U.S. money and bank reserves.

The proposal has the support of the Kennedy administration. It has been advanced over the past year with increasing frequency by sophisticated leaders of the monetary fraternity. Most recently it was advocated by President Kennedy's distinguished commission, on the balance-of-payments situation, chairmaned by Allan Sproul, of Kentfield, Calif., former president of the Federal Reserve Bank of New York, and a recognized authority.

This week, a group of leading businessmen and economists in the Committee for Economic Development (CED), presents a similar recommendation, a position they had arrived at before the Multer amendment was introduced.

CED CLOSELY INVOLVED

As a matter of fact the CED statement and the administration's testimony, scheduled by Treasury Secretary Douglas Dillon, supporting the Multer bill, will coincide, an interesting fact until it is recognized that Dr. Roy Blough, a member of the Sproul commission is also a member of the CED Research Advisory Board.

Dr. Paul Samuelson, professor of economics at Massachusetts Institute of Technology who headed the Kennedy Economics Task Force, is also a member of the same Board. Mr. Sproul is a member of the CED Research and Policy Committee. Thus three key advocates of the measure, in the administration are also vocal in the CED.

The tie-in between the two events is fairly obvious. A sophisticated, internationally minded business group is thus placed wholeheartedly behind the proposal at the time hearings begin on it in the House.

BOOSTED BY MANY

Dr. Per Jacobsson, Managing Director of the International Monetary Fund, who addressed the CED last fall, is a major advocate of the proposal, as are Henry C. Alexander, chairman of Morgan Guaranty Trust, and Dr. Roy L. Reierson, vice president and chief economist of Bankers Trust, have also advocated the change.

The support of Secretary Dillon for the measure is significant abroad and to the domestic banking community.

Thus the gold bill reaches the Congress with impressive endorsement.

This does not mean that the gold bill will have smooth sailing. It might not get through. Congress does not readily repeal its own powers. A great many Americans are not so ready as is the internationally inclined business and economic community to remove the final legal restriction on their gold; the sole remnant of the days when the Nation was on the gold currency standard, which was ended by President Roosevelt and the New Deal Congress.

The Wall Street Journal in an editorial May 12, entitled, "Dismantling a Discipline," takes the position that the proposed removal of the 25-percent requirement ignores the real dangers and substitutes instead a monetary gimmick. The Economists' National Committee on Monetary Policy, in a statement by Dr. Walter E. Spahr, its executive vice president, opposes the move as one more step in what it considers to be a dangerous trend.

Arguments pro and con on the measure are as follows:

[PRO:]

The 25-percent requirement is a mere technicality and is itself meaningless. The Federal Reserve Board of seven members has always had the authority to suspend the 25-percent rule.

In an international emergency of such proportions that the foreign depositors who hold savings accounts in U.S. gold would all start a run on the U.S. Treasury, the Congress and the administration would, of necessity, be required to embargo the gold outflow and stop the run, while new legal limits were set up.

Gold is not itself an arbiter. It is far better to trust to international methods of cooperation, consultation, management to prevent international or national crises to lean on the crutch of a gold legal requirement. A technique is a poor substitute for judgment, and a nonintelligent metal is a poor substitute for reasoned, informed, flexible, sensitive monetary management.

The existence of such a crutch therefore, as a 25-percent legal requirement for domestic currency prevents intelligent and practical efforts to work through existing monetary problems to the kinds of solutions which are required.

Since American money is not on a gold standard, that is, Americans cannot spend gold coins, it is absurd to have a gold bullion as its base. Such a base in itself is meaningless. In a crisis, such as that of 1933, the gold does not add value to money.

Only a people's confidence in their own ability to combat problems builds confidence in their currency. No amount of gold can substitute for human ingenuity, growth, endeavor, productivity, which are the real worth of a people. The gold is only a symbol, and its worth is only what the people themselves give it.

As a base, therefore, for national currency gold is an outmoded symbol. The 25-percent reserve requirement is a technicality which has been outgrown, because gold as a basis of the national currency has been outgrown. It is, therefore, an encumbrance.

On the other hand, the world has not outgrown gold as a basis for international settlements. Outside of the national borders of the United States gold is still accepted as the supreme arbiter of payments. Nations can be built or can fall on whether they meet their international payments on time, and with gold. Gold is the international symbol of a nation's solvency.

Since gold is an international symbol of a nation's solvency, the 25-percent reserve requirement on U.S. gold seemed to international bankers and economists a strange stricture, since American gold, presumably, existed primarily and almost solely for the settlement of international accounts. Why should some $11 billion of the existing $17,400 million U.S. gold pile be set aside under an arbitrary requirement for U.S. money, when it could not be used to redeem the money? it was asked.

This strange anomaly was simply the Congress' bow to the residue of the American public which still attached national monetary value to their gold. It was a bow to nationalistic pride and conservatism.

Under the Multer bill, the American gold will be held as a base solely for the settlement of international payments. It is an enormous pile of gold, and its sheer enormity seems somehow to reassure world bankers.

The next step, beyond the Multer bill, is one now hardly breathed in Congress or American banking circles. It is the final internationization of the gold by committing it, or a large part of it, to the International Monetary Fund and World Bank for the basis of settling the monetary clearances of the free world.

This step may come sooner than anyone now expects. It most certainly may come within 25 years. When and if it does, it will symbolize the final internationalization of the free world's economic authorities. Before that day, however, much more cooperation, understanding, and trust needs to be built between the free nations; namely, the United Kingdom and the Commonwealth, the European Economic Community of West Germany, France, Italy, the Netherlands, Belgium, and Luxembourg, and the free trade community of Sweden, Norway, Switzerland, Austria, Finland, Portugal, and Denmark, plus Japan, India, the Philippines, and the growing nations of Latin America, Africa, southeast Asia, and the Middle East.

[Con:]

The reserve requirement of 25 percent represents a discipline on American extravaganza. Despite the argument that American currency is not redeemable in gold, the requirement represents a brake on credit of Federal Reserve banks which create money themselves through credit.

In other words, the gold brick requirement is a symbol of credit. It is a symbol of credit control, a symbol of credit restriction. So long as it exists, the Federal Reserve banks must maintain a base for the credit they extend member banks anchored firmly in gold. The money supply can be increased or decreased by tightening or loosening this form of credit.

In a very direct way, therefore the gold base requirement acts to restrict overly rapid increases in the money supply. It acts therefore as a very real restraint on money inflation.

Although it can be argued that reasonable men will still run the Treasury, will still govern the Federal Reserve System, will still attempt to act as watchdogs in the Congress on economic trends and monetary policies, the latent stricture of the 25-percent requirement is always there as a mandatory command, should the watchdogs be asleep or off on a junket, to the Federal Reserve banks to expand or contract.

The issue is therefore domestic. It is not solely international. The gold acts as a governor on the monetary system, on the banking system, and human

politics, human inclinations to expand when the governor is removed, are all too evident in nations which have not had a governor.

Any nation needs some sort of a governor, some sort of an automatic control. Waves of emotion, of political maneuvering, of monetary pressures can warp the judgments of officials. But a cold impersonal metal, committed by law to the credit system, cannot be easily moved.

While it is argued, that the depression of the 1930's took place under the solid gold system and that it took the reasoned judgment of men and the productivity of the public to restore confidence, even so the condition could have been much worse had the gold not been there. The fact that it was there gave a foundation or stepping-stone to economic recovery.

Since gold is the internationally recognized symbol of world wealth and stability, it is a dangerous step in gimmicky for the United States to think it has solved its international payments problem simply by removing the domestic stricture on $11 billion of its gold. So long as the stricture is on the books, the Nation's leaders are compelled to adjust to it and to work harder and with more ingenuity to solve the international payments problem.

Removal of the stricture and the existence of such a large gold base for international payments removes pressure to solve problems, encourages extravagance, public forgetfulness, and congressional alertness. It is the beginning of a loosening in the economic system which can only end in more serious measures being imposed at a time of international monetary crisis.

The final economic state will therefore be worse than the present one. It is better, in other words, to solve the international balance-of-payments problem with the 25-percent stricture on the books than to be forced to solve the problems with it off the books. The stricture is a necessary goad to ingenuity and international solvency.

The removal of the 25-percent stricture is liable to be taken as an evidence of the United States inability to solve its international problems and to conceal them by such a device.

West German, Swiss, and British bankers would be more impressed with the stability of the American economy if it could minimize its extreme swings between recession and inflation, it could balance out its domestic accounts more carefully, and if it could take the steps internationally which will make it act in a sound and responsible manner externally.

The basic problems with the American economy are not in themselves monetary in nature. The basic problems are the strictures placed on the economy by tight trade union rules which force railroads, for instance, to operate with outmoded equipment and persons no longer needed; which force municipal railways to keep labor no longer needed; which restrict building practices to such a degree that construction costs are artifically held at a nonproductive level; which compel the use of outmoded equipment in publishing, steel production, coalmining, trucking, and so on.

The strictures extend to managerial obsolescence, a stubborn refusal of managements to streamline their decisionmaking and to increase the tempo of their competitiveness. The strictures extend to a Federal tax system which puts a penalty on progress and saving.

Attention to some of these things, the conservatives argue, would be more convincing to bankers overseas than the gesture of removing the 25-percent requirement on gold.

Anything to make the American economy more productive, to get prices and costs down, to make American goods more competitive in quality and price overseas would impress others.

The 25-percent base also goads the President and the administration to developing new arrangements with allies for the sharing of economic aid costs to the developing nations, for sharing the military burdens of the free world, particularly in the North Atlantic Treaty Organization, and for promoting international tourism within the United States.

Without the 25-percent goad, there would not be the pressure to work out real and genuine solutions.

These are some of the arguments pro and con. Many others exist and can be developed. Undoubtedly they will be developed as the debate in the Congress proceeds.

Meanwhile, the dignity and sophistication of the persons and groups advocating repeal is so high that Congress might be convinced. It will certainly take

leadership in Congress to affect this repeal. Congress gives up its prerogatives reluctantly.

It has never yet yielded to the very practical and also high-level pressure to remove the 4¼-percent ceiling on long-term Government bonds. Removal of this ceiling would do more toward helping the Treasury stretch out and refund the national debt than any single measure, many believe, yet the Kennedy administration is not seeking its removal, as did the Eisenhower administration.

It will be interesting to watch if Congress is as protective over its present custody of 25 percent of the U.S. gold as it has been over its custody of the Nation's long-term interest rate structure.

This single issue—the Multer bill—can prove to be a real test in the Congress of Kennedy-Dillon prestige on affairs of money.

# THE UNITED STATES BALANCE OF PAYMENTS

## III—Exchange Rates—How Flexible Should They Be?

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THURSDAY, NOVEMBER 14, 1963

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

The joint committee met, pursuant to recess, at 10:03 a.m., in room AE-1, U.S. Capitol Building, Hon. Paul H. Douglas (chairman) presiding.

Present: Senators Douglas, Sparkman, Proxmire, Javits, Miller, and Jordan; Representatives Reuss and Curtis.

Also present: Representative Halpern.

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

Chairman DOUGLAS. The committee will come to order.

We are very happy to have these three distinguished witnesses with us, Professor Friedman, Professor Hexner, and Professor Wallich, discussing the subject of flexible as opposed to fixed exchange rates, together with a description of the existing situation.

We are happy to have as our first witness a former colleague of mine, a very distinguished economist, Prof. Milton Friedman, who has been perhaps the foremost advocate in this country of flexible exchange rates and, along with Professor Meade of England, one of the two leading advocates in the world of flexible exchange rates.

We are very glad to welcome you, Professor Friedman.

### STATEMENT OF MILTON FRIEDMAN, PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO

Mr. FRIEDMAN. Thank you, Professor Douglas—Senator Douglas.

Discussions of U.S. policy with respect to international payments tend to be dominated by our immediate balance-of-payments difficulties. I should like today to approach the question from a different, and I hope more constructive, direction. Let us begin by asking ourselves not merely how we can get out of our present difficulties but instead how we can fashion our international payments system so that it will best serve our needs for the long pull; how we can solve not merely this balance-of-payments problem but the balance-of-payments problem.

A shocking, and indeed, disgraceful feature of the present situation is the extent to which our frantic search for expedients to stave off balance-of-payments pressures has led us, on the one hand, to sacrifice

major national objectives; and, on the other, to give enormous power to officials of foreign governments to affect what should be purely domestic matters.

Chairman DOUGLAS. May I say, so far, so good. I enjoyed that 100 percent.

Representative REUSS. It might be wise to stop there.

Mr. FRIEDMAN. Foreign payments amount to only some 5 percent of our total national income. Yet they have become a major factor in nearly every national policy.

I believe that a system of floating exchange rates would solve the balance-of-payments problem for the United States far more effectively than our present arrangements. Such a system would use the flexibility and efficiency of the free market to harmonize our small foreign trade sector with both the rest of our massive economy and the rest of the world; it would reduce problems of foreign payments to their proper dimensions and remove them as a major consideration in governmental policy about domestic matters and as a major preoccupation in international political negotiations; it would foster our national objectives rather than be an obstacle to their attainment.

To indicate the basis for this conclusion, let us consider the national objective with which our payments system is most directly connected: the promotion of a healthy and balanced growth of world trade, carried on, so far as possible, by private individuals and private enterprises with minimum intervention by governments. This has been a major objective of our whole postwar international economic policy, most recently expressed in the Trade Expansion Act of 1962. Success would knit the free world more closely together, and, by fostering the international division of labor, raise standards of living throughout the world, including the United States.

Suppose that we succeed in negotiating far-reaching reciprocal reductions in tariffs and other trade barriers with the Common Market and other countries. To simplify exposition I shall hereafter refer only to tariffs, letting these stand for the whole range of barriers to trade, including even the so-called voluntary limitation of exports. Such reductions will expand trade in general but clearly will have different effects on different industries. The demand for the products of some will expand, for others contract. This is a phenomenon we are familiar with from our internal development. The capacity of our free enterprise system to adapt quickly and efficiently to such shifts, whether produced by changes in technology or tastes, has been a major source of our economic growth. The only additional element introduced by international trade is the fact that different currencies are involved, and this is where the payment mechanism comes in; its function is to keep this fact from being an additional source of disturbance.

An all-around lowering of tariffs would tend to increase both our expenditures and our receipts in foreign currencies. There is no way of knowing in advance which increase would tend to be the greater and hence no way of knowing whether the initial effect would be toward a surplus or deficit in our balance of payments. What is clear is that we cannot hope to succeed in the objective of expanding world trade unless we can readily adjust to either outcome.

Many people concerned with our payments deficits hope that since we are operating further from full capacity than Europe, we could supply a substantial increase in exports whereas they could not. Implicitly, this assumes that European countries are prepared to see their surplus turned into a deficit, thereby contributing to the reduction of the deficits we have recently been experiencing in our balance of payments. Perhaps this would be the initial effect of tariff changes. But if the achievement of such a result is to be sine qua non of tariff agreement, we cannot hope for any significant reduction in barriers. We could be confident that exports would expand more than imports only if the tariff changes were one sided indeed, with our trading partners making much greater reductions in tariffs than we make. Our major means of inducing other countries to reduce tariffs is to offer corresponding reductions in our tariff. More generally, there is little hope of continued and sizable liberalization of trade if liberalization is to be viewed simply as a device for correcting balance-of-payments difficulties. That way lies only backing and filling.

Suppose then that the initial effect is to increase our expenditures on imports more than our receipts from exports. How could we adjust to this outcome?

One method of adjustment is to draw on reserves or borrow from abroad to finance the excess increase in imports. The obvious objection to this method is that it is only a temporary device, and hence can be relied on only when the disturbance is temporary. But that is not the major objection. Even if we had very large reserves or could borrow large amounts from abroad, so that we could continue this expedient for many years, it is a most undesirable one. We can see why if we look at physical rather than financial magnitudes.

The physical counterpart to the financial deficit is a reduction of employment in industries competing with imports that is larger than the concurrent expansion of employment in export industries. So long as the financial deficit continues, the assumed tariff reductions create employment problems. But it is no part of the aim of tariff reductions to create unemployment at home or to promote employment abroad. The aim is a balanced expansion of trade, with exports rising along with imports and thereby providing employment opportunities to offset any reduction in employment resulting from increased imports.

Hence, simply drawing on reserves or borrowing abroad is a most unsatisfactory method of adjustment.

Another method of adjustment is to lower U.S. prices relative to foreign prices, since this would stimulate exports and discourage imports. If foreign countries are accommodating enough to engage in inflation, such a change in relative prices might require merely that the United States keep prices stable or even, that it simply keep them from rising as fast as foreign prices. But there is no necessity for foreign countries to be so accommodating, and we could hardly count on their being so accommodating. The use of this technique therefore involves a willingness to produce a decline in U.S. prices by tight monetary policy or tight fiscal policy or both. Given time, this method of adjustment would work. But in the interim, it would exact a heavy toll. It would be difficult or impossible to force down prices ap-

preciably without producing a recession and considerable unemployment. To eliminate in the long run the unemployment resulting from the tariff changes, we should in the short run be creating cyclical unemployment. The cure might for a time be far worse than the disease.

This second method is therefore also most unsatisfactory. Yet these two methods—drawing on reserves and forcing down prices—are the only two methods available to us under our present international payment arrangements, which involve fixed exchange rates between the U.S. dollar and other currencies. Little wonder that we have so far made such disappointing progress toward the reduction of trade barriers, that our practice has differed so much from our preaching.

There is one other way and only one other way to adjust and that is by allowing (or forcing) the price of the U.S. dollar to fall in terms of other currencies. To a foreigner, U.S. goods can become cheaper in either of two ways—either because their prices in the United States fall in terms of dollars or because the foreigner has to give up fewer units of his own currency to acquire a dollar, which is to say, the price of the dollar falls. For example, suppose a particular U.S. car sells for $2,800 when a dollar costs 7 shillings, tuppence in British money (i.e., roughly £1=$2.80). The price of the car is then £1,000 in British money. It is all the same to an Englishman—or even a Scotsman—whether the price of the car falls to $2,500 while the price of a dollar remains 7 shillings, tuppence, or, alternatively, the price of the car remains $2,800, while the price of a dollar falls to 6 shillings, 5 pence (i.e., roughly £1=$3.11). In either case, the car costs the Englishman £900 rather than £1,000, which is what matters to him. Similarly, foreign goods can become more expensive to an American in either of two ways—either because the price in terms of foreign currency rises or because he has to give up more dollars to acquire a given amount of foreign currency.

Changes in exchange rates can therefore alter the relative price of U.S. and foreign goods in precisely the same way as can changes in internal prices in the United States and in foreign countries. And they can do so without requiring anything like the same internal adjustments. If the initial effect of the tariff reductions would be to create a deficit at the former exchange rate (or enlarge an existing deficit or reduce an existing surplus) and thereby increase unemployment, this effect can be entirely avoided by a change in exchange rates which will produce a balanced expansion in imports and exports without interfering with domestic employment, domestic prices, or domestic monetary and fiscal policy. The pig can be roasted without burning down the house.

The situation is, of course, entirely symmetrical if the tariff changes should initially happen to expand our exports more than our imports. Under present circumstances, we would welcome such a result, and conceivably, if the matching deficit were experienced by countries currently running a surplus, they might permit it to occur without seeking to offset it. In that case, they and we would be using the first method of adjustment—changes in reserves or borrowing. But again, if we had started off from an even keel, this would be an undesirable method of adjustment. On our side, we should be sending out useful goods and receiving only foreign currencies in return. On the side of our partners, they would be using up reserves and tolerating the creation of unemployment.

The second method of adjusting to a surplus is to permit or force domestic prices to rise—which is of course what we did in part in the early postwar years when we were running large surpluses. Again, we should be forcing maladjustments on the whole economy to solve a problem arising from a small part of it—the 5 percent accounted for by foreign trade.

Again, these two methods are the only ones available under our present international payments arrangements, and neither is satisfactory.

The final method is to permit or force exchange rates to change—in this case, a rise in the price of the dollar in terms of foreign currencies. This solution is again specifically adapted to the specific problem of the balance of payments.

Changes in exchange rates can be produced in either of two general ways. One way is by a change in an official exchange rate; an official devaluation or appreciation from one fixed level which the Government is committed to support to another fixed level. This is the method used by Britain in its postwar devaluation and by Germany in 1961 when the mark was appreciated. This is also the main method contemplated by the IMF which permits member nations to change their exchange rates by 10 percent without approval by the Fund and by a larger amount after approval by the Fund. But this method has serious disadvantages. It makes a change in rates a matter of major moment, and hence there is a tendency to postpone any change as long as possible. Difficulties cumulate and a larger change is finally needed than would have been required if it could have been made promptly. By the time the change is made, everyone is aware that a change is pending and is certain about the direction of change. The result is to encourage flight from a currency, if it is going to be devalued, or to a currency, if it is going to be appreciated.

There is in any event little basis for determining precisely what the new rate should be. Speculative movements increase the difficulty of judging what the new rate should be, and introduce a systematic bias, making the change needed appear larger than it actually is. The result, particularly when devaluation occurs, is generally to lead officials to "play safe" by making an even larger change than the large change needed. The country is then left after the devaluation with a maladjustment precisely the opposite of that with which it started, and is thereby encouraged to follow policies it cannot sustain in the long run.

Even if all these difficulties could be avoided, this method of changing from one fixed rate to another has the disadvantage that it is necessarily discontinuous. Even if the new exchange rates are precisely correct when first established, they will not long remain correct.

A second and much better way in which changes in exchange rates can be produced is by permitting exchange rates to float, by allowing them to be determined from day to day in the market. This is the method which the United States used from 1862 to 1879, and again, in effect, from 1917 or so to about 1925, and again from 1933 to 1934. It is the method which Britain used from 1918 to 1925 and again from 1931 to 1939, and which Canada used for most of the interwar period and again from 1950 to May 1962. Under this method, exchange rates adjust themselves continuously, and market forces determine the magnitude of each change. There is no need for any official to

decide by how much the rate should rise or fall. This is the method of the free market, the method that we adopt unquestioningly in a private enterprise economy for the bulk of goods and services. It is no less available for the price of one money in terms of another.

With a floating exchange rate, it is possible for Governments to intervene and try to affect the rate by buying or selling, as the British exchange equalization fund did rather successfully in the 1930's, or by combining buying and selling with public announcements of intentions, as Canada did so disastrously in early 1962. On the whole, it seems to me undesirable to have government intervene, because there is a strong tendency for government agencies to try to peg the rate rather than to stabilize it, because they have no special advantage over private speculators in stabilizing it, because they can make far bigger mistakes than private speculators risking their own money, and because there is a tendency for them to cover up their mistakes by changing the rules—as the Canadian case so strikingly illustrates—rather than by reversing course. But this is an issue on which there is much difference of opinion among economists who agree in favoring floating rates. Clearly, it is possible to have a successful floating rate along with governmental speculation.

The great objective of tearing down trade barriers, of promoting a worldwide expansion of trade, of giving citizens of all countries, and especially the underdeveloped countries, every opportunity to sell their products in open markets under equal terms and thereby every incentive to use their resources efficiently, of giving countries an alternative through free world trade to autarchy and central planning—this great objective can, I believe, be achieved best under a regime of floating rates. All countries, and not just the United States, can proceed to liberalize boldly and confidently only if they can have reasonable assurance that the resulting trade expansion will be balanced and will not interfere with major domestic objectives. Floating exchange rates, and so far as I can see, only floating exchange rates, provide this assurance. They do so because they are an automatic mechanism for protecting the domestic economy from the possibility that liberalization will produce a serious imbalance in international payments.

Despite their advantages, floating exchange rates have a bad press. Why is this so?

One reason is because a consequence of our present system that I have been citing as a serious disadvantage is often regarded as an advantage, namely, the extent to which the small foreign trade sector dominates national policy. Those who regard this as an advantage refer to it as the discipline of the gold standard. I would have much sympathy for this view if we had a real gold standard, so the discipline was imposed by impersonal forces which in turn reflected the realities of resources, tastes, and technology. But in fact we have today only a pseudo gold standard and the so-called discipline is imposed by governmental officials of other countries who are determining their own internal monetary policies and are either being forced to dance to our tune or calling the tune for us, depending primarily on accidental political developments. This is a discipline we can well do without. See my article entitled "Real and Pseudo Gold Standards" which I will present later for inclusion in the record.

Chairman DOUGLAS. The article will be placed in the record at the end of your oral presentation.

Mr. FRIEDMAN. A possibly more important reason why floating exchange rates have a bad press, I believe, is a mistaken interpretation of experience with floating rates, arising out of a statistical fallacy that can be seen easily in a standard example. Arizona is clearly the worst place in the United States for a person with tuberculosis to go because the death rate from tuberculosis is higher in Arizona than in any other State. The fallacy in this case is obvious. It is less obvious in connection with exchange rates. Countries that have gotten into severe financial difficulties, for whatever reason, have had ultimately to change their exchange rates or let them change. No amount of exchange control and other restrictions on trade have enabled them to peg an exchange rate that was far out of line with economic realities. In consequence, floating rates have frequently been associated with financial and economic instability. It is easy to conclude, as many have, that floating exchange rates produce such instability.

This misreading of experience is reinforced by the general prejudice against speculation; which has led to the frequent assertion, typically on the basis of no evidence whatsoever, that speculation in exchange can be expected to be destabilizing and thereby to increase the instability in rates. Few who make this assertion even recognize that it is equivalent to asserting that speculators generally lose money.

Floating exchange rates need not be unstable exchange rates—any more than the prices of automobiles or of Government bonds, of coffee or of meals need gyrate wildly just because they are free to change from day to day. The Canadian exchange rate was free to change during more than a decade, yet it varied within narrow limits. The ultimate objective is a world in which exchange rates, while free to vary, are in fact highly stable because basic economic policies and conditions are stable. Instability of exchange rates is a symptom of instability in the underlying economic structure. Elimination of this symptom by administrative pegging of exchange rates cures none of the underlying difficulties and only makes adjustment to them more painful.

The confusion between stable exchange rates and pegged exchange rates helps to explain the frequent comment that floating exchange rates would introduce an additional element of uncertainty into foreign trade and thereby discourage its expansion. They introduce no additional element of uncertainty. If a floating rate would, for example, decline, then a pegged rate would be subject to pressure that the authorities would have to meet by internal deflation or exchange control in some form. The uncertainty about the rate would simply be replaced by uncertainty about internal prices or about the availability of exchange; and the latter uncertainties, being subject to administrative rather than market control, are likely to be the more erratic and unpredictable. Moreover, the trader can far more readily and cheaply protect himself against the danger of changes in exchange rates, through hedging operations in a forward market, than he can against the danger of changes in internal prices or exchange availability. Floating rates are therefore more favorable to private international trade than pegged rates.

Though I have discussed the problem of international payments in the context of trade liberalization, the discussion is directly applicable to the more general problem of adapting to any forces that make for balance-of-payments difficulties. Consider our present problem, of a deficit in the balance of trade plus long-term capital movements. How can we adjust to it? By one of the three methods outlined: first, drawing on reserves or borrowing; second, keeping U.S. prices from rising as rapidly as foreign prices or forcing them down; third, permitting or forcing exchange rates to alter. And, this time, by one more method: by imposing additional trade barriers or their equivalent, whether in the form of higher tariffs, or smaller import quotas, or extracting from other countries tighter "voluntary" quotas on their exports, or "tieing" foreign aid, or buying higher priced domestic goods or services to meet military needs, or imposing taxes on foreign borrowing, or imposing direct controls on investments by U.S. citizens abroad, or any one of the host of other devices for interfering with the private business of private individuals that have become so familiar to us since Hjalmar Schacht perfected the modern techniques of exchange control in 1934 to strengthen the Nazis for war and to despoil a large class of his fellow citizens.

Fortunately or unfortunately, even Congress cannot repeal the laws of arithmetic. Books must balance. We must use one of these four methods. Because we have been unwilling to select the only one that is currently fully consistent with both economic and political needs—namely, floating exchange rates—we have been driven, as if by an invisible hand, to employ all the others, and even then may not escape the need for explicit changes in exchange rates.

We affirm in loud and clear voices that we will not and must not erect trade barriers—yet is there any doubt about how far we have gone down the fourth route? After the host of measures already taken, the Secretary of the Treasury has openly stated to the Senate Finance Committee that if the so-called interest equalization tax—itself a concealed exchange control and concealed devaluation—is not passed, we shall have to resort to direct controls over foreign investment.

We affirm that we cannot drain our reserves further, yet short-term liabilities mount and our gold stock continues to decline.

We affirm that we cannot let balance-of-payments problems interfere with domestic prosperity, yet for at least some 4 years now we have followed a less expansive monetary policy than would have been healthy for our economy.

Chairman DOUGLAS. We thank you for that, Professor Friedman.

Mr. FRIEDMAN. Even all together, these measures may only serve to postpone but not prevent open devaluation—if the experience of other countries is any guide. Whether they do, depends not on us but on others. For our best hope of escaping our present difficulties is that foreign countries will inflate.

In the meantime, we adopt one expedient after another, borrowing here, making swap arrangements there, changing the form of loans to make the figures look good. Entirely aside from the ineffectiveness of most of these measures, they are politically degrading and

demeaning. We are a great and wealthy Nation. We should be directing our own course, setting an example to the world, living up to our destiny. Instead, we send our officials hat in hand to make the rounds of foreign governments and central banks; we put foreign central banks in a position to determine whether or not we can meet our obligations and thus enable them to exert great influence on our policies; we are driven to niggling negotiations with Hong Kong and with Japan and for all I know, Monaco, to get them to limit voluntarily their exports. Is this posture suitable for the leader of the free world?

Chairman DOUGLAS. I do not wish to interrupt you, but I would like to say that I think many visits to Monaco are for a different purpose. [Laughter.]

Go ahead.

Mr. FRIEDMAN. It is not the least of the virtues of floating exchange rates that we would again become masters in our own house. We could decide important issues on the proper ground. The military could concentrate on military effectiveness and not on saving foreign exchange; recipients of foreign aid could concentrate on how to get the most out of what we give them and not on how to spend it all in the United States; Congress could decide how much to spend on foreign aid on the basis of what we get for our money and what else we could use it for and not how it will affect the gold stock; the monetary authorities could concentrate on domestic prices and employment, not on how to induce foreigners to hold dollar balances in this country; the Treasury and the tax committees of Congress could devote their attention to the equity of the tax system and its effects on our efficiency, rather than on how to use tax gimmicks to discourage imports, subsidize exports, and discriminate against outflows of capital.

A system of floating exchange rates would render the problem of making outflows equal inflows unto the market where it belongs and not leave it to the clumsy and heavy hand of Government. It would leave Government free to concentrate on its proper functions.

In conclusion, a word about gold. Our commitment to buy and sell gold for monetary use at a fixed price of $35 an ounce is, in practice, the mechanism whereby we maintain fixed rates of exchange between the dollar and other currencies—or, more precisely, whereby we leave all initiative for changes in such rates to other countries. This commitment should be terminated. The price of gold should be determined in the free market, with the U.S. Government committed neither to buying gold nor to selling gold at any fixed price. This is the appropriate counterpart of a policy of floating exchange rates. With respect to our existing stock of gold, we could simply keep it fixed, neither adding to it nor reducing it; alternatively, we could sell it off gradually at the market price or add to it gradually, thereby reducing or increasing our governmental stockpiles of this particular metal. In any event, we should simultaneously remove all present limitations on the ownership of gold and the trading in gold by American citizens. There is no reason why gold, like other commodities, should not be freely traded on a free market.

The CHAIRMAN. Thank you very much, Professor Friedman. Your paper, entitled "Real and Pseudo Gold Standards" will appear at this place in the record.

## Real and Pseudo Gold Standards[1]

(Milton Friedman, University of Chicago)

International monetary arrangements have held a consistently important place among the topics discussed at the meetings of our society. This is eminently fitting, since there is probably no other major facet of economic policy with respect to which liberals (in the sense of our society) reach such divergent conclusions from the same underlying principles.

One group, of which Philip Cortney is a distinguished member, favors a continuation of the formal linking of national currencies to gold, rigid exchange rates between different national currencies, a doubling or more than doubling of the official price of gold in terms of national currencies, and an abandonment of governmental measures designed to evade the discipline of gold. This group is apparently indifferent about whether gold circulates as coin; it is satisfied with a gold bullion standard.

A second group, represented by the Economists' National Committee on Monetary Policy, also favors a continuation of the formal linking of national currencies to gold together with rigid exchange rates between different national currencies. But it emphasizes the importance of gold coinage and of a widespread use of gold coin as money in national as well as international payments. Apparently, this group believes there is no need for a change in present official prices of gold, or, at least, in the U.S. price.

A third group, of which I count myself a member, favors a separation of gold policy from exchange-rate policy. It favors the abandonment of rigid exchange rates between national currencies and the substitution of a system of floating exchange rates determined from day to day by private transactions without government intervention. With respect to gold, there are some differences, but most of us would currently favor the abandonment of any commitment by governments to buy and sell gold at fixed prices and of any fixed gold reserve requirements for the issue of national currency as well as the repeal of any restrictions on private dealings in gold.

I have stated and defended my own policy views elsewhere, at some length.[2] Hence, I would like to use this occasion instead to explore how it is that liberals can reach such radically different conclusions.

My thesis is that current proposals to link national currencies rigidly to gold whether at present or higher prices arise out of a confusion of two very different things: the use of gold as money, which I shall call a real gold standard; governmental fixing of the price of gold, whether national or international, which I shall call a pseudo gold standard. Though these have many surface features in common, they are at bottom fundamentally different—just as the near identity of prices charged by competitive sellers differs basically from the identity of prices charged by members of a price ring or cartel. A real gold standard is thoroughly consistent with liberal principles, and I, for one, am entirely in favor of measures promoting its development, as, I believe, are most other liberal proponents of floating exchange rates. A pseudo gold standard is in direct conflict with liberal principles, as is suggested by the curious coalition of central bankers and central planners that has formed in support of it.

It is vitally important for the preservation and promotion of a free society that we recognize the difference between a real and pseudo gold standard. War aside, nothing that has occurred in the past half century has, in my view, done more to weaken and undermine the public's faith in liberal principles than the pseudo gold standard that has intermittently prevailed and the actions that have been taken in its name. I believe that those of us who support it in the belief that it either is or will tend to be a real gold standard are mistakenly fostering trends the outcome of which they will be among the first to deplore.

This is a sweeping charge, so let me document it by a few examples which will incidentally illustrate the difference between a real and a pseudo gold standard before turning to an explicit discussion of the difference. My examples are mostly for the United States, the country whose monetary history I have studied in most detail.

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[1] Paper written for the Mont Pelerin Society meetings in September 1961.

[2] See, in particular, "The Case for Flexible Exchange Rates" and "Commodity-Reserve Currency," in my Essays in Positive Economics, pp. 157–203, 204–250 (1953), and "A Program for Monetary Policy, pp. 77–84 (1959).

### A. EXAMPLES OF EFFECTS OF A PSEUDO GOLD STANDARD

*1. U.S. monetary policy after World War 1*

Nearly half of the monetary expansion in the United States came after the end of the war, thanks to the acquiescence of the Federal Reserve System in the Treasury's desire to avoid a fall in the price of Government securities. This expansion, with its accompanying price inflation, led to an outflow of gold despite the great demand for U.S. goods from a war-ravaged world and despite the departure of most countries from any fixed parity between their currencies and either gold or the dollar. The outflow of gold finally overcame Treasury reluctance to see the price of Government securities fall. Beginning in late 1919, then more sharply in January 1920 and May 1920, the Federal Reserve System took vigorous deflationary steps that produced first, a slackening of the growth in the stock of money, and then a sharp decline. These brought in their train a collapse in wholesale prices and a severe economic contraction. The near-halving of wholesale prices in a 12-month period was by all odds the most rapid price decline ever experienced in the United States before or since. It was not of course confined to the United States, but spread to all countries whose money was linked to the dollar either by having a fixed price in terms of gold or by central bank policies directed at maintaining rigid or nearly rigid exchange rates. Only those countries that were to experience hyperinflation escaped the price collapse.

Under a real gold standard, the large inflow of gold up to the entry of the United States into the war would have produced a price rise to the end of the war similar to that actually experienced. But neither the postwar rise nor the subsequent collapse would have occurred. Instead, there would have been an earlier and milder price decline as the belligerent nations returned to a peacetime economy. The postwar increase in the stock of money occurred only because the Reserve System had been given discretionary power to "manage" the stock of money, and the subsequent collapse occurred only because this power to manage the money had been accompanied by gold reserve requirements as one among several masters the System was instructed to serve.

Under a wholly fiduciary currency, with floating exchange rates, the initial postwar expansion might well have occurred much as it did, though the depreciating value of the dollar in terms of other currencies might have been a quicker and a more effective check than slowly declining gold reserves. But the subsequent collapse would almost surely not have occurred. And neither the initial price inflation nor the subsequent price collapse would have been communicated to the rest of the world.

The worldwide inflation and then collapse was at the time a severe blow to a belief in free trade at home and abroad, a blow whose severity we now underrate only because of the later catastrophe that overshadowed it. Either a real gold standard or a thoroughly fiduciary standard would have been preferable in its outcome to the pseudo gold standard.

*2. U.S. monetary policy in the 1920's and Britain's return to gold*

There is a widespread myth among gold standard advocates that the U.S. monetary policy during the 1920's paved the way for the great depression by being unduly inflationary. For example, Cortney writes, "the Federal Reserve Board succeeded in the 1920's in holding up the price level for a surprising length of time by an abnormal expansion of inflationary credit, but in so doing it helped produce the speculative boom." [3] Nothing could be farther from the truth. The U.S. monetary policy in the 1920's and especially in the late 1920's, judged in terms of either a real gold standard in the abstract or prior U.S. experience, was if anything unduly deflationary.

The sharp 1920–21 price decline had brought prices to a level much closer to the prewar level than to the postwar peak though they were still appreciably above the prewar level. Prices rose only moderately in the subsequent cyclical expansion which reached its peak in 1923. From then until 1929, wholesale prices actually fell, at a rate of roughly 1 percent a year.

As to gold, credit, and money, the Federal Reserve System sterilized much of the gold inflow, preventing the gold from raising the stock of money anything like as much as it would have done under a real gold standard. Far from

[3] In Introduction to Charles Rist, The Triumph of Gold, p. 8 (1961).

the Reserve System engaging in an "abnormal expansion of inflationary credit," Federal Reserve credit outstanding in June 1929 was 33 percent lower than it had been in June 1921 and only 16 percent higher than in June 1923 although national income was nearly 25 percent higher in 1929 than in 1923 (in both money and real terms). From 1923 to 1929, to compare only peak years of business cycles and so avoid distortion from cyclical influence, the stock of money, defined to include currency, demand deposits, and commercial bank time deposits, rose at the annual rate of 4 percent per year, which is roughly the rate required to match expansion of output. On a narrower definition, excluding time deposits, the stock of money rose at the rate of only 2½ percent per year.[4]

The deflationary pressure was particularly strong during the great bull market in stocks, which happened to coincide with the first few years after Britain returned to gold. During the business cycle expansion from 1927 to 1929, wholesale prices actually fell a trifle; one must go back to 1891–93 to find another expansion during which prices fell and there has been none since. The stock of money was lower at the cyclical peak in August 1929 than it had been 16 months earlier. There is no other occasion from the time our monthly data began in 1907 to date when so long a period elapsed during a cyclical expansion without a rise in the stock of money. The only other periods of such length which show a decline have an end point in the course of severe contractions (1920–21, 1929–33, 1936–37).

So far as the United States alone was concerned, this monetary policy may have been admirable. I do not myself believe that the 1929–33 contraction was an inevitable result of the monetary policy of the 1920's or even owed much to it. What was wrong was the policy followed from 1929 to 1933, as I shall point out in a moment. But internationally, the policy was little short of catastrophic. Much has been made of Britain's mistake in returning to gold in 1925 at a parity that overvalued the pound. I do not doubt that this was a mistake—but only because the United States was maintaining a pseudo gold standard. Had the United States been maintaining a real gold standard, the stock of money would have risen more in the United States than it did, prices would have been stable or rising instead of declining, the United States would have gained less gold or lost some, and the pressure on the pound would have been enormously eased. As it was, by sterilizing gold, the United States forced the whole burden of adapting to gold movements on other countries. When, in addition, France adopted a pseudo gold standard at a parity that undervalued the franc and proceeded also to follow a gold sterilization policy, the combined effect was to make Britain's position untenable. The adverse consequences for faith in liberal principles of the deflationary policies adopted in Britain from 1925 to 1931 in the vain effort to maintain the reestablished parity are no less obvious than they were far reaching.

*3. U.S. policy in 1931–33*

U.S. monetary behavior in 1931–33 is in some ways a repetition of that from 1920 to 1921, but on a more catastrophic scale, in less fortunate circumstances, and with less justification. As we have seen, in 1919 the Reserve System deviated from the policy that would have been dictated by a real gold standard. In 1920, when it saw its gold reserves declining rapidly, it shifted rules, over-reacted to the outflow, and brought on a drastic deflation. Similarly, from 1922 to 1929, the Reserve System sterilized gold and prevented it from exercising the influence on the money stock that it would have had under a real gold standard. And again in 1931, when Britain went off gold and the United States experienced an outflow of gold, the Reserve System shifted rules, over-reacted to the outflow, and catastrophically intensified a deflation already 2 years old.

The circumstances were less fortunate in 1931 than in 1920 in two different respects, one domestic and the other foreign, and both in some measure the Reserve System's own creation.

The domestic difference was that the deflationary action of 1920 came at the end of a period of expansion which was widely regarded as temporary and exceptional, and served to intensify without necessarily prolonging a recession that would probably have occurred anyway. The deflationary action of 1931

[4] These statements are based on estimates of the stock of money from 1867 to date constructed by Anna J. Schwartz and me in connection with a study for the National Bureau of Economic Research. Hereafter, I will use the term "stock of money" as referring to the first of these two definitions.

came after 2 years of severe contraction which had been showing some signs of terminating; probably served to nip in the bud a revival; and both greatly intensified and substantially prolonged the contraction, turning it into the most severe for nearly a century.

This difference was largely the Reserve System's creation because of its inept handling of the banking difficulties that started in the fall of 1930. Until that date, the contraction, while rather severe, had shown no signs of a liquidity crisis. Widespread bank failures culminating in the failure of the Bank of the United States in late 1930 changed the aspect of the contraction. This episode turned out to be the first of a series of liquidity crises, each characterized by bank failures and runs on banks by depositors anxious to convert deposits into currency, and each producing strong downward pressure on the stock of money. The Reserve System had been set up with the primary aim of dealing with precisely such crises. It failed to do so effectively but not because it lacked the power or the knowledge. At all times, it had ample power to provide the liquidity that the public and the banks desperately sought and the provision of which would have cut short the vicious chain reaction of bank failures. The System failed because accidents of personality and shifts of power within the System left it with no dominant personality who could avoid the usual outcome of committee control: the evasion of responsibility by inaction, postponement, and drift. More fundamentally yet, the failure reflected the adoption of a monetary system that gave great power to a small number of men and therefore was vulnerable to such accidents of personality and shifts of power. Had the liquidity crisis been cut short at its onset in 1930 and the Bank of the United States kept from failing (as very likely would have occurred before the Federal Reserve System), the economy would probably have been vigorously expanding by September 1931 instead of being precariously balanced on the verge of another liquidity crisis.

The international difference in circumstances that was less fortunate in 1931 than in 1920 was the monetary situation in other countries. In many countries, monetary arrangements in 1920 were in a state of flux, so they could adapt with some rapidity. By 1931, a new pattern of international monetary arrangements had become established, in considerable measure under the patronage of the Federal Reserve Bank of New York, as well as the Banks of England and France. More serious and more directly to be laid at the Reserve System's door, its gold sterilization policy had, as we have seen, increased the problem of adjustment for many other countries and so left them more vulnerable to new difficulties. In the event the monetary world split in two, one part following Britain to form the sterling area; the other following the United States, in the gold bloc. The sterling area countries all reached bottom and began to expand in late 1931 or early 1932; most gold bloc countries experienced further deflation and did not reach bottom until 1933 or 1934.

The deflationary monetary actions had less justification in the fall of 1931 than in 1920 for two different reasons. First, in 1920, the Federal Reserve System was still in its infancy, untried and inexperienced. Set up under one set of conditions, it was operating under a drastically different set. It had no background of operation in peacetime, no experience on which to base judgments. By 1931, the System had more than a decade of experience and had developed a well-articulated body of doctrine, which underlay the gold sterilization policy and which called for its offsetting an outflow of gold rather than reinforcing its deflationary effect. Second, the gold situation was drastically different. By early 1920, the gold stock was declining rapidly and the Reserve System's gold reserve ratio was approaching its legal minimum. Prior to September 1931, the System had been gaining gold, the monetary gold stock was at an alltime high, and the System's gold reserve ratio was far above its legal minimum—a reflection of course of its not having operated in accordance with a real gold standard. The System had ample reserves to meet the gold outflow without difficulty and without resort to deflationary measures. And both its own earlier policy and the classical gold standard rules as enshrined by Bagehot called for its doing so: the gold outflow was strictly speculative and motivated by fear that the United States would go off gold; the outflow had no basis in any trade imbalance; it would have exhausted itself promptly if all demands had been met.

As it was, of course, the System behaved very differently. It reacted vigorously to the external drain as it had not to the internal drain by raising discount rates within a brief period more sharply than ever before or since. The

result was a major intensification of the internal drain, and an unprecedented liquidation of the commercial banking system. Whereas the stock of money had fallen 10 percent from August 1929 to August 1931, it fell a further 28 percent from August 1931 to March 1933. Commercial bank deposits had fallen 12 percent from August 1929 to August 1931; they fell a further 35 percent from August 1931 to March 1933. Never was there a more unnecessary monetary collapse or one which did more to undermine public acceptance of liberal principles.

Once again, either a real gold standard throughout the 1920's and 1930's or a consistent adherence to a fiduciary standard would have been vastly preferable to the actual pseudo gold standard under which gold inflows and minor gold outflows were offset and substantial actual or threatened gold outflows were overreacted to. And this pattern is no outmoded historical curiosity: witness the U.S. reaction to gold inflows in the early years after World War II and its recent reaction to gold outflows; witness the more recent German sterilization of gold inflows. The pseudo gold standard is very much a living menace.

*4. U.S. nationalization of gold*

After going off gold in March 1933, the United States reestablished a fixed official price of gold in January 1934, raising the price to $35 an ounce. Many current proponents of a rise in the official price of gold approve this action, regarding it as required to bring the value of the gold stock into line with an allegedly increased fiduciary circulation. Perhaps a rise in the price of gold was desirable in 1934 but it cannot be defended along these lines, at least for the United States itself. In 1933, the ratio of the value of the gold stock to the total stock of money was higher than it had been in 1913 or at any date between. If there be any valid argument for a rise in the price of gold along these lines, it is for 1929, not 1934.

Whatever may be the merits of the rise in the price of gold, there can be little doubt that the associated measures, which were taken in order that the rise in the price of gold should have the effect desired by the Roosevelt administration, represented a fundamental departure from liberal principles and established precedents that have returned to plague the free world. I refer, of course, to the nationalization of the gold stock, the prohibition of private possession of gold for monetary purposes, and the abrogation of gold clauses in public and private contracts.

In 1933 and early 1934, private holders of gold were required by law to turn over their gold to the Federal Government and were compensated at a price equal to the prior legal price, which was at the time very decidely below the market price. To make this requirement effective, private ownership of gold within the United States was made illegal except for use in the arts. One can hardly imagine a measure more destructive of the principles of private property on which a free enterprise society rests. There is no difference in principle between this nationalization of gold at an artificially low price and Fidel Castro's nationalization of land and factories at an artificially low price. On what grounds of principle can the United States object to the one after having itself engaged in the other? Yet so great is the blindness of some supporters of free enterprise with respect to anything touching on gold that as recently as last year Henry Alexander, head of the Morgan Guaranty Trust Co., successor to J. P. Morgan & Co., proposed that the prohibition against the private ownership of gold by U.S. citizens be extended to cover gold held abroad. And his proposal was adopted by President Eisenhower with hardly a protest from the banking community.

Though rationalized in terms of "conserving" gold for monetary use prohibition of private ownership of gold was not enacted for any such monetary purpose, whether itself good or bad. The circulation of gold and gold certificates had raised no monetary problems either in the 1920's or during the monetary collapse from 1930 to 1933. Except for the final weeks just preceding the banking panic, the internal drain had not been for gold but for currency of any kind in preference to deposits. And the final gold drain was the consequence of the rumors, which proved correct, that Roosevelt planned to devalue. The nationalization of gold was enacted to enable the government to reap the whole of the "paper" profit from the rise in the price of gold—or perhaps, to prevent private individuals benefiting from the rise.

The abrogation of the gold clauses had a similar purpose. And this too was a measure destructive of the basic principles of free enterprise. Contracts entered into in good faith and with full knowledge on the part of both parties to them were declared invalid for the benefit of one of the parties!

This collection of measures constituted a further step away from a real gold standard to a pseudo gold standard. Gold became even more clearly a commodity whose price was fixed by governmental purchase and sale and rationing rather than money or even a form of money.

*5. International Monetary Fund and postwar exchange policy*

I agree fully with Professor Rist's criticisms of the International Monetary Fund and the arrangements it embodied.[5] These arrangements are precisely those of a pseudo gold standard: each country is required to specify a formal price of gold in terms of its own currency and hence, by implication, to specify official exchange rates between its currency and other currencies. It is forbidden to change these prices outside narrow limits except with permission. It commits itself to maintaining these exchange rates. But there is no requirement that gold serve as money; on the contrary, many of the IMF provisions are designed to prevent it from doing so.

The results have been anything but happy from a liberal viewpoint: widespread controls over exchange transactions, restrictions on international trade in the forms of quotas and direct controls as well as tariffs; yet repeated exchange crises and numerous changes in official exchange rates. No doubt, conditions are now far better than shortly after the war, but clearly in spite of the IMF and not because of it. And the danger of foreign exchange crises and accompanying interferences with trade is hardly over. In the past year, the United States moved toward direct interferences with trade to cope with a balance-of-payments problem; Germany appreciated; and Britain is now in difficulties.

B. THE DISTINCTION BETWEEN A REAL AND A PSEUDO GOLD STANDARD

Because of its succinctness and explicitness, Cortney's numbered list of prerequisites for the restoration of "monetary order by returning to an international gold standard" forms an excellent point of departure for exploring the difference between a real and a pseudo gold standard. His point (6) concludes "the price of gold will have to be raised to at least $70 an ounce." His point (7) is "Free markets for gold should be established in all the important countries, and trading in gold, its export and import should be absolutely free."[6] Here is the issue in a nutshell. Can one conceive of saying in one breath that worldwide free markets should be established in, say, tin, and in the next, that the price of tin should "be raised" to some specified figure? The essence of a free market is precisely that no one can "raise" or "fix" price. Price is at whatever level will clear the market and it varies from day to day as market conditions change. If we take Cortney's point (7) seriously, we cannot simultaneously take his point (6) seriously, and conversely.

Suppose we follow up the logic of this point (7) and suppose a free market to prevail in gold. There might then develop, as there has in the past, a real gold standard. People might voluntarily choose to use gold as money, which is to say, to express prices in units of gold, and to hold gold as a temporary abode of purchasing power permitting them to separate an act of barter into a sale of goods or services for money and the purchase of goods or services with money. The gold used as money might be called different things in different languages: "or" in French, "gold" in English; it might be measured in different units: say in grams in France and ounces in the United States; special terms such as "napoleon" or "eagle" might develop to designate convenient amounts of gold for use in transactions, and these might differ in different countries. We might even have governments certifying to weight and fineness, as they now inspect scales in meat markets, or even coining "eagles," "double-eagles," and the like. Changes in nomenclature or in units of measure, say, the shift from ounces to grams, might be made by legislation, but these would clearly have no monetary or income or redistributive effects; they would be like changing the standard units for measuring gasoline from gallons to liters; not comparable to changing the price of gold from $35 an ounce to $70 an ounce.

If such a real gold standard developed, the price of commodities in terms of gold would, of course, vary from place to place according to transportation costs of both the commodities and of gold. Insofar as different countries used gold, and used different units, or coins of different size, the price of one kind of gold in terms of another would be free to vary in accordance with preferences

[5] See Charles Rist, op. cit., supra note 3, pp. 188, 193.
[6] Ibid., p. 37.

by each country's citizens for the one kind or the other. The range of variation would, of course, be limited by the cost of converting one kind of gold into another, just as the relative price of commodities is similarly limited.

Under such a real gold standard, private persons or governments might go into the business of offering storage facilities, and warehouse receipts might be found more convenient than the gold itself for transactions. Finally, private persons or governments might issue promises to pay gold either on demand or after a specific time interval which were not warehouse receipts but nonetheless were widely acceptable because of confidence that the promises would be redeemed. Such promises to pay would still not alter the basic character of the gold standard so long as the obligors were not retroactively relieved from fulfilling their promises, and this would be true even if such promises were not fulfilled from time to time, just as the default of dollar bond issues does not alter the monetary standard. But, of course, promises to pay that were in default or that were expected to be defaulted would not sell at face value, just as bonds in default trade at a discount. And, of course, this is what has happened when a system like that outlined has prevailed in practice (e.g., in much of the pre-Civil War period in the United States).

Such a system might, and I believe would raise grave social problems and foster pressure for governmental prohibition of, or control over, the issue of promises to pay gold on demand.[7] But that is beside my present point, which is that it would be a real gold standard, that under it there might be different national names for the money, but there would not be in any meaningful sense either national currencies or any possibility of a government legislating a change in the price of gold.

Side by side with such a standard, there could, of course, exist strictly national currencies. For example, in the United States from 1862 to 1879, greenbacks were such a national currency which circulated side by side with gold. Since there was a free market in gold, the price of gold in terms of greenbacks varied from day to day; i.e., in modern terminology, there was a floating rate of exchange between the two currencies. Since gold was in use as money in Britain and some other countries, its main use in the United States was for foreign transactions. Most prices in the United States were quoted in greenbacks but could be paid in gold valued at the market rate. However, the situation was reversed in California, where most prices were quoted in gold but could be paid in greenbacks at the market rate. No doubt, in this historical episode, the expectation that greenbacks would some day be made promises to pay gold had an effect on their value by expanding the demand for them. But this was not essential to the simultaneous coexistence of the two currencies, so long as their relative price was freely determined in the market, just as silver and gold, or copper and silver, have often simultaneously circulated at floating rates of exchange.

If a government abjured a national currency, it might still borrow from the community in the form of securities expressed in gold (or bearing gold clauses), some of which might be demand obligations and might be noninterest bearing. But it would thereby surrender everything that we now call monetary policy. The resources it could acquire by borrowing would depend on the interest it was willing to pay on interest-bearing securities and on the amount of non-interest-bearing demand securities the public was willing to acquire. It could not arbitrarily issue any amount of non-interest-bearing securities it wished without courting inability to meet its promises to pay gold and hence seeing its securities sink to a discount relative to gold. Of course, this limitation in governmental power is precisely what recommends a real gold standard to a liberal, but we must not make the mistake of supposing that we can get the substance by the mere adoption of the form of a nominal obeisance to gold.

The kind of gold standard we have just been describing is not the kind we have had since at least 1913 and certainly not since 1934. If the essence of a free market is that no one can "raise the price," the essence of a controlled market is that it involves restrictions of one kind or another on trade. When the Government fixes the price of wheat at a level above the market price, it inevitably both accumulates stocks and is driven to control output; i. e., to ration output among producers eager to produce more than the public is willing to buy at the controlled price. When the Government fixes the price of housing space at a level below the market price, it inevitably is driven to control occupany; i.e., to ration space among purchasers eager to buy more

[7] See my "A Program for Monetary Stability," pp. 4–9 (1959).

than sellers are willing to make available at the controlled price. The controls on gold, like the related controls on foreign exchange, are a sure sign that the price is being pegged; that dollar, pound, etc., are not simply different names for different sized units of gold, but are national currencies. Insofar as the price of gold in these currencies and the price of one currency in terms of another are stable over considerable periods, it is not because of the ease of converting one quantity of gold into another and not because conditions of demand and supply make for stable prices, but because they are pegged prices in rigged markets.

The price of $35 an ounce at which gold was supported by the United States after January 1934 was initially well above the market price, like the price at which wheat is currently being supported. The evidence is in both cases the same: a rapid expansion of output and the accumulation of enormous stockpiles. From 1933 to 1940, production in the United States rose from less than 2.6 to 6 million ounces; in the world, from 25 to 41 million ounces; the gold stock in the Treasury rose from 200 to 630 million ounces, or by 1¾ times as much as the total of world output during the intervening period. Had this pace of increase in output and stock continued, the gold purchase program might well have been limited in scope; perhaps, as the U.S. silver purchase program finally was, to domestic output alone.

But the war intervened, which stopped the inflow of gold and brought a major rise in the stock of money. The resultant rise in other prices with no change in the price of gold has altered the character of the fixed U.S. price. It is now probably below the market price (given the present monetary use of gold), like rents under rent control. The evidence is again in both cases the same; a reduction in production, a decline in stocks, and a problem of rationing demanders. The U.S. gold output is now less than in 1933, though world output still exceeds the level of that year. The U.S. gold stock has declined to roughly 500 million ounces, well below its wartime peak but still 2½ times its level when the present price for gold was established. The restriction on the ownership of gold abroad by U.S. citizens is a first, and feeble, step toward still tighter rationing of demanders. The gentlemen's agreement among central banks not to press for conversion of dollar balances into gold is a more far reaching, if still rather weak, additional step. The history of every attempt at Government price fixing suggests that if the pegged price is far below the market price for long, such attempts are doomed to fail.

Doubling the price of gold would no doubt reverse the situation and raise the pegged price again above the market price. Gold production and U.S. gold stocks would no doubt rise. But to what avail? Gold would still be simply a commodity whose price is supported; countries would continue with their separate monetary policies; fixed exchange rates would freeze the only market mechanism available under such circumstances to adjust international payments; foreign exchange crises would continue to succeed one another; and direct controls of one kind or another would remain the last resort, and one often appealed to, for resolving them.

This kind of pseudo gold standard violates fundamental liberal principles in two major respects. First, it involves price fixing by Government. It has always been a mystery to me how so many who oppose on principle Government price fixing of all other commodities can yet approve it for this one. Second, and no less important, it involves granting discretionary authority to a small number of men over matters of the greatest importance; to the central bankers or Treasury officials who must manage the pseudo gold standard. This means the rule of men instead of law, violating one of our fundamental political tenets. Here again, I have been amazed how so many who oppose on principle the grant of wide discretionary authority to governmental officials are anxious to see such authority granted to central bankers. True, central bankers have on the whole been "sound money" men with great sympathy for private enterprise. But since when have we liberals tempered our fear of concentrated power by trust in the particular men who happen at a particular moment to exercise it? Surely our cry has been very different—that benevolent or not, tyranny is tyranny and the only sure defense of freedom is the dispersal of power.

### C. CONCLUSION

Let me close by offering a proposal, not for reconciling our views, but at least for possible agreement among us on one part of the gold problem. Can we not all agree with Mr. Cortney's point (7): The establishment of a thoroughly

free market in gold, with no restrictions on the ownership, purchase, sale, import, or export of gold by private individuals? This means in particular, no restrictions on the price at which gold can be bought or sold in terms of any other commodity or financial instrument, including national currencies. It means, therefore, an end to governmental price fixing of gold in terms of national currencies.

The major problem in achieving such a reform is, as for the U.S. wheat program, the transitional one of what to do with accumulated Government stocks. In both cases, my own view is that the Government should immediately restore a free market, and should ultimately dispose of all of its stocks. However, it would probably be desirable for the Government to dispose of its stocks only gradually. For wheat, 5 years has always seemed to me a long-enough period so I have favored the Government committing itself to dispose one-fifth of its stocks in each of 5 years. This period seems reasonably satisfactory for gold as well, and hence my own proposal for the United States, and also other countries, would be that the Government should sell off its gold in the free market over the next 5 years. Perhaps the greater ratio of the accumulated stock to annual production for gold than for wheat makes a longer transitional period appropriate. This seems to me a matter of expediency not of principle.

A world-wide free market in gold might mean that the use of gold as money would become far more widespread than it is now. If so, governments might need to hold some gold as working cash balances. Beyond this, I see no reason why governments or international agencies should hold any gold. If individuals find warehouse certificates for gold more useful than literal gold, private enterprise can certainly provide the service of storing the gold. Why should gold storage and the issuance of warehouse certificates be a nationalized industry?

Chairman DOUGLAS. The next witness is Mr. Ervin Hexner, professor of economics at Pennsylvania State University, who has a paper under the title of "The Relevance of Actual Experience Under Flexible Exchange Rates to Present Day Conditions."

## STATEMENT OF ERVIN P. HEXNER, PROFESSOR OF ECONOMICS, PENNSYLVANIA STATE UNIVERSITY

Chairman DOUGLAS. We are very glad to have you as a witness, Professor Hexner.

Mr. HEXNER. My written statement is somewhat longer than contemplated, and I shall read only the more important points of the sections, but I will read the conclusions fully.

I shall deal with what the United States can learn from foreign countries' experiences in the last two decades with flexible rate regimes.

In these series of hearings the Joint Economic Committee seems to be primarily interested in policy alternatives for the external financial affairs of the United States. I hope to assist this work of the committee by commenting on certain monetary developments, and offering a brief analysis of foreign countries' experiences with flexible rate systems during the last two decades. These experiences were after 1945 organically connected with the operations of the International Monetary Fund. It is in that context and on the basis of published reports of the IMF that flexible rate practices have been traditionally discussed. This will be my line of approach, also.

### THE THREE POLICY ASPECTS OF THE "FIXED VERSUS FLEXIBLE RATES" CONTROVERSY

Policy determining agencies of the United States (and no doubt the Joint Economic Committee) are confronted with three aspects of the flexible rate issue for action or deliberate nonaction. These three aspects are closely interconnected. However, they may be separated here to facilitate analysis of our principal subject. The

first aspect relates to the value and the gold content of the U.S. dollar which the Federal Government is authorized to determine and required to maintain. The principal question here is: Could and should we continue to base the external value of the U.S. dollar on a fixed relation to gold? The second group of problems confront the United States in its capacity as an important Government now participating in the overall review and revision of the international monetary system. The third aspect relates to the U.S. position on the fixed versus flexible rate issue in its capacity as (very important) factor in the current administration of monetary affairs within the IMF. The Executive Director appointed by the United States is participating as a matter of daily routine in decisions of the IMF often involving flexible rate problems. My somewhat tentative conclusions will distinguish between these three aspects. My conclusion on the first aspect will be that experiences of foreign countries with flexible rate regimes (including Canada) are of very little assistance in deciding the desirability and feasibility of our embarking on a flexible exchange rate regime. However, the United States can considerably profit from the experiences of other nations in regard to the second and third group of policy aspects.

### DISTINCTION AMONG FLEXIBLE RATE REGIMES

I would like to make a distinction among existing and suggested flexible rate regimes according to their broad characteristics.

A flexible rate scheme may be suggested for general application; that is, to all significant currencies. Under such scheme, no (convertible) reference currency whose value is fixed institutionally in terms of gold would exist. This situation was somewhat approximated during a short period of time between 1933 and 1934 before the U.S. dollar was fixed again in relation to gold.

A scheme may be suggested according to which market forces alone determine spot and forward exchange rates without any official intervention. This is a completely flexible (automatically adjusting) exchange market.

A flexible scheme may apply to convertible currencies only; that is, to currencies which are not subject to governmental restrictions on incoming and outgoing foreign payments.

A flexible scheme may be operated within the broad framework of a comprehensive, permanent monetary arrangement (analogous to the IMF) requiring effective cooperation of member states in their external financial policies, including their administering (or not administering) their exchange rates. A flexible scheme need not have institutional cooperation.

A flexible scheme may be limited to one (convertible) currency which is temporarily abandoning its institutionally agreed par value. This currency may or may not be a key currency. However, one reserve currency would maintain its fixed gold value.

A flexible rate scheme may operate within a framework of multiple currency rates containing also fixed rates for certain transactions; for example, Brazil, Argentina, and so on.

These somewhat pedantic orientation points indicate that the fixed versus flexible rate issue may refer at one extreme, to an all-embracing monetary scheme which requires a change in the whole machinery

of international payments, or at the other extreme, it may refer to less important arrangements in which the flexible rate scheme constitutes a transitional remedy which is intended to lead to the establishment of a fixed rate system.

### LANDMARKS RELATIVE TO THE FLEXIBLE RATE ISSUE

The thirties are frequently referred to as the period in which countries made good use of flexible rate regimes in bringing about adjustment in their foreign accounts.

The British flexible rate regime starting on the tragic day of September 20, 1931, and lasting until 1939, is frequently mentioned in this connection.

The Swedish experience of 1931–33, before the Krueger difficulty, and before the Swedish rate was pegged to the sterling is also often mentioned.

I doubt whether lessons from the thirties are much applicable to our present circumstances. In fact, I suspect that one of the reasons for including the fixed rate concept in the IMF scheme in such rigid terms was the experience of the thirties. From 1931 to 1939 was a period of great political disturbances, unemployment, the introduction of restrictive practices, and a period of confused short- and long-term capital movements, public and private. It was the period in which political agencies assumed more conscious control of exchange rate affairs. A number of exchange equalization accounts were established to counteract "natural" developments on exchange markets.

Certain private arrangements attempted to create reference currency schemes.

I tried to indicate, as an example, the international steel industries' gold currency scheme.

The following brief discussion of exchange developments (admittedly arbitrarily selected) refers to events accompanying the establishment and operation of the IMF.

From 1942 to 1944: Preparatory stage of IMF scheme. No suggestions advanced by monetary experts to incorporate in scheme provisions on flexible rates. The "joint statement" endorsed by the United States, the United Kingdom, and the U.S.S.R., which served as initial basis for Bretton Woods discussions, does not permit flexible rates.

July 1944: No document suggesting flexible rate alternative to fixed rate system was presented to Bretton Woods Conference by participating governments. The fixed rate system was endorsed by experts of the rank of Dennis Robertson, Camille Gutt, Louis Rasminsky, Lord Keynes, Emanual Goldenweiser, Alvin Hansen, E. M. Bernstein, Lionel Robbins, Pierre Mendes-France, and Leslie Melville. Constituent instrument of IMF contains fixed par value scheme for spot transactions (not for forward transactions).

In 1947: IMF notices that transactions at premium prices occur in gold markets. It admonishes governments and points to its strict policy concerning official gold transactions.

IMF approves (for practical reasons) parities for currencies of almost all of its member states, knowing that several of these will not be tenable in the longer run. They were approved for practical reasons.

IMF notices that in a number of member states flexible rate regimes prevail in various forms and contexts. IMF incorporates these practices into its operational scheme by recognizing them as one category of multiple currency practices.

In 1948 the first big drama occurred in the area of flexible rates. Mexico, a country with a fully convertible currency, embarks on a flexible rate regime because it felt that its economic position is in fundamental disequilibrium and its monetary authorities were not able (at that time) to suggest a parity which would be "appropriate" to its situation. IMF does not object to this flexible rate regime, considering it the best available approach leading to a fixed rate regime without application of payments restrictions.

In 1949: Establishment of an effective fixed par value by Mexico.

Devaluation of sterling and other important currencies. The British Chancellor of the Exchequer made it clear in Parliament that official circles gave consideration to the possibility of departing from the fixed unitary exchange standard and adopting some form of a floating rate. However, the Government decided (and Parliament approved) to continue on a (devalued) fixed rate standard.

In 1950, departure of Canada from agreed parity. IMF "took note" of the Canadian decision.

In 1951, (A), issuance of comprehensive IMF statement on fluctuating rate policy.

(B) Issuance of comprehensive policy statement on changed Fund attitude toward premium prices in official gold transactions.

In 1952, flexible rate system for sterling (Operation Robot) seriously considered (and rejected) by London Cabinet. Similar proposals repeatedly considered by the United Kingdom until 1955. "Operation Robot" was suggested by the British Monetary Authority, i.e., by the Bank of England, and the British Treasury, but it was defeated in the Cabinet by two noneconomists—it was defeated by the Prime Minister, Winston Churchill, and one of his physicist advisers, Lord Cherwell.

In 1954, (A) extension of transferable sterling regime (with fluctuating rate) to countries outside of sterling area.

And (B), issuance by IMF of regulations on Fund transactions in fluctuating rates currencies.

In 1955, transferable sterling put under explicit control of Exchange Equalization Account (no further fluctuation of transferable sterling rate).

In 1957, the United Kingdom formally expressed its adherence to a fixed exchange rate policy.

In 1958, establishment of external convertibility of many industrial countries.

In 1962, (A) establishment of new parity by Canada; and (B) reaffirmation without change by IMF of policies on fluctuating rates, originally issued in 1951. The new parity was established by Canada, and the International Monetary Fund found it necessary to reaffirm the policies on fluctuating rates exactly in the same version as in 1951.

In 1963, procedure for review of international monetary system. Express repudiation of flexible rate approach.

Chairman DOUGLAS. You are reading a most scholarly and most valuable paper, and I think that you are making a good contribution to

the historical development of the controversy between fixed and fluctuating exchanges. I notice that the text of your paper runs for 28 pages. I wonder if you could condense the latter portion of your paper, because all of it is going to be published. And perhaps you could give your conclusions, if you would be willing to do that.

Mr. HEXNER. Yes, sir, Mr. Chairman. The conclusions are the following, which occur toward the end of my paper.

Chairman DOUGLAS. That is on the last two pages?

Mr. HEXNER. Yes. Conclusions. Experience with fluctuating rate regimes after the Second World War, weighted in the light of the views of monetary administrators and monetary economists and also in light of published relevant documentation, leads to the following policy conclusions:

(*a*) There has been no experience with a foreign exchange market (for a convertible currency) in which prices have automatically adjusted to the unfettered forces of supply and demand. No such foreign exchange market has operated along the lines of commodity markets in which workable competition prevails.

(*b*) There does not exist now, nor is it likely that there will exist in the foreseeable future, any proposal by monetary administrators looking toward the establishment of a free exchange market (in the sense indicated above) for any convertible currency. There is empirical evidence that at present no responsible government would permit its exchange rate to fluctuate without some form of effective public control. This evidence applies to exchange systems with fixed and flexible rates.

(*c*) Experience with flexible rate regimes in the last two decades was limited—with very few exceptions—to monetary regimes operating under severe inflationary pressures or extraordinary political conditions. Flexible rate regimes were instrumental in stemming the outflow of monetary reserves and in balancing (at least in part) incoming and outgoing payments. Canada, Mexico, and Peru arrived at a fixed rate regime. All flexible regimes between 1946–63 operated in the context of a world monetary system in which major industrial countries had effective fixed par values. Foreign trade transactions of flexible rate countries took place mostly in convertible currencies with a fixed exchange rate.

Prices for steel and copper, Brazilian coffee, and Uruguayan wool have been traded in U.S. dollars.

(*d*) A general system of fluctuating exchange rates (with or without government control over market developments)—in the judgment of almost all monetary administrators—is not a workable alternative for an effective par value system. This finding in no way implies that a fixed rate system does not have considerable disadvantages, both in regard to domestic and external monetary policy. Nor does this imply that the expectations concerning an economization of reserves under a flexible rate regime are illusory. However, a number of substantive disadvantages and risks connected with a general flexible rate system, and the technical complexities of administering it, seem to outweigh its disadvantages. The defense of fixed rate regimes of

individual countries has been considered not only in the light of national monetary reserves, but also in the light of large (common) IMF reserves.

(*e*) Institution of a general system of fluctuating rates is fundamentally inconsistent with the existing IMF scheme. Establishment of such system would require a complete rethinking of the present pattern of worldwide monetary cooperation. Current proposals concerning desirable policies in regard to the volume, structure, and distribution of international reserves (Triffin, Stamp, Maulding, Posthuma, Bernstein, Zolotas, et cetera) are based on a fixed rate system.

(*f*) The institution and maintenance of a general flexible rate regime would involve a number of complex technical problems on a national and international scale. Extremely little literature is available on technical aspects. How would a flexible rate regime behave in a situation like Suez or the Cuban emergency, is difficult to say.

(*g*) Available experience on past and present flexible rate regimes (including Canada's) does not significantly contribute to the U.S. policy decision of whether to embark on a flexible rate regime.

(*h*) The institution of a flexible rate regime in the United States would involve the necessity of a fundamental revision of the present IMF scheme. A fixed relation between the U.S. dollar and gold is one of the essential prerequisites for the operations of the IMF on its present basis (although this condition is not explicitly stated in the IMF Charter).

Chairman DOUGLAS. Thank you very much, Mr. Hexner. Your complete paper will appear at this point in the record.

(The statement is as follows:)

PREPARED STATEMENT OF ERVIN P. HEXNER, THE PENNSYLVANIA STATE UNIVERSITY

WHAT CAN THE UNITED STATES LEARN FROM FOREIGN COUNTRIES' EXPERIENCES IN THE LAST TWO DECADES WITH FLEXIBLE REGIMES?

(1) In these series of hearings the Joint Economic Committee seems to be primarily interested in policy alternatives for the external financial affairs of the United States. I hope to assist this work of the committee by commenting on certain monetary developments, and offering a brief analysis of foreign countries' experiences with flexible rate systems during the last two decades. These experiences were, after 1945, organically connected with the operations of the International Monetary Fund. It is in that context and on the basis of published reports of the IMF that flexible rate practices have been traditionally discussed. This will be my line of approach also.

(2) *The three policy aspects of the "fixed versus flexible rates" controversy.*—Policy-determining agencies of the United States (and no doubt the Joint Economic Committee) are confronted with three aspects of the flexible rate issue for action or deliberate nonaction. These three aspects are closely interconnected. However, they may be separated here to facilitate analysis of our principal subject. The first aspect relates to the value and the gold content of the U.S. dollar which the Federal Government is authorized to determine and required to maintain. The principal question here is, Could and should we continue to base the external value of the U.S. dollar on a fixed relation to gold? The second group of problems confronts the United States in its capacity as an important Government now participating in the overall review and revision of the international monetary system. The third aspect relates to the U.S. position on the fixed versus flexible rate issue in its capacity as a (very important) factor in the current administration of monetary affairs within the IMF. The

Executive Director appointed by the United States is participating as a matter of daily routine in decisions of the IMF, often involving flexible rates. My somewhat tentative conclusions will distinguish between these three aspects. My conclusion on the first aspect will be that experiences of foreign countries with flexible rate regimes (including Canada) are of very little assistance in deciding the desirability and feasibility of our embarking on a flexible exchange rate regime. However, the United States can considerably profit from the experiences of other nations in regard to the second and third group of policy aspects.

(3) *Distinction among flexible rate regimes.*—Some distinction among (existing and suggested) flexible rate schemes according to their broad characteristics may facilitate consideration of the subject. A crude orientation scheme may indicate the following broad conceptual categories.

(*a*) A flexible rate scheme may be suggested for general application, i.e., to all significant currencies. Under such a scheme, no (convertible) reference currency whose value is fixed institutionally in terms of gold would exist. This situation was somewhat approximated during a short period of time between 1933 and 1934 before the U.S. dollar was fixed again in relation to gold.

(*b*) A scheme may be suggested according to which market forces alone determine spot and forward exchange rates without any official intervention. This is a completely flexible (automatically adjusting) exchange market.

(*c*) A flexible scheme may apply to convertible currencies only, i.e., to currencies which are not subject to governmental restrictions on incoming and outgoing foreign payments.

(*d*) A flexible scheme may be operated within the broad framework of a comprehensive, permanent monetary arrangement (analagous to the IMF) requiring effective cooperation of member states in their external financial policies, including their administering (or not administering) their exchange rates. A flexible scheme need not have institutional cooperation.

(*e*) A flexible scheme may be limited to one (convertible) currency which is temporarily abandoning its institutionally agreed par value. This currency may or may not be a key currency. However, one reserve currency would maintain its fixed gold value.

(*f*) A flexible rate scheme may operate within a framework of multiple currency rates containing also fixed rates for certain transactions.

These somewhat pedantic orientation points indicate that the fixed versus flexible rate issue may refer at one extreme, to an all-embracing monetary scheme which requires a change in the whole machinery of international payments, or at the other extreme, it may refer to less important arrangements in which the flexible rate scheme constitutes a transitional remedy which is intended to lead to the establishment of a fixed rate system.

(4) *Landmarks relative to the flexible rate issue.*—The thirties are frequently referred to as the period in which countries made good use of flexible rate regimes in bringing about adjustment in their foreign accounts. I doubt whether lessons from the thirties are much applicable to our present circumstances. In fact, I suspect that one of the reasons for including the fixed-rate concept in the IMF scheme in such rigid terms was the experience of the thirties. 1931–39 was a period of great political disturbances, unemployment, the introduction of restrictive practices, and a period of confused short- and long-term capital movements, public and private. It was the period in which political agencies assumed more conscious control of exchange rate affairs. A number of exchange equalization accounts were established to counteract "natural" developments on exchange

markets.[1] Certain private arrangements attempted to create reference currency schemes.[2]

The following brief discussion of exchange developments (admittedly arbitrarily selected) refer to events accompanying the establishment and operation of the IMF.

1942–44: Preparatory stage of IMF scheme. No suggestions advanced by monetary experts to incorporate in scheme provisions on flexible rates. "Joint statement" endorsed by United States, United Kingdom, and U.S.S.R. which served as initial basis for Bretton Woods discussions, does not permit flexible rates.

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[1] R. S. Sayers writes the following about intervention of political factors in central bank administration and about the role of the British exchange equalization account in the thirties:

"* * * when the monetary system broke down and the breakdown appeared at least partly responsible for the unemployment and impoverishment that characterized the early thirties, it was inevitable that political ministers should assume more conscious control of monetary organization * * *.

"* * * The fall of sterling in 1931, triggered off a chaos of exchange rate movements, and governments, already sensitive about the decline in international trade, were forced into direct action on exchange rates when their abrupt movements hit the already shrunken volume of trade. This was most clearly seen in Britain although the statutory purpose of the exchange equalization account was to prevent 'undue fluctuation,' its political origin was rooted in the wish to protect British trade from too abrupt a recovery of sterling after its initial collapse. Then when the Americans, partly in reaction to the British policy and partly for complicated reasons of their own, adopted an aggressive exchange rate policy, all was in the hands of the political administration while the Federal Reserve System took a back seat; and when, a little later, they established an exchange equalization account of their own, the new balance of power was confirmed. Again, as the countries of the European gold bloc got deeper and deeper into the mire, their monetary actions inevitably became increasingly matters of government decision * * *.

"* * * When one mammoth operator, the British exchange account, intervened in an essentially private market in currencies, it could choose the rates provided that it could and would take the consequences in the shape of ups and downs in its international reserves; but when there were two or more such mammoth official operators, a difference of view about the desirable level of exchange rates could cause a fantastic tug of war in which all pretense of offsetting private speculative movements would be lost in the battle between the official giants."

("Cooperation Between Central Banks," the Three Banks Review, September 1963, pp. 9–10.)

[2] It may be worthwhile to indicate here one of the practices in world trade that attempted to counteract uncertainties in the foreign exchange market. Steel prices in world trade were quoted until September 1931 (the date of the departure of the United Kingdom from the fixed rate regime) in pounds. After it appeared that the United Kingdom would not stabilize its currency, prices of rolled steel products were quoted in "gold sterlings" in contrast to paper sterlings.

The Entente Internationale de l'Acier, in Luxembourg, to which all European major steel export groups belonged, determined the conversion factor, by which "paper sterling prices" were transformed into "gold sterling prices." The first published conversion factor (July 1, 1933) was 1.463. The last one published (January 1939) was 1.675 to 1.800. Changes in the conversion factors are listed below:

| Date | Conversion rate | Date | Conversion rate |
|---|---|---|---|
| August 1933 | 1.489 | October 1934 | 1.675 |
| September 1933 | 1.552 | November 1934 | 1.650 |
| October 1933 | 1.553 | January 1935 | 1.675 |
| November 1933 | 1.519 | February 1935 | 1.700 |
| December 1933 | 1.486 | March 1935 | 1.750 |
| January 1934 | 1.550 | April 1935 | 1.725 |
| March 1934 | 1.625 | May 1935 | 1.700 |
| September 1934 | 1.650 | June 1935 | 1.675 |

See Iron and Coal Trade Review (London) Jan. 20, 1939, p. 153, Jan. 27, 1939, p. 218, The Economist, Dec. 24, 1938, p. 675, and the official journal of the Belgian Central Bank, Bulletin d'Information et de Documentation, January 1939, p. 34.

1944 July: No document suggesting flexible rate alternative to fixed-rate system was presented to Bretton Woods Conference by participating governments.[3] The fixed-rate system was endorsed by experts of the rank of Dennis Robertson, Camille Gutt, Louis Rasminsky, Lord Keynes, Emanuel Goldenweiser, Alvin Hansen, E. M. Bernstein, Lionel Robbins, Pierre Mendes-France, Leslie Mellville.[4] Constituent instrument of IMF contains fixed-par-value scheme for spot transactions (not for forward transactions).[5]

1947: (a) IMF notices that transactions at premium prices occur in gold markets. It admonishes governments and points to its strict policy concerning official gold transactions.

(b) IMF approves (for practical reasons) parities for currencies of almost all of its member states, knowing that several of these will not be tenable in the longer run.

(c) IMF notices that in a number of member states flexible-rate regimes prevail in various forms and contexts. IMF incorporates these practices into its operational scheme by recognizing them as one category of multiple currency practices.

1948: Mexico, a country with a fully convertible currency, embarks on a flexible rate regime because it felt that its economic position is in fundamental disequilibrium and its monetary authorities were not able—at that time—to suggest a parity which would be "appropriate" to its situation. IMF does not object to this flexible-rate regime, considering it the best available approach leading to a fixed-rate regime without application of payments restrictions.

1949: (a) Establishment of an effective fixed-par value by Mexico.

(b) Devaluation of sterling and other important currencies. The British Chancellor of the Exchequer made it clear in Parliament that official circles gave consideration to the possibility of departing from the fixed-unitary exchange standard and adopting some form of a floating rate. However, the Government decided—and Parliament approved—to continue on a (devalued) fixed rate standard.[6]

1950: Departure of Canada from agreed parity. IMF took note of the Canadian decision.

1951: (a) Issuance of comprehensive IMF statement on fluctuating rate policy.

(b) Issuance of policy statement on changed Fund attitude toward premium prices in official gold transactions.

1952: Flexible-rate system for sterling (Operation Robot) seriously considered (and rejected) by London Cabinet. Similar proposals repeatedly considered by the United Kingdom until 1955.

1954: (a) Extension of transferable sterling regime (with fluctuating rate) to countries outside of sterling area.

(b) Issuance of IMF of Regulations on Fund Transactions in Fluctuating Rates currencies.

1955: Transferable sterling put under explicit control of Exchange Equalization Account (no further fluctuation of transferable sterling rate).

1957: United Kingdom formally expressed its adherence to fixed-exchange-rate policy.[7]

1958: Establishment of external convertibility of many industrial countries.

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[3] Sir Dennis Robertson regarded the possibility of a floating rate under the Bretton Woods scheme "as anything but a very temporary expedient." "Utility and All That and Other Essays," London, 1954, p. 171. Robertson reflects on this rigid Bretton Woods position in the light of the controversies around the Canadian fluctuating rate in his "Memorandum Submitted to the Canadian Royal Commission on Banking and Finance," Princeton, 1963, p. 29.

[4] No large-scale discussion took place in Bretton Woods on the fixed versus flexible rate issue. "There was a long controversy on the very familiar topic 'Rigidity versus Stability' [sic] about which we all have heard for nearly 20 years" wrote the reporting delegate of the Committee on Fund Operations at Bretton Woods, Prof. Robert Mossé. "Probably neither the adherents of flexibility, nor the adherents of stability have changed their minds during our discussion. But, most of them are almost willing to end this 20-year war by a compromise." "Proceedings and Documents of the U.N. Monetary and Financial Conference" (Department of State publication 2866), vol. I, p. 312.

[5] The IMF regime of fixed exchange rates can be suspended only in case of an emergency or other unforeseen circumstances for a short period of time and only for the membership as a whole. The suspending measure must be based on a unanimous decision of the Executive Board. No such emergency measure is authorized for suspension of the regulation concerning official gold prices (art. XVI, sec. 1(a) of the Fund agreement).

[6] 468 House of Commons Debates (5th Ser.) 7 (1949).

[7] IMF, "Summary Proceedings of the Board of Governors," 1957, pp. 43–44, and 580 House of Commons Debates (5th Ser.) 1267 (1958).

1962: (a) Establishment of new parity by Canada.

(b) Reaffirmation without change by IMF of policies on fluctuating rates, originally issued in 1951.

1963: Procedure for review of international monetary system. Express repudiation of flexible-rate approach.

(5) *The IMF position on flexible rates.*—The IMF agreement shows beyond doubt that its Founding Fathers took a completely adverse position toward flexible-exchange rates. In its Bretton Woods version, the Fund scheme contains two general adjusting mechanisms which pertain to the machinery of the world's monetary system as a whole. In addition, the Fund scheme contains four particular adjusting mechanisms intended to assist in the establishment of equilibrium in the foreign payment position of one or more individual member states.

The first general adjusting mechanism in the hands of the Fund is a change of gold prices involving a universal proportionate change of parities (which are expressed in terms of gold). Such a decision would result in a change from one set of fixed rates to another.[8] The second general adjustment mechanism is intended to deal with unforeseen critical situations in the world's payment system. It envisages the possibility of suspending the IMF par value regime for all member states for a very short period by unanimous decision of the Executive Board. This emergency measure suspends all individual member states' international obligations in regard to their exchange rates. But it is not sure that each member state would then choose to embark on a fluctuating rate regime. Therefore, it cannot be stated that this emergency suspension of the par value obligation will result in some form of a general flexibility regime of the world. In view of the expressly transitional and emergency nature of this measure, we do not need to analyze it further.[9]

The particular adjusting mechanisms of the IMF scheme pertaining to the payment position of one individual country are—

(*a*) Use of the Fund's financial resources.

(*b*) Authorized change of the par value.

(*c*) Authorized imposition of restriction on payments.[10]

(*d*) Authorized institution of multiple currency practices and discriminatory currency arrangements.

None of these particular measures involve fluctuating rate regimes.

The rigid provisions of the IMF charter were softened by the IMF practitioners in two major directions. First, fluctuating rates were recognized as one category of multiple currency practices. This development occurred right at the beginning of the Fund's operations (1947). Within the framework of a comprehensive policy statement, the Fund declared fluctuating rates ("free markets" and "the auction system") as categories within the broad framework of multiple currency practices.[11] In this way, one category of flexible rate systems received legitimate existence in the Fund's operations. In the course of its activities, the Fund tried to simplify multiple currency practices—but unless a country's position was propitious for a (noninflationary) fixed-rate regime, the Fund did not encourage the suppression of flexible rates in those countries. In fact, it may be concluded from the Fund's exchange restriction and other reports that it tacitly encouraged individual flexible-rate regimes in countries whose economic or political system could not support an effective fixed-rate system.

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[8] Art. IV, sec. 7 of the Fund agreement reads: "Uniform changes in par values. Notwithstanding the provisions of sec. 5(b) of this article, the Fund by a majority of the total voting power may make uniform proportionate changes in the par values of the currencies of all members, provided each such change is approved by every member which has 10 percent or more of the total of the quotas. The par value of a member's currency shall, however, not be changed under this provision if, within 72 hours of the Fund's action, the member informs the Fund that it does not wish the par value of its currency to be changed by such action."

[9] Art. XVI, sec. 1(a) reads: "Temporary suspension. In the event of an emergency or the development of unforeseen circumstances threatening the operations of the Fund, the Executive Directors by unanimous vote may suspend for a period of not more than 120 days the operation of any of the following provisions: (i) Art. IV, sec. 3 and 4(b) [foreign exchange dealings based on parity, and obligations regarding exchange stability]."

[10] Controls on incoming and outgoing capital movements may be, of course, used as adjustment mechanisms. However, capital controls are generally authorized by the IMF scheme. They do not need separate mention here.

[11] The Fund is authorized to permit multiple currency practices (art. VIII, sec. 3 of the Fund agreement). See "Communication sent by the Fund to Members on Multiple Currency Practices" of Dec. 19, 1947, annex II to "Annual Report for 1948," pp. 65–72.

Second, in a few individual cases, the IMF decided to tolerate temporarily the institution of a flexible-rate system (and therefore did not object to the abandonment of the country's agreed par value). The Fund was fully aware of the fact that it has no power to permit flexible-rate regimes (which are not represented of being sectors of a multiple-rate regime). The Fund decided in 1951 on a broad policy noting the existence of individual flexible-rate regimes under exceptional circumstances. The issuance of a comprehensive policy statement on this subject at that particular time suggests that the Fund might have anticipated the possibility of certain industrial countries temporarily establishing flexible-rate regimes, in addition to the Canadian scheme. However, the policy statement makes as clear as possible two points which are of decisive interest for the consideration of the Joint Committee.

The first point made by the Fund is a sharp and explicit rejection of a flexible-rate system as a general method of adjustment.

"The [par value] system is not a wise one merely because it was written into the articles of agreement. But it is correct to state that it was written into the articles of agreement because it emerged from the experience of the world over a period of many years.

"Those who advocate allowing rates to find their 'natural' level, permitting market forces to determine a rate of exchange that will be stabilized, seek to provide a simple solution for a very complex problem. There is no such thing as a 'natural' level for the rate of exchange of a currency. The proper rate will, in each case, depend upon the economic, financial and monetary policies followed by the country concerned and by other countries with whom it has important economic relationships. If the economy of a country is to adapt itself to a given exchange rate, there must be time for the producers, sellers, and buyers of goods and services to respond to the new set of price and cost relationships to which the rate gives rise. This means that the short-run changes in the exchange rate are either no test or a very poor test of basic economic interrelationships.

"When a rate of exchange becomes inappropriate because of fundamental changes in a country's balance of payments, arising from forces either external or internal, it should be adjusted to the new situation."

Second, the Fund's flexible rate policy has been based on the assumption that one major currency will serve as a point of reference by maintaining its fixed value vis-a-vis gold.

"Parenthetically it may be mentioned that generally implicit in the arguments for fluctuating rates is the assumption that some major currency will remain stable as a point against which to operate the fluctuating rates." [12]

In other words, it was not assumed by the IMF that the U.S. dollar would ever embark on that exceptional regime. In addition to its policy statement here mentioned, the IMF issued detailed regulations regarding the transaction of Fund business if flexible currencies are involved.[13] These regulations provide that the U.S. dollar be regarded as a "reference currency." The Fund's policy declaration by implication covers currency blocs whose currencies would collectively fluctuate.[14]

(6) *Flexible rate practices of individual countries.*—I am enclosing with my written statement an excerpt from the IMF Exchange Restriction Report for 1963. You may see from it the list of flexible rate practices now in existence. However fascinating even a cursory description and analysis of the reaction of various flexible exchange markets to current events would be, their story seems to me of little relevance for the three policy aspects considered here. Especially certain exotic flexible exchange markets (e.g. Brazil, Indonesia) in which extra-economic considerations primarily govern monetary developments are of little relevance in this discussion. No fruitful result is to be expected for our work from the analysis of fluctuating, or free exchange regimes which have been stable (and are expected to remain stabilized) in the future (e.g. Lebanon, Syria, Venezuela, Paraguay). The reasons for their not establishing an effective and formal par value are psychological or excessively legalistic. Finally, I am excluding from my brief analysis flexible rate practices which do not relate to the

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[12] See "Annual report of the Executive Directors for 1951," pp. 36–41, confirmed and reprinted in "Annual report for 1962," pp. 62–67.

[13] "Decision on Transactions and Computations Involving Fluctuating Currencies," published as appendix II (pp. 125–127) to IMF "Annual report of Executive Directors for 1955."

[14] See Robert A. Mundell, "A Theory of Optimum Currency Areas," American Economic Review, September 1961, pp. 657–665.

whole monetary system of a country but only to one sector of it. Such practices are listed in the first part of the excerpt from the IMF Exchange Restriction Report. The IMF list contains flexible rate practices of Holland, Britain, and Belgium applying to certain capital movements. These countries do not wish to apply uniform policies concerning support of their currency to all exchange transactions taking place in their respective currencies. They differentiate between current and capital transactions as permitted by the IMF Agreement.

Among the monetary developments of the last 20 years certain positions and policies of the United Kingdom, Mexico, Peru, and Canada seem to be most interesting from the aspects discussed here. The position of the United Kingdom is interesting because sterling is a key currency and has been partially fulfilling the role of a reserve currency. An inquiry into the Canadian flexible rate regime (1950–62) is interesting because, apart from the initial first 2 years of its history (1950–52), the Canadian currency was convertible and did not operate under extreme inflationary or deflationary pressures. In addition, the Canadian arrangement has been frequently referred to as example to be followed by the United States. Discussions of the experience in Mexico and Peru also follow.

(*a*) The United Kingdom has some experience in the administration of fluctuating exchange rates (1931–39). It seriously considered the institution of such a regime when its reserve position was precarious after World War II. Transferable sterling for current transactions in the middle fifties, and various types of sterling in connection with capital movements, were marketed at fluctuating rates. There is no doubt that the United Kingdom exchange equalization account kept control over fluctuations.[15] These controlled fluctuations have been one accompaniment of the British restrictive system. They will completely disappear when sterling will become fully convertible (on capital account).

It may be useful to indicate here that British governmental circles seriously considered the abandonment of the fixed parity between 1949 and 1955. At their 1952 conference, the Finance Ministers of the British Commonwealth countries seriously discussed a "floating rate" system accompanying some form of convertibility measures.[16] However, the suggestion was not accepted. When the fundamental reform of the European payments system was considered in 1955, the United Kingdom suggested an arrangement which envisaged, for European currencies, fluctuations outside permitted margins. The United Kingdom suggested—according to Roy Harrod—3-percent margins on either side of parity.[17] This United Kingdom proposal was rejected also by all continental European countries.

On September 24, 1957, Peter Thorneycroft, the British Chancellor of the Exchequer declared in the IMF Board of Governors meeting that the United Kingdom would maintain the external and internal value of its currency. This position was approved by Parliament.[18] This appears to have terminated official British suggestions of flexible rates for the sterling countries. It may be assumed that the British proposals concerning flexible rates were based on the assumption that the value of the U.S. dollar would remain fixed.

(*b*) Mexico embarked on a fluctuating rate regime in July 1948. The U.S. National Advisory Council on International Monetary and Financial Problems (NAC) reported this event to Congress as follows:

"On July 22, 1948, the Bank of Mexico withdrew its support of the 20.6 cent initial par value of the peso agreed to with the Fund. The principal reason for this action was a continuous heavy drain on Mexico's foreign exchange reserves throughout the postwar period, and especially during the first 7 months of 1948. In accordance with the United States-Mexican Stabilization Agreement, Mexico discussed this matter fully with the officials of the U.S. Treasury."[19]

On June 17, 1949, the IMF announced that Mexico had established a new fixed parity. The United States agreed to support the new parity by a stabilization scheme which has been renewed up to the present. The Mexican experience is an example of the use of flexible rates, under a convertible regime, to find a viable level for a new fixed rate. It operated without restrictions on capital outflow. However, the succeeding change in Mexico's parity (April 19, 1954)

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[15] Published reports on the operations of the exchange equalization account are not very revealing. Sir Ivor Jennings cites the operations of the exchange equalization account as being as confidential as the use of money by the secret service. "Cabinet Government," London, 1951, p. 448.

[16] Roy Harrod, "The Pound Sterling," 1951–58, Princeton, 1958, p. 7.

[17] Ibid., p. 30.

[18] 580 House of Commons Debates (5th Ser.) 1267 (1958).

[19] NAC Report for the Second Semester 1948, H. Doc. 120, 81st Cong., 1st sess., p. 30.

did not follow this course of action. Mexico then devalued from one fixed parity to another.

(*c*) Peru arrived at an effective par value and a fully convertible currency 2 years ago after several experiments with flexible rate regimes. In November 1949, it adopted a system of dual fluctuating rates, one ("certificate rate") applying to most trade transactions, and a "draft rate" applying to other transactions. In 1953, the certificate rate depreciated by 28 percent because the world market prices of Peruvian exports decreased. Between 1957 and 1959, the exchange rate for the U.S. dollar increased from 19 Peruvian sols to 27.70. Peru provides an interesting example of a flexible rate system which, under IMF guidance, ultimately resulted in a fairly well operating fixed rate regime. As in Canada, the Peruvian Central Bank often emphasized that its intervention in the exchange market was limited to smoothing out short-term fluctuations.[20] This assertion gives cause to some skepticism.

(*d*) Canada reestablished an effective parity (92.5 Canadian cents per U.S. dollar) on May 2, 1962. Sir Dennis Robertson said about the termination of the Canadian flexible regime that "a fixed rate of exchange came to look more like a home of refuge than like a prison."[21] It was known early in 1950 that the Canadian dollar was undervalued and that sooner or later some major intervention would be needed to establish a more harmonious relation to other currencies. Capital inflow was strong in the summer of 1950 in expectation of gains from an early appreciation of the exchange rate, then pegged at 90.9 U.S. cents per Canadian dollar.

An often quoted statement of the Canadian Minister of Commerce, C. D. Howe, is characteristic for the atmosphere prevailing which encouraged speculation:

"It is true, at the moment, that Canadian funds are at 10-percent discount, but that is a temporary situation. This historic position of the Canadian dollar is at par with the United States. How long that discount will continue I don't know * * * but it may not continue very long."[22]

Canada abandoned its par value under pressure on its exchange markets on September 30, 1950. However, it was not prepared to decide at that time on a new parity. With tacit "consent" of the IMF, it embarked on a flexible rate regime. A sheet enclosed with my written statement contains a survey of Canadian exchange rate developments during its flexible period.

After the Second World War, there was a great demand for Canadian products (wheat, pulp, lumber, nickel, copper, etc.) and there was heavy external (mostly U.S.) investment in Canadian industrial development. In addition to a speculative inflow of short-term funds, there was a considerable inflow of long-term investment capital. A continuing large increase in the Canadian monetary reserves would have affected domestic measures designed to restrain the growth of the money supply. After freeing the Canadian exchange rate from IMF obligations, the value of the Canadian currency rose in terms of U.S. dollars. The high exchange rate—in addition to curbing short-term capital inflow—assisted in moderating inflationary pressures. It helped the Canadian monetary authorities to develop policies counteracting inflationary pressures. When, however, the demand for Canadian products on world markets decreased and industrial development slowed down, the flexible exchange rate was less responsive and helpful. A member of the Canadian Government described this situation as follows:

"As long as the external demand for our products and the pressure on our resources was maintained the relatively high value of our currency was helpful in restraining inflationary pressures. However, when world demand for our products eased, and our economic growth became less rapid, the exchange rate failed to move down to a level more appropriate to our economic circumstances. Buoyed up by a continuing and substantial capital inflow, the high exchange rate impaired the international competitive position of Canadian industries, and was an important factor in our inability fully to absorb our rapidly expanding labor force. Unemployment rose and was aggravated by heavy deficits on international current account. For some years we imported annually from abroad more than a billion dollars worth of goods and services in excess of our exports.

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[20] See S. C. Tsiang, "An Experiment With a Flexible Exchange Rate System: The Case of Peru, 1950–54," IMF staff papers, February 1957, pp. 449–476.

[21] "A Memorandum Submitted to the Canadian Royal Commission on Banking and Finance." Princeton, 1963, p. 30.

[22] Financial Post, June 10, 1950, quoted by Paul Wonnacott, The Canadian Dollar 1948–58, Toronto, 1960, p. 57.

"As a central element in its program to encourage economic growth and redress our international current deficit, the Canadian Government in 1960 and 1961 took a series of steps to facilitate an orderly movement of the exchange rate to a more appropriate level. These steps included the removal of certain special incentives to capital movements and a number of measures designed to make it more attractive for Canadian borrowers to draw upon Canadia savings instead of seeking funds abroad. In my budget statement in June 1961, I indicated that, as these measures might take some time to achieve their purpose, the exchange fund would, if necessary, be used to purchase foreign exchange and thus influence the rate. As it turned out, this was not necessary. For most of the period between June 1961 and May 1962, the Canadian dollar moved within the range of 3- to 5-percent discount on the U.S. dollar and the exchange fund's interventions continued to be directed toward moderating movements in the rate, not toward bringing such movements about.

"In April of this year (1962), however, it had become clear that there was considerable uncertainty in the exchange market and that this was giving rise to speculative pressures. In these circumstances, the Government concluded that the time had come to declare a par value and give those engaged in international transactions the advantages and security of a fixed rate of exchange." [23]

Canada had experience with some form of floating rates between 1929–39. It wished, in September 1950, to operate for a while along the lines of its earlier exchange practice. In the period 1950–57, the floating rate seemed to be working well, making easier an anticyclical monetary policy. Afterward, the situation became more complex. When the boom faded away, the rate did not continue to behave in an anticyclical manner. In addition, monetary policy in Canada, after 1957, followed a road which has been severely criticized with the advantage of hindsight. On December 1960, Canada started to manage its flexible rate in an open and deliberate way, whereas earlier intervention was not as open or forceful. Canada's flexible rate regime had great limitations in its last 2 years. The general opinion, in and outside of Canada, was, however, that the flexible regime worked fairly well between 1950–57.

The Canadian experiment has been observed by professors and practitioners with tremendous interest. A number of economic developments were attributed to exchange rate movements (and vice versa) and a number of elasticity coefficients were calculated with more or less success. Little authentic evidence is available however, about decisive facts of the experiment, especially about the direct intervention of the Exchange Equalization Account and the indirect intervention of the Bank of Canada. Very little attention was devoted to the flexible rate problem in the recent review of the Canadian monetary system by the Royal Commission on Banking and Finance. The comprehensive submission of the Bank of Canada and the Governor virtually did not touch this aspect of Canadian external financial affairs. Very few questions were asked on this subject by the Commissioners. Gov. Louis Rasminsky answered them fairly briefly and strictly to the point.[24] Only Sir Dennis Robertson's memorandum contains a few impor-

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[23] Address of Donald M. Fleming, in meeting of Board of Governors of IMF, Sept. 19, 1962, IMF Press Release No. 43, p. 2.

[24] Two answers of Mr. Rasminsky deserve to be quoted here. The first relates to the monetary authorities' concern with the exchange rate under a flexible rate regime.

Mr. Rasminsky explained:

"I think that under any exchange system, whether it is a fixed rate or a fluctuating rate, that (*a*) the policy of the country, including the monetary policy, has to have regard to the country's international position, to its balance of payments, to the state of its international transactions; and I think (*b*) that a country cannot fail to be concerned with the level of its exchange rate, regardless of the system which is in force at that moment.

"I think that the exchange rate is too important in the economy for the public authorities to look away from it and to be unconcerned with what is the value of the exchange rate. In that respect I do not think that the question is one of black and white as between a fluctuating rate system and a fixed rate system." Royal Commission on Banking and Finance, hearings, vol. 59, pp. 7530–31.

In response to the question "* * * would it be true to say if one holds large reserves he creates conditions for domestic policy which approach those under a floating rate system * * *," Mr. Rasminsky replied:

"No, I do not think so. I think that large reserves give you more leeway; but under either system, whether you have a fixed rate system and take fluctuations in reserves, or whether you have a fluctuating rate system, with the impact of imbalance in the foreign exchange account coming on to the exchange rate rather than on to the exchange reserves—I think that in either case you would have to be concerned in your policies with what is happening to your international accounts, whether reflected in exchange reserves or in exchange rate. It may be that really the answer I should have given to your question, the short answer to your question was: Yes, that the two systems are similar, not in the sense that large reserves give you freedom to disregard international considerations, but rather in the sense that you do not have that freedom under a fluctuating exchange rate anyway." Hearings, vol. 60, p. 7792.

tant comments on the success of the experiment. It was revealed that toward the end of the flexible regime there prevailed some confusion about the principles and procedures of monetary policy in governmental circles.

The monetary reserves of Canada during its flexible rate experiment moved between not too unsatisfactory limits ($1,821 millions in October 1950—and $1,501 millions in May 1962). The difference between the Canadian flexible rate regime and that of other countries lies importantly in the fact that Canada's reserves were not falling at the time of the institution of this practice and did not substantially diminish until late in this period.

None of the exchange systems analyzed here operated in a generally flexible environment. The U.S. dollar was used as a reference currency in all operations. In addition, the foreign trade of most countries with flexible rates was conducted in fixed rate currencies (dollar or pound). The IMF prepared a brief but comprehensive report on flexible regimes in its Annual Report for 1962. A few excerpts—admittedly out of context—might illustrate the IMF position:

"It is an illusion to expect the fluctuating rate to ease the problems facing the monetary authorities. On the contrary, by eliminating the rallying point of the defense of a fixed par value, a fluctuating rate makes it necessary for the authorities to exercise greater caution in determining monetary policy.

"* * * if an exchange rate fluctuates widely, it may be expected to depreciate over time. The movements of exchange rates and prices over the last 10 years in six countries that had fluctuating rates (Argentina, Brazil, Chile, Indonesia. Peru, Uruguay) show, on the whole, a persistent tendency in that direction.

"Recent experience with fluctuating rates, which has been commented on here, suggests that the countries using this device have not, on the whole, been able to protect their reserves from expansionary domestic policies. In particular, a fluctuating exchange rate tends to aggravate the pressures on the balance of payments arising out of domestic economic policies." [25]

No mention is made in the Fund's report of the reasons which kept the IMF from exercising pressure on the Canadian monetary authorities to terminate the flexible regime earlier.

(7) *Flexible rate regime banned from policy considerations.*—In the fall meeting of the Board of Governors of the IMF, there was almost general agreement on the usefulness, if not necessity, of reviewing the structure and operation of the international monetary system with a view to adapting it to the expected evolution of international trade. Studies on long-range operational problems will be prepared by the Fund itself and by the monetary authorities of the group of 10. It has been clearly and explicitly understood in the relevant discussions that the investigations and reform proposals should not involve a change in the regime of fixed exchange rates and in the price of gold since "the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements." [26]

Conversely, the much-contested problem of the volume, structure, and distribution of international reserves was to be approached by cooperative studies. This happened on the international scene. On the U.S. national scene, the President and high officials of his administration formally proclaimed on several occasions that the United States is not prepared to consider as a possible approach to the solution of its present payment crisis a change in the fixed relation of the U.S. dollar to gold nor is such an approach envisaged in case of future fluctuations in the U.S. payments position. Thus, according to officials responsible for monetary administration, the fixed versus flexible rates controversy is to be eliminated from the agenda of those policy studies which concern the long-range reform of the international payments system and those which relate to the reestablishment of balance in the short-run payments position of the United States. This decision of all monetary administrators left apparently unaffected the widespread opinion prevailing among many outstanding economists (as the records of the Joint Economic Committee show). The opinion expressed is that a general regime of flexible rates is the best (or second best) temporary and permanent approach to a workable coordination of the internal and external payment position of individual nations all over the world (because such a regime would give them more freedom to determine their domestic economic policy).

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[25] Annual Report for 1962, pp. 62–67.
[26] IMF, press release of Oct. 2, 1963. "Int. Fin. News Survey," Oct. 11, 1963, p. 351.

They hold also that radical departure by the United States from the regime of fixed exchange rates is the most useful and workable approach to its present and future balance-of-payments difficulties. A number of economists consider the resistance of monetary administrators to flexible rate regimes as being based on irrational motivations. In the judgment of Gottfried Haberler, in the United States and the United Kingdom "a mountain of prejudices and taboos stands in the way of a rational solution." [27]

Reasonable and experienced people of affairs refuse outright further consideration of an overall approach to burning problems which is recommended by reputable academic people.[28] To be sure, this outright refusal by monetary administrators applies to the general institution of a flexible rate regime which would include the departure of the United States from a fixed par value. The refusal does not seem to apply to the fluctuating rate policy which is at present incorporated into the operating scheme of the IMF.

In addition to the adverse attitude of practitioners based on economic arguments, sometimes extraeconomic (mostly political) arguments enter the flexible rate discussion. Statesmen, not particularly versed in monetary affairs may oppose departure from the par value system on account of national prestige, faith of the people in the stable value of their currency, international relations, and so forth. For example, the British Cabinet refused in 1952 to institute a flexible exchange regime in the United Kingdom, a scheme known dramatically as Operation Robot which was proposed by the British monetary administrators to husband the rather modest and decreasing monetary reserves by extraordinary arrangements. According to reliable reports, this decision was decisively influenced by arguments of a political nature advanced by Sir Winston Churchill and his physicist-adviser, Lord Cherwell. "The essence of Robot was," wrote the Economist, "that it should be sprung on the world suddenly, after only a minimum of consultation with the Commonwealth and the United States." [29]

(8) Fixed parity of the U.S. dollar.—The institution of a flexible rate regime for the U.S. dollar was rather rarely suggested before 1958.[30] Some mention was made of the flexible rate problem by the Randall Commission (1954), however, it seems that in its report, it did not intend to deal with the exchange rate of

[27] "I cannot refrain from making a final remark, although for lack of space it must remain brief and dogmatic" writes Haberler in a study on the present foreign financial position of the United States. "How much simpler all these problems would be if we had a rational system of variable exchange rates. Imagine Canada finding herself in the position of the United States. 'All she would have to do is to let her dollar go down a few points and the problem would have disappeared. I know that the United States, or the United Kingdom for that matter, cannot do that at the present time, chiefly because a mountain of prejudices and taboos stands in the way of a rational solution. The only weighty but by no means unanswerable objection to the system of fluctuating exchanges which I can see is that it would remove an important barrier to financial indiscipline. But in my opinion this argument does not apply to the leading industrial countries. Their internal sensitivity to prolonged inflation (and to a continuing fall of their exchange if they had a freely fluctuating rate) is a sufficient inducement to financial discipline. However, the time does not seem ripe for a sensible and rational system of fluctuating exchanges. We have to find the solution within the existing framework of institutions, prejudices and taboos." Excerpt from "The State and Prospects of the U.S. Economy" by Gottfried Haberler, p. 34, "Lloyds Bank Review," January 1961.

[28] According to Robert V. Roosa the problem of flexible rates has "probably through the years fascinated more professors and frustrated more practitioners than any other tool in the kit of international financial machinery." "Outlook for U.S. Balance of Payments, Hearings Before the Joint Economic Committee," December 1962, p. 118.

[29] Earl of Birkenhead, "The Professor in Two Worlds, the Official Life of Prof. F. A. Lindemann, Viscount Cherwell," London, 1961, pp. 283–294. When the policy of the British Government was defended in the House of Commons by the (then) Chancellor of the Exchequer, R. A. Butler, the (then) leader of the opposition Hugh Gaitskell, praised Lord Cherwell for his torpedoing the fluctuating rate approach. "He [Lord Cherwell] has really done us a very good service if his relationship to the Prime Minister has enabled him to stop such a disastrous turn in our policy." Gaitskell characterized Butler's arguments of establishing convertibility accompanied by a flexible rate system as follows: "This debate has certainly been notable for a more than usually large number of platitudinous and vague statements by Her Majesty's Ministers. I thought that until he came right to the end and introduced this wonderful phrase of a policy of balanced flexibility. I suppose that means something like tightrope walking on a rope which is not very tight." See Parliamentary Debates (Hansard) Nov. 11, 1952, 507, H. C. Deb. London, 1952, columns 784 and 795–6. See also "How Sterling Nearly Floated," The Economist, Nov. 11, 1961.

[30] Milton Friedman, a leading advocate of general flexibility of exchange rates, indicated in 1950 that such general flexibility was not inconsistent with the fixed relation between the monetary unit of one country (e.g., United States) and gold, although he did not propose continued maintenance of such a relationship by the United States. "Essays in Positive Economics," Chicago, 1953, p. 191.

the U.S. dollar.[31] A number of such proposals were advanced between 1958 and 1963, and the discussions and publications of this committee justifiably devoted great attention to them. A thorough technical analysis was given to the flexible rate problem in the United States upon request of this committee by a staff study of the Federal Reserve Board. Among the recommendations for abandoning a fixed gold price by the United States, advanced after 1957, Milton Friedman's proposal has been the broadest. He suggested a genuinely free rate without any governmental intervention. Professor Friedman considered it practicable for the IMF to continue operating in an environment in which the U.S. dollar would fluctuate.[32] The least radical flexibility of the U.S. dollar (no doubt with governmental intervention and control) has been advanced as a short-term measure by Professors Halm[33] and Meade.[34] Both of these proposals wish to maintain monetary cooperation within the IMF. They would moderately broaden the present margins within which exchange rates (and gold prices) must be maintained by Fund members. Among the moderate proposals wishing to maintain monetary cooperation within the IMF may be counted Walter Salant's proposal, which designates his flexible rate recommendation as a second best approach.[35]

It is not necessary to specify here the views of academicians and men of practice opposing changes in the present U.S. par value regime. You might have noticed that I myself belong to that group. However, it does seem necessary to state here that in my personal judgment the U.S. discussion of its exchange rate policy can profit relatively little from the (published) experiences of other nations. The distribution of constitutional responsibilities in regard to the formulation and administration of monetary policies greatly differs in the United States from that of other nations. The locus and effectiveness of these responsibilities would play an important role if the United States were to insitute a flexible rate regime. The position of the United States in international political and economic affairs greatly differs from that of Canada, Mexico, United Kingdom, and others. The role of the U.S. dollar in international trade and on capital markets as a reserve currency differs from that of other currencies which embarked on a flexible rate regime. This is not to say that information on exchange rate and monetary reserve developments, prices, interest rates, and related economic measures in Canada between October 1950 and May 1962 are not instructive for U.S. policies. However, these data and correlations do not affect the merits of the principal issue.

In view of the fact that the Canadian example has been frequently suggested as a model to be fully or partially followed in revising U.S. exchange rate policies, it might be useful to list a few arbitrarily selected orientation points for a workable distinction between the Canadian and the sometimes proposed U.S. arrangements and the context in which they operated or would operate. The Canadian experience would differ from that of the United States in the following ways:

(1) Except during the last phase of the Canadian fluctuating rate regime, no other country's economic and employment position was adversely affected by Canada's flexible rate policy.

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[31] In January of 1954, the U.S. Commission on Foreign Economic Policy, the so-called Randall Commission, reported to the President and Congress that it was "sympathetic to the concept of a 'floating rate,' which provides alternative methods of meeting trade and speculative pressures." The Commission thought, however, that each country would have to decide for itself whether it is strong enough, externally and internally, to administer such a system effectively. U.S. Commission on Foreign Economic Policy, "Report to the President and to Congress," p. 73 (January 1954). See also Joint Committee on the Economic Report, "Foreign Economic Policy," S. Rept. 1312, 84th Cong., 2d sess. (1956), which concludes that no final judgment is possible in choosing between fixed and floating rates although the report presents a prima facie case for stable rates.

[32] "Capitalism and Freedom," Chicago, 1963, p. 70. Friedman recognizes that these measures would be inconsistent with the formal obligation of the United States under the IMF agreement. "However, the Fund found it possible to reconcile Canada's failure to specify a parity with its [the IMF] articles and to give its approval to a floating rate for Canada. There is no reason why it [the IMF] cannot do the same for the United States" (ibid.). See also his suggestions in this committee on Oct. 30, 1959, hearings, "Employment. Growth and Price Levels," pt. 9A, p. 3023.

[33] George Halm suggests the institution of flexible exchange rates "in a very preliminary form and within the present framework of the IMF by permitting the members of the Fund to introduce greater margins above and below par value for transactions in gold according to art. IV, sec. 2 [of the IMF agreement]" (Joint Economic Committee, "Factors Affecting the U.S. Balance of Payments," p. 560 (1962)). Each nation would administer its flexible rate through domestic stabilization funds (Joint Economic Committee, "Outlook for U.S. Balance of Payments," p. 180 (1963)).

[34] See "Outlook for U.S. Balance of Payments," pp. 241–243, concerning the dangers of an uncontrolled fluctuating rate system. See the comments of James Meade, in "Factors Affecting the U.S. Balance of Payments," p. 247 ff.

[35] "The U.S. Balance of Payments in 1968," Washington, 1963, p. 258 ff.

(2) Canada's flexible rate regime was intended to be reversible at any time without serious repercussions on its own and other countries' economic positions. Although Canada did not wish to have its reserves rapidly increased by capital inflow, it maintained a comfortable reserve position. Canada's flexible rate was not instituted to release it from the cushioning of its foreign economic position by reserves.

(3) Canada's flexible rate operated in the context of a stable reserve currency. Its main export commodities were marketed in terms of U.S. dollars.

(4) The switch from the fixed rate to the flexible regime and vice versa could be achieved by executive action. Monetary actions of the Government were institutionally endorsed by a Parliamentary majority.

(5) Canada has no (voluntary) commitment to convert its currency at fixed rates into gold.

(6) The Canadian flexible rate regime did not involve changes in the world's monetary machinery.

(7) The Canadian flexible rate regime did not involve problems of national prestige.

(8) Canada's balance-of-payments structure and the vulnerability points of its external economic regime differ considerably from that of other countries. Canada was most vulnerable on current account.

It is interesting to ask in this context whether there was less governmental intervention in foreign economic policies under a flexible rate regime than under a fixed one. Contrary to frequently expressed expectations that there will be less governmental intervention in monetary operations under a flexible rate regime, this optimistic hope is not borne out by foreign experience. There is good reason to agree with Hal B. Lary's caveat, presented in this committee, that "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." [36]

Little attention has been devoted by the propounders of the flexible rate system to the influence of national peculiarities and local circumstances. This aspect seems to be important in weighing the institution of a flexible rate system in certain countries—especially the United States. Professor Caves (a strong advocate of the general flexible rate regime) emphasized to the Joint Committee that economic arguments in favor of flexible rate regimes must be considered in the context of one particular political and economic environment if actual policy considerations are involved.[37] There is much less certainty than is generally believed in the minds of monetary administrators how to manage a flexible rate system in certain countries, especially in the light of local circumstances, coexistent flexible rate systems in other countries, and in view of many expected domestic and foreign forward operations.

Foreign countries' experiences with flexible rate systems do not contain any significant fact or factor which would indicate that a system of flexible rates in the United States, whether free of official intervention or with intervention determined by the monetary authority, would facilitate the achievement of major domestic goals of economic policy without incurring overwhelmingly adverse effects, national and international.

(9) *U.S. position in reviewing the international monetary system.*—The United States will have, no doubt, a very weighty voice in both teams, those within the Fund and within the Paris group, reviewing the IMF scheme. The U.S. representatives will certainly abide by the terms of reference which have excluded from consideration the general institution of flexible exchange rates and a change in official gold prices. This limitation might, however, not preclude them from participating in a review of present arrangements pertaining to the administration of the fixed rate system and to the administration of the IMF provisions on official gold transactions. Review of these arrangements will take place if the teams do not limit themselves to problems of international liquidity in the narrowest sense, i.e., if they include in their considerations the operation of the machinery of international payments as a whole. It may be that in the course of a review of the world's liquidity problems, the strengthening of the fixed rate regime may come under consideration and in that context recent experience with flexible rate regimes may be pertinent.

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[36] Joint Economic Committee, "The U.S. Balance of Payments," hearings on July 29, 30, 1963, pt. 2, p. 305.

[37] "Outlook for U.S. Balance of Payments," hearings before Joint Economic Committee on Dec. 14, 1962.

The present operative IMF arrangements on official gold prices, par values, and exchange rates are much more flexible than they appear in the provisions of the constituent instrument. Implicit adaptation of the somewhat ascetic Fund provisions to a more flexible regime was achieved by piecemeal adjustments by the Executive Board with the express or tacit consent of the member states. The overall review of the international payment system may be a good occasion to relax the text of those provisions of the Fund's basic instrument concerning gold prices and exchange rates which in practice proved to be excessively rigid. Such revision should take advantage of member states' experiences with flexible rates.

Experience does not show the necessity of changing the broad framework of the par value mechanism, its relation to gold and the machinery for the universal change of gold prices within the IMF. However, experience does show that the general fixed rate regime of IMF may be strengthened by making flexible a few of its provisions which proved to be excessively severe and unwieldy. This could be easily achieved by expressly authorizing the Executive Board to formulate and implement policies without substantially changing broad principles.

Such implementing authority would not institute a general flexible rate regime. It would facilitate administration of the fixed rate regime by making it more manageable. A few examples may illustrate the line along which such review might proceed:

(*a*) Gold purchases based on par values. The Fund agreement requires treasuries and central banks to buy and sell monetary gold only at official prices (parity price plus and minus 1 percent). This provision proved to be excessively severe in practice, although the principle itself is an essential element of the par value regime.[38] In practice, a number of central banks have participated in gold transactions which exceeded official prices. This has had no obvious adverse effects but, on the contrary, proved beneficial. Express authority given to the Executive Board to issue implementing regulations would bring this proscription in line with modern practice.

(*b*) Foreign exchange dealings based on parity. In the case of spot transactions 1 percent is the present margin (up and down) by which exchange rates should not exceed the par value.[39] Thus spot exchange transactions involving U.S. dollars in London are to remain within the limits of 2.80 plus or minus 1 percent equals 2.828 or 2.772. Margin requirements even within a fixed rate regime could be better determined from time to time by monetary technicians than by an inflexible provision in the basic instrument. Experience in European countries has shown that the 1 percent margin is too rigid and that a more flexible margin would facilitate arbitrage operations without necessarily producing a flexible rate system. Express authority given to the Executive Board to issue general regulations by which the 1 percent margin may be somewhat increased or decreased (e.g. by 50 percent) would make the rigid provision adaptable and consistent with operative practices.

(*c*) Changes in par values. The Fund's fixed rate regime recognized that the established par value of a country, which is to govern exchange transactions, may become untenable. A specific procedure is prescribed for changes in par values in case of fundamental disequilibrium in a member state's economic system.[40] Prior consultation with the Fund on the proposed change is required. The mechanism of change requires a transition from one par value immediately to another par value. The immediate transition from one parity to another may involve hardships, as the Mexican and Canadian examples prove. What may be even more burdensome, the present preparatory and consultative procedure may involve practical difficulties in cases in which large scale speculative movements may accompany the prospective change in par value. To avoid domestic

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[38] Art. IV: Sec. 2, reads as follows: "Gold purchases based on par values.—The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin."

[39] Art. IV: Sec. 3 reads: "Foreign exchange dealings based on parity.—The maximum and the minimum rates for exchange transactions between the currencies of members taking place within their territories shall not differ from parity (i) in the case of spot exchange transactions, by more than 1 percent; and (ii) in the case of other exchange transactions, by a margin which exceeds the margin for spot exchange transactions by more than the Fund considers reasonable."

[40] Art. IV, sec. 5, reads in part: "Changes in par values.—(a) A member shall not propose a change in the par value of its currency except to correct a fundamental disequilibrium. (b) A change in the par value of a member's currency may be made only on the proposal of the member and only after consultation with the Fund.

and foreign speculation, member states may be reluctant to abide by the consultative requirements of the present fixed rate regime.[41] Two sets of adaptive measures may lessen the rigidities of the present provisions. The Executive Board of the IMF could be authorized to permit within specified time limits individual fluctuating rate regimes which are in general accord with the Fund's basic principles.[42] It is to be expected that in the course of the present discussions, the Fund's policy concerning flexible rates (reaffirmed in 1962) will be examined and adapted to the new arrangements. The Executive Board of the IMF may be authorized to issue regulations which would permit Fund scrutiny of proposed changes without creating a risk of speculative activity.[43]

These suggestions, which are advanced very tentatively, require much thought and technical elaboration. They may indicate the line along which past experience can be used in reforming the monetary system in the area of exchange rates.

One caveat seems to be important in discussing monetary cooperation. International scrutiny of exchange rates imposes delicate functions on the Executive Board of the Fund. The Board has discharged these duties with caution, although sometimes somewhat strained reasoning was required to keep within the limits of the present charter. Administration of a general fluctuating system on a worldwide basis may involve duties for a monetary organization which it is unable to discharge satisfactorily. Triffin[44] and Meade[45] called attention to this aspect. Senator Paul Douglas wished to explore this aspect in connection with a recent reform proposal.[46] The question may be properly asked if nations are willing currently to submit matters of such fundamental significance to international decisionmaking and if international agencies are now capable of reconciling conflicting interests in such a delicate sphere.

(10) *U.S. position in IMF affairs.*—Given the weighted voting scheme of the IMF and the position of the United States in international economic and political affairs, the U.S. Executive Director is, no doubt, one of the most important factors in the Executive Board of the IMF. This Board is responsible for the conduct of general operations of the Fund. The U.S. Executive Director is in continuous consultation with the members of the National Advisory Council of International Monetary and Financial Problems (NAC) which in turn periodically reports to Congress on IMF affairs. It is no exaggeration to state that no general policy decision of the IMF on flexible rates and no decision on the consent (or nonconsent) in individual cases involving the institution or maintenance of flexible rates would prevail in practice if it is inconsistent with the judgment of the U.S. monetary authorities as portrayed by its Executive Director. Consequently, it may be assumed that all significant items on the agenda of the IMF, and in particular those relating to flexible rates and policies concerning the monetary affairs of countries which find themselves under extraordinary

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[41] Under present conditions, the propensity of national monetary authorities to submit their contemplated exchange measures to IMF scrutiny (even outside of emergencies) has been judged rather pessimistically by some experienced experts. J. Herbert Furth wrote recently the following " * * * many countries seem to break international financial commitments whenever it suits their purposes. In recent months we have seen one leading commercial and financial country, a model of international rectitude (and indeed the home of the International Court of Justice) change the par value of its currency without bothering to consult with the International Monetary Fund in advance, as required by art. IV, sec. 5(b) of the Fund agreement. Several other countries that had solemnly accepted the obligations of currency convertibility have instituted exchange restrictions without bothering to request Fund approval, contrary to art. VIII, sec. 2(a). These actions were taken not to meet emergencies, which might leave no room for legal niceties, but merely because the authorities believed on rather doubtful grounds, that the illegal actions were more convenient than legal conduct would have been." "Professor Triffin and the Problem of International Monetary Reform", 21 Zeitschrift für Nationalökonomie 417 (Vienna, 1962).

[42] Whereas the Mexican and Canadian individual flexible regimes had been tolerated by the Fund and their status vis-a-vis other countries and the Fund was somewhat obscure. According to the above suggestion such emergency regimes would become legitimate if this suggestion is accepted.

[43] A number of complexities connected with the weighted voting scheme of the Fund would have to be clarified in that connection.

[44] Robert Triffin critically commenting on the Keynes' Clearing Union proposals called attention to the fundamental necessity of "distinguishing what may be accomplished through worldwide agreements and what may prove achievable only on the regional scale within smaller and more homogeneous groups of highly independent countries * * *." "Gold and the Dollar Crisis," New Haven 1960, p. 95.

[45] "Such proposals," writes James Meade, "raise, of course, the most far-reaching questions of the proper nature for the management and governing body of an IMF that was transformed into so powerful a supranational instrument." "Factors Affecting the U.S. Balance of Payments," p. 252.

[46] "The U.S. Balance of Payments," hearings before the Joint Economic Committee of U.S. Congress, July 29, 1963, pt. 2, Washington 1963, p. 254.

inflationary pressures, are discussed with appropriate U.S. governmental departments and these views are reflected in the Executive Board. In addition, U.S. consultations with other countries which go on outside the IMF are reflected by the U.S. Executive Director. It is doubtful that a nation like the United Kingdom would submit to the IMF a significant proposal affecting its exchange rate without prior, private consultation with the United States. Thus, the U.S. position in the IMF will reflect our own policies and the experiences of other countries. For example, U.S. political relations with Mexico and its interest in a convertible Mexican exchange regime will be reflected in the Executive Board deliberations.

(11) *Conclusions.*—Experience with fluctuating rate regimes, after the Second World War, weighted in the light of the views of monetary administrators and monetary economists and also in light of published relevant documentation leads to the following policy conclusions:

(*a*) There has been no experience with a foreign exchange market (for a convertible currency) in which prices have automatically adjusted to the unfettered forces of supply and demand. No such foreign exchange market has operated along the lines of commodity markets in which workable competition prevails.

(*b*) There does not now exist, nor is it likely that there will exist in the foreseeable future, any proposal by monetary administrators looking toward the establishment of a free exchange market (in the sense indicated above) for any convertible currency. There is empirical evidence that at present no responsible government would permit its exchange rate to fluctuate without some form of effective public control.

(*c*) Experience with flexible rate regimes in the last two decades was limited—with very few exceptions—to monetary regimes operating under severe inflationary pressures or extraordinary political conditions. Flexible rate regimes were instrumental in stemming the outflow of monetary reserves and in balancing (at least in part) incoming and outgoing payments. Canada, Mexico, and Peru arrived at a fixed rate regime after their experience with flexible rates. All flexible regimes between 1946–63 operated in the context of a world monetary system in which major industrial countries had effective fixed par values. Foreign trade transactions of flexible rate countries took place mostly in convertible currencies with a fixed exchange rate.

(*d*) A general system of fluctuating exchange rates (with or without governmental control over market developments)—in the judgment of almost all monetary administrators—is not a workable alternative for an effective par value system. This finding in no way implies that a fixed rate system does not have considerable disadvantages, both in regard to domestic and external monetary policy. Nor does this imply that the expectations concerning an economization of reserves under a flexible rate regime are illusory. However, a number of substantive disadvantages and risks connected with a general flexible rate system, and the technical complexities of administering it, seem to outweigh its advantages. The defense of fixed rate regimes of individual countries has been considered not only in the light of national monetary reserves but also in the light of large (common) IMF reserves.

(*e*) Institution of a general system of fluctuating rates is fundamentally inconsistent with the existing IMF scheme. Establishment of such system would require a complete rethinking of the present pattern of worldwide monetary cooperation. Current proposals concerning desirable policies in regard to the volume, structure, and distribution of international reserves (Triffin, Stamp, Maulding, Posthuma, Bernstein, Zolotas, etc.) are based on a fixed rate system.

(*f*) The institution and maintenance of a general flexible rate regime would involve a number of complex technical problems on a national and international scale. Extremely little literature is available on these technical aspects. It would be interesting to speculate on how fluctuating rates would move in situations like the Cuban or Suez crisis, and other political emergencies.

(*g*) Available experience on past and present flexible rate regimes (including Canada's) does not significantly contribute to the U.S. policy decision of whether to embark on a flexible rate regime.

(*h*) The institution of a flexible rate regime in the United States would involve the necessity of a fundamental revision of the present IMF scheme. A fixed relation between the U.S. dollar and gold is one of the essential prerequisites for the operations of the IMF on its present basis (although this condition is not explicitly stated in the IMF charter). The institution of flexible

regimes in major industrial countries (especially the United States) would probably invoke, on the part of many countries, quantitative (and maybe payments) restrictions in order to protect home markets. Retaliatory restrictions would certainly follow.

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EXCERPTS FROM THE IMF 14TH ANNUAL REPORT EXCHANGE RESTRICTIONS (1963)

(*1*) *Capital payments, Netherlands, United Kingdom, Belgium*

The Netherlands and the United Kingdom permit capital transactions related to dealings in foreign securities, and to dealings in domestic securities by nonresidents, to be carried out in exchange markets separated from those for current transactions. Belgium and Luxembourg permit all capital transactions to be carried out in the free market. In these markets during the past 12 months the exchange rates have not, with the exception noted below, exceeded the exchange rate margins prescribed by the Fund.

In the United Kingdom there is a market in which the foreign exchange proceeds resulting from the sale abroad of foreign currency securities owned by residents, and from the receipt from abroad by residents of certain capital funds (e.g., legacies), may be negotiated at freely determined rates, usually attracting a premium over the official market rate. For a number of years these funds have been available for reinvestment in marketable foreign currency securities, but in May 1962 the possibility was opened up for their use for approved direct investments abroad for which official exchange is not provided. From June 1962 onward there has been a more or less steady rise in the amount of the premium; at the end of March 1963 it was around 10 percent (pp. 5–6).

(*2*) *Afghanistan*

The par value is afghanis 45.00 equals US$1. The Bank of Afghanistan (the central bank) charges a commission of 0.67 percent of parity for buying or selling.

The official selling rate applies to foreign exchange payments by the Government and certain government agencies for imports and other purposes. All other transactions take place at free market rates through either the banks or the bazaar. On March 22, 1963, the free market rate of the Bank of Afghanistan was Afg50 buying, Afg50.65 selling, per US$1, and the free market buying rate in the bazaar was Afg50 per US$1.

NOTE.—On March 22, 1963, the exchange system was reformed and simplified and an initial par value for the afghani of Afg45.00 per US$1 was established with the International Monetary Fund (pp. 17, 19).

(*3*) *Argentina*

On January 9, 1957, a par value for the Argentine peso was established by Argentina with the Fund. However, exchange transactions no longer take place at rates based on that par value. Purchases and sales of gold and foreign currencies, including foreign banknotes, take place without restriction in a free exchange market, in which the rate on December 28, 1962, was M$N134.10 per US$1 (p. 20).

(*4*) *Bolivia*

On May 14, 1953, a par value for the boliviano was established by Bolivia with the Fund. However, exchange transactions no longer take place at rates based on that par value. A single, freely fluctuating rate was established by virtue of Supreme Decree 4538 of December 15, 1956. All exchange transactions are carried out in a free market, in which the exchange rate has remained stable since January 1959. On January 1, 1963, the boliviano was replaced by the Bolivian peso at a rate of Bs1,000 equals $b1.00 (p. 41).

(*5*) *Brazil*

On July 14, 1948, a par value for the Brazilian cruzeiro was established by Brazil with the Fund. However, exchange transactions no longer take place at rates based on that par value. There is a free exchange market where, in principle, exchange rates should be freely negotiated. At present, however, the rate for the U.S. dollar is held at Cr$460 buying, Cr$475 selling, per US$1. Exchange rates for other convertible currencies are based on these rates and the dollar quotations for such currencies in international markets (p. 43).

(6) *Chile*

No par value for the Chilean escudo (which was introduced on January 1, 1960) has been established with the Fund. The par value for the Chilean peso established with the Fund on October 5, 1953, is not applied to any transactions under the present exchange system.

There are two exchange markets: the official market (known as the banking market), where only commercial banks are allowed to operate, and the brokers' market, where commercial banks and authorized exchange dealers are allowed to operate. The rates of exchange in both markets fluctuate freely (p. 70).

(7) *Colombia*

On December 17, 1948, a par value for the Colombian peso was established by Colombia with the Fund. However, exchange transactions no longer take place at rates based on that par value. There is a buying rate, fixed by the Board of Directors of the Bank of the Republic in conformity with Law No. 1 of 1959, of Col$7.10 per US$1 for the foreign exchange proceeds of exports of coffee, precious metals except platinum, and certain manufactured products, and for incoming capital for the exploration and exploitation of petroleum and for the metal-extracting industries. An exchange rate equal to the average free market rate of the preceding week is applied to all other export proceeds (p. 78).

(8) *Ecuador*

The par value is Ecuadoran sucres 18.00 equals US$1. The official rates are S/17.82 buying, and S/18.18 selling, per US$1. These rates apply to nearly all export receipts and payments for imports and related invisibles, to official transactions, to other essential invisibles, to registered capital, and to all contractual private foreign debt operations entered into after July 14, 1961. For all other transactions there is a free market, in which the rates as at December 31, 1962, were S/21.99 buying, and S/22.41 selling, per US$1 (p. 102).

(9) *Guatemala*

The par value is Guatemalan quetzal 1.00 equals US$1. There are three markets for foreign exchange transactions: (1) The official market applies to exchange proceeds subject to obligatory surrender and to payments for essential imports and specified invisibles and capital. The rates in the official market are Q1.00 buying, and Q1.01 selling per US$1. (2) In the auction market, exchange licenses are to be offered at least once a week in amounts equal to official exchange holdings considered in excess of the requirements for essential transactions. Holders of exchange licenses may apply them to payments for nonessential imports and specified nonessential invisibles. (3) The free exchange market is for incoming exchange not subject to surrender and for all outgoing payments for which exchange is not available through the official or auction markets (p. 145).

(10) *Indonesia*

No par value for the Indonesian rupiah has been established with the Fund. The basic official rate is Rp45.00 per US$1, on which are based the Bank Indonesia's rates of Rp44.83125 buying, and Rp45.28125 selling, per US$1.

The Bank's effective buying rates vary from Rp44.83125, which applies to to transactions with the oil companies, to Rp179.83125, the special rate for tourists. There is a retention system for all other exchange receipts which permits exporters and other exchange earners to retain 15 percent of exchange proceeds for sale on a free market. This produces three effective exchange rates; as at the end of December 1962 these were Rp169.73156, Rp171.41906, and Rp173.10656, per US$1 (p. 173).

(11) *Laos*

No par value for the Laotian kip has been established with the Fund. The official rate is K80 equals US$1. The National Bank of Laos conducts exchange transactions with authorized banks only in U.S. dollars, French francs, and pounds sterling, at rates equivalent to K80.00 buying, and K80.35 selling, per

US$1. Bank are authorized to charge commissions not exceeding 1 percent on purchases and sales of these currencies. There is also an unofficial free market for transactions not covered by the regulations, in which the kip is bought and sold at a considerable discount (p. 236).

*(12) Lebanon*

On July 29, 1947, a par value for the Lebanese pound was established by Lebanon with the Fund. However, exchange transactions no longer take place at rates based on that par value. Practically all transactions take place at free market rates, which for the U.S. dollar as of December 31, 1962, were LL3.06 buying, and LL3.0750 selling, per US$1. Under an agreement with the United Arab Republic, a special rate of LL8.00 equals LE1 is applied to exchange purchased from Egyptian tourists. There are no restrictions on foreign payments (p. 240).

*(13) Paraguay*

On March 1, 1956, a par value for the Parguayan guarani was established by Paraguay with the Fund. However, exchange transactions no longer take place at rates based on that par value. Exchange transactions take place at free market rates, which since October 1960 have been G123.60 buying, and G126.00 selling, per US$1 (p. 301).

*(14) Philippines*

The par value is Philippine pesos 2.00 equals US$1. A fluctuating rate applies to all exchange payments and to all receipts other than 20 percent of proceeds from merchandise exports. To this 20 percent the par value rate of ₱2.00 per US$1 applies, resulting in a mixing rate of approximately ₱3.52 per US$1 for total export proceeds. On December 31, 1962, the fluctuating rate averaged ₱3.89193 buying, and ₱3.91053 selling, per US$1 (p. 305).

*(15) Syria*

On July 29, 1947, a par value for the Syrian pound was established by Syria with the Fund. However, exchange transactions no longer take place at rates based on that par value. There are two exchange rates, an official rate of LS3.80 buying, LS3.82 selling, per US$1, and a free market rate, which is, in practice, close to the official rate. As of December 31, 1962, the rate in the free market was LS3.815 buying, LS3.817 selling, per US$1 (p. 356).

*(16) Uruguay*

On October 7, 1960, a par value for the Uruguayan peso was established by Uruguay with the Fund. However, exchange transactions no longer take place at rates based on that par value. All exchange transactions take place in a free market with fluctuating rate, which on December 31, 1962, was Ur$10.95 buying, Ur$10.98 selling, per US$1. A tax of 6 percent is levied on payments for nearly all merchandise imports; in addition, a tax of one-tenth of 1 percent is payable on all funds received from or remitted abroad (p. 401).

*(17) Venezuela*

The par value is Venezuelan bolivars 3.35 equals US$1. There are controlled market rates and "official free" market rates. The controlled market selling rate of Bs3.35 per US$1 applies to payments for essential imports, certain invisibles, some capital, and essential Government payments. The corresponding buying rate of Bs3.33 per US$1 applies to the proceeds of exports of iron ore and other noncombustible minerals and of reexports of imports paid for at the controlled market rate, and to receipts of the Government. Exchange is purchased from the petroleum companies at special buying rates. Under certain conditions, preferential rates apply to the proceeds of coffee and cacao exports. Other exchange transactions take place at official free exchange rates; on December 31, 1962, these rates were Bs4.525 buying, and Bs4.54 selling, per US$1. There is also a small exchange market with a fluctuating rate, in which the commercial banks do not participate; the rate for the U.S. dollar in this market was approximately Bs4.525 on December 31, 1962 (p 404).

TRANSACTIONS AND COMPUTATIONS INVOLVING FLUCTUATING CURRENCIES [1]

(Decisions of executive directors of International Monetary Fund of June 15, 1954, August 4, 1961, and December 20, 1961)

The Fund has examined certain problems relating to the adjustment of its holdings of fluctuating currencies and to transactions and computations involving such currencies and has come to the following conclusions:

I. The Fund does not intend to apply the rules set forth in II below to its holdings of members' currencies having fluctuating rates when there is no practical interest for the Fund or members to do so. To avoid misunderstanding, it may be useful to point out that these rules do not constitute a formula for dealing with the currencies of countries in which current transactions are conducted at multiplte rates.

II. Subject to I above, the following rules are adopted:

Where the foreign exchange value of a currency fluctuates so that exchange transactions in that currency are not based on parity in accordance with article IV, section 3, and the Fund decides to apply article IV, section 8, computations by the Fund relating to that currency (hereinafter referred to as "fluctuating currency") for the purpose of applying the provisions of the articles of agreement of the Fund will be made as follows:

1. (i) Computations will be based on the midpoint, between the highest rate and the lowest rate for the U.S. dollar quoted, for cable transfers for spot delivery, in the main financial center of the country of the fluctuating currency on the day specified in subparagraph (ii) below; provided, however, that when prescribed by subparagraph (iii) below computations will be based on the midpoint between the highest rate and the lowest rate for the fluctuating currency quoted in New York for cable transfers for spot delivery. Arrangements will be made with the Fund's depository in the country of the appropriate exchange market as determined hereunder to communicate to the Fund the rates referred to in this subparagraph (i).

(ii) For the purpose of subparagraph (i) the specified day will be:

(a) For the sale of purchase by the Fund of a fluctuating currency in exchange for another currency, or the purchase of gold by the Fund under article V, section 6(a), or the sale of gold by the Fund under article VII, section 2, or voluntary repurchase, or borrowing or the repayment of borrowing under article VII, section 2, the last business day in the main financial center of the country of the fluctuating currency, before the Fund instructs its depository to transfer or receive the fluctuating currency.

(b) For computations for the purpose of article V, section 7(b) or article V, section 8(f), the day as of which the computation is made.

(iii) If a midpoint cannot be determined in the main financial center of the country of the fluctuating currency in accordance with subparagraph (i) for the day specified in subparagraph (ii), there will be substituted therefore the midpoint for the fluctuating currency in New York determined in accordance with subparagraph (i) for the same calendar day. If no such midpoint can be determined for that day, there will then be substituted, to the extent necessary, first the previous business day in the main financial center of the country of the fluctuating currency, and secondly the same calendar day in New York. This procedure will be followed to the extent necessary, until a midpoint is determined in accordance with subparagraph (i), except where the Fund decides to make a special determination under paragraph 6 below.

2. Where as the result of the application of paragraph 1 the amount of currency which the Fund has agreed to sell would exceed the amount that the purchasing member is entitled to purchase under article V, section 3(a) (iii), the amount of currency to be sold will be reduced to the amount the purchasing member is entitled to purchase under that provision unless the Fund makes a waiver under article V, section 4.

[1] Published in IMF, "Selected Decisions of Executive Directors," September 1962.

3. The Fund will revalue all of its holdings of a fluctuating currency on the basis of the midpoint employed for a computation under paragraph 1, and such revaluation will take effect as of the day specified for the computation in subparagraph (ii) of paragraph 1. As a minimum, revaluation will be made as of each July 31, October 31, January 31, and April 30.

4. Whenever the Fund revalues its holdings of a fluctuating currency under paragraph 3, it will establish an account receivable or an account payable, as the case may be, in respect of the amount of the currency payable by or to the member under article IV, section 8. For the purpose of applying the provisions of the articles as of any date, the Fund's holdings of the fluctuating currency will be deemed to be its actual holdings plus the balance in any such account payable as of that date.

5. Any amount receivable or payable established under paragraph 4 above will be settled promptly after each July 31, October 31, January 31, and April 30, provided, however, that settlement will not be necessary for any July 31, October 31, or January 31 on which the midpoint as determined under paragraph 1 above does not differ by more than 5 percent from the rate for the last settlement. Settlement of any account receivable or payable established under paragraph 4 above will always be made when requested by either the Fund or the member.

6. In any case in which it appears to the Fund that any of the provisions of paragraphs 1 to 5 above are not adequate or satisfactory, the Fund will make a special determination for the treatment of such case.

III. Sections I and II above of this decision shall be communicated to members together with SM/54/25 as amended by SM/54/25, supplement 1 as an explanatory memorandum.

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SPOT EXCHANGE RATES FOR U.S. DOLLAR IN CANADA AS OF THE END OF THE MONTH (AUGUST 1950–JUNE 1962)

| | January | February | March | April | May | June | July | August | September | October | November | December |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Canada: | | | | | | | | | | | | |
| 1950 | ----- | ----- | ----- | ----- | ----- | ----- | ----- | 1.105 | 1.105 | 1.053 | 1.040 | 1.053 |
| 1951 | 1.055 | 1.046 | 1.051 | 1.068 | 1.068 | 1.067 | 1.056 | 1.058 | 1.055 | 1.048 | 1.036 | 1.017 |
| 1952 | 1.003 | 1.000 | .987 | .980 | .983 | .974 | .964 | .961 | .960 | .967 | .973 | .971 |
| 1953 | .970 | .983 | .982 | .986 | .991 | .994 | .994 | .992 | .981 | .980 | .975 | .974 |
| 1954 | .971 | .965 | .980 | .986 | .981 | .979 | .973 | .970 | .970 | .970 | .969 | .966 |
| 1955 | .972 | .988 | .983 | .989 | .984 | .986 | .984 | .985 | .990 | .998 | 1.000 | .999 |
| 1956 | .999 | .999 | .999 | .997 | .989 | .981 | .981 | .980 | .977 | .968 | .959 | .960 |
| 1957 | .958 | .958 | .956 | .958 | .956 | .953 | .948 | .948 | .965 | .959 | .968 | .985 |
| 1958 | .982 | .979 | .975 | .970 | .964 | .959 | .962 | .973 | .976 | .969 | .966 | .964 |
| 1959 | .969 | .973 | .968 | .962 | .962 | .955 | .959 | .952 | .948 | .947 | .949 | .953 |
| 1960 | .953 | .951 | .957 | .966 | .988 | .980 | .976 | .970 | .978 | .976 | .978 | .996 |
| 1961 | .991 | .988 | .989 | .988 | .988 | 1.036 | 1.031 | 1.031 | 1.030 | 1.033 | 1.042 | 1.043 |
| 1962 | 1.046 | 1.050 | 1.050 | 1.050 | 1.090 | 1.086 | ----- | ----- | ----- | ----- | ----- | ----- |

SPOT EXCHANGE RATES FOR U.S. DOLLAR IN MEXICO AS OF THE END OF THE MONTH (JANUARY 1948–OCTOBER 1949)

| | January | February | March | April | May | June | July | August | September | October | November | December |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1948 | 4.86 | 4.86 | 4.86 | 4.86 | 4.86 | 4.86 | [1] 4.86 | 6.83 | 6.89 | 6.91 | 6.89 | 6.88 |
| 1949 | 6.88 | 6.97 | 6.97 | 7.00 | 8.06 | [2] 8.22 | 8.65 | 8.65 | 8.65 | 8.65 | ----- | ----- |

[1] Through July 21. Average for July 22–Dec. 31 was 6.81.
[2] June 1–17. On June 17 rate fixed at 8.65 pesos per U.S. dollar.

Source: International Financial Statistics.

Chairman DOUGLAS. The final paper is by Prof. Henry C. Wallich, of Yale University, under the topic, "Exchange Rates: How Flexible Should They Be?" Professor Wallich, we are happy to have you back with us.

## STATEMENT OF HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. WALLICH. Thank you very much, Mr. Chairman. Let me say at the outset that I conceive of my paper as a defense of fixed rates. The title indicates that I would like to see the pros and cons weighed because there are pros and cons, of course.

Flexible rates have achieved a high measure of acceptance in academic circles, but very little among public officials. This raises the question whether we have a parallel to the famous case of free trade: almost all economists favor it in principle, but no major country ever has adopted it. Does the logic of economics point equally irrefutable to flexible rates, while the logic of politics points in another direction?

The nature of the case, I believe, is fundamentally different. Most countries do practice free trade within their borders, although they reject it outside. But economists do not propose flexible rates for the States of the Union, among which men, money, and goods can move freely, and which are governed by uniform monetary, fiscal, and other policies. Flexible rates are to apply only to relations among countries that do not permit free factor movements across their borders and that follow, or may follow, substantially different monetary and fiscal policies. It is the imperfections of the world that seem to suggest that flexible rates, which would be harmful if applied to different parts of a single country, would do more good than harm internationally.

It is quite arguable that the Appalachian area would benefit if it could issue a dollar of its own, an Appalachian dollar which in that case would sell, probably, at 60 or 90 cents. Exports from that region would increase, and unemployment would diminish. A great many good things would happen, but we are also aware of what it would do to the economy of the United States—and, therefore, we do not propose that solution. The question is, Do we want to look upon the world as quite different from the United States, as hopelessly divided into self-contained units where cooperation and efforts to coordinate policies are doomed to frustration? In that case, flexible rates may be the best way to avoid a very bad situation. But should we not try to establish within the world something that begins to approximate the conditions that prevail within a country, in the way of coordination of policies, freer flow of capital and of goods and so try to achieve the benefits of one large economic area within the world? That is what we should try for.

Now to resume: The proponents of flexible rates argue, in effect, that flexible rates can help a country get out of almost any of the typical difficulties that economies experience. This is perfectly true. If the United States has a balance-of-payments deficit, a flexible exchange rate allows the dollar to decline until receipts have risen and payments fallen enough to restore balance. If the United States has

unemployment, flexible rates can protect it against the balance-of-payments consequences of a policy of expansion. We would then have less unemployment. If the United States has suffered inflation and fears that it will be undersold internationally, flexible rates can remove the danger.

All of these advantages are quite clear.

Other countries have analogous advantages. If Chile experiences a decline in copper prices, flexible rates can ease the inevitable adjustment. If Germany finds that other countries have inflated while German prices have remained more nearly stable, flexible rates could help to avoid importing inflation. If Canada has a large capital inflow, a flexible rate will remove the need for price and income increases that would otherwise be needed to facilitate the transfer of real resources.

There are other adjustments, however, that must be made in all of these cases. If a country allows its exchange rate to go down, some price adjustments still remain to be made. Furthermore, each time a country makes this kind of adjustment, allowing its exchange rate to decline, other countries suffer. If the U.S. dollar depreciates, we undersell the Europeans. It could be argued that if the U.S. price levels go down instead of the exchange rate, we also undersell the Europeans, and if because of a declining price level we have unemployment we would be buying still less from them. Nevertheless, there is a difference. A price adjustment tends to be slow and is likely to be no greater than it need be and tends to be selective for particular commodities. In contrast, an exchange rate movement is unpredictable. It can be large—we could easily have a drop of 10 or 20 percent in an exchange rate. It comes suddenly. And it compels other countries to be on their guard.

Why, given the attractions of flexible rates, should one advise policy-makers to stay away from them? Since the dollar problem is the concrete situation in which flexible rates are being urged today, it is in terms of the dollar that they must be discussed. In broadest terms, the reason why flexible rates are inadvisable is that their successful functioning would require more self-discipline and mutual forbearance than countries today are likely to muster. Exchange rates are two sided—depreciation for the dollar means appreciation for the European currencies. To work successfully, a flexible dollar, for instance, must not depreciate to the point where the Europeans would feel compelled to take counteraction. I believe that the limits of tolerance, before counteraction begins today are narrow and that a flexible dollar would invite retaliation almost immediately.

In the abstract, the European countries perhaps ought to consider that if the United States allows the dollar to go down, it is doing so in the interests of all-round equilibrium. They ought perhaps to consider that with a stable dollar rate the same adjustment might have to take place through a decline in prices here and a rise in prices there. In practice, they are likely to be alive principally to the danger of being undersold by American producers if the dollar goes down, in their own and third markets. The changing competitive pressure would fall unevenly upon particular industries, and those who are hurt would demand protection.

The most likely counteraction might take one of two forms. The Europeans could impose countervailing duties, such as the United

States also has employed at times. They could alternately also depreciate European currencies along with the dollar or, what would amount to almost the same thing, prevent the dollar from depreciating. This might involve the European countries in the purchase of large amounts of dollars. If they are to peg the dollar, they could minimize their commitment by imposing a simple form of exchange control that the Swiss practiced during the last war. The Swiss purchased dollars only from their exporters, also requiring their importers to buy these dollars thereby stabilizing the trade dollar, while allowing dollars from capital movements—finance dollars—to find their own level in the market.

The large volume of not very predictable short-term capital movements in the world today makes such reactions under flexible rates particularly likely.

Chairman DOUGLAS. Is that not what has been done for the last 2 years or so by Great Britain and the Netherlands?

Mr. WALLICH. Yes, in mild form for securities; that is correct, sir.

A sudden outflow of funds from the United States, for instance (because of the fear of budget deficits or many other things that could happen), would tend to drive the dollar down. As a result, American exporters could undersell producers everywhere else in the world. It seems unlikely that foreign countries would allow a fortuitous short-term capital movement to have such far-reaching consequences. It would not even be economically appropriate to allow a transitory fluctuation in the capital account of the balance of payments to have a major influence on the current account. Such a fluctuation should not alter the pattern of trade, because the situation is likely to be reversed. Other countries therefore would probably take defensive action to make sure that no industry is destroyed and after several years may have to be rebuilt because of the ups and downs of short-term capital movements.

It can be argued that under flexible rates the effects of such a movement would be forestalled by stabilizing speculation on a future recovery of the dollar. This is possible. It is possible also, however, that speculation would seek a quick profit from the initial drop in the dollar, instead of a longer run one from its eventual recovery. Then short-run speculation would drive the dollar down farther at first. In any case there is not enough assurance that speculators will not make mistakes to permit basing the world's monetary system upon the stabilizing effects of speculation.

In the case of countries which import much of what they consume, such as England, a temporary decline in the local currency may even be self-validating. If the cost of living rises as the currency declines, wages will rise. Thereafter, the currency may never recover to its original level.

This points up one probable consequence of flexible exchange rates: A worldwide acceleration of inflation. In some countries the indicated ratchet effect of wages will be at work. If exchange rates go down, wages will rise, and exchange rates cannot recover. In the United States the rise in the cost of imports would not be very important. But the removal of balance-of-payments restraints may well lead to policies that could lead to price increases. The American inflation of the 1950's was never defeated until the payments deficit became serious.

Elsewhere, the removal of balance-of-payments disciplines might have the same effect. Rapid inflation in turn would probably compel governments to intervene drastically in foreign trade and finance.

Chairman DOUGLAS. The payment deficit as a means of checking price advances—are you welcoming that?

Mr. WALLICH. No, I do not, but I am aware, Mr. Chairman, that there is a choice to be made here—more employment or more stable prices. If we pursued more sensible policies and exerted a little more self-restraint, this choice would not be upon us. But if we insist on raising costs and raising prices in the presence of unemployment then this unpleasant choice must be made. As Mr. Friedman has said, it is quite clear that the discipline of the balance of payments has made for a more restrictive policy in this country than would have been followed in the absence of this discipline. It is quite conceivable that the absence of balance-of-payments disciplines would have strong inflationary effects in some countries. In that case governments would be compelled immediately to intervene drastically in foreign trade and finance; in other words, flexible exchange rates would contribute to their own extinction or to exchange control.

The prospect that flexible rates would greatly increase uncertainty for foreign traders and investors has been cited many times. It should be noted that this uncertainty extends also to domestic investment decisions that might be affected by changing import competition or changing export prospects. It has been argued that uncertainties about future exchange rates can be removed by hedging in the future market. This, however, involves a cost even where cover is readily available. The history of futures markets does not suggest that it will be possible to get cover for long-term positions. To hedge domestic investment decisions that might be affected by flexible rates is in the nature of things impracticable.

The picture that emerges of the international economy under flexible rates is one of increasing disintegration. Independent national policies and unpredictable changes in each country's competitive position will compel governments to shield their producers and markets. The argument that such shielding would also automatically be accomplished by movements in the affected country's exchange rate underrates the impact of fluctuations upon particular industries, if not upon the entire economy. That international integration and flexible rates are incompatible seems to be the view also of the European Common Market countries, who have left no doubt that they want stable rates within the EEC. The same applies if we visualize the "Kennedy round" under the Trade Expansion Act. I think if we told the Europeans that, after lowering our tariffs, we were going to cast the dollar loose and let it fluctuate, we would get very little tariff reduction. They would want to keep up their guard.

If the disintegrating effects of flexible rates are to be overcome, a great deal of policy coordination, combined with self-discipline and mutual forbearance, would be required. The desired independence of national economic policy would in fact have to be foregone—interest rates, budgets, wage and prices policies would have to be harmonized. If the world were ready for such cooperation, it would be capable also of making a fixed exchange rate system work. In that case, flexible rates would accomplish nothing that could not more cheaply and sim-

ply be done with fixed rates. It seems to follow that flexible rates have no unique capacity for good, whereas they possess great capacity to do damage.

A modified version of the flexible rates proposal has been suggested. This version would allow the dollar and other currencies to fluctuate within a given range, say 5 percent up and down. This "widening of the gold points" is believed to reduce the danger of destabilizing speculation. It might perhaps enlist speculation on the side of stabilization, for if the dollar, say, had dropped to its lower limit, and if the public had confidence that that limit would not be broken, the only movement on which to speculate would be a rise. The spectacle of a currency falling below par may induce, according to the proponents, a strong political effort to bring it back.

This proposal likewise strikes me as unworkable. For one thing, I doubt that people would have a great deal of confidence in a limit of 5 percent below par, if par itself has been given up. Political support for holding this second line would probably be less than the support that can be mustered to hold the first. For another, the execution of the plan would still require the maintenance of international reserves, to protect the upper and lower limits. But with fluctuating rates, dollar and sterling would cease to be desirable media for monetary reserves. International liquidity would become seriously impaired. A third objection is that under today's conditions, the complex negotiations and legislation required, in the unlikely event that the plan could be negotiated at all, could not go forward without immediate speculation against the dollar before the plan goes into effect.

It remains only to point out that, even in the absence of a high degree of international cooperativeness, a system of fixed exchange rates can be made to work. It can be made to work mainly because it imposes a discipline upon all participants, and because within this discipline there is nevertheless some room for adjustment. The principal sources of flexibility are productivity gains and the degree to which they are absorbed by wage increases. Wages cannot be expected to decline. But their rise can be slowed in relation to the rate of productivity growth, in which case prices would become more competitive relative to other countries. With annual productivity gains of 2 to 3 percent in the United States and more abroad, it would not take many years to remove a temporary imbalance.

Chairman DOUGLAS. I want to thank and compliment each of you gentlemen for these papers. I have felt for some time that it was necessary to get a public discussion of this issue. I have been somewhat dissatisfied at the way the Treasury and the Federal Reserve Board for many years have tried to mute the controversy and have refused to discuss the issue on its merits. I want to say that I have followed the literature on this matter and I think this is the best discussion from various points of view which I know. I hope it will not be buried in the volume which we intend to bring out.

I am going to ask Congressman Reuss to begin the discussion.

Representative REUSS. I, too, commend you three gentlemen for your magnificent contribution. I think that I will direct my first question to you, Dr. Friedman, if I may, because I happen to disagree with your end result, although, let me say, your analysis is beautiful, you are magnificent in the attack, and, particularly, when you talk about our

Treasury men negotiating niggling little agreements in Hong Kong, and so on, you thrill me as nobody has since Teddy Roosevelt. Incidentally, I think that your analysis shows that in political terms—and after all we are a democracy and politics are important—this dry and dusty subject need not be wholly bereft of values that the people can understand. So I commend you without limit for your analysis of the demeaning character of what we are now doing. However, let us take a look at the remedies.

I put it to you that in your zest for fluctuating exchange rates, you deal cavalierly with another method of getting out of our pickle; namely, some reform of the international monetary mechanism which would give a much longer borrowing period for much larger amounts. I am not quite satisfied with your disposition of that in the early part of your report.

You first say that we cannot rely on further borrowings from abroad because they are only temporary. You then answer that yourself by saying: Maybe some long-term arrangements could be made, so that they are not so temporary.

At that point I leave you. I cannot understand your objection to better borrowing arrangements.

Mr. FRIEDMAN. What adjustments do we make—what produces them?

Representative REUSS. You say that while we expand exports a bit we also expand our unemployment and this throws men out of work.

Question No. 1: on page 453, the fourth paragraph, the first sentence:

> The physical counterpart to the financial deficit is a reduction of employment in industries competing with imports that is larger than the concurrent expansion of employment in export industries.

Mr. FRIEDMAN. I have not limited it to that. I have not said that there necessarily is a financial deficit as a result of tariff reduction. I am saying, suppose there were. If you go back a few sentences earlier, I state:

> Suppose then that the initial effect is to increase our expenditures on imports more than our receipts from exports.

And then I go on later to consider the opposite.

Representative REUSS. I see.

Mr. FRIEDMAN. If there is a financial deficit, it has as a physical counterpart these changes in employment to which I refer. Hence, we do not get a valid analysis of the situation by looking only at the financial flow. We must ask also, what is the physical counterpart?

And in those items, I must ask you, if we are going to rely entirely on reserves and borrowing, what is there that produces any adjustment within the country? What is the adjustment mechanism that you are using?

Representative REUSS. Well, does it not adjust itself? Incidentally, I admire your skill in putting me in the witness chair. [Laughter.] And I have not gotten an answer to my question yet. Meanwhile, what is the adjustment mechanism of the economy?

Mr. FRIEDMAN. No, this is the whole point——

Representative REUSS. All right, let us take rate fluctuations. We will assume the dollar fluctuates——

Mr. FRIEDMAN. Yes.

Representative REUSS. Fluctuates down. Wheat is cheaper abroad, but I am not at all sure that we can sell much more of it, because demand may not grow much as the dollar price falls. I find in none of the papers much of an analysis of what to me is the most important consideration of all. If the dollar were to fluctuate down, imports of certain things would be more expensive, and our exports would appear cheaper to foreigners. Therefore, we would make and sell more Ramblers and other products, but I would think that over the intermediate term, in the domestic economy, changes in demand, because of differences in investment, would tend to work things out. And the mere fact that we were borrowing abroad from the IMF, let us say, under a financial arrangement—I do not see that that would prevent us making the adjustments merely to keep us alive abroad.

Mr. FRIEDMAN. Not at all. If you will pardon me, the difficulty with the view that you are expressing, and with the view that is expressed by Mr. Wallich in his paper, is that you compare the flexible exchange rate system with a hypothetical situation that does not exist. You are comparing it with a situation in which somehow or other everybody can keep doing whatever he wants without anybody having to make any adjustments. If you are going to compare the flexible exchange rate system with some alternative, you must ask yourself, "What is it under the alternative that produces an adjustment corresponding to the adjustment produced by flexible rates"?

If we borrow from abroad to meet the deficit indefinitely, there is no mechanism.

Representative REUSS. Take the real world today, and let me put my question. Right now Europe has full employment, super-full employment, with housewives demanding consumer durables, experiencing difficulty in getting them because they are too expensive, the wrong type, and plants are not geared to make them. America stagnates with 6 percent unemployment, consumer durable plants have vast capacity unused, workmen are available to work those machines to make these goods, and the time required to get into the European market at existing exchange rates is 3 or 4 years. When we do get in there, it helps our lagging growth rate, our unbalanced Federal budget and unemployment, even our balance-of-payments situation. Why is it not a sensible solution, in addition to a fluctuating exchange rate, to buck up our present inadequate international monetary arrangement, so that we can borrow from the IMF or some new Paris club, enough to prevent us from doing all of these disgraceful things that you point out here.

Mr. FRIEDMAN. What you are doing—let me point out——

Representative REUSS. Then these adjustments occur during that period?

Mr. FRIEDMAN. Quite right, they do. Let me point out to you that what you are describing is precisely the use of the second method of adjustment that I described. What you are implicitly suggesting is our following a policy which involves forcing down U.S. prices relative to foreign prices, but doing so gradually over a long period of time.

With respect to your description of the situation in recent years, I would like to point out several things. The first is that the European inflation is not unrelated to our stagnation. It is partly because of it.

It is partly because of our balance-of-payments problem that Europe has inflated.

Mr. Wallich pointed out in his statement that the inflation in the United States did not come to an end until the balance-of-payments deficit arose. He is quite right. But he did not point out that the prior inflation in the United States was partly a result of the fixed exchange rate and of our balance-of-payments surplus. If the fixed rates are to be given the credit for stopping the inflation, they must also be given the blame for producing the inflation.

The question I should like to ask you is, is it really a better method of adjustment for us to spend 6 years accumulating large foreign debts while we slowly carry on with an unduly large volume of unemployment, while we let Europe have inflation—that is a method of adjustment—is that really better than the much simpler device of having a change in the exchange rate which keeps Europe from having inflation, which keeps us from having to have deflation, and makes it unnecessary for us to borrow abroad? Where is the advantage in the first method?

Representative Reuss. Of course, nobody has suggested that.

Mr. Friedman. But you have.

Representative Reuss. What you have just said is your hypothetical question.

Mr. Friedman. But that is exactly what you suggested.

Representative Reuss. I suggested that what is needed is a method whereby we can avoid having unemployment here, but escape the foreign exchange consequences.

Mr. Friedman. There is no——

Representative Reuss. Over a period of time.

Mr. Friedman. There is no——

Representative Reuss. By expanding borrowing capacity.

Mr. Friedman. There is no way that you can do that. You are trying to repeal the laws of arithmetic. Borrowing can tide you over, but it does not avoid the necessity for making adjustments. And my first question to you was, what force produces the adjustment? And when you answered this, the force you implicitly referred to as producing the adjustment was unemployment in the United States and inflation abroad.

Representative Reuss. Not unemployment in the United States. Getting rid of unemployment in the United States is the force that produces the adjustment—forcing us to a liberalized world trading pattern, in those industries where we have comparative advantages.

Mr. Friedman. I beg your pardon. If you do not have a change of prices in the United States relative to the foreign countries, there is no mechanism producing adjustment.

Representative Reuss. You have some changes in prices in the United States by getting full production and getting our unit costs lower. You will be able to lower your prices, not as a result of unemployment, but as a result of full employment.

Mr. Friedman. But unless you are going to force down the whole level of prices in the United States relative to the level abroad, there is nothing that moves resources to export industries.

Representative Reuss. Precisely, but under your gloomy assumption, the only way that you get prices down is by having unemploy-

ment. Under my rosy view of life, you do this by having full employment.

Mr. FRIEDMAN. How? How do you force down the prices of those products which are needed for export relative to the prices at which they are produced abroad? How? What is the method?

Representative REUSS. By having full employment, so that you can spread the unit costs over a larger amount. I see that my time has expired. [Laughter.]

Mr. FRIEDMAN. But that is not it.

Chairman DOUGLAS. To use the language of the prize ring, rather than the language of John Donne and Ernest Hemingway: "The bell rings even though it does not toll." You have passed the 10-minute mark. I will call on Representative Curtis.

Representative CURTIS. I was enjoying the exchange. I want to add my expression of appreciation to all three of you for what to me are stimulating papers. I wish I had the knowledge in this field so that I could put a qualitative judgment on them, but, frankly, I do not have that.

What bothers me, and I expressed it yesterday, is this: What are we trying to do with money? I have now determined that is where I run into difficulty, in trying to follow this debate over a period of years. It seems to me that there is a school that believes that money should be made, or tried to be made, a measuring stick—a way of measuring economic values in labor groups, savings, borrowings, and the like. If that is the sole objective, then it is one thing. But if money is to be used to produce other economic results, to get rid of unemployment, to obtain social as well as economic results, then, of course, you have a different thing. I find that a great deal of the papers are arguments over what to do after you agree that money is going to be used for something other than a preservative or a medium of exchange.

Mr. Wallich, you expressed it in one sense, I felt, when you were talking about applying flexible rates to the United States. I was interested in your application on a geographical basis, to the Appalachian or the Allegheny region.

Mr. WALLICH. What we call the major distressed area.

Representative CURTIS. Yes.

Mr. WALLICH. That is the Appalachian region.

Representative CURTIS. Whatever it was, I thought it was very apt. But these values are not always geographical, of course. I think we have been using flexible rates here to adjust between the creditor and the debtor groups, and there are many ways in which, I regret to say, I feel monetary policies have been used domestically. Then we translate this into the foreign area. Those who believe that monetary policy should be used in this fashion, of course, carry over their various sophistications they have developed in our own domestic economy.

If I could once determine what I regard as the basic point of disagreement—if everyone were agreed that we should use monetary policy for other than preserving money as a measure of value, I could get into it, but I am reluctant to make that assumption. I have other ways to suggest for making economic judgments due to political mechanisms. I think it should be done through our expenditure policies in order to preserve some way of measuring what we are doing in

this economic field. Is what I am saying completely lacking in sense to all of you?

Mr. WALLICH. If I may comment, there is a possibility of taking the international monetary mechanism out of this argument and substituting something else. That might, also, satisfy Congressman Reuss.

At present, when we have a deficit, other central banks acquire dollars or gold and monetize their own surplus—they increase the money supply in their countries, which inflates their economy and is distasteful to them. If, instead, we were to borrow abroad not from the central banks, but from the capital market on a long-term basis, we would be able to continue what then would have ceased to be a deficit in the way that the Department of Commerce defines our balance-of-payments situation. We would be able to continue to do what we are doing for a considerable time and finance this deficit on a noninflationary and quite stable basis. In other words, it would not be an unsound operation. It would be perfectly bankable, because the United States is acquiring, very rapidly, high-yielding assets abroad in the form of direct investments.

If we were to borrow at 4 or 6 percent, in foreign capital markets to finance that, we would still be doing well. There are some technical difficulties. The capital markets abroad are small.

Representative CURTIS. Could I ask you at this point, under that syllogism, as I understand it, would you be using money as a standard, something against which to measure things? Or would you use money there to try to produce certain results? Are you trying to use it as a measure, or are you trying to produce other economic results? It is hard for me to visualize that.

Mr. WALLICH. I am trying to get the monetary mechanism out of it, so that the deficit in our balance of payments will no longer have monetary consequences abroad or here. The monetary system would be run on what I believe you consider its merits, whereas the financing of payments deficits would occur through a different market.

Representative CURTIS. But the point I was getting at, Mr. Wallich, was this, that you would not be establishing a real monetary policy, such as I was describing, in international affairs. Could you answer that?

Mr. FRIEDMAN. I believe, Mr. Curtis, that you are at the moment seeking for something which is not feasible and obtainable, but which I too would like to have, if we could have it. I would like very much to have a situation in which monetary policy was automatic and was not subject to discretionary control. However, under present circumstances there is no such automatic policy that is possible on an international basis.

Representative CURTIS. How about domestically?

Mr. FRIEDMAN. Only if you have floating exchange rates.

Representative CURTIS. Do you think we have it domestically?

Mr. FRIEDMAN. No, we do not. One reason we do not have it domestically is because we are required by our international payments arrangements to use monetary policy, primarily, in the first instance, to protect our balance of payments.

Representative CURTIS. All right then, let me continue. You would have it as an ideal. Most ideals are never attained, but it makes a big difference whether or not that is what you are shooting for.

I suspect many of the people who are in this debate do not have that as their ideal. That is, I think, what is confusing me and keeps us from moving the debate forward. I can debate with people I disagree with on fundamentals and get somewhere, but not unless we have it clear in the beginning that that is not their ideal. And I do not think it is the ideal of many of these people.

Mr. FRIEDMAN. Let me make the point in this way, in connection with the comments that have been made about the 50 States of the United States and the Appalachian region. I think that these comments confuse what should be kept very separate; namely, a unified currency and a set of national currencies linked by fixed rates. Those are not the same things. There is a crucial difference between them. We have a unified currency in the United States. That means that if one part of the United States has a balance-of-payments deficit it automatically loses money, by which I mean, money in the literal sense of currency or deposits, not in the sense of reserves. As a result of the outflow of money, automatic forces go to work immediately to force down prices in that area relative to other areas. And this adjustment is much eased by the fact that there is free movement of resources.

On the other hand, if two countries are linked by a rigid exchange rate, and one country has a deficit, there is under present circumstances no automatic link that forces adjustment. There is not a unified currency. There is some agency in between—that agency in between is a central bank or treasury which must, through its explicit action, transmit the impulse. Therefore, different national currencies linked by rigid exchange rates cannot be free from the political forces that you and I would like them to be free from.

There is all the difference in the world between a unified currency and a set of national currencies linked by pegged rates of exchange.

On the international level I would like to see in the course of years the development of a unified currency—or rather, of a world in which you could have a unified currency.

Representative CURTIS. That is fine, because that is what I think we need to do. We must put our ideals forward and see if we have the same objectives. I happen to have that ideal. Now I can talk in terms of how we might move toward it.

I was going to ask about this one point. I see that my time is up, but I will pose the point and then come back to it if I have the time. Mr. Hexner points out that there has been no experience with the foreign exchange market. The question I was going to ask is seen through history. It seems to me where one nation has been strong enough, in effect, to become the international currency—and I think that the United States has been in that position—that is one way that you can do it, rather than on a cooperative basis. Perhaps we are at the point where the United States is no longer in a position of doing that. I will pose that if I get some more time.

Chairman DOUGLAS. Senator Sparkman.

Senator SPARKMAN. Mr. Chairman, I had the privilege of hearing only the last paper and not the other papers. I think that I should in deference pass on to those who have been here.

Chairman DOUGLAS. Senator Javits.

Senator JAVITS. I have not yet read those statements. I was detained this morning on other business. I would like to ask the panel members—and please correct me if I am asking them a question that should not be asked in view of their statements and testimony—what is their reaction to the news this morning that the Bernstein plan looks like it is being favorably regarded by the Paris Club of Ten, and to feel free in their respective answers to comment, also, on the other plans which have been proposed. That would be the first part of my question.

The second part would be to ask the panel's comments upon whether the time has come to take some significant steps with respect to the so-called international liquidity question.

And third, I would like to ask the panel if they would have any comment upon the question of the desirability or the undesirability of repealing the requirement for the 25 percent gold reserve for our currency. I guess that will take my time.

Chairman DOUGLAS. Who wants to volunteer?

Mr. FRIEDMAN. I will be glad to start. I have very clear straightforward views on all of these points that I do not mind setting forth.

Starting with the third point: I believe that we should repeal the 25-percent requirement. I think we should repeal, along with it, all restrictions on the holding or ownership of gold by any American citizen in any way whatsoever.

We should also repeal the provision which requires the U.S. Government to guarantee to buy and sell gold at a fixed price. And I hasten to add, all of this can be done without in any way departing from the IMF or from our other commitments. That is a separable point.

Other countries which state prices to the IMF do not, as a factual matter, regularly buy and sell at that price.

Second, on the question of international liquidity, I think that is a smokescreen. This is a point that Mr. Reuss brought up: the problem of how you tide yourself over. The crucial problem of solving the balance-of-payments situation is not how you tide yourself over a deficit but what adjustment mechanisms you have to eliminate the deficit. If a young man is in the position of spending more than he receives, I do not think that you are doing him a good service by saying, "You had better arrange to be able to borrow more some way or another—you had better do so rather than consider the question of how to run your life so as to make your expenditures come down to your receipts."

In addition, I believe that most of these proposals for international liquidity involve serious dangers for the United States. They involve giving greater power over our domestic affairs to foreign central bankers, who, it seems to me, should not have any power over our domestic affairs. I am an internationalist but I am not in favor of specific civil servants of certain countries having powers over the internal economies of other countries. I think it is not generally realized how much our present balance-of-payments problem, and the attempt to plaster it over along liquidity lines, has done to give power over the United States to people on the outside.

So I would say with respect to your first item, whether the Bernstein plan receives favorable attention from the Ten or not, it seems to me is irrelevant to what ought to be the U.S. policy with respect to it.

Senator JAVITS. Thank you very much. May we hear from Dr. Hexner?

Mr. HEXNER. I think that so far as the 25-percent limitation is concerned, I am in favor of removing it. I think the reason for its maintenance is mostly psychological. It is stated that it imposes a certain discipline upon our monetary authorities, but my feeling is that there are other methods of disciplining our monetary authorities. Although classical economists might not agree with me, there are few who today suggest that this method should be used in the United States.

The question whether we need an increase of international liquidity is debatable. Whether international disequilibrium will increase with the growth of international trade is not proved. I agree that it requires investigation.

International liquidity has very little to do with domestic liquidity, and the financing of international trade. Generally, international transactions offset one another. An increase in international trade does not necessarily require more international liquidity. International liquidity consists of national and international reserves to settle imbalances resulting from disequilibriums. Whether or not imbalances will grow in the future needs to be investigated.

So far as supply of international liquidity is concerned, Professor Triffin was suggesting an international central bank like Keynes was suggesting originally, with power to create and to destroy money. This is distinguished from the Bernstein plan and from those plans which do not want to have an international agency creating and destroying money, something along the line of the central banks.

I did not read the reference to the Bernstein plan in the New York Times this morning. However, I have read descriptions of the proposal. It consists generally of two sections. One, he would like to change the International Monetary Fund policy and make Fund members entitled to draw about 50 percent of their quotas. Furthermore, Bernstein suggests that the drawing rights should not be regarded as a secondary reserve, but as a primary reserve, from which members would draw freely, and if they draw on those reserves this should not imply that they are in difficulty. This is one fragment of Bernstein's suggestion.

The second part of his suggestion is an arrangement between the so-called Paris Club, between the 10 major industrial countries. These countries should have a multicurrency reserve expressed in reserve units. In other words, he wants to deburden the United States and Great Britain as reserve countries, and wants to have something of a cooperative reserve arrangement of which the IMF would serve as a trustee. I do not think that he is very far from the so-called revised Posthuma plan.

Senator JAVITS. Do you favor the Bernstein plan?

Mr. HEXNER. Yes.

Senator JAVITS. First, I would like to welcome you to the committee, Professor Wallich. You are an old friend. It is very good to see you here.

Mr. WALLICH. Thank you.

Of the 25-percent reserve, I would say repeal it. I would not think, however, that repeal is worth bleeding and dying over. If it is not repealed and we should get to the point where reserves are inadequate,

the Federal Reserve could suspend. It would be an embarrassing situation, of course. The suspension must be renewed every 2 weeks. Furthermore, if the reserve should fall very low, I think to $4½ billion, an increase in the discount rate would become necessary. The law is so written, however, that this increase in the discount rate is in effect unlikely.

If the 25-percent requirement cannot be repealed, I would hope that the Congress would be understanding with the Federal Reserve when they have to suspend and live with this suspension thereafter.

On the Bernstein plan I think this is the most realistic of the plans that have been presented. Professor Hexner has outlined it very ably. The core of it is the mutual currency account. The purpose is to establish a separate account in the IMF, so as to limit the arrangement to the 10 Paris Club members, and not to extend it to the 102 countries that are members of the IMF. The objective is, furthermore, to keep any currency operations that have to do with this account out of the general operations of the Fund.

All countries would put money into the account and get a share in the total account with which to make payments when they had to. They would not get a general claim on assistance from the Fund by making this contribution to the account. This strikes me as realistic.

As for the need to improve the monetary system; yes, I think that there is a need. I think this is a problem separate from the U.S. balance-of-payments problem.

I do not agree with those who think we should finance the deficit indefinitely, if that means monetization of the balance-of-payments surplus in other countries. I am quite sure that the other side is not going to do this financing for us, so that there is not much point in proposing it. I think the other side is going to give us a limited amount of credit, provided we mend our affairs. If we cease mending our affairs we may find that we have to pay everybody in gold, hereafter, whenever we have deficits.

I do not think it is hopeful at all to promote a large ambitious plan. I think the other side is not minded to accept it, and I do not think that it is urgently needed. If we coordinate our policies—and this is inherent in a system of stable exchange rates—we will have smaller deficits and more controllable deficits. Then we could get by with, first, an extension of the Federal Reserve-Treasury swaps and borrowing arrangements, second, a substantial enlargement of the IMF quotas, and, third, hopefully but not necessarily, something like the Bernstein plan.

Senator Javits. Thank you very much. I thank the chairman for his indulgence.

Chairman Douglas. Senator Proxmire.

Senator Proxmire. I would like to ask Dr. Friedman, first, to tell us the effect on the balance of payments of the proposed tax reduction of about $11 billion—first, with a fixed exchange rate, and then with a floating exchange rate.

Mr. Friedman. What the effect of the tax reduction is will depend upon what monetary policy accompanies it. That is, it will depend upon how the deficit is financed. If the additional deficit is financed by borrowing funds from the market at large and not by printing money, the effect will be to drive up interest rates. This rise in in-

terest rates will, on the one hand, offset the domestic expansion effect of the deficit. I do not mean necessarily offset it fully, but offset it to some extent.

The rise in interest rates will, on the other hand, have some effect in attracting foreign capital to this country and keeping capital here.

So, insofar as the deficit raises interest rates, it will enable us to borrow more from abroad than we otherwise could.

But this is not the whole story. Insofar as the deficit, even if financed by borrowing, has an expansion effect on our domestic activity, that will work against the balance of payments, by tending to promote the expansion of imports relative to exports. Therefore, if the deficit is financed by borrowing, there is a favorable effect on capital movements, an unfavorable effect on current payments.

If the deficit is financed by printing money, it will have only the unfavorable effect on current payments and will not attract capital. Put differently, if the Government should follow a policy of trying to maintain interest rates at roughly their present level, until unemployment gets down to 4½ or 4 percent, then the tax reduction would clearly have an adverse effect on the balance of payments.

Senator PROXMIRE. So, supposing that we have a floating exchange rate, what would be the effect?

Mr. FRIEDMAN. So far as that is concerned, again, we have to take the two cases, whether we finance the deficit by borrowing or by printing money.

Senator PROXMIRE. All right, go ahead.

Mr. FRIEDMAN. If we finance by borrowing, so that it raises interest rates, then there is no way of saying what the effect would be on the exchange rate. Under the floating rates, the exchange rate might under those circumstances either be unaffected or it might be raised a little or it might be lowered a little.

In making this judgment, I am neglecting the effect of shifting from a fixed-rate system to floating rates. Such a shift would of course produce a new structure of rates, different from the current fixed rates.

Now I am asking what further effect would flow from also having an $11 billion cash deficit. And there, I say, if you finance the deficit by borrowing the effect would be uncertain. We cannot predict which way.

If you finance the deficit by printing money, then the effect would be to cause a depreciation in the exchange rates.

As to the balance-of-payments situation, you cannot have any balance-of-payments problem under a floating rate. You do not have any. Where you have a free price, it equates the amount people demand with the amount other people supply. So the effect of the tax reduction under those circumstances would be zero on the balance of payments, but there would be some effect on the rate of exchange.

Senator PROXMIRE. I should like to ask you, Professor Wallich, if you would concur—without changing our present system and maintaining a fixed exchange rate—in the view that the tax reduction accompanied by the present monetary ease, if you want to call that the monetary policy, and trying to maintain it at the present level, would have an adverse effect on the balance of payments?

Mr. WALLICH. It would increase imports. And if the rise in the GNP that would occur is not allowed to affect interest rates and, gen-

erally, to influence the capital and stock markets, then there would be no offset to this increase in imports. Whether or not an increase in interest rates such as would occur automatically from greater economic activity would be sufficient to attract enough capital and to keep enough capital from going out, nobody can tell.

Senator PROXMIRE. May I ask Professor Hexner, is it not true that historically in periods of domestic economic expansion the balance of payments has tended to deteriorate a little bit, and that the expansion of activity abroad has tended to improve our balance of payments.

What I am getting at is, a policy that expands the economy tends to have an adverse effect on the balance of payments.

Mr. HEXNER. Yes.

Senator PROXMIRE. And, historically, has that not been found to be the case?

Mr. HEXNER. Yes.

Mr. FRIEDMAN. May I make a qualification?

Senator PROXMIRE. Yes.

Mr. FRIEDMAN. I believe it is important in such a statement to distinguish between cyclical and long-run movements. Over the longer period, expansion which has reflected the growth in the economic activity and the capacity of a country has tended to work favorably on the balance of payments. On the other hand, given the general trend, cyclical expansions have operated in the direction which you have mentioned. And cyclical contractions have operated the other way. Therefore, a policy which provides for a healthy, sound long-term economic growth of the country will work to improve the balance of payments, not against it.

Senator PROXMIRE. In his disagreement with you, Professor Wallich implies that the floating exchange rate would take complex negotiations, a great deal of time to put into effect. I wonder what steps would have to be taken, by the Congress, the Treasury, and the Federal Reserve Board—what steps would have to be taken in other countries before this could be accomplished?

Mr. FRIEDMAN. No steps would have to be taken in other countries.

Senator PROXMIRE. What negotiation, any?

Mr. FRIEDMAN. The problem arises about the International Monetary Fund. That is the only real problem, as I understand it. I am not an expert on the detailed legal arrangements, but my understanding is that our only real commitment in this direction is the IMF. I know that the IMF has in the past, as in the Canadian case, approved floating rates. I see no reason why we should be treated discriminatorily by them. And I see no reason why we should not get the approval of the IMF for the floating rate.

So far as our congressional acts are concerned, I am not certain what the situation is. The key problem is, under present circumstances, to refrain from selling gold at $35 an ounce to foreign governments and central banks for monetary purposes. As I understand the situation, we are committed to sell it to them only for "monetary purposes." And as I understand the situation, we could decide administratively that they were not entitled to any more gold for monetary purposes. I am under the impression that we could do this without an act of Congress, but I may be wrong—I am no expert on this.

Mr. WALLICH. I agree. You are right.

Senator PROXMIRE. Professor Hexner also agrees.

Mr. FRIEDMAN. We could stop selling gold at a fixed price, and that would be the only step that we would have to take.

Senator PROXMIRE. Do you want to comment on that?

Mr. HEXNER. Professor Friedman mentioned this analogy between Canada and the United States in his book. There is a small difference between us which is important. The Monetary Fund never approved the Canadian departure from par value. As a matter of fact, the Monetary Fund in its policy statement clearly admitted that it had no authority to approve this Canadian departure.

In my statement I put in quotation marks, that the Fund "notes" that Canada departed from its par value. This is one aspect of our difference.

The other aspect of our difference is more important. In the Fund policy statement on fluctuating rates it is expressly stated that the Fund knows or tolerates individual departures under emergency conditions, provided that one reference currency will remain fixed to gold; in other words, insofar as I can interpret the Fund policy, the Fund considers the U.S. dollar as the reference currency. The fixed rate of the U.S. dollar is part of the Fund's constitutional structure. The Fund permits certain Latin American countries, in order to arrive at a fixed rate, to depart from parity for a little time, like when somebody takes benzedrine, not as a food, but in order to restore his health. This is the Fund's conception as I see it.

When the Fund "noted" the Canadian departure from the par value, it issued a statement along the following lines: "We note that Canada is departing from parity. However, Canada will remain in permanent consultation with the Fund. And the Fund expects that Canada will come back very soon to the par value system."

It is an interesting question why the Fund did not press Canada earlier to reestablish parity. Probably because of the absence of any adverse effect on other countries.

Senator PROXMIRE. I understand that my time is up.

Professor Friedman, you said that the legal restriction of purchasing gold at $35 an ounce could be so administratively interpreted that it would apply only for monetary purposes?

Mr. FRIEDMAN. Yes.

Senator PROXMIRE. Could we make the finding for that reason that we did not have to purchase it?

Mr. FRIEDMAN. It is a question of sales.

Senator PROXMIRE. Of sales, I see. Sales for monetary purposes. I beg you pardon.

Mr. FRIEDMAN. Right.

Chairman DOUGLAS. Senator Miller.

Senator MILLER. Professor Friedman, in your response to Senator Proxmire's original question, I believe you pointed out what would be the results of financing the borrowing of money, and how this could offset the result, that is, the tax cut result. Insofar as what would happen if the financing was done by printing money, I should like to hear from you.

Mr. FRIEDMAN. If the financing is done by the printing of money, why then the effect would be, first of all, that you would have an expansion in the stock of money. This would tend to make for

domestic expansion in prices as well as income. And this would tend to worsen our balance-of-payments problem under the fixed rates. That is, our imports would tend to expand. Our exports would tend to decrease, and there would be no offsetting effect on the capital accounts, so that the net effect would be to worsen our balance of payments.

Senator MILLER. And we would also have a devaluation in the value of our dollar, would we not?

Mr. FRIEDMAN. It depends upon what you mean by "devaluation."

Senator MILLER. The purchasing power of the dollar.

Mr. FRIEDMAN. Yes, we would have a reduction in the purchasing power of the dollar.

Senator MILLER. Thank you. Now I would like to say that I join with my colleagues in expressing a great amount of appreciation and admiration for these scholarly presentations by the various members of the panel. However, I am a little disappointed in the responses given to Senator Javits's question regarding the removal of the gold requirement on our currency. I do think that, probably, Professor Friedman is consistent, insofar as his thesis is concerned with respect to the fluctuation of foreign exchanges, but I am not so sure that the other two panel members are consistent, as I detected they are opposed to Professor Friedman's theory. It seems to me, gentlemen, that you have come before this committee to tell us how, in your judgment, the balance-of-payments deficit and our gold problem should be solved, that is, our outgoing gold problem should be solved. Yet in answer to Senator Javit's question, your response indicates to me that you go along with the idea of resolving the problem just by eliminating it altogether—by doing it that way.

I would like to ask whether you would not favor doing something about the problem, so that we would never get into a squeeze on our gold reserves. Would that not be a better way to handle it, than just to eliminate the problem altogether by doing away with the gold reserves?

Mr. WALLICH. If I may address myself to this. There are two aspects to it.

One is how far should we allow our gold reserves to go down. About 5 years ago we would hardly have contemplated that we would get to $15½ billion, but this has happened, and I wish that we had found the means of preventing it. But facing the situation now as it is, what is the best way to get out of the scrape?

I agree with you that the proximity of this limit imposes some constraint upon us. But I think, on the whole, that we get plenty of constraint from the fact that the gold reserves are falling, quite aside from the fact that they are falling toward this limit.

On the other hand, I can see the possibility of a misunderstanding in the outside world if we do not remove the limit. People might think that with $12.5 billion of gold, which would be about the present amount, I believe, of the 25-percent requirement, we would devalue. Since that is not our intention, we ought not to expose ourselves to this misunderstanding. A belief that we would not break the limit might cause central bankers to convert their dollars into gold. That might be the thing that they would do. Even Americans might decide to take their money out of the country, so long as the dollar is stable.

These risks we could reduce by making it quite clear that we will not devalue if we should ever get down to that 25-percent minimum.

Senator MILLER. In other words, you do not think that there could be a psychological reaction the other way, that if we decided to remove this limitation, perhaps some people might get the idea that we might resort to printing money; and, therefore, they will run out with their dollars and buy gold, anyhow.

Is that not possible?

Mr. WALLICH. I think this is quite likely to happen in some cases. It is a question which risk one thinks is greater. I would think that the risk of a misunderstanding, of causing an acceleration of the gold outflow, as we approach the limit, is greater.

Senator MILLER. Why get ourselves into that risk situation? Why not eliminate the problem by taking certain action to remove the balance-of-payments deficit problem, so that we do not have that risk? Is that not a better way to do it? Why do we have to assume the fatalistic assumption, regardless of all of the recommendations that are being presented by you and other economists, regardless of what we do that we will have to get into that gold nest egg someday. So let us eliminate that problem.

Mr. WALLICH. We could do this provided it can be done without very great cost in unemployment, deflation of the economy, or sacrifices in international policy, such as pulling back troops and cutting aid. But when we got down to the $12.5 billion minimum, which is more than one-quarter of the gold in the world, we would still have a large reserve. It strikes me as somewhat unreasonable to immobilize such an amount in a reserve.

Senator MILLER. Do you think that we are faced only with that as the alternative, upsetting our commitments, military and foreign aid programs? Is this the only thing that we can do to satisfy the balance-of-payments problem without digging into the nest egg? Do we have to say that we are through with these commitments?

Mr. FRIEDMAN. Nobody has suggested anything else other than floating exchange rates. The fact of the matter is that there has not been a serious suggestion that anybody is willing to back up an alternative method of doing it.

Senator PROXMIRE. How about the interest equalization tax?

Mr. FRIEDMAN. That is concealed devaluation in one form. It says that dollars that are brought over here as capital shall be valued at a different exchange rate than dollars that are not. That is devaluation.

Senator MILLER. I do believe that Professor Friedman is consistent. I would like to get to the real acid test of your theory, Professor Friedman. These economic theories sound good, but sometimes they are not practical, and your colleagues point out some of the practical limitations of your thesis. What I am really interested in—and I think what most of the taxpayers of the country are really interested in—is: If your theory goes into effect, what is going to be the impact on the purchasing power of our dollars? What is going to be the impact on the purchasing power of the billions of dollars of social security and retirement and annuities? This, to me, is the acid test. What is your response to that?

Mr. FRIEDMAN. My response to that is that that depends on how responsible the Senators and the Members of the House of Congress are in pursuing domestic objectives. I would hope myself that we would follow a policy which would keep the purchasing power of the dollar stable. We can follow such a policy. Whether we do depends upon whether the Members of the Senate and the Members of the House of Congress are willing to impose a sensible discipline upon our monetary authorities and our fiscal authorities. I, for one, do not believe that the right way to solve the problem is to say, "We will let the foreign central bankers impose the discipline."

Senator MILLER. I think that most of us agree that we do not like to have that situation happen. It is too bad that we have to look to an outside discipline to tell us that, that we cannot look to our internal discipline to do it. I disagree with Professor Wallich when he says that one probable consequence of the flexible exchange rate is that it would accelerate inflation.

Mr. FRIEDMAN. I think he is wrong. I think that you have to choose between a system which is as strong as its weakest link, and one in which each link separately can be strong. The essence of a fixed-rate system is that it is as strong as its weakest link. There is a lot of inflation going on in the world. There will continue to be a lot of inflation going on in the world, whatever we do about exchange rates.

I do not believe that the United States would accelerate inflation by adopting a floating exchange rate system. It will simply enable you gentlemen controlling the destinies of this country to decide whether you want us to have inflation or not. If you want us to have inflation, you can produce it. If you do not want it, you can stop it.

Senator MILLER. Your answer is that the mere enactment of the flexible exchange rate, according to your theory, would not per se affect the stability of the dollar one way or the other?

Mr. FRIEDMAN. No, sir.

Senator MILLER. My time is up. Thank you.

Chairman DOUGLAS. Senator Jordan.

Senator JORDAN of Idaho. This has been a very excellent presentation you have made in your various theories on the exchange rate. I am not going to deal with that specifically, because I come from the West, from a gold mining area, and I would like to find out your thinking on what is likely to happen to the price of gold if we go on a free market. I will ask for volunteers.

Mr. FRIEDMAN. I think that there is no way of saying. If we allowed the price of gold to go free at the moment it probably would rise. However, if we were successful in holding our price level with the floating exchange rate, if we were successful in having an acceptable monetary policy internally without using gold as a basis, then I believe that the price of gold would probably decline in the long run. I do not believe anybody can make a firm prediction at the moment about what the long-run effect on the price of gold would be.

Senator JORDAN. Thank you.

Professor Hexner?

Mr. HEXNER. I am not sure what the consequences would be of the United States embarking upon a flexible regime in foreign countries.

It would, of course, probably cause all other countries to start flexible regimes and you would have general uncertainty, with the hoarding of gold, probably. But if we are asking about the price of gold, we have to ask the price in terms of what? If you say $40 as the price for an ounce of gold, what does the price $40 mean in terms of foreign currency? Probably there will be a psychological situation where people will seek gold privately, as hoarders. However, I am not sure.

You might be interested to know that Mr. Holloway, professor of economics, and former Secretary of the Treasury of South Africa, recently issued a pamphlet, trying to develop the idea that the Bretton Woods meeting undertook the obligation to increase the price of gold periodically. He is now issuing a brochure entitled, "Is a Rise in the Price of Gold Uncovenanted?" In his brochure he argues against the theory that the price of gold was covenanted at Bretton Woods.

Senator JORDAN. Thank you.

Professor Wallich?

Mr. WALLICH. If we had a genuine system of flexible rates, in which countries no longer needed foreign exchange reserves, then they would no longer buy gold, and the price of gold would go way down. If on top of that the central banks sold their existing gold stocks, as would be logical if they no longer needed reserves, the price of gold would go down very steeply and very fast. This, however, is a hypothetical case which I do not think would arise.

The realistic way in which flexible rates might come about is that the United States would stop selling gold. The dollar then would either depreciate or would somehow be pegged by foreign countries. In the latter case, if it were pegged at its present level, there would be no change in the price of gold. If it were allowed to depreciate the price would rise in the United States and stay constant abroad. However, if, as I foresee, inflation is the result of the universal adoption of flexible exchange rates, the price of gold would continue to rise. Trying to be realistic, the most likely course of events would be this: After currencies had fluctuated for a while and everybody had found flexible exchange rates difficult to live with, we would stabilize again. The price of gold would again become fixed, probably, at some higher level.

Senator JORDAN. I think you said that it would require such a high degree of cooperation among nations to implement a floating exchange rate that the same degree of cooperation would make the present system work admirably.

Mr. WALLICH. My point was that, if exchange rates fluctuated too much against each other, countries would have to put up their guard and impose quantitative restrictions on trade. To keep this from happening we would have to keep the fluctuations within narrow limits. If we do that, we do not have the freedom of domestic policy that we might hope to get. We might just as well use this cooperativeness to make the present system work.

Senator JORDAN. Will you comment on that?

Mr. FRIEDMAN. Yes. I believe that the situation is precisely the reverse. I believe that a system of floating rates requires far less coordination and cooperation than our present system—just as any free market does.

One of the great difficulties in our discussion is that we talk about relations between countries when we ought to be talking about relations between people. The virtue of a floating exchange rate system is that it enables governments to get out of the business. It lets the trader in one country buy from the trader in the other country on any terms that the two can agree upon.

I might make one more statement about gold. So far as my own policy is concerned it would involve eliminating the present legal prohibition on U.S. citizens buying and holding and trading in gold. That would be an additional source of demand for gold.

Senator JORDAN. Thank you for an interesting discussion. My time is up.

Chairman DOUGLAS. Senator Sparkman.

Senator SPARKMAN. I thought that we were developing a very good debate. These questions may be quite elementary, but, nevertheless, I need them for my own clarification.

When we speak of the floating rate or the flexible rate, I understand them to be synonymous terms, are they not? And, Dr. Friedman, if I understand your point of view, it is that those rates would be enforced as a matter of the free trading by individuals and would not require any national or international agencies; is that right?

Mr. FRIEDMAN. Quite right.

Senator SPARKMAN. Then what is your opinion on that, Dr. Wallich?

Mr. WALLICH. I think that it is not practical to expect governments to get out of the business of stabilizing or influencing rates. Even the countries that have had floating rates for a while, as Professor Hexner pointed out, have always maintained facilities for intervening through their exchange stabilization funds. But even in the remote case that we were prepared to abolish these facilities, it would take an international agreement. No country would do it if it knew that other countries maintained these weapons. But even in that case we still would not have deprived governments of the power to intervene. Any change in interest rates, every announcement about budget intentions, every time the Government said it would finance the budget deficit by printing money, or by borrowing money, it would have an immediate effect upon the exchange rate. There is no way if flexible rates exist, for governments to keep out of the exchange rate regulation business.

Senator SPARKMAN. Dr. Hexner, do you take sides, or are you the referee?

Mr. HEXNER. I am afraid that I would have to state that the maintaining of an orderly market in foreign exchange, what Professor Friedman suggests, would require something in the way of a larger bureaucracy than for the maintenance of the fixed rate—it would require a larger bureaucracy, I repeat. If I may use an analogy, the antitrust mechanism of the United States to maintain and regulate competition in the business sector requires quite a Government mechanism.

Money, especially convertible foreign money, even if we call it a commodity, is something which cannot be marketed like wheat. There are not only various kinds of interests involved, but the foreign ex-

change market mechanism in itself differs radically from others. The policing of it, according to the scheme suggested by Professor Friedman, would require quite a complex agency, in my judgment.

Mr. FRIEDMAN. That is simply wrong. And unhistorical. Let us look at the evidence of history. I wonder how many people realize that present exchange control arrangements and present stabilization fund activities date from 1934. There was quite a lot of history before 1934. And in all of that history before 1934, so far as I know, with minor exceptions during World War I, there never was a case in which you had governmental officials managing the terms on which people traded the currency of one country for the currency of another country. And yet it worked. You had a free market. If you go back to experience in the United States from 1862 to 1879, we had a perfectly free exchange rate. We had a floating exchange rate. We had no governmental bureaucracy doing anything about it.

It is simply wrong to assert that the maintenance of a free market in currency in the world at large would require a bureaucracy. Such a bureaucracy would be required only if you wanted through governmental means to manipulate and change the rates.

This brings me to Professor Wallich's point. I believe we want to separate very sharply what the United States can control from what it cannot. We cannot prevent other countries from having stabilization funds. We should not try to do so. We should not negotiate with them about whether they do. We should tend to our business. So far as we are concerned, the United States need not have a stabilization fund. It need not manipulate. If other countries want to peg their currency to the American dollar, that is their business. The problem of maintaining it then will be theirs. I do not believe that we ought in any way try to prevent them from doing it.

So I think I will go back to his statement and ask whether he would disagree that the United States could, if it wanted to, stay out of the business of having an exchange stabilization fund.

Mr. WALLICH. May I comment?

Senator SPARKMAN. Yes.

Mr. WALLICH. We would not, I think divest ourselves of this means of defending ourselves internationally, so long as other countries preserved the power to maintain their own currencies by such a fund.

Mr. FRIEDMAN. What are we defending against?

Mr. WALLICH. Could I just finish my statement?

Mr. FRIEDMAN. Surely.

Mr. WALLICH. If a country decides to peg to the dollar, it thereby deprives us of many of the advantages that we think that we get from flexible rates. For instance, we will not then get the benefit of larger exports as our exchange rate drops, since it does not drop. I see no possibility at all of dismantling the Treasury and the Federal Reserve apparatus as long as other countries have theirs. But, as I said, we do not even have to consider direct intervention in the exchange market. Every action of the Government, every speech of the President is an indirect intervention in the exchange market. It will make people think that prices will rise or they will not rise, incomes will expand or not expand, and they will go into the exchange market to take advantage of what they think will happen. So there is just no

way in which the Government could be neutral, even if it wanted to be.

Mr. FRIEDMAN. But, surely, this final thing is a very, very different thing. Every statement of the President, every act of Congress has a domestic effect, too. It is intervention into the domestic area. There is nothing special about that on the international market. And the fact is that the world free market would handle it. Some actions might cause some fluctuation in the rate but they would cause very little fluctuation. If experience is any guide in the countries which have had the floating rate, it would cause very minor effects.

Mr. WALLICH. Is that right? Did not the Canadian Government with the announcement, admittedly a very severe announcement, that the Canadian dollar ought to decline—did it not drive the Canadian dollar from where it was about $1.06?

Mr. FRIEDMAN. It was an announcement that it was going to drive down the dollar. It was not an announcement about general policy. It was an announcement about the particular fact that it was going to drive down the dollar. I do not think there is the slightest doubt that if the U.S. Government announced tomorrow that it was going to drive up the price of men's shirts by offering to buy all offered at a high price that the price of shirts would go up, of course. But if you take general governmental policy announcements by Canada, they had very little effect.

Mr. WALLICH. I think that this is true.

Senator SPARKMAN. Right along that line, may I ask this question? You advocate, as I understand it, the repeal of the gold reserve requirement. And you also said that if we quit selling gold at $35 an ounce, as I understand it, it would more or less settle the matter. So far as the gold question was concerned, would that, in itself, produce the kind of a free market that you seek?

Mr. FRIEDMAN. If you stay out of it, yes.

Senator SPARKMAN. If we could get out of the gold business?

Mr. FRIEDMAN. If we should get out of the gold business.

Senator SPARKMAN. For monetary purposes?

Mr. FRIEDMAN. Under present circumstances, as I understand it, we also have other agencies through which we could intervene in the exchange market as distinct from the gold market. We could get out of the gold market, and yet we could, through the Treasury stabilization funds, and through the Fed, intervene in the exchange market. To have the completely free market I favor we would have to do two things. We would have to get out of the gold market, and we would have to get out of the exchange market.

Mr. WALLICH. And beg off from the IMF.

Mr. FRIEDMAN. That is right.

Senator SPARKMAN. And do what?

Mr. WALLICH. The IMF would have to agree to fluctuations greater than 10 percent in our currency.

Senator SPARKMAN. Yes. Well, now, would that influence——

Mr. HEXNER. It does not have the authority to do this, which means——

Senator SPARKMAN. I know that we are dealing in "ifs."

Mr. HEXNER. The Fund would have to change its constitution.

Senator SPARKMAN. Would our doing that influence the organizations of the world, that is, other nations of the world to follow suit?

Mr. HEXNER. Yes.

Mr. FRIEDMAN. Yes.

Senator SPARKMAN. In other words, it almost simplifies itself to this, if one could apply the term of simplification to any of this, that our fixing the price of gold virtually controls the situation at the present time.

Mr. FRIEDMAN. No, it is quite the opposite.

Senator SPARKMAN. It is quite the opposite?

Mr. FRIEDMAN. By our fixing the price of gold, we have given up control and handed it over to the central bankers in other countries.

Senator SPARKMAN. That is what I should have said.

Mr. FRIEDMAN. On that score I think that people who hope that we are going to get out of our situation easily, because the European countries will inflate and bail us out of our difficulties, do not take into account the enormous political advantage that the European countries currently reap from our situation. They have some control over whether they will bail us out that way, and they would be very foolish people, politically, if they did not bend every effort to try to keep us in a deficit position, though of course other considerations may override this one. There has been a very great accession to their political power which has come from our insisting on hanging on to $35 an ounce as the price of gold.

Senator SPARKMAN. Yes.

Mr. WALLICH. I am distressed by these imputations to foreign officials. First of all, I think that their power is much more limited than Professor Friedman assumes. These people reflect the working of economic forces, and they respond just about the way that you would have expected them to respond. So far, they have been, on the whole, very helpful. If anybody had asked us in 1958 whether we would be able to get as much credit as we have been getting and as little counteraction, we probably would have said, "no." As a result of this we have been able to continue foreign aid, we have been able to keep troops abroad—all this has been of very great benefit to us.

If we are to be nationalists, at the mercy of other nationalists, that is one thing. To me the story of the postwar period is one of growing cooperation, of increasing integration of the world economy. That is the direction in which we should go. Where the flexible rate approach seems to lead us is toward a disintegration of this international system. We tell foreign countries that we are no longer going to consult, no longer going to negotiate—we are going to mind our own business, which means to tell them to mind their business, and the world will fall apart. We did this once before in 1930. We did not go on a flexible rate then. We passed the Smoot-Hawley tariff which had very much the same effect. We let the world go hang.

I know that is very far from Professor Friedman's intentions. He states that he is a good internationalist. I am afraid that the unintended effect is going to be this.

Senator SPARKMAN. Thank you very much. My time is up.

Chairman DOUGLAS. We are very happy to welcome a distinguished Member of the House here. Congressman Halpern.

Representative HALPERN. I did have a few questions, but I am afraid that my time has run out. We are on call in the House. I do have to get over there. But I do want to say how much I welcome the privilege of sitting in on these hearings as the ranking minority

member of the House Subcommittee on International Finance and as the ranking minority member of the Subcommittee on International Trade. I must say that I have been considerably enlightened by the testimony of these able witnesses today. I wish to commend Professors Friedman, Hexner, and Wallich for their superb presentations.

I must admit, Mr. Chairman, I am still somewhat confused, but I have been fed a lot of food for thought. I am sure that out of this web of testimony and exchange of views, and through a full evaluation of it from what these witnesses have presented as well as the others before the committee, I am confident that this joint committee will do much to help resolve this problem.

I want to compliment the chairman, Senator Douglas, and the members of the committee for their labors in this field and for leaving no stones unturned in trying to come up with answers.

Thank you very much.

Chairman DOUGLAS. Thank you very much. I do not wish to prolong the hearing unduly, because you have been discussing this matter now for 2 hours and 40 minutes. There is one question for clarification that I would like to ask of Professor Friedman.

When you speak of cutting loose from gold, you specifically only mentioned that we would cease to sell gold. Do you mean, also, that we would cease to buy gold?

Mr. FRIEDMAN. Under present circumstances, as they used to say, that is an academic question. We are not being offered much gold at $35 a ounce, but, personally, I would cease both to buy and to sell, and then decide what to do about our present gold stocks. That is a different question.

Chairman DOUGLAS. But you see no advantages in continuing to buy gold?

Mr. FRIEDMAN. I see every disadvantage. I see no reason for using our resources to cause this metal to be dug out of the earth in one part of the world, in order to be buried in Fort Knox in another part of the world. I can conceive that that price would be worth paying for a real gold standard, but I see no sense in paying that price for the kind of pseudo gold standard we now have.

Chairman DOUGLAS. Now, I believe it is true—and I wish that Senator Jordan were here as he spoke of Idaho being a gold-producing State—that the total production of gold in all of the United States—including South Dakota with its Homestake mine, and Alaska, where they had the gold rush—came to only $54.5 million in 1962. Assuming that the gross national product was around $550 billion, that comes to less than one ten-thousandth of the gross national product, and I do not think that we should allow so minute a "de-tail" to wag so large a dog. I hesitate to make this point in the absence of Senator Jordan, but since I would make it if he were present, perhaps it is all right for me to state it.

Mr. FRIEDMAN. I might add that if you look at the corresponding policy with respect to silver——

Chairman DOUGLAS. That is just what I was coming to.

Mr. FRIEDMAN. I have estimated in another publication that it cost roughly $25 of Federal funds on the average, for every dollar of benefit, net benefit to the silver miner.

Chairman DOUGLAS. For 10 years I tried to stop the purchase of silver and I never got anywhere. The commercial price was below the

price at which the mint bought silver. So this was a very profitable market for the silver producer. Also, it kept up the commercial price of silver. We have had an alliance not only of the 8 silver-producing States, but of these and other States as well, the so-called 18 reclamation States, which are more or less in unity in such matters. While their population is not great, they have 36 Members in the U.S. Senate and they form a very powerful bloc.

I might say that the silver-consuming areas of the country, Rhode Island and Massachusetts, and, to some degree, Connecticut, were not as vigorous and robust as I thought they should have been. They were overawed by the so-called Western bloc. It was only when the commercial price of silver rose above the price at which we would buy silver at the mint and there was a commercial shortage of silver—and no one quite knows the reason for it, although it may be connected with space and atomic energy—that we were able to stop the purchase of silver and gradually provide for the release of the silver stocks. We freed ourselves from silver. But I think that it is also true that we have a very strong latent gold lobby, plus this sentimental attachment to gold.

Apparently, Dr. Friedman, you are not bewitched by the idea that you must have a currency redeemable in gold, nor are you bewitched by the idea that your dollars from the international standpoint must be redeemable in gold; is that not true?

Mr. FRIEDMAN. You do not have a currency at home redeemable in gold.

Chairman DOUGLAS. That is right.

Mr. FRIEDMAN. And you do not in fact have an international currency redeemable in gold, except for central banks and treasuries.

Chairman DOUGLAS. Now let me ask you this question: So far as the other countries are concerned, do they buy gold as a reserve against their internal currencies?

Mr. WALLICH. In the sense of countries having a reserve requirement, very few countries do. I believe that Belgium has now. I cannot think of other countries that do.

Chairman DOUGLAS. As I understand it, our Treasury has a fixed obligation to give $35 for every ounce of gold that is presented to it; is that not true?

Mr. WALLICH. I am sorry. I misunderstood your question. A great many countries buy gold at a fixed price, because that is the way in which they keep their currencies stable.

Chairman DOUGLAS. Might I rephrase this: Do they have free coinage, just as Mr. Bryan advocated the free coinage of silver?

Mr. WALLICH. No.

Chairman DOUGLAS. Would we have free coinage of gold if this buying policy were discontinued? They might have a program for free gold coinage?

Mr. WALLICH. I misunderstood the point.

Chairman DOUGLAS. Then is this the answer, that no other country has free coinage of gold except possibly Switzerland?

Mr. HEXNER. I think that Switzerland has.

Mr. WALLICH. Switzerland mints some coins, but with limitations. In the sense of buying gold freely and giving to the man or bank bringing the gold the countervalue, not in coins, but in currency—

practically all countries buy gold at a fixed rate. In some countries it is a matter of law what the rate shall be, as it is in the United States. In some countries, it is an administrative decision—a big political decision.

Chairman DOUGLAS. Do I understand, then, that there is no free coinage of gold except possibly in Switzerland?

Mr. FRIEDMAN. That is right.

Chairman DOUGLAS. There is no convertibility of domestic currencies into gold except in the case of Switzerland—am I right on that?

Mr. HEXNER. Yes.

Mr. WALLICH. Yes.

Mr. FRIEDMAN. Yes.

Chairman DOUGLAS. But countries will, from time to time, buy gold, just as we would buy silver under the Sherman Act during the period prior to 1896.

Mr. WALLICH. They would buy it continually from other central banks and some producers as offered, unless they wanted to take dollars.

Chairman DOUGLAS. I suppose it is inevitable that if we were to stop buying gold, the price of gold would fall, because the commercial usage for gold has not developed to the point that the commercial usage of silver has developed.

Mr. FRIEDMAN. I do not believe that is necessarily correct. It depends partly on whether we simultaneously make it legal for Americans to hold gold.

Chairman DOUGLAS. What are the alternative uses of gold, aside from money? In the case of silver we have photographic materials, silverware, and jewelry. I do not know the intricate details, but I imagine that the rise in the price of silver was not due merely to the increased demand for such uses, but due to other developments which I will not go into right now.

Senator PROXMIRE. I talked to one Senator who has potential gold mines in his State, and he stated that the present production of gold just about meets, or not quite meets, the need for dental and jewelry purposes.

Chairman DOUGLAS. Yes.

Mr. WALLICH. If we stopped buying gold, I think it would make no difference at all, because we have a balance-of-payments deficit and we are on balance selling gold. If we get back to an active balance of payments, and then refuse to buy gold, it would cause an appreciation of the dollar in terms of the gold.

Chairman DOUGLAS. I have here the IMF International Financial Statistics. The total production of gold——

Mr. WALLICH. It must be close to a billion dollars.

Chairman DOUGLAS. The total was $1,300 million in 1962, that is, the gold total. I do not know what proportion of that went into official reserves. Mr. Pollack, would you give us those figures?

Mr. POLLACK. Twenty-five percent in 1962.

Chairman DOUGLAS. Twenty-five percent went into official reserves, so that you have to develop an added commercial demand amounting to approximately one-quarter or more of new gold production. If you do not buy gold, and you sell gold, and other countries begin to sell off their gold—with the monetary gold stocks of the world

amounting to $41,700 million in addition to commercial stocks amounting to much less than that—if this were suddenly dumped on the market it would be catastrophic.

Mr. HEXNER. Would you permit export of gold?

Mr. FRIEDMAN. Why not—why not have a perfectly free gold market? I believe, Senator Douglas, that you are underrating the private demands for gold that there would be, not for commercial purposes, but for hoarding purposes. In India, for example, a country which is not affected by the U.S. price, the internal price of gold is twice the world price, because of the restrictions imposed on the inflow of gold. That is entirely for hoarding purposes. You may say that the foreign central banks hold gold, because they know that they can always get $35 an ounce for it.

Chairman DOUGLAS. If you cannot get gold for paper money, for bank loans, if you cannot get gold for international payments, what is the purpose of gold, aside from adornment and any commercial use that it may have?

Mr. WALLICH. I believe that Mr. Friedman is quite right, because if all countries cut loose from gold, a great many people would try to secure it. A great many people would figure that it would be a transfer period in which all currencies are going to pot, and after these years whoever has gold will be——

Mr. FRIEDMAN. I notice that you——

Chairman DOUGLAS. That is Mr. Friedman's argument.

Mr. FRIEDMAN. I am only admitting that people might think that. I am not saying that it would be true. [Laughter.]

Senator PROXMIRE. Could I ask this question?

Chairman DOUGLAS. Yes.

Senator PROXMIRE. Dr. Wallich, I thought that your presentation was very good and very strong, but what I am concerned about is this: you start off by saying that flexible rates have a high measure of acceptance in the academic community. I do not feel any awe for academic circles. But I am concerned if the academic people who study this matter and make it a career approve of flexible exchange rates, while the public officials who give it less study disapprove. I wonder if this is a prevalent academic view that flexible rates are the better way. I think this would have a great force with me and other members of the committee.

Mr. WALLICH. I have not taken a poll, but I am surprised to find how many good economists believe in flexible rates. However, none of these good economists are employed by central banks or treasuries.

Senator PROXMIRE. Very good. That makes it even stronger. Or, let me make it even stronger. My next question is this, and I think that the lack of an answer to this question is a most persuasive argument for flexible rates. What is the alternative? This committee is here to try to find answers to the balance-of-payments problem. We have not come up with very much except the temporary expedient of more liquidity. What is the alternative that you offer?

Mr. WALLICH. The alternative is not painless. All choices are painful. It is not a painless process. The alternative is to take advantage of productivity gains, to let prices fall slightly or fall relative to prices

abroad without bringing down wages. I am aware that it is inconceivable to argue that wages should come down. But if wages could rise a little less, then with the increase in productivity prices would come down. Prices are moving in the economy all the time.

Senator PROXMIRE. If I may interrupt. This means a constant change in our fiscal policy and monetary policy, does it not? Otherwise, there is no way in which we can consciously do this if we just leave it to chance and hope that somehow our inflation will be less than the inflation abroad?

Mr. WALLICH. If a full employment policy can be implemented only with inflation, then I would say, "Yes, there would be a restraint." But since I believe that we can be reasonable enough to maintain full capacity operations without continuing inflation, I am not convinced that we must face this choice.

Senator PROXMIRE. I am talking about expansion, not inflation.

Mr. WALLICH. I would think that we can have expansion of the economy without inflation. It would take more restraint, and it would not be as rapid.

Senator PROXMIRE. It cannot be as rapid expansion—you cannot solve the unemployment problem as rapidly or as effectively.

Mr. WALLICH. I think more effectively in the long run, because dragging this payments deficit along is worse than anything else. But we cannot expand as quickly now through the budget or monetary policies as we might in the absence of the payments deficit. But the concern about falling prices is overdone, because in our economy, prices are moving all the time. We allow prices in an industry to fall. We do not say that the industry must be protected at all odds against falling prices. We do not do anything about it.

Chairman DOUGLAS. Why not let the price of gold rise and fall, then?

Mr. WALLICH. Because that goes back to the whole argument.

Mr. FRIEDMAN. May I ask a question along this line? Suppose it turned out that with a feasible amount of decline in prices at home relative to prices abroad, our balance of payments improved, but only very slowly. What else would you do?

Mr. WALLICH. May I answer that?

Senator PROXMIRE. That question was directed to you.

Chairman DOUGLAS. I would like to answer this, if I may. We should encourage the Europeans to raise their prices. You have spoken of the cooperation of the European central banks in being so kind as to hold American dollars. I would say the greatest contribution would be to let their price level rise so that we could increase our exports. Instead of people being afraid of the European central banks, we ought to urge them to join in international cooperation as we have cooperated with them for many years.

Senator PROXMIRE. The answer to that, of course, is that they have been doing that in the last year. They had a substantial inflation, far more than ours, about four times more than ours.

Chairman DOUGLAS. Let them continue.

Senator PROXMIRE. That is urging a pretty rough course.

Chairman DOUGLAS. Excuse me.

Mr. WALLICH. Is it not a fact that we have sought short-term capital abroad? And are we not actually accumulating long-term assets

abroad? It would be perfectly sound for us to go on borrowing abroad, providing it can be done on terms that do not inflate the other side. They will object to inflation, they will say, "No," Senator Douglas, whether we like it or not.

Chairman DOUGLAS. We are the only ones that must give. They must never give. Cooperation consists in Americans willing to do what Europe wants us to do—not in Europe helping us. I am not speaking from the Chicago Tribune standpoint, either.

Mr. WALLICH. There are other ways of doing this, Senator. We can borrow abroad in a way that is not inflationary. We can borrow in the capital markets, sell our obligations at 4 or 6 percent, and use this money as we are doing right now to buy their enterprises that yield us 20 percent.

Senator PROXMIRE. This is my last question. How about the interest equalization tax? We had two economists the day before yesterday who told us that the reason for the very sharp improvement in the balance of payments in the third quarter was very largely because of the announcement of the interest equalization tax. Why is this not a realistic way, at least, to cope with a very, very difficult situation? After all, capital flows are at the heart of our problem.

Mr. WALLICH. I deplore that we are driven to this extreme. I would call it not a devaluation, but a tariff. Mr. Friedman said it was devaluation, but it comes to about the same thing.

Senator PROXMIRE. It works.

Mr. WALLICH. I wish that we were not driven to this. There might be other and better devices—a capital issues committee could perhaps have done a better job—but now that we are launched on this I think that we ought to go ahead with it.

Chairman DOUGLAS. I think that we have kept the gentlemen here long enough. It has been very fascinating.

Senator PROXMIRE. It has been very helpful and informative.

Chairman DOUGLAS. I could make quite a speech now, but I am not going to do so.

Before we adjourn, let me ask unanimous consent to have inserted in the record at the conclusion of today's proceedings some materials that Senator Javits has prepared.

(The documents follow:)

## A PRACTICAL PROGRAM FOR INTERNATIONAL MONETARY RESERVES [1]

(By Edward M. Bernstein,[2] president, EMB, Ltd., research economists, Washington, D.C.)

### ADEQUACY OF MONETARY RESERVES

For the past 5 years there has been an almost continuous concern with international monetary reserves. Whatever views one may have regarding the strength of the present international payments system based on gold, reserve currencies, and the resources of the Fund, there can be no doubt that an examination of the functioning of this system is of the highest order of importance. The framework for this system was established at Bretton Woods nearly 20 years ago. Since then, far-reaching changes have taken place in the world economy and new

[1] Published in the Quarterly Review and Investment Survey, fourth quarter, 1963, a publication of Model, Roland & Co., New York, N.Y.

[2] Mr. Bernstein was formerly an Assistant to the Secretary of the U.S. Treasury and from 1946 to 1958 the Director of Research and Statistics at the International Monetary Fund. He was executive secretary and chief technical adviser of the U.S. delegation at the Bretton Woods Conference in 1944 which established the Fund and the World Bank.

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problems regarding monetary reserves have emerged that could not be foreseen at Bretton Woods. The International Monetary Fund has announced that it will make a broad study of international monetary reserves. At the same time, 10 large industrial countries (the signatories of the Paris agreement) are making a study of their special reserve problems as well as reserve questions generally.

The adequacy of gold and foreign exchange reserves for the world economy will depend not only on their magnitude, but on their composition and distribution, and the nature of future balance-of-payments problems. A large number of low-income countries hold very small reserves, although their balance of payments may show large and sudden fluctuations. For these countries, the holding of larger reserves requires investment of real resources in gold and foreign exchange which they are unable to undertake. In practice, therefore, the adequacy of reserves can refer only to the gold and foreign exchange holdings of the principal European countries, the United States, Canada, Japan, Australia, New Zealand, and South Africa.

When important countries have large and persistent payments deficits, reserves never seem adequate. This was true in the early postwar period, when Western Europe had enormous deficits. It is true now, when the United States has been having persistent deficits. If it is assumed that gold and foreign exchange reserves must be large enough to finance payments deficits of such magnitude and persistence, then the present level of reserves is not adequate, nor would much larger reserves be adequate. The practical question is whether present monetary reserves are sufficient to meet the ordinary fluctuations in international payments that must be expected in a reasonably well-balanced world economy. When the U.S. balance of payments is restored, there will be no doubt that monetary reserves are adequate for all ordinary purposes, provided account is taken of the resources of the Fund.

*Gross official holdings of gold and foreign exchange* [1]

[Million U.S. dollars]

| End of— | Gold | Foreign exchange | Total |
|---|---|---|---|
| 1951 | 33,925 | 15,150 | 49,075 |
| 1952 | 33,900 | 15,665 | 49,565 |
| 1953 | 34,320 | 17,170 | 51,490 |
| 1954 | 34,950 | 18,285 | 53,235 |
| 1955 | 35,410 | 18,845 | 54,255 |
| 1956 | 36,055 | 19,830 | 55,885 |
| 1957 | 37,305 | 19,015 | 56,320 |
| 1958 | 38,030 | 19,280 | 57,310 |
| 1959 | [2] 37,880 | [2] 19,205 | 57,085 |
| 1960 | 38,030 | 21,835 | 59,865 |
| 1961 | 38,855 | 22,455 | 61,310 |
| 1962 | 39,230 | 22,545 | 61,775 |
| June 1963 (estimated) | 39,350 | 23,970 | 63,320 |

[1] All countries outside the Communist bloc, and not including gold holdings of the IMF, the BIS, or the European Fund.

[2] The decline in gold holdings in 1959 is attributable to the gold payments of members of the IMF when their quotas were increased. The decline in foreign exchange holdings in 1959 was the result of the liquidation of the European Payments Union and the accompanying settlement of claims.

Although the present level of monetary reserves would be adequate under ordinary conditions, the growth of reserves in the future may not be sufficient for an expanding world economy. Since 1953, the gross official gold and foreign exchange reserves of all countries outside the Communist bloc have increased by $13.8 billion. Of this increase, $5.5 billion was in gold and $8.3 billion in foreign exchange, all in U.S. dollars. When the U.S. balance of payments is restored, any further increase of reserves will have to come from newly mined gold and gold sales of the Communist bloc that do not go into private hoards, and from foreign exchange in some form other than U.S. dollars. This would not be enough to meet the needs of the world economy without greater dependence on the resources of the International Monetary Fund.

### CREATION OF RESERVE CREDIT

The Fund has been criticized as an inflexible institution hampered in providing reserves for its members by limited powers and complicated procedures. The critics of the Fund, led by Prof. Robert Triffin, propose that it be changed into a world central bank with the power to create reserve credit through loans and open market operations. Such a radical change in the structure and operation of the Fund is wholly unnecessary.

The principal point made by these critics is that the Fund cannot create reserves. In fact, all of the currency holdings of the Fund represent the creation of monetary reserves. There are limitations, however, on the creation of reserve credit by the Fund. In the first place, the amount of resources that any country can draw from the Fund is limited by its quota, unless the Fund agrees to a waiver. In the second place, the amount of resources that any country must provide the Fund is limited by its quota, unless it consents to lend the Fund additional resources. The reformers want to remove the quota limitations on the power of the Fund to create reserve credit. As a practical matter, it would be far more difficult to assure an adequate growth of reserves through an international institution that makes loans or undertakes open market operations than through the present system of drawing on the Fund within quota limits.

A system for creating reserve credit must be based on sufficient discipline, exercised by national and international authorities, to compel the recipients to maintain their international payments in order. The extent to which such discipline will have to be imposed by an international institution depends on the power it is given to create reserve credit. The Clearing Union, for example, was designed to provide enormous sums not only for monetary stabilization, but for reconstruction and relief in the immediate postwar period. To balance this, the Clearing Union had severe restraints to make sure that countries did not use its resources too freely. Under the Clearing Union, a country would have had great freedom in drawing up to one-half of a rather large quota. Thereafter, Keynes proposed that:

"As a condition of allowing a member state to increase its debit balance to a figure in excess of a half of its quota, the Governing Board may require all or any of the following measures:

"(i) A stated reduction in the value of the member's currency, if it deems that to be the suitable remedy;

"(ii) The control of outward capital transactions, if not already in force; and

"(iii) The outright surrender of a suitable proportion of any separate gold or other liquid reserve in reduction of its debit balance.

Furthermore, the Governing Board may recommend to the government of the member state any internal measures affecting its domestic economy which may appear to be appropriate to restore the equilibrium of its international balance."

A system by which creation of reserves is linked to ad hoc borrowing by a deficit country from a world central bank with broad powers to create reserve credit would necessarily involve a high degree of international control. It is doubtful whether the large industrial countries would permit themselves to become dependent on such borrowing for their reserve needs. On the other hand, a system by which reserves are made available to all member countries on the basis of established quotas has the great advantage of providing an assured, although limited, amount of reserve credit without requiring more than a moderate degree of international control. The Fund has worked reasonably well so far precisely because it combines the minimum essential degree of international control with the maximum permissible freedom of national economic policy.

### FUND RESOURCES AS WORKING RESERVES

As of September 30, 1963, 48 countries have drawn over $7 billion in foreign exchange from the Fund, of which more than $5.3 billion has been repaid. In addition, the Fund has made standby agreements totaling $7.4 billion, of which nearly $1.8 billion is still in effect. The quotas of individual members of the Fund have been raised on numerous occasions and a general revision of quotas, amounting to $5.4 billion, was authorized in 1959. To assure the Fund of ade-

quate resources for emergency needs, 10 large industrial countries have undertaken to lend the Fund up to $6 billion of their currencies in accordance with the Paris agreement of 1962.[3] Early this year, the Fund adopted a policy under which 25 percent of the quota would be available, virtually automatically, to a member as compensatory credit to finance a shortfall in its export receipts. This is the record of an institution alert to the reserve problems of its members and determined to deal with them.

Nevertheless, the procedures and policies of the Fund should be modified over the next few years to deal with some of the new problems that will arise. The Fund holds a large common reserve for all its members. This reserve consists of $2.3 billion in gold, an additional $800 million in its gold investment account, and $11.7 billion in currencies. Of the currency holdings of the Fund, over $4.5 billion is in U.S. dollars and sterling and $2.1 billion is in the currencies of the other signatories of the Paris agreement. In addition, the Fund has access to $6 billion of these 10 currencies under the borrowing arrangements. There could be no shortage of reserves if the resources of the Fund were used as part of the working reserves of its members. As the Canadian Minister of Finance has said, "the need for additional reserves and for enlarged reserve facilities will be lessened * * * if members of the Fund make full use of the reserve facilities that are already available."

The basic principle of the Fund is that its resources should be used whenever a member draws on its own reserves and that it should restore its position in the Fund whenever it is adding to its own reserves. The United Kingdom and the United States have not used the Fund in this way. They have allowed their reserves to be considerably reduced before coming for a drawing or a standby. This imputes an air of crisis to a transaction that should be routine. There is no reason why members of the Fund should not draw on the Fund for moderate amounts within their quota limits whenever they use their own reserves.

The corollary to this is a policy by the Fund which gives members assurance that they can count on using the resources of the Fund within quota limits. At present, a country has an absolute right to draw on the Fund for any purpose, without any repurchase obligation, until the Fund's holdings of its currency equal 75 percent of its quota. A member has virtually complete assurance that it will be able to draw the next 25 percent of its quota, the so-called gold tranche. Thereafter, with each successive drawing of 25 percent of the quota, a country has to meet increasingly severe tests to satisfy the Fund that it is taking steps to restore its balance of payments.

There is no reason why the Fund cannot give its members assurance that they will be able to use their quotas, within the prescribed limits, provided they remain eligible to use Fund resources. This is, in effect, the assurance that members now have under a standby arrangement. With such assurance, its quota position could be included in a member's reserves, noting at the same time the contingent obligation against the quota. The Fund would, of course, be entitled to impose conditions for use of its resources when a country draws more than 25 percent of its quota in a 12-month period, or when a drawing increases the Fund's holdings above 200 percent of the quota, or when the member is declared ineligible.

At present, members are required to repay the Fund within 3 years of a drawing, with an outside limit of 5 years. Ordinarily, this is sufficient time for a country to restore its balance of payments. There are instances, however, in which a somewhat longer time for adjustment would be desirable. In any case, if a member is to be able to use 25 percent of its quota in a 12-month period until the Fund's holdings of its currency have reached 200 percent of the quota, it must be allowed 4 years within which to repay. Otherwise, repayment of the first credit tranche would become due before a member could draw the fourth credit tranche. Such a modest extension of the repayment period can be made merely by revising the schedule of interest charges which establishes the normal period for repayment.

With such a policy on drawings and repayments, the Fund would occupy a central role in the world monetary system. Its help to members, through actual drawings and through assured use of quotas, would be greatly increased and its influence with members correspondingly strengthened. There is no reason to fear that members would abuse these rights. The Fund could always advise members, as it does now in its annual consultations, to deal promptly

[3] The signatories of the Paris agreement are the United States, the United Kingdom, France, Germany, Italy, the Netherlands, Belgium, Sweden, Canada, and Japan.

with their payments problems. In extreme cases, a member could be informed that it is not making proper use of Fund resources and that it would be unwise to continue to draw on its quota.

INCREASE OF QUOTAS

Under the articles of agreement, the Fund may consider at any time the adjustment of the quota of a member at its request. Furthermore, the Fund must "at intervals of 5 years review, and if it deems it appropriate propose an adjustment of, the quotas of the members." The Fund's holdings of certain key currencies are not adequate for its operations. In general, the quotas of Belgium, France, Germany, Italy, Netherlands, Sweden, Japan, and Canada are too small to reflect their importance in international trade and payments. As a consequence, the liquidity of the Fund is not as great as it should be. As a practical matter, it is more urgent to increase the quotas of these countries, in order to provide the Fund with more of their currencies, than to have a general increase in quotas in order to provide all members with larger drawing rights.

In 1959, there was a general increase in quotas of about 50 percent. Such a large increase could be justified because the basic quotas had been set in 1944 at Bretton Woods. The policy hereafter should not be to have a massive increase of quotas at infrequent intervals, but to have a moderate increase every 5 years or sooner. From mid-1959 to mid-1963, a period of more than average increase in monetary reserves, the gold and foreign exchange reserves of all countries outside the Communist bloc increased by 14 percent. A general increase of about 15 percent in the quotas of all members, apart from larger increases for certain countries, would maintain the previous relationship of Fund resources to the reserves of its members. Such a general increase in quotas could be authorized at the next annual meeting of the Fund in Tokyo.

With the suggested modifications in the Fund's policies on drawings and repayments, the resources of the Fund could become an important part of the working reserves of its members. Any doubt regarding the adequacy of monetary reserves would disappear. As additional reserves become necessary, apart from the gold and foreign exchange reserves held by countries, the need could be met through changes in the quotas of individual members and through a general increase of quotas. Such a program would meet all reasonable requirements for monetary reserves. It would make unnecessary sweeping changes in the structure of the International Monetary Fund.

NATIONAL MONETARY RESERVES

The problem of monetary reserves is not entirely a matter of supplying additional resources through the Fund. It is also necessary to have sufficient national monetary reserves of gold and foreign exchange. This is particularly important for the large industrial countries that are prime movers in the world economy. They need large reserves of their own in order to have greater autonomy in dealing with payments difficulties, when they occur, without imposing severe restrictions on international trade and investment or undue restraints on domestic economic activity. Furthermore, since the restoration of convertibility of the leading European currencies, short-term capital movements among the large industrial countries have increased enormously. Finally, some of the reserve centers must contend with the possibility of massive conversions of their currencies into gold when they have balance-of-payments deficits or when other countries, holding these currencies as reserves, use the reserve currencies to meet their balance-of-payments deficits.

The gold and foreign exchange reserves of all countries outside the Communist bloc amount to over $63 billion, of which 70 percent is held by the signatories of the Paris agreement and Switzerland. These 11 countries have recognized a special responsibility on monetary reserves and have taken cooperative action to avoid disturbance in the international payments system arising from large capital movements and conversions of currencies into gold. The Federal Reserve has entered into 12 reciprocal currency agreements with the central banks of other countries providing for swaps of national currency amounting to $1,950 million, to deal with temporary pressures in the exchange markets. In addition, the 10 signatories of the Paris agreement have undertaken to lend the Fund additional amounts of their own currencies, amounting to $6 billion, under stated conditions. Switzerland, not a member of the Fund, has approved bilateral arrangements with the signatories to lend up to $200 million under the same conditions as those of the Paris agreement.

*Agreed borrowing and reciprocal currency arrangements*

[Millions of U.S. dollars]

| Country or Institution | Amount subscribed to borrowing arrangements | Amount of U.S. reciprocal currency arrangements [1] |
|---|---|---|
| United States | 2,000 | |
| Canada [2] | 200 | 250 |
| United Kingdom | 1,000 | 500 |
| Japan | 250 | 150 |
| Belgium | 150 | 50 |
| France | 550 | 100 |
| Germany | 1,000 | 250 |
| Italy | 550 | 250 |
| Netherlands | 200 | 100 |
| Sweden | 100 | 50 |
| Austrian National Bank | | 50 |
| Bank for International Settlements [3] | | 100 |
| Swiss National National Bank | | 100 |
| Total | 6,000 | 1,950 |

[1] The reciprocal currency arrangements are between the Federal Reserve and the central banks of the countries listed below.
[2] Borrowing arrangements awaiting ratification.
[3] In Swiss francs.

The reciprocal currency arrangements and the borrowing arrangements are an indication of the importance that the 11 countries attach to the maintenance of a strong international payments system which will give confidence in the stability of the major currencies and their continued convertibility. These arrangements are not designed, however, to provide monetary reserves in the ordinary meaning of the term. They are special facilities for dealing with short-run pressures in the exchange market and for meeting serious disturbances in the international payments system. Apart from such special arrangements, it is necessary to assure the normal growth of national monetary reserves, particularly those of the large industrial countries, and to avoid competitive measures to concentrate monetary reserves in the form of gold.

RESERVE CURRENCIES AND GOLD

Of the more than $63 billion in the monetary reserves of all countries outside the Communist bloc, over $39 billion is in gold and $24 billion is in foreign exchange. The growth of monetary reserves cannot depend on newly mined gold and gold sales of the Soviet Union, much of which now goes into private boards. In the last 3½ years, the increase in the gold reserves of all countries outside the Communist bloc was 3.9 percent—an average annual increase of only 1.1 percent. Nor is it possible to depend much longer on increased holdings of U.S. dollars as a source of monetary reserves. The United States cannot permit its liabilities to foreign official institutions, all convertible into gold, to continue to rise while its gold reserves decline.

*Gross gold and foreign exchange reserves of 11 countries, 1957–63*

[Millions of U.S. dollars]

| | Dec. 31 | | | | June 30, 1963 | | | |
|---|---|---|---|---|---|---|---|---|
| | 1959 | 1960 | 1961 | 1962 | Total reserves | Gold | Foreign exchange | Percent gold |
| United States | 19,507 | 17,804 | 17,063 | 16,156 | 15,955 | 15,829 | 126 | 99.2 |
| Canada | 1,876 | 1,836 | 2,064 | 2,547 | 2,701 | 755 | 1,946 | 28.0 |
| United Kingdom | 2,750 | 3,239 | 3,324 | 2,809 | 2,716 | 2,447 | 269 | 90.1 |
| Japan | 1,322 | 1,824 | 1,486 | 1,842 | 2,089 | 289 | 1,800 | 13.8 |
| Belgium | 1,222 | 1,422 | 1,657 | 1,622 | 1,763 | 1,373 | 390 | 77.9 |
| France | 1,720 | 2,070 | 2,939 | 3,610 | 4,257 | 2,814 | 1,443 | 66.1 |
| Germany | 4,533 | 6,737 | 6,542 | 6,447 | 6,699 | 3,753 | 2,946 | 56.0 |
| Italy | 2,953 | 3,079 | 3,419 | 3,441 | 3,318 | 2,289 | 1,029 | 69.1 |
| Netherlands | 1,339 | 1,742 | 1,715 | 1,743 | 1,838 | 1,581 | 257 | 86.0 |
| Sweden | 440 | 490 | 673 | 753 | 744 | 182 | 562 | 24.5 |
| Switzerland | 2,063 | 2,324 | 2,759 | 2,871 | 2,707 | 2,530 | 177 | 93.5 |
| 11 countries | 39,725 | 42,567 | 43,641 | 43,841 | 44,787 | 33,842 | 10,945 | 75.6 |
| All others | 17,360 | 17,298 | 17,704 | 17,934 | 18,533 | 5,508 | 13,025 | 29.7 |
| World total | 57,085 | 59,865 | 61,345 | 61,775 | 63,320 | 39,350 | 23,970 | 62.1 |
| Percent, 11 countries | 69.6 | 71.1 | 71.1 | 71.0 | 70.7 | 86.0 | 45.7 | |

If foreign exchange is to supply a considerable part of the increase in national reserves, it will have to be in some other form than in U.S. dollars and sterling; and there will have to be some agreement among the gold-holding countries regulating the proportion of their reserves held in gold and the conversion of their foreign exchange holdings into gold. This problem is of primary concern to the 11 large industrial countries. In mid-1963, they held 86 percent of the monetry gold of all countries outside the Communist bloc. There are, of course, great differences among them in their holdings of gold relative to foreign exchange. The United States, the United Kingdom, the Netherlands, and Switzerland have 86 to 99 percent of their reserves in gold. Belgium, France, Germany, and Italy have from 56 to 78 percent of their reserves in gold. On the other hand, Canada, Japan, and Sweden hold less than 30 percent of their reserves in gold—about the same proportion as the rest of the world.

Professor Posthuma, a director of the Netherlands Bank, has suggested that the burden of maintaining the gold exchange standard could be shared more equitably, and the system greatly strengthened, if the large industrial countries would all hold an agreed proportion of their reserves in foreign exchange. If this proportion were about the present average, it would permit holdings of foreign exchange by the large industrial countries to grow with the increase of gold reserves. This would, however, be at a very slow rate. Furthermore, an agreement to hold a stated proportion of reserves in foreign exchange would not necessarily be equitable among different countries, nor would it assure a country against the risks of massive conversion of foreign-held balances into gold. The proposal of Professor Posthuma could be of great importance if an agreement were reached among the 11 countries to standardize the composition of their holdings of gold and foreign exchange and their use in international settlements with each other.

### FOREIGN EXCHANGE AS RESERVE UNITS

The best way to assure an equitable distribution of the holding of foreign exchange reserves by the large industrial countries would be for them to enter into an agreement to establish a reserve unit, equivalent to a gold dollar, consisting of a stated proportion of each of the 11 currencies. Thus, a reserve unit might consist of about 50 cents in U.S. currency and lesser amounts in sterling, French francs, marks, lire, Canadian dollars, yen, guilders, etc. The proportion of the reserve unit consisting of each currency would be agreed on the basis of its present role as a reserve currency and its importance in international trade and investment. Some consideration should be given to the total reserves of a country, but not to their present composition.

The participating countries would be free to hold their reserves in any form—gold, foreign exchange, and reserve units—but holdings of gold would have to be matched by a minimum amount of reserve units. The ultimate objective would be for each country to hold reserve units amounting to at least one-half of its gold reserves. Holdings of foreign exchange would be exempt from this requirement. As the creation and holding of reserve units would increase the monetary reserves of the participating countries, the plan would have to be put into effect by stages. Initially, for example, about $3.5 billion of reserve units could be created and countries would be obligated to hold a minimum of one reserve unit for each $9 of reserves they hold in gold.

To create the reserve units for the initial stage, each participating country would deposit its own currency with the International Monetary Fund, acting as trustee, to an amount equal to its pro rata share of the reserve units to be created. The United States, for example, would deposit $1.7 billion in U.S. dollars—just under 50 percent of the total. The other countries would deposit their assigned shares in their own currencies. In return, each country would be given a credit on the books of the trustee denominated in reserve units. Thus, the trustee would hold $3.5 billion in the currencies of the 11 participating countries and they, in turn, would hold $3.5 billion in reserve units. As in all other cases, the currencies held by the Fund would be guaranteed against exchange depreciation.

The participating countries would be obligated to convert balances of their currencies, when held by the monetary authorities of the other countries, in gold and reserve units in the prescribed proportion under the conditions set forth in article VIII, section 4 of the Fund agreement. Thus, in the initial stage, the conversion of official balances of a currency would be 90 percent in gold and 10 percent in reserve units. The proportion of reserve units would be raised in later stages and ultimately the conversion of official balances of a currency would be two-thirds in gold and one-third in reserve units. In effect, this would establish a composite standard consisting of gold and reserve units.

To compensate countries for the real resources (including capital assets) transferred when part of the payments deficit is settled in reserve units, all countries would pay the trustee 2 percent per annum on their currencies in the reserve unit account. The trustee, in turn, would pay countries 2 percent per annum on their balances of reserve units. The interest on reserve units would be substantially less than could be earned in the money markets of the participating countries. This is justified by the greater security attached to the holding of reserve units and the reciprocal benefits derived from the operation of the plan.

Such a system would involve little change in the present international monetary system. Thus, gold would remain the basis for the value of currencies, the reserve unit would have a fixed gold value, and official holdings of the currencies of the participating countries would be convertible into gold, although only in conjunction with reserve units. With such a system, the monetary reserves of the 11 countries could continue to grow without being hampered by a potential inadequacy of monetary gold. Finally, the system would help equalize the ratio of gold and foreign exchange in the reserves of participating countries and provide a means by which all 11 currencies would share in supplying an equitable part of reserves in foreign exchange.

### HOLDINGS OF U.S. DOLLARS

An agreement by the 11 countries to hold reserve units would have some effect on the holding of U.S. dollars. As the U.S. dollar would continue to be the principal currency used in international payments, private holders of dollars would maintain their present holdings and increase them gradually. Furthermore, the nonparticipating countries would find it necessary to continue to hold a substantial amount of reserves in U.S. dollars. Thus, once adjustment to the new system had been made, the accumulation of U.S. dollars would continue on a moderate scale.

Nevertheless, with the required holding of reserve units by the other 10 large industrial countries, their need for reserves in the form of U.S. dollars would diminish. The total official holdings of foreign exchange by the other 10 countries—that is, excluding the United States—was $10.8 billion on June 30, 1963, nearly all in U.S. dollars. About 90 percent of these dollar reserves are held by

six countries—Canada, Japan, France, Germany, Italy, and Sweden. The other four countries—Belgium, Netherlands, Switzerland, and the United Kingdom—hold an average of 88 percent of their reserves in gold and have no reason for reducing their present limited holdings of dollars. The question, therefore, is what the other six countries may wish to do about their present official holdings of U.S. dollars after they begin to hold reserve units.

Three of these countries—France, Germany, and Italy—hold about $5.5 billion in foreign exchange, about 30 to 44 percent of their reserves. There is no doubt that they would prefer to hold a much larger proportion of their reserves in gold. If it is assumed that these countries would wish to increase their gold holdings to about 85 percent of their reserves, excluding reserve units, they might ultimately convert nearly about $2.5 billion of their present official holdings of U.S. dollars. Canada, Japan, and Sweden hold about 78 percent of their reserves in foreign exchange, to a considerable extent because they prefer dollars. With the establishment of a composite standard of gold and reserve units, these countries, nevertheless, would wish to raise the proportion of gold to foreign exchange in their reserves and might ultimately convert about $1.5 billion of their present official U.S. dollar holdings.

After the composite standard is in full operation, and when the U.S. balance-of-payments deficit is eliminated, the conversion of $4 billion into gold and reserve units would not strain the reserves of the United States, particularly as the new system would increase U.S. reserves in the form of reserve units. On the other hand, there could be considerable pressure on U.S. reserves if the conversion had to be made before the composite standard is in full operation and before the U.S. payments deficit is eliminated. To avoid this, transitional arrangements would be necessary under which countries would agree to the gradual conversion of their present holdings of U.S. dollars into gold and reserve units. Of course, a country would be able to use any of its U.S. dollar reserves at any time if it should need them to meet a balance-of-payments deficit during the transition period. Such an arrangement is fully in accord with article VIII, section 4 of the Fund agreement.

### A PRACTICAL PROGRAM ON MONETARY RESERVES

The present international monetary system, based on gold, foreign exchange, and the International Monetary Fund, has worked very well. There is no need to abandon it in order to establish a new system based on an international central bank with the power to create reserve credit. Nevertheless, it must be recognized that certain changes are necessary in the present international monetary system. The growth of reserves in the future cannot depend entirely on newly mined gold and gold sales of the Soviet Union; nor can it depend on large increments of U.S. dollars for additional foreign exchange reserves.

To assure an adequate growth of monetary reserves, it is necessary to integrate the resources of the Fund with the working reserves of its members. This means that countries should be able to count on their quotas in the Fund as a part of their reserves. From time to time, quotas could be increased as world trade and investment grows. At present, it is more important to increase the quotas of some creditor countries in order to strengthen the liquidity of the Fund than to have a general increase of quotas to provide more reserves. After the Fund has completed its study of reserves, these individual adjustments can be made and a general increase of about 15 percent in quotas can be approved at the annual meeting next year.

To enable the large industrial countries to hold substantial monetary reserves of their own, it is necessary for them to agree on some method of standardizing their holding and use of gold and foreign exchange reserves. The large industrial countries must accept the responsibility on monetary reserves that their position in world trade and investment requires. The practical way for sharing such responsibility is for all countries to participate in the supply of foreign exchange reserves through reserve units. This would assure an adequate growth of monetary reserves, a secure form of holding foreign exchange reserves, and the continued use of gold as the basis for national currencies. The need for settlement in gold and reserve units would provide a necessary restraint on large and persistent balance-of-payments deficits in any country, particularly the reserve centers.

[From the New York Times, Nov. 14, 1963]

## WESTERN NATIONS SEEK TO CREATE NEW MONEY UNIT—INTERNATIONAL CURRENCY PLAN WOULD ALLEVIATE BURDEN ON AMERICAN DOLLAR

### U.S. SUPPORT EXPECTED—PROPOSAL IS MAJOR ELEMENT IN PROGRAM TO IMPROVE THE MONETARY SYSTEM

(By Edwin L. Dale, Jr., special to the New York Times)

WASHINGTON, November 13.—The United States and nine other leading industrial nations are actively considering the creation of a new unit of international currency.

The unit would be the heart of a plan for improvement of the international monetary system that would gradually lessen the burden on the dollar as the keystone of the system.

The plan is one of several related ideas now under close study, all of which have the same basic objective: to maintain world prosperity by allowing the currencies of the prosperous nations of Western Europe to play a larger role in the international monetary system.

The system, which has worked well in the period since World War II, has recently been under strain, mainly because of the chronic deficit in the international payments of the United States and the loss of its gold.

*Gradual shift envisioned*

The new plan would not change in any way the need for eliminating the U.S. payments deficit. But it would gradually transform the system in such a way that in the future the financial health of the Western World would not depend so much on the state of the U.S. gold reserve.

The plan calls for the creation of a new international currency unit in which nations would hold part of their monetary reserves. At present nations hold only gold and dollars, and in a few cases British pounds.

The international unit would be made up of such strong currencies as the German mark, the French franc, the Italian lira, the Dutch guilder, and the Swedish kroner, as well as the dollar and the pound.

Nations would continue to hold as much gold, or dollars, as they wished. The new international "reserve unit" would be a supplement, but its introduction would gradually change the way countries now settle accounts with each other.

The idea of an international reserve unit or something similar, it is understood, is a key element in the deliberations of the "Paris Club" of the 10 leading industrial nations that hold the bulk of the world's reserves. The group has set out to correct the flaws, both actual and potential, in the present monetary system, known formally as the gold exchange standard.

Any reform in the system agreed upon by the 10 nations is expected to be adopted. Among other things, they jointly control a big majority of votes in the International Monetary Fund. The aim of the group is to reach agreement on improvements in the system by next September's annual Monetary Fund meeting.

The members of the Paris Club are the United States, Britain, Canada, Japan, France, West Germany, Belgium, the Netherlands, Italy, and Sweden. Switzerland may be brought into the studies and may participate in any plan eventually agreed upon.

The plan about which most details are known has been developed by Edward M. Bernstein, former research director of the International Monetary Fund and now a consultant to central banks. Formerly confidential, the plan was published today in the quarterly review of Model, Roland & Co., a New York Stock Exchange member firm specializing in foreign securities. Some details of the plan had become known recently.

Several of the "group of 10" are known to have reacted favorably to the plan. The United States is keenly interested and may support it. It is regarded as a strong possibility that some plan with the same basic objectives will emerge from the combined study and negotiation now underway among the group.

*To cure alleged ills*

The aim of the plan, or plans, is to cure two alleged ills of the present system, one actual and one potential.

The actual ill stems from the nature of a system relying upon only one or two "key currencies." The system is potentially unstable, if a key currency such as the dollar should get into difficulty through a prolonged deficit in international payments. It creates different "rules of the game" for nations that have key currencies and those that do not. Some officials feel it can contribute to inflation.

The potential ill is called the problem of "international liquidity," a term used to define the total of nations' reserves of gold and dollars plus their access to international credit.

The growth in liquidity in recent years has been mainly supplied by the dollars and gold flowing to other nations from the U.S. payments deficit, something that everybody agrees must not continue for much longer. Yet total international liquidity must grow over time, just like a nation's supply of money. A nation's balance of payments is the relationship between its total payments to foreigners and its total receipts from foreigners.

Under the new plan, the 10 members, plus Switzerland, would contribute at the outset an agreed amount of their own currencies, about $3,500 million in all. The International Monetary Fund would hold these currencies as trustee. Each contributing member would be credited in turn with an equivalent amount of reserve units backed by all 11 currencies, with each reserve unit probably equivalent in value to $1.

A nation running a deficit in its international payments could use its reserve units to acquire any needed currency from a member of the group, though it would also have to pay a major part in gold. This would apply to the United States like any other nation. In the future, the United States could not "finance" its deficit simply by the device of other nations piling up holdings of dollars. Increasingly, reserve units would replace dollars as the medium for holding reserves in addition to gold.

*Rise in liquidity seen*

The original creation of $3,500 million of reserve units would add that much from the outset to international liquidity. Additional amounts could be created from time to time upon agreement of the members.

Under the Bernstein version of the plan, international settlements would eventually be made by all the leading nations one-third in reserve units and two-thirds in gold.

The plan could easily lead to an initial gold loss by the United States. Nearly half of the members of the "group of 10" now probably hold more dollars than they prefer. There could be a series of bilateral agreements providing for the gradual conversion of these foreign dollar holdings into gold and reserve units.

Chairman DOUGLAS. I want to announce the meeting tomorrow in this same room at 10 o'clock, and the subject will be "The Problem of International Liquidity."

Thank you very much.

(Whereupon, at 1 p.m., the committee adjourned, to reconvene at 10 a.m., Friday, Nov. 15, 1963.)

# THE UNITED STATES BALANCE OF PAYMENTS

## IV. The Problem of International Liquidity

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**FRIDAY, NOVEMBER 15, 1963**

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

The Joint Committee met, pursuant to recess, at 10 a.m., in room AE-1, U.S. Capitol Building, Hon. Henry S. Reuss presiding.

Present: Representative Reuss; Senators Douglas, Proxmire, Miller, and Jordan.

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

Representative REUSS (presiding). Good morning. The Joint Economic Committee will be in order.

We welcome this morning three very distinguished contributors to this symposium on balance of payments in the international monetary situation, Roy Blough, professor of economics at Columbia; Robert Mundell, professor of economics at McGill; and James Tobin, Sterling professor of economics at Yale.

We are very grateful to you gentlemen, and we will proceed in the regular way.

Mr. Blough, would you lead off, please?

## STATEMENT OF ROY BLOUGH, PROFESSOR OF INTERNATIONAL BUSINESS, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY

Mr. BLOUGH. Thank you, Mr. Chairman.

I appreciate the invitation of the committee to testify on the important problem of international liquidity. I am sure that everyone who is actively interested in the U.S. balance of payments or the operation of the international monetary system is greatly impressed by the very active and constructive role which your committee has played and is playing in advancing and disseminating knowledge and understanding of these matters.

A key question to which I shall devote most of my opening remarks concerns the nature of international liquidity and the circumstances under which it should be considered adequate or inadequate, as the case may be. I believe that much of the controversy over policy for the international monetary system stems from differences in the answers given to this question.

### LIQUIDITY OF THE UNITED STATES AS INTERNATIONAL BANKER

One concept of international liquidity makes it analogous to the liquidity of a bank that must be prepared to meet demand obligations if and when they are presented to it. In this sense, the United States has the liquidity problem of being able to meet demands for gold made upon it through the presentation of dollar claims by foreign central banks and foreign governments. While this is clearly a problem of concern to key currency countries that are performing the role of world banker, and particularly the United States, which is virtually unique in its promise to pay gold, it is a relatively minor aspect of the general problem of international liquidity.

### ABILITY TO FINANCE INTERNATIONAL DEFICITS

Perhaps the most commonly accepted concept of international liquidity relates to the ability of national governments to finance deficits in their international balances of payments. Under this concept international liquidity constitutes the resources that can be brought to bear in settling residual balances of a country when for a period of time its outpayments exceed its inpayments. It is this kind of liquidity to which President Kennedy referred in his speech before the International Monetary Fund last October when he said, "No nation should be forced to make drastic alterations in its domestic and trading policies because of short-run movements in its reserve position."

All countries experience swings in their balance-of-payments position. There are two general causes of swings; namely, imbalances in trade and other international earnings, and international movements of capital, particularly "hot money." Long-term capital investment of course also may move irregularly and may thereby contribute to balance-of-payments swings.

Two forms of resources constituting international liquidity need to be distinguished. First are the owned reserves representing gold and foreign currency which appear as assets on the balance sheets of central banks or that can readily be mobilized by central banks. Second are standby arrangements to borrow foreign currencies when needed, or other well-founded expectations of being able to borrow such currencies.

The adequacy of international liquidity depends in part on the form which it takes. Standby borrowing arrangements do not appear on the balance sheet of the central bank and therefore do not have the psychologically calming influence of owned reserves. Moreover, borrowing arrangements are rarely without restrictive conditions, and these conditions make them less satisfactory than owned reserves. In a sense it might be said that an adequate amount of international liquidity for purpose of meeting balance-of-payments swings is what central bankers consider to be adequate. Probably a smaller amount of owned reserves would be considered adequate than of standby arrangements to borrow, especially if the latter were subject to conditions.

Central bankers also may prefer gold to foreign exchange as part of their international reserves. That preference of course constitutes part of the liquidity problem of the United States as international banker. The nature of gold as an international reserve is often mis-

understood. All international reserves in the last analysis are based on credit, as is the case with national currencies. Gold may seem to constitute an exception and in part it does, but only to the extent that its value rests on demand for industrial purposes. The remainder of the value of gold, which I would suppose is the major part, rests on the promise of the U.S. Government to pay dollars, which likewise are promises, at a fixed rate, and on the expectation that other governments will follow suit. Gold as an international reserve thus rests in large part on the explicit or implict promises of many nations. Any increase in the price of gold would rest entirely on such promises. Aside from being anonymously negotiable, gold seems to fall basically in the same category as the promises of a supercentral bank underwritten by all the important trading and financial nations.

### WHEN IS LIQUIDITY ADEQUATE?

The determination of how much international liquidity is adequate is thus in part a question of the form it takes. In part also it is a question of how large and violent the balance-of-payments swings are likely to be, and in part a question of attitudes toward the responsibility of government to take such steps as may be necessary to end the imbalance.

Let us take this last point first. The pre-World War I gold standard envisioned prompt elimination of balance-of-payments deficits. It relied on automatic forces working on the money supply to bring about deflation in the deficit country and inflation in the surplus country, in the absence of even more prompt or anticipatory application of governmental measures to the same end. A number of European economists and bankers, and at least a few Americans, maintain that this is the correct and desirable policy today. If this policy were promptly and vigorously applied to all countries, a much smaller volume of international liquidity could be considered adequate than if countries postponed corrective action or took only mild steps in the belief that seasonal, cyclical, and other factors would in due course correct the imbalance. Obviously, the larger the swings that a country wishes to prepare itself against or that are permitted to develop, the larger the amount of international liquidity necessary for "adequacy."

The rather substantial differences of opinion on the responsibilities of governments in dealing with balance of payments disequilibriums stem in part from differences in expectations regarding the self-correcting character of deficits and surpluses. Repetitive seasonal imbalances should not call for corrective action at all. Liquidity should be sufficient to avoid any interference from such imbalances with domestic or international economic policies.

In principle, the same might be said of cyclical imbalances to the extent that they are genuine, measurable cyclical swings that repeat themselves more or less predictably over time. The concept of the business cycle as a normal phenomenon of business that corrects itself automatically is not as widely held as it once was and many economists no doubt would deny its existence entirely.

In any event, whatever genuine cyclical movement there may be in business is complicated by secular trends and structural changes that

are cumulative and not compensatory in character. The extent of secular trends and structural changes often cannot be determined or at any rate measured until after they have occurred. Judging currently what part of a downward movement is genuinely cyclical and what part is structural gives rise to wide differences of opinion. Obviously, if adverse structural changes are not recognized and action taken to offset their effect on international equilibrium, international reserves and borrowing power available to a country may be exhausted before an adjustment is made. Drastic measures may then be necessary that interfere with the flow of trade and with domestic policy. The clearest examples are presented by the less-developed countries, which have such chronic tendencies to deficits in their balance of payments that expanded liquidity tends to wind up as foreign aid rather than in meeting swings.

It must be said that the lip service often paid to prompt and vigorous action on the part of deficit and surplus countries to restore international balance is by no means commonly followed in practice. The surplus countries are pleased to see their reserves increase, at least up to a point, but take internal measures to prevent as far as possible this expansion from resulting in the internal inflation that would operate to correct the international imbalance. The deficit countries, at least with respect to deficits arising from trade, are likely to replace through monetary policy the funds which have been lost as a result of the deficit, and thus the deflationary influences are prevented from operating. The result is that adequacy of international liquidity means larger reserves and accessibility to credit than would be the case under the ideal possibilities of the system.

The adequacy of liquidity in meeting balance-of-payments swings depends heavily on the magnitudes of the swings. One important factor affecting their magnitude is the growth in international trade. The relevant question is: What is the relation between the growth of trade and the magnitudes of the balance-of-payments swings that must be provided for through international liquidity. To the extent that the growth in the dollar volume of international trade was a reflection of rising prices of export commodities the swings might be expected to increase proportionately to the growth of trade, or perhaps even more than proportionately, in case the inflationary price movements took place at different times or to different degrees in different countries.

Growth in the physical quantity of international trade might in itself be expected to increase the size of the balance-of-payments swings by somewhat less than the rate of the growth of trade. The fact that more items were traded in larger quantities would tend both to reflect greater international stability and promote such stability. However, this result is by no means assured. A great deal would depend on the source of the increased trade.

The economic development and industrialization of less developed countries, the as yet undetermined impact of the European Common Market on trade among members of the six and with outside countries, the unknown potential of other possible Common Market arrangements, the apparently determined effort of the Soviet bloc to expand trade in competition with Western industrial countries, and the increased rapidity of technological change; all are factors that tend to shift international trade patterns.

Shifts in trade patterns necessitate adjustments of production patterns also—and such adjustments tend to be delayed until made necessary by international disequilibrium. For these reasons there would seem to be little cause for optimism that future growth of trade will be accompanied by a less than proportionate increase in the magnitude of international swings on the trade side, although the effect of the factors mentioned should perhaps be considered separately from the effects of the growth in the quantity of trade.

Still another factor that affects the adequacy of international liquidity is the extension of convertibility of currencies to additional countries. The use of exchange controls, import quotas, and other control devices often is necessitated by the lack of international liquidity and in a sense are a substitute for reserves and international borrowing. Full convertibility of currencies would mean an end of these control devices and accordingly an increase in the amount of international liquidity required to meet swings in balance-of-payments deficits and surpluses.

The adequacy of international liquidity is not determined by the size of reserves and access to borrowing that would be needed if all currencies were fully convertible because there is no prospect that some countries will achieve such convertibility at least in the near future. Liquid reserves would be wasted on countries with built-in chronic tendencies to deficits in their balance of payments. The provision of capital for underdeveloped countries is not the same thing as international liquidity to meet swings.

The same line of thought leads to the conclusion that the introduction of controls over capital movements, for example, reduces the amount of liquidity required for adequacy. Opinions differ on the relative desirability of trying to meet all capital movements out of reserves instead of restricting the movement through exchange controls or otherwise.

A decline in international political tensions and an increase in international political stability would decrease the need for international liquidity to meet speculative capital movements, and would tend to increase reserves by encouraging the dishoarding of gold. Cooperative arrangements among central banks, such as have been developed, also tend to reduce speculative movements and thereby, also, the need for international liquidity to meet swings from this source.

## FINANCING INTERNATIONAL TRADE

A somewhat different concept of international liquidity relates it to the need of funds for financing international trade and other international transactions. This need really breaks down into two parts. One part is the need for foreign exchange. This is an element in the problem of balance-of-payments swings which was previously considered. No matter how large the volume of trade the need for foreign exchange presents only "fractional" problems as long as inpayments and outpayments are equal. It is the deficits in the balance of payments that give rise to shortages of foreign exchange to finance international trade.

The second part of the problem of the financing of international trade is the general credit problem of supplying funds to carry the exporter or importer from the time the goods are produced or shipped

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until the time they are sold to the final user and collection made. These funds, of course, may be supplied by banks in one country to borrowers in another country; this is a form of short-term investment already noted.

For the rest, any amount of international trade can be financed out of domestic liquidity. Given the availability of spot foreign exchange, either the bank of the exporter can finance him in his currency while he awaits payment from the importer, or the bank of the importer can finance the importer, enabling him to pay immediately. If there is an adequate volume of domestic liquidity both domestic production and trade and foreign trade can and undoubtedly will be financed. In this respect, any inadequacy of "international liquidity" is in reality a shortage of domestic liquidity.

### INTERNATIONAL LIQUIDITY AND DOMESTIC LIQUIDITY

This brings me to the last major concept of adequacy of international liquidity that I recall having seen used in the literature. In a closed economy the money managers can make available as large a volume of bank reserves as they deem to be desirable for the healthy growth of the domestic economy.

In an open economy, however, the expansion of bank reserves in one country, if followed by borrowing for spending or investment, is likely to result in an outflow of part of the money thus brought into being. For one thing, some of the increase in purchasing power will be spent on foreign goods. For another thing, the expansion of the available money supply may lead to lower interest rates, which in turn tends to cause an outflow of capital seeking higher rates of return abroad. While the extent to which these two factors would operate depends on many circumstances, it cannot be doubted that the tendencies are present, and that if a country is highly dependent on export and import trade, the amount of the outflow may be very substantial.

This effect of monetary expansion is, of course, one of the factors relied on to bring about an equilibrium in the balance of payments of a country when it finds itself in a deficit position. Obviously, however, a country that is seeking to encourage domestic economic growth finds itself in a difficult position to do so unless other countries also are expanding so that outflows in one direction are matched by reverse flows. But this depends on the willingness of other trading partner countries also to engage in expansionary policies.

Unless this occurs, countries with relatively small international reserves find themselves unable to expand their economies sufficiently to solve their problems of unemployment and to achieve desirable and feasible rates of economic growth without resorting to restrictions on trade and payments. An expansion of the international liquidity available to a country which would permit it to expand internally within the limits of full employment without bringing on a payments crisis has been considered by some commentators, especially in Great Britain, to be a necessary mark of adequacy in international reserves, and since this has not occurred they believe international reserves to be inadequate.

A common monetary policy among important trading countries would reduce and perhaps eliminate the need for international liquid-

ity in this sense, but there is at present little sign of any large degree of international cooperation of this kind.

Without examining in this introductory statement the merits of these various concepts of international liquidity, it may be noted that the choice of concept has a significant bearing on changes to be sought in the international monetary mechanism. The liquidity problem of the United States was brought on by increasing the adequacy of international liquidity for other countries. If our own liquidity is all that concerns us, a rapid improvement in our balance of payments along with interbank cooperation is all that is needed. But such action would not increase and might decrease the international reserves of other countries.

The improvement and elaboration of central bank cooperation could substantially increase the standby credit type of international liquidity and help bring massed resources to meet emergency speculative or other balance-of-payments swings, particularly those arising from capital movements. Cooperation to the extent of making currency swaps for very long periods would increase the volume of owned reserves, although there would always be the psychological restriction coming from the knowledge that the swaps would have to be repaid. The International Monetary Fund, by creating a pool of currencies, has expanded liquidity, and the size of this currency pool could be increased in the future as it has been in the past. A super central bank, of course, could create international reserves through purchasing the securities or other obligations of countries in need of such reserves and setting up deposits in the form of an international currency acceptable to member governments.

## CRITERIA FOR EVALUATING INTERNATIONAL MONETARY PROPOSALS

It may be said that the concept of international liquidity as a method of "buying time" while a country is being restored to international equilibrium, is an essentially static concept. Adding the facilitation of economic growth introduces a dynamic dimension. Considerations of policy should not omit the dynamic dimension of growth, since both population and productivity are rising rapidly in most if not all nations.

With this in mind, the main criteria to be applied to any proposal for improving the international monetary system would seem to be the following:

1. How does it rank (in comparison with alternatives) in providing stability of expectations for those engaged in international trade and investment?
2. How does it rank in facilitating orderly—as distinct from emergency—adjustment of international disequilibrium?
3. How does it rank in facilitating the optimum use of resources from the viewpoints of (a) the nation and (b) the world?
4. How does it rank in facilitating a maximum rate of noninflationary economic growth?
5. How does it rank in maintaining national freedom of action with respect to domestic and foreign economic policies?

To these must be added of course the further questions of how acceptable the proposed change can be made to those political and financial powers that must agree if there is to be any chance of adoption.

It will be noted that one assumption underlying the previous discussion has been that exchange rates would be permanently fixed or at least pegged for long periods of time, with adjustments needing to be made within this framework. International reserve requirements would of course be much smaller with a flexible exchange rate system. Although flexible exchange rates are very satisfying in abstract economic models, especially for economists who have great faith in markets and little faith in governments, there is little reason to believe that they will be adopted as a major element of international monetary arrangements.

This conclusion can be defended on economic, sociological, and political grounds. I will content myself here by suggesting that just as variable exchange rates between New York, Atlanta, New Orleans, Chicago, Denver, and San Francisco would operate to restrict trade and investment within the country, substantial uncertainties about exchange rates between countries are a restraint on international trade and investment. It is a restraint which, I submit, is not consistent with the obvious trend of the economy to become increasingly international with every passing decade.

Thank you.

Representative REUSS. Thank you, Mr. Blough.

Mr. Mundell, would you proceed?

## STATEMENT OF ROBERT MUNDELL, PROFESSOR OF ECONOMICS, McGILL UNIVERSITY, MONTREAL

Mr. MUNDELL. Thank you, Mr. Chairman.

The purpose of liquidity is to finance balance-of-payments deficits. If deficits are corrected quickly not much liquidity is required, but if they are corrected slowly a great deal may be necessary. Liquidity problems arise because adjustment problems are not solved quickly enough.

Representative REUSS. May I interrupt you. You did not read the heading on your paper, which I think is very nice, "The Gold Herring." That should be shared with all of us.

Mr. MUNDELL. The speed of adjustment may itself be influenced by the availability of reserves. A country with no reserves or borrowing power has to adjust immediately, while a country with limitless reserves does not have to adjust at all. This means that an increase in liquidity, which eventually increases the reserves of surplus countries, shifts the burden of adjustment from deficit to surplus countries.

A shift in the burden of adjustment is evidently desirable in certain cases. If there were a worldwide depression the provision of finance to deficit countries would stimulate a desirable expression in the world as a whole. Or if there were a worldwide inflation a restriction of finance to deficit countries would reduce inflationary pressures desirably throughout the world.

Neither of these situations exist today. Since 1958 the surplus industrial countries have experienced inflationary pressures while the deficit industrial countries have been stagnating. An increase in liquidity would shift the burden of adjustment from the United States and accelerate or prolong inflation in Europe.

Would this be desirable? A European economist might well argue as follows:

Since 1958 we have expanded as surplus countries should at considerable inconvenience to ourselves. The money supply has risen by over 50 percent in Germany and over 75 percent in France and Italy, putting upward pressure on prices and unit wage costs far beyond what we prefer or would have allowed on domestic grounds alone. Further expansion would cause us serious future difficulties and it may be that we have already gone too far.

But an American economist might plead an equally good case along the following lines:

Since 1958 we have restricted monetary expansion to less than 10 percent, and inflation to an annual rate of 1 percent, a better record than any other industrial country. In fact, we have deflated so much that our economy is stagnant, over 5.5 percent of our labor force is out of work, and the accumulated loss of GNP since 1958 now amounts to the colossal figure of $200 billion; $40 billion a year for 5 years. We would never have allowed this to happen had our international accounts been in order, and further restriction would be neither in our interest nor the interest of the world economy.

Both these arguments are substantially correct and they indicate that there is no easy way of judging the adequacy of liquidity. They also reveal the enormous cost of current adjustment methods, about which I shall have more to say later. The United States has now about $15 billion in gold, which still represents about 35 percent of the world monetary gold stock. To be sure, quick liabilities are much greater, and the bulk of the gold stock is mortgaged to the gold reserve requirements. Despite this I do not believe that the United States can be said to be short of liquidity. Short-term borrowing abroad has not been exhausted and there remain a few billions in credits that could be forthcoming from the International Monetary Fund. At any time the United States can choose to make a different disposal of its gold stock than to use it to back existing Federal Reserve liabilities, and I think it would be a wrong principle to revise the international payments system because the United States chooses to continue the fiction of an artificial gold bullion standard. (I am speaking of the 25 percent reserve requirement.)

The argument is often made, however, that when the U.S. deficit is corrected other countries will be starved for liquidity. I find this argument also difficult to accept. Other countries can be starved for liquidity only when they run deficits, but continental Europe alone has over $20 billion in reserve assets, not counting drawing rights on the Fund. Whether this will be adequate or not depends on how rapidly the adjustment mechanism will work in the future and whether and how rapidly the United States will be willing to inflate when the U.S. accounts turn into a surplus. I personally have no way of predicting the United States willingness to inflate 3 years from now, and I cannot, therefore, predict the ultimate amount of financing that continental Europe will require.

Because I cannot predict the United States willingness to inflate when the U.S. accounts are in surplus 3 years from now I cannot tell whether there is likely to be a liquidity shortage at that time.

Senator MILLER. Would you mind reading that statement again where you started? Perhaps you have an insert that I do not have.

Mr. MUNDELL. This is in a hypothetical situation, but I think it is not unreasonable that if there is a liquidity shortage in the future, it has to be borne by deficit countries. The deficit countries at that time might be typically European countries, which means that the United States, if the other countries are not in balance, would have to be in surplus. The United States would have to be in surplus at that time if the rest of the world was in serious deficit. In that case, there is an existing adjustment mechanism, which is that the surplus countries inflate and the deficit countries deflate.

Senator MILLER. I understand. I thought you had added something in there.

Mr. MUNDELL. I think I did slip in there "when the U.S. accounts are in surplus."

Senator MILLER. I was wondering if you intended "when" or "if."

Mr. MUNDELL. I could replace "when" with "if." If the Europeans have a liquidity shortage, it will have to have come about because the U.S. accounts are in surplus.

Senator MILLER. I understand.

Mr. MUNDELL. Fortunately there already exists a mechanism for expanding liquidity through the International Monetary Fund which makes it unnecessary for me to make that prediction. The Fund produces a special kind of liquidity. Since drawings on the Fund have to be both approved and repaid, they are most closely analogous to the lender-of-last-resort borrowings from central banks. Because of this characteristic of Fund drawings and the amount of discretion that rests with the Executive Board, it is preferable to err on the side of expansion of increasing quotas. But instead of increasing quotas by a lump sum every 5 or 10 years I would prefer a quinquennial increase of about 50 percent, 10 percent of which should come into effect each year.

I do not, however, wish to imply that the liquidity problem is as important as the need for an effective and efficient adjustment mechanism. Increasing liquidity is like papering over the cracks. While I do not believe the wall must be torn down I do think that some replastering is necessary. For we should not forget after the current balance-of-payments cycle is turned, and I might add, "if" to that as a qualification, that its cost by any reckoning will have been enormous, several times the actual deficit itself. Apart from the $200 billion in lost output due to unemployment, not all of which can be attributed to the deficit, there will remain a residue of distortions brought on by the inadequacy of the present system: tied aid, hidden tariffs, and concealed export subsidies, not to speak of the blow to New York as a world capital center as a consequence of the proposed foreign issues tax. That is what foreigners call it, the foreign issues tax. Here it is usually called the interest equalization tax.

At Bretton Woods a system was devised to obviate the need for the inflation-stagnation methods of the gold standard. The IMF was given a liquidity function, expressed in the bag of currencies of which the Fund consists, and an adjustment function giving countries the right, after consultation with the Fund, to alter exchange rates in the event of a fundamental disequilibrium. It is the adjustment function, not the liquidity function, of the IMF that has failed, as the short-run stability of the adjustable-peg mechanism turned into long-run rigid-

ity. The failure of the adjustment mechanism has led us back to the very system which the Bretton Woods Conference was convened to replace. That is, it has led us back to the inflation-stagnation methods of the gold standard. It is therefore ironical that a large part of the financial community has attacked the one feature of the Fund which was successful, its liquidity function, and neglected its basic failure which now lies at the heart of international problems, the failure to implement the adjustable-peg system.

I recognize the many persuasive arguments against the adjustable-peg mechanism and its inherent defects. But the issue cannot be swept under the rug and we cannot pretend that we still have the Bretton Woods system when we do not. If we do not want to implement the adjustable-peg system that has fallen into desuetude, we should replace it with a better alternative, rather than allowing the world community to slip back toward the gold standard rules or a system of creeping controls. Certainly the adjustable-peg mechanism is better than the inflation-stagnation methods that have been used to adjust balances over the past 6 years, a system Keynes characterized as "the most dangerous technique for the maintenance of equilibrium that can possibly be imagined."

It is interesting to note that the same 1936 passage of Keynes was concluded with one of his few optimistic prognostications: "Recently, practical bankers in London have learnt much, and we can almost hope that in Great Britain the technique of bank rate will never be used again to protect the foreign balance in conditions in which it is likely to cause unemployment at home." Unfortunately, this was also one of Keynes' wrong predictions.

We need an adjustment mechanism to replace the adjustable-peg system and its current transmogrification. The solution I offer, which would simultaneously solve any potential liquidity problem, is not a very original one, but I am comforted by the thought that it is probably the right one. I recommend a widening of the buying and selling limits on gold, to not less than 7½ percent on either side of par. This would introduce an indispensable flexibility into the international price mechanism without imposing on countries the burdens of stagnation and domestic inflation. The additional exchange rate flexibility would at the same time provide guidelines for noninflationary monetary policies. I would expect it to be followed by a dismantling of all those devices imposed for purely balance-of-payments reasons, including things like tied aid, interest equalization taxes, hidden export subsidies, quotas, and such things. I would further expect that central bank intervention in markets for foreign currencies could be dispensed with and that the outstanding short-term dollar liabilities to foreign central banks could be reduced. (I should say I want to emphasize again not less than 7.5 percent. I would have no objection to a system which allowed—made a differential between the buying and selling limits of gold at 10 or 12 or 15 or 20 percent, as wide as you like.)

Senator Miller. Mr. Chairman, may I ask a question at that point?

Representative Reuss. Surely.

Senator Miller. I am not sure I understand what you mean by 7.5 percent. Are you talking about 7.5 percent in quantity or in price?

Mr. MUNDELL. No; in terms of price. To take an illustration although the details of this would be a matter for study, the United States could buy gold at $35 an ounce and sell it at $40 an ounce. That would be a little more than 7.5 percent.

Senator MILLER. Could it buy at $40 an ounce?

Mr. MUNDELL. I would not like that system. I would prefer buying and selling only at margins; but it would not be impossible to allow some central bank intervention between them. There would be no point in buying at $40. You may want to sell some gold before you got to a $40 upper margin.

Senator MILLER. You would advocate permitting the United States to buy at $35 an ounce or up to 7.5 percent in excess of that?

Mr. MUNDELL. Depending on what you took as the par value. If you took $35, which is the existing par value, 7.5 percent on either side of par would mean the lower limit would be something like $32.50, and the upper limit would be something like $37.50. In the current situation, because the U.S. dollar is currently overvalued, you may want to put the central mark at something like $37.50, buy at $35 and sell at $40. Or you may want to buy at $34 and sell at $42 or $41. But the main point is to allow the price of gold to fluctuate so that relative currency prices throughout the world can fluctuate relative to one another.

Senator MILLER. I want to make sure I understand it. Would you also permit buying at $37 and selling at $32.50?

Mr. MUNDELL. I do not understand why a central bank would ever want to do that, but in principle, some kinds of intervention within these limits would be possible.

At the present time, today, other countries buy and sell foreign currencies at rates of three-fourths of a cent above and below par value. They intervene between these limits. They do not restrict themselves to intervene only at the outside limits. I would not find it necessary to intervene in the intermediate range. But in principle, I would not object to it. Many people would believe that some intervention would be desirable.

Senator MILLER. The reason for my question, Professor Mundell, was that in your illustration you talked about buying at the lower figure and selling at the higher figure. I wonder if the reverse would also comply with your recommendation, buying at the higher figure and selling at the lower figure, as conditions warranted.

Mr. MUNDELL. Well, if conditions ever warrant, this would be all right. I am merely saying that I cannot foresee the conditions that would ever warrant it.

Senator MILLER. Thank you.

Mr. MUNDELL. The International Monetary Fund would, in such a system, come into its proper role, that of supervising the adjustment mechanism and providing the short-term international credits that would continue to be desirable. These primary functions, in addition to its secondary, but truly valuable, statistical and consulting services, would amply justify the Fund's continuing existence in its present form.

To conclude, then, the liquidity problem today is a gold herring that distracts attention from the incredible waste associated with a wasteful adjustment mechanism, and from the need to provide more

genuine flexibility to exchange rates. If we look closely at our payments system we see that the emperor does indeed have no clothes and that his nakedness can only be adorned, not covered, by an increase in liquidity.

Representative REUSS. Thank you, Professor Mundell.

Professor Tobin?

## STATEMENT OF JAMES TOBIN, STERLING PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. TOBIN. Every society must agree on a common money. What things will be generally acceptable to the members of the society in settlement of their obligations to one another? Anthropology and history record a remarkable variety of answers to this question: immovable stones, cattle, pieces of metal, cigarettes, pieces of paper.

Representative REUSS. If I may interrupt at this point, the chairman of the Banking and Currency Committee, Wright Patman, once told the Daughters of the American Revolution that at one time in Ireland, beautful young slave girls constituted the medium of exchange. Do you know anything about that?

Mr. TOBIN. No, I do not.

The immovable stones referred to are these large round, millstone shaped objects which I think are used on the island of Yap, which are too heavy for anyone to move. In fact, one of them is invisible, being at the bottom of a pond. But ownership to it is still transferred.

The decisive common property of these and other moneys is evidently not their intrinsic value, because money generally commands more human labor than either its utility to man in consumption or its cost of production would merit. The crucial property is simply the social agreement itself. In any society, A accepts money in payment for goods and services because, and only because, he knows that B will in turn accept money from him in return for things A needs and wants. The reason B accepts money is the same. Thus general acceptability, the essential property of money, is a circular phenomenon: something used as money is generally acceptable because it is generally acceptable. Given the social function which money serves, it is easy to understand why every society, primitive or advanced, reaches a consensus on things that can serve as means of payment. It is not so easy to understand or explain or predict what objects this social consensus will select.

Mr. Patman's example seems to bear that out. In this respect, money is like language—the important thing for a society is to agree on a common language; which language matters much less.

The society of nations, like any other society, needs a common money. Like individuals, the national governments of countries connected by trade and other economic transactions, must agree on what things will be generally acceptable in settlement of their obligations to one another. In particular, in a regime of fixed exchange rates between national currencies, governments must agree on "international money," assets which they will always accept in payment for their own currencies. As in the case of tribes or nations, it matters less what they agree on than that they agree on something. For once again, the important thing is general acceptability. Country X will accept the in-

ternational money in settlement of its claims on country Y because, and only because, X is confident that this money can later be used to discharge debts it may incur to country Z. Given the essential circularity of the process, firm agreement by a handful of major countries is all that is needed to establish the general acceptability of a money in settling balances between national central banks.

The present international moneys are first, gold and second, key national currencies (principally the dollar, but also, within limited groupings of nations, the pound sterling and the French franc.) Gold accounts for roughly two-thirds, and national currencies one-third of national monetary reserves. National central banks have accepted gold and U.S. dollars in payment of their claims on other nations, because they think they will be able to use gold and dollars to discharge their own obligations in future. Gold owes this status largely to historical tradition. But the standing promise of the United States to buy gold for dollars is an assurance to other countries that gold will command goods and services available in the United States. Dollars came to be accepted as international money partly because of the heavy demands of the rest of the world for U.S. products, properties, and securities in the 1940's and early 1950's and partly because of the U.S. commitment to foreign central banks to convert their dollars into gold on demand.

There are difficulties in operating a monetary system with two or more moneys convertible into each other on demand—difficulties exemplified on the one hand by the "dollar shortage" of World War II and the few years following, when the rest of the world preferred dollars to gold and dumped gold into the U.S. Treasury, and, on the other hand, by the reversal of this preference during recent years. I understand you have discussed this instability to which the gold-exchange standard is vulnerable in a previous session.

Two important questions to ask about any kind of money, national or international, are these: (1) How is the supply increased? (2) Who is the initial beneficiary of the increase in supply?

In the case of gold, the growth of the monetary supply depends mainly on new production in the West, and on sales by the Soviet Union. New production outside the Communist bloc evidently cannot increase the monetary gold stock more than 2½ percent per year, even if it all goes into monetary use.

May I interject that the increase in the gold stock of 2.5 percent does not increase the reserve by 2.5 percent per year, because gold is only two-thirds of reserves; so it would be two-thirds of 2.5, or about one and a half or something like that, that we could hope for if gold production would increase the gold stock—the stock of reserves.

Continuation of this rate of production is subject to the hazards of political instability in the Union of South Africa, the major producing country. Soviet gold sales have been running at about $250 million per year, less than 1 percent of the monetary gold stock of the West.

Once again prediction is hazardous. In recent years, nearly half of new gold has gone into private uses and hoards. Private dishoarding could significantly increase the flow of gold into monetary reserves for a few years, provided that those who have been speculating in gold (at considerable sacrifice of income from alternative investment possibilities) become convinced that its price will never be raised.

That is how the gold component of international money gets increased. Now, as to the initial beneficiaries of an increase, they are principally the gold mining countries which are able to buy, with newly mined gold, things that they want—grain, for example—from the rest of the world.

These countries can, in effect, run chronic deficits in their balance of payments, financing them with gold. It is somewhat ironical that the principal beneficiaries of our monetary use of gold are countries whom we would be scarcely be inclined to aid by grants or loans.

The same two questions may be asked about reserve currencies. How do dollars find their way into the monetary reserves of central banks? This happens when Americans, and foreigners who have acquired dollars in transactions with Americans, offer dollars for foreign currency, let us say French francs, in the exchange market.

If not enough private purchasers come forward to buy these dollars, the Bank of France is obliged to step into the breach to keep the franc from appreciating against the dollar. If the Bank of France is content to hold the dollars, rather than to ask for gold, then world monetary reserves have increased; the French hold more international money, and neither the United States nor any other country holds less. Thus it is an excess supply of dollars, stemming from current or past deficits in the U.S. balance of payments, which increases the stock of dollars in world monetary reserves.

Here, however, we have the dilemma to which my colleague, Prof. Robert Triffin, called to the world's attention 5 years ago. It is not possible to increase the supply of reserve currencies beyond some point without endangering the stability of the gold-exchange system. If the reserve-currency country continues in deficit, its demand liabilities rise relative to the gold available to meet them and its creditors become uneasy. But if it succeeds in stemming the flow of its currency to other central banks, then total reserves in this form will cease to grow. Throughout the 1950's, dollar accumulations by foreign central banks were the major source of expansion in world monetary reserves. Some time around 1959 or 1960, however, dollar deficits ceased to expand the effective supply of world liquidity. This is not because the deficits ceased, but because the United States had to begin to worry about its liabilities to foreign central banks, in effect to reckon its own monetary gold reserves not of these liabilities. It was no longer true that accumulation of dollars abroad left U.S. reserves unchanged. Once this revolution in attitudes had occurred, the reserve-currency mechanism for increasing the effective supply of international money ceased to function.

It still functions statistically, but I do not think it functions really in effect.

Representative REUSS. By this you mean that for every dollar translated into francs and held as a dollar by the French Central Bank, an equivalent dollar is subtracted in somebody's mind from our gold stock because they claim the mortgage is increased by that much?

Mr. TOBIN. Exactly.

Under the reserve currency system properly functioning, the initial beneficiary of an increase in the supply of international money is obviously the reserve currency country itself. It is pleasant to have a mint or printing press in one's backyard, and the gold exchange standard gave us, no less than South Africa, this privilege. We were able

to run deficits in our balance of payments for 10 years because our I O U's were generally acceptable as money. No one worried about those deficits. They did not appear to be a problem until the acceptability of the money we were "printing" to finance them came into question.

The United States need not apologize for the manner in which we used the privilege of coining international money. We did not use it to live beyond our means, or to promote purely American interests. We did not use it to go on a binge of inflation, contaminating the rest of the world. We used it for international purposes—for the common defense, for development assistance, for long-term investments in capital-hungry economies all over the world.

Nevertheless, we must recognize, I think, that we have come near the end of this particular road. We no longer own a printing press for international money. Whatever technique the major countries may now develop for the creation of new international money will be more symmetrical as between nations. The privilege of putting new money into international circulation will be shared, rather than concentrated on one country. It is important that the international responsibilities which the United States has associated with this privilege be shared as well.

I have spoken so far of the prospects for expansion in the supplies of the two kinds of international money which dominate the present system. Clearly, the prospective expansion of effective monetary gold and dollar reserves does not match the growth in trade and production which we expect and hope. While world trade and international transactions grow at perhaps 5 or 6 percent per year, gold will probably be adding less than 2 percent per year to the stock of reserves and dollars effectively nothing at all.

I do not regard this comparison as conclusive proof of an impending shortage of liquidity, because the aggregate demand of central banks and governments for international monetary reserves is only loosely related to the growth of the world economy. I do not happen to believe in a mechanical connection between economic activity and money on a national level, and certainly not on an international plane either. And it is quite possible that ways will be found to economize international money. Nevertheless, I think there is a considerable risk that there will be, if there is not already, a shortage of international money under present international monetary arrangements.

Why does a country need international reserves? The principal reason is this: In a regime of fixed exchange rates, a country is obliged to buy its own currency in the foreign exchange markets to keep its exchange rate from falling. (Under the Bretton Woods system a country must keep the rate within 1 percent of the officially declared parity.) The government or central bank must be prepared to buy its own currency with foreign currencies. The country's monetary reserves either provide it directly with foreign currency to sell—e.g., when the reserves are in dollars—or provide it with the means of obtaining the needed currency from other governments—as when the reserves are in gold. When a country is in balance-of-payments deficit the demand for its currency is less than the supply at the fixed rate of exchange. The government or central bank has to make up the difference. Therefore, the quantity of reserves a country needs, or believes

it needs, depends on the size and duration of the deficits in its balance of payments that it may have to finance.

If international payments were always perfectly balanced, there would be no need for international reserves. But if there are large swings of long duration in payments balances, then countries need large reserves in order to finance them. Therefore, to appraise the need for international reserves, it is necessary to consider the magnitude of the swings which countries should be prepared to finance. There are two parts to this question. The first concerns the causes of these swings. The second concerns the strength and speed of mechanism, both in the economies of the countries affected and in their policies, which work to correct and reverse imbalances in international payments.

The sources of swings in international payments are numerous and various. Changes in technology and in taste can alter the competitive positions of different nations in trade, and change the relative attractiveness of various areas for capital investment. Political and military events can alter the risks of holding wealth in one country relative to another. Business cycles can be out of phase as between countries. Labor forces and their productivities can grow at different rates. National policies can differ. The list could be extended in great detail.

It may be, as some people hope, that the basic sources of imbalance—now in one direction, now in another—will be less important relative to the size of world trade and the world economy in the next decade than they have been in the past 15 to 20 years. But it would not be prudent to base policy on so optimistic an assumption. This is especially true because we may not yet have experienced the full impact on the mobility of private capital of establishment in 1958 of convertibility between major currencies.

Assuming that imbalances continue to arise, how strong are the policies and mechanisms which can correct and reverse them? The more effective and speedy these policies and mechanisms, the less need there will be for international reserves with which to finance deficits. I cannot go into detail on this difficult question, which I have tried to deal with elsewhere. I refer to my paper entitled, "Economic Progress and the International Monetary System." I submit it for the record.

Representative REUSS. It will be made a part of the record at the end of your oral presentation. (See p. 556.)

Mr. TOBIN. To summarize, I believe that the acceptable policies and mechanisms cannot be expected to correct imbalances very quickly. I underline the word "acceptable," because there are always some expedients often unacceptable, in the sense that they undermine the national and international objectives which it is the very purpose of the international monetary system to promote. Indeed, the major symptom of a shortage of international liquidity would be—and perhaps already is—that countries resort to such expedients.

All the major monetary countries are committed to full employment and to economic growth. If each successive deficit country is forced to retard its economy and to waste its resources in unemployment and excess capacity, in order to conserve its international reserves, then the international monetary system is not promoting but is

obstructing a basic goal of policy. Similarly, the purpose of fixed exchange rates is to promote efficient trade and capital investment across national boundaries. If exchange controls, or special import quotas and duties, or preferences to domestic suppliers, are imposed for balance-of-payments reasons, then once again the servant has become the master—fixed exchange rates are preserved but the purpose of fixing them is sacrificed. If governments have to cut back on programs of great national importance simply because of their costs in foreign currency, they are being forced to adjust to balance-of-payments deficits too fast.

Under the Bretton Woods system, a country may adjust to a "fundamental disequilibrium" by devaluing its currency. But frequent use of this expedient robs the system of the major advantage of fixed exchange rates—that they permit traders and investors to make transactions within and across national boundaries free of the risks of changes in exchange rates. Moreover, changes in exchange parities can be self-defeating from the standpoint of the reserve needs of the system as a whole, because they incite speculative movements of funds between currencies.

There are acceptable mechanisms and policies of adjustment, which do not conflict with more basic economic and political objectives. For example, a deficit country with overfull employment and inflation can remedy both its internal and its external difficulties by more restrictive monetary and fiscal policies. Unfortunately, this case, although it dominates much thinking on this subject, is by no means the only kind of imbalance that occurs. Other kinds of imbalance require difficult, far-reaching, and slow changes in economic structure, during which the deficit country needs enough reserves or credit to defend its exchange parity.

When there is a world shortage of liquidity, the burden of adjustment to imbalance falls disproportionately on the deficit countries. The surplus countries have a much smaller incentive to take actions to arrest or reverse the inflow of reserves. Instead, they are glad to build up their reserve positions against the day when events beyond their control will place them in a deficit position.

It is true that accumulation of monetary reserves is an unprofitable investment for a nation, and beyond some point the country will prefer to use these resources to import goods for domestic consumption or investment and to acquire less liquid but higher yielding foreign assets. But as nations advance in prosperity they can better afford the luxury and security of accumulating reserves. This phenomenon is another reason for expecting the demand for reserves to increase at least as fast as the world economy grows. It is not too difficult to divide the world between (1) countries which live on a hand-to-mouth basis, spending fairly promptly all the foreign exchange they can acquire and (2) countries that accumulate and decumulate reserves as their balance-of-payments fortunes fluctuate. The first category includes the poorer and less developed countries. The second category has been growing in number since the war as national standards of living have improved.

The "right" amount of aggregate international liquidity would give surplus countries as great an incentive to take actions to stem the inflow of reserves as deficit countries have to stem the outflow. The

burden of adjustment to payments imbalances would be symmetrically shared. It is in this sense—that the burden falls disproportionately on deficit countries and forces them to take undesirable measures—that there is today and may well be tomorrow a shortage of international liquidity.

An excess of liquidity is conceivable. The symptoms would be the opposite of those of a shortage. Surplus countries would feel a disproportionate pressure to adjust—for example, by lowering interest rates, acquiescing in inflation, appreciating their currencies, or spending foreign currencies freely on government programs. Deficit countries would be too free of discipline. This is not an immediate danger. But it is a reason for making sure that the creation of international money is under control, whatever form it takes, so that the supply does not outrun the demand.

Evidently there is good reason to believe (1) that the effective supplies of principal kinds of international money—gold and official dollar balances—cannot keep pace with world trade and production, and (2) that demands for international liquidity will grow at least as fast as the world economy. Moreover, it is by no means clear that the supplies are even today adequate. How can this gap be filled?

I referred earlier to the possibility that the major monetary countries can find ways to use international money more efficiently. International liquidity is a broader concept than international money. It includes facilities for the granting of credit from one country, or group of countries, to another. To the extent that deficit countries can count on receiving such credit, they have less need for reserves.

In the past 3 years an impressive network of lines of credit between governments and central banks has been constructed, thanks in large part to the initiative and imagination of the U.S. Treasury and the Federal Reserve System. These new arrangements have considerably strengthened the hands of the participating countries in dealing with temporary swings from one currency to another due to speculation of other quickly reversible causes.

But credit facilities are an imperfect substitute for reserves. They generally provide liquidity conditional on the consent of the lenders, while owned reserves provide unconditional liquidity. Lenders are, after all, "in the driver's seat." They may refuse to grant credit or to extend it, or they may require as a condition the adoption of certain policies by the borrowing country. Anticipating this, a country may well seek to acquire unconditional reserves just so that it will not have to ask for credit when its currency is under pressure.

Consequently the liquidity gap will, in my opinion, have to be filled at least in part by new species of international money. The liabilities of the International Monetary Fund are an obvious candidate. Member countries now have virtually unconditional rights to draw certain amounts from the Fund in convertible currencies. (They also have conditional lines of credit for additional amounts.) These automatic drawing rights should be regarded as international reserves. There are various devices by which they could (*a*) be made more easily transferable from one country to another, and (*b*) be systematically and gradually increased in total amount. These devices do not require radical or abrupt changes in the IMF or other existing institutions.

They would lead eventually to an international money whose supply would be under international control, not subject to the vagaries of gold production and gold hoarding or to fluctuations in the payments positions of reserve-currency countries. The initial disposition of newly created IMF drawing rights could be shared in an agreed and equitable manner among the members, not concentrated in gold-mining or reserve-currency countries.

The problem is important. If the major monetary countries have the will to solve it, the technical means are not hard to find.

Representative REUSS. Thank you, Professor Tobin.

Your paper, "Economic Progress and the International Monetary System," will be placed in the record at this point.

(The paper is as follows:)

## ECONOMIC PROGRESS AND THE INTERNATIONAL MONETARY SYSTEM

(An address before the Academy of Political Science, May 8, 1963)

By James Tobin, Sterling professor of economics, Yale University

The topic assigned in the program is, as the chairman says, a very challenging topic—so challenging I have had to redefine it. I am going to take off from the last few paragraphs of Mr. Lary's paper and discuss the mechanisms of adjustment in a regime of stable exchange rates. In the process, I will be discussing the conflicts between external and domestic balance, and the possible ways of resolving them. But I am going to talk more about the world monetary system as a whole, I am afraid, than about current U.S. problems and policies in particular.

A great teacher of mine, Prof. Joseph Schumpeter, used to find puzzling irony in the fact that devotees of the free market were unwilling to let the market determine the prices of foreign currencies, and that opponents of Government support of the price of wheat were strongly committed to Government support of the price of gold. Thanks to the Bretton Woods Agreement of 1944, the Western World is committed to a system of fixed—or nearly fixed—rates of exchange among currencies and between currencies and gold. Market exchange rates are kept within 1 percent of official parities, as declared to the International Monetary Fund, by governmental purchases and sales in the exchange markets. Since the major currencies of North America and Western Europe can now (for all practical purposes) be freely bought and sold, one for another, considerable official intervention may at times be necessary to prevent a currency in high demand from appreciating more than the allowed 1 percent, or to prevent a currency under selling pressure from depreciating beyond the permitted margin.

This is where international reserves come in. The international reserves of a country are essentially the resources it can quickly mobilize, in gold and foreign currency, in order to buy its own currency and prevent it from depreciating. Clearly the need for international reserves is very largely a property of the system of fixed exchange rates. If countries were willing to entrust exchange rates entirely to private markets and to accept whatever gyrations in exchange rates might occur, they would have no use for international reserves. There would be, by definition, no international balance-of-payments problems and no need for international money to move from the country in "deficit" to the country in "surplus." Instead the exchange rate would move—in favor of the country which would otherwise be in surplus—enough to bring market supplies and demands for the currencies into balance.

I do not propose to discuss today the merits of a system of market-determined flexible exchange rates as compared to the Bretton Woods system of fixed rates to which we are now committed. I propose rather to discuss the workability of the system we have.

Its workability depends essentially on two things: (1) The availability of international reserves permitting deficit countries to defend their exchange rates, and (2) the efficacy and speed of those corrective mechanisms which arrest and reverse flows of reserves from country to country. If the corrective mechanisms are strong and fast, the system can operate with small total reserves. If they are weak and slow, the system requires large reserves.

I shall discuss below the principal mechanisms that might be used to correct imbalances in international payments today, and I shall consider the limitations on their effectiveness or acceptability. But before getting to the specific list, I would like to offer four general observations on the process of international financial adjustment.

I

First, corrective mechanisms may be classified, in principle at least, into two groups: automatic and discretionary. Automatic mechanisms are economic processes that come into play as a result of imbalances in currency markets or as a byproduct of the factors creating the imbalances. Discretionary mechanisms are policy actions taken by the governments concerned, designed to arrest or reverse outflows or inflows of reserves. The distinction is worth making, even though most of the automatic mechanisms are also discretionary, in the sense that government policy can moderate or suspend their operation.

Second, the mechanisms, automatic or discretionary, set into operation by payments deficits and surpluses are not necessarily or always corrective. They may aggravate, rather than correct, the initial disequilibrium. Economists are fond of self-correcting mechanisms. But we are far from having proved that a stable equilibrium in international payments exists, or that if it does exist it is speedily reached. We know, in fact, that some of the natural reactions of economies and of government policymakers to disequilibrium may be destabilizing rather than stabilizing. I give a possible example below in discussing domestic deflation as a reaction to balance-of-payments deficits.

Third, pressures to take discretionary actions to correct imbalances are more keenly felt by deficit than by surplus countries. A country in deficit is forced to take action no later than when it exhausts its reserves and lines of credit. A country in surplus is under no corresponding compulsion. Indeed as a lender, a surplus country is in the driver's seat, able to exact adjustments by the deficit country as a condition of extending credit. Yet the appropriate corrections may involve adjustments at least as great in the economy and policy of the surplus country. One piece of financial ideology which obscures a dispassionate assessment of responsibilities for adjustment is the common and facile assumption that balance-of-payments surpluses reflect financial virtue while deficits are the natural penalty for profligacy and sin. Often, no doubt, this judgment is justified. But sometimes the reverse is true. And most often, perhaps, serious imbalances of payments are the result of basic economic, political, or even military events and trends; they reflect neither credit nor blame on either creditor or debtor.

The chief sanction inducing action by a surplus country is its awareness that balance-of-payments success is a transient glory, that someday it, too, will sit in the debtor's chair. This reflection leads countries to grope collectively for some "rules of the game," which prescribe the behavior expected of good creditors as well as good debtors. The "rules of the game" are unwritten, informal, and uncertain. They are still in the process of development for the present monetary system of the West—evolving from gradual accumulation of precedents as well as from explicit consultations between governments. These consultations take various forms, including discussions in the OECD, the Bank for International Settlements, and the International Monetary Fund.

The fourth point is the most fundamental. International monetary arrangements are not ends in themselves. They are means to more basic ends. Their ultimate purpose is to promote the economic progress of the free world, facilitating international commerce and the efficient use of the world's productive resources. In particular, the rationale of the Bretton Woods system is that stability of exchange rates eliminates a risk which would otherwise impede economically justified flows of goods and services and capital across national boundaries. It is essential not to lose sight of the basic objective and basic rationale of the system in appraising its various mechanisms of adjustment. The "rules of the game" should not force or even permit countries to defend their exchange rates by means which are inconsistent with the whole purpose of the system; that is, by measures which retard world economic growth or restrict efficient movements of goods and services and capital.

In examining below the principal mechanisms of adjustment to imbalances in international payments, I shall ask in each case how effectively and speedily the mechanism can in today's world be expected to correct imbalances, and also how consistent the mechanism is with the essential objective and rationale of the system. I will anticipate the conclusion I draw from this survey. The system

does contain some effective and acceptable corrective mechanisms, but these certainly cannot be relied upon to operate quickly and powerfully. Major imbalances are likely to take years to eliminate, unless they are corrected by measures which hamper economic growth or restrict world commerce. Consequently, in my opinion, successful operation of the Bretton Woods system requires an adequate and growing stock of international liquidity, permitting countries to ride out prolonged periods of deficit.

In stating this conclusion, I run squarely into the debate between those who say the trouble with the international monetary system at present is lack of liquidity and those who say, on the contrary, that the trouble is simply the existing imbalances in payments. Certainly we have troubles on both counts. I want nothing I say to be interpreted to mean that any country, even the United States, is able or should be able to run balance-of-payments deficits forever. No country can do so unless it possess the "printing press" for creating international money, whether this "printing press" takes the form of inexhaustible gold mines or of some more rational and less costly equivalent. And no one country should possess such a printing press; this is a function which ought to be internationalized, for the same reasons that have led governments to nationalize the power of creating domestic money.

However, I do not find convincing the observation, so frequently repeated, that international liquidity would be ample if the system were only in balance-of-payments equilibrium. True enough, if we were always in equilibrium no reserves would be needed. But this is asking a great deal of the adjustment mechanisms. Every major imbalance may seem to be the last—if we can only remedy this one, the system will have smooth sailing from now on. But the dollar shortage is succeeded by the dollar problem; Korea is followed by Suez, and Suez by Berlin and Cuba; the seemingly endless exchange troubles of France give way to an apparently chronic French surplus. The causes of imbalances are many—technological, economic, military, political. The only thing we can be sure of is that these causes will not all disappear, and that they will frequently represent and require deep-seated structural changes. If we are to weather the readjustments they impose within a system of fixed exchange rates, we will need both a large supply of international money in the future and improved international procedures for regulating this supply.

The details of such procedures are not part of my subject today. Let me say only that the technical details are, in my opinion, distinctly secondary in importance and in difficulty to an understanding of the problem and a concerted will to resolve it. No more important aspect of international economic cooperation confronts the governments of the major advanced countries. If they do not solve it successfully and soon, then the Bretton Woods system will be a barrier rather than an avenue to economic progress and will eventually give way.

## II

What are the mechanisms which correct imbalances in payments between countries in a regime of fixed exchange rates? What limitations on their use are imposed by other national and international objectives? How well and how fast can we expect the appropriate mechanisms to operate in the modern world?

### CHANGES IN THE EMPLOYMENT OF LABOR AND INDUSTRIAL CAPACITY

I refer here to short-run changes in different countries in levels of real income and employment, and correspondingly in the utilization of industrial capacity. These changes—the kind under discussion in the morning session—result mainly from variations in aggregate demand. An increased trade deficit—say, from a fall in export sales—automatically lowers aggregate demand both directly and indirectly through its "multiplier" effects on domestic incomes and expenditures. A reduction in aggregate demand lowers imports and frees domestic capacity to compete for foreign orders. Thus a rise in the trade deficit tends to be self-correcting. But it cannot be completely self-correcting, for reasons well known in multiplier theory. If the trade balance is to be restored by reduction of aggregate demand, government fiscal and monetary policy must be actively restrictive.

All advanced countries are committed, almost without regard to political party, to full employment. Our friends in Western Europe are even more committed than we of North America. Deliberate deflation of aggregate demand, creating unemployment and excess capacity, is not a method of adjustment con-

sistent with these commitments. Indeed, we must count it as a serious defect of our present system that countries where resources are idle for lack of effective demand, where no inflationary price increases are occurring, should feel themselves under pressure to adopt deflationary measures or to refrain from expansionary measures. For after all, the purpose of our economies is production; the purpose of international monetary arrangements is to promote the efficient use of productive resources; and the wastes of unemployment and unused capacity are the greatest of inefficiencies Canada, faced by an exchange crisis last year, felt it necessary to take deflationary fiscal and monetary measures at a time when its internal economic situation indicated the contrary. The United States has for several years felt itself compelled to follow monetary, and perhaps fiscal, policies inappropriate to the need for domestic expansion.

The usefulness of this mechanism is, therefore, doubtful because of the priority of the objective of full employment and full production. But in any case it is far from clear that the mechanism always corrects, rather than aggravates, the imbalance which sets it in motion. No doubt it tends to correct the balance of trade. But in the process it may (as I think Mr. Lary suggested) turn the balance of capital movements in the opposite and perverse direction. This is because profit performance and prospects, so important in the geographical placement of direct corporate investment and purchases of equities, are very sensitive to the level of business activity and utilization of capacity. I personally suspect that the failure of the U.S. economy to achieve full employment and full use of capacity over the past 5 years has lost us more in direct and equity investment capital outflow than it has gained us in the balance of trade.

### CHANGES IN PRICE LEVELS

Price increases in surplus countries, and price declines in deficit countries, are, of course, the classic mechanism of adjustment of the trade balance. These price level adjustments are closely related to the movement of real economic activity just discussed; and they are set in motion by the same reactions of the economy and of government fiscal and monetary policy to external imbalance. However, this mechanism too has its limitations.

First, price deflation is simply not a realistic possibility in modern industrial economies, and has not been for several decades. For a number of reasons, wages and prices are not flexible downward. Deflationary stimuli, whether from the trade balance itself or from government policy, will be reflected in reduction of employment and output for more than in reduction of prices. And for the reason suggested above, contraction of real economic activity may not be favorable to the balance of payments as a whole.

Second, our countries seek stability of their internal price levels as well as full employment. Surplus countries are certainly not willing to undergo rapid and drastic inflation in order to draw in imports and damage the competitive position of their export industries.

This does not mean, fortunately, that price levels can be or need to be absolutely frozen in every country. We know that European money wages and prices have been rising in recent years somewhat faster than employment costs and prices in North America. This divergence in price trends will in time contribute to the correction of European surpluses and American deficits. But the process does take time, because European governments will not tolerate more than a modest upward creep in their price levels.

Governmental wage, price, and "incomes" policies can encourage this type of adjustment if they are applied less severely in surplus countries than in deficit countries. But at present our countries differ widely in the ability and disposition of the government to enforce such policies, whether by law or by persuasion.

### CHANGES IN MONETARY POLICY AND INTEREST RATES

Most national monetary systems, including our own, are geared to international reserves in such a way that domestic money is created to purchase inflowing gold and foreign currency, and domestic money is destroyed when gold and foreign exchange are sold. If the authorities do not offset these transactions by other monetary measures, monetary conditions become easier and interest rates tend to fall in a surplus country, while the reverse is happening in a deficit country. The response of internationally mobile private funds to these changes in credit conditions and interest rates is a corrective mechanism, and sometimes a very powerful one. It may be reinforced by the further effects of these monetary changes on domestic aggregate demand.

But this mechanism too has its limitations.

First, the reallocation of private funds between national currencies is largely a one-time operation. The flow induced by a given interest rate differential will taper off. A country cannot expect to cover a basic deficit on current or long-term investment account indefinitely by attracting short-term money, unless it is prepared to jack its interest rates higher and higher.

Second, and more important, every country has domestic as well as external objectives for monetary policy. In many circumstances these will coincide, as when a country confronts simultaneously inflation at home and a deficit abroad. In other circumstances, like those of the United States today, the objectives diverge. Restrictive monetary policy would hold private funds here, but it would be generally deflationary. Correspondingly, a European surplus country could diminish its surplus by lower interest rates, but only at some risk of domestic inflation.

There are two ways in which the conflict between these objectives might be diminished. One is to dedicate monetary instruments to external balance, relying on fiscal measures for internal stabilization. This is a prescription which has been mentioned several times today. Many Europeans have been urging the United States to tighten monetary policy, and to pursue a fiscal policy sufficiently expansionary to restore full employment even in the face of higher interest rates and tighter credit conditions. Correspondingly, European governments can be urged to combat whatever domestic inflationary problems they face by tighter budgets, while pursuing easier monetary policies in the interests of international balance.

The trouble is that there are in every country constraints, both economic and political, on the mixtures of monetary and fiscal medicine which can be administered. The proposed U.S. tax reduction looks to be about the largest dose of fiscal stimulant that is politically palatable in the United States. Moreover, domestic economic objectives going beyond full employment and countercyclical stabilization can limit the acceptable mixtures. For example, if we in this country place a high priority on private investment to promote longrun economic growth, we will not wish to suppress investment demand by tight money and high interest rates even if we could wholly compensate such restriction of demand by fiscal measures favoring consumption. Indeed we cannot even be sure that an "easy budget tight money" mixture will benefit the balance of payments in the long run. For improvement in our trade balance depends on an accelerated advance in productivity difficult to achieve in a low-investment economy.

The other way of trying to reconcile the conflicting uses of monetary policy is to devise and to employ techniques of monetary control which serve both masters at once. U.S. monetary authorities and debt managers have for the past 2 or 3 years sought to keep short-term interest rates relatively high while increasing bank reserves and credit availability, and so far as possible lowering long-term interest rates. The assumption of this policy is that short rates are relatively more important for international flows of funds, and bank reserves, credit availability, and long-term rates relatively more important for domestic expansion. The techniques used have been various: (*a*) to increase the supply to the public of Treasury bills and other Federal obligations of maturity less than 1 year, relative to other maturities of public debt; the Federal Reserve has accordingly concentrated its open market purchases in securities of maturity longer than 1 year; (*b*) to reduce bank reserve requirements in order to supply banks with new free reserves without open market purchases; and (*c*) to raise interest rates payable on commercial bank time and saving deposits, steering the bulk of the increase in bank deposits since the end of 1961 into this form rather than into demand accounts and giving the commercial banks an incentive to increase their holdings of mortgages, State and local bonds, and other long-term assets.

These policies have been moderately successful. In 2 years of recovery, short-term rates have risen by about three-quarters of a point. Rates on longer term Federal obligations are virtually unchanged, and other long-term rates have fallen slightly. Conceivably, this kind of policy could be pursued even more consistently and vigorously. For example, the Treasury appears to have acted counter to this policy in its successful efforts to place more of the Federal debt in maturities beyond 10 years. And the Federal Reserve has not aggressively sought long securities to buy, even in weeks when open market purchases were necessary to provide reserves.

Under the best of circumstances, however, these techniques can somewhat reduce but not wholly resolve the dilemma of the monetary and debt management authorities. Short- and long-term interest rates are linked by a chain of substitution which limits the degree to which the differentials between them can be altered. Furthermore, short rates are of some importance to domestic expansion, as well as to international capital flows; and long rates are of considerable relevance to international capital flows as well as to domestic business activity. The policy we have been following is a good compromise, but it is at best a compromise.

We cannot escape the fact that in a regime of convertible currencies the money and capital markets of different countries are closely linked. This means that countries have less scope for independent monetary policies than in the past. But we cannot escape, either, the fact that national monetary policies must be adapted to domestic circumstances, needs, and objectives which differ widely from country to country. In my view the major monetary powers will have to concert their monetary policies, through international consultation and cooperation, more than they have done in the past. If interest rates need to be brought into closer alinement, at what level should the alinement occur? Do the countries with high interest rates need to come down, or the countries with low rates go up? This is the kind of problem which has to be laid on the table when government officials and central bankers meet at Paris or Basle or Washington. At the same time, I am convinced that our international monetary arrangements must leave room for divergences in national monetary policies and interest rates to accommodate differences in domestic requirements. In many cases it will be easier for the central banks and governments concerned to offset private capital flows by official movements in the other direction than to adjust national monetary policies so as to shut off these flows altogether.

RESTRICTIONS ON PRIVATE TRANSACTIONS IN FOREIGN EXCHANGE

An instinctive reaction of a government to a balance-of-payments deficit is to restrict private transactions leading to purchases of foreign currency. The devices are too numerous to catalog—the spectrum ranges from higher tariffs to a complete battery of exchange controls and includes import quotas, controls of capital movements, and restrictions on foreign travel. Needless to say, these expedients undermine the central purpose of a system of fixed exchange rates, to facilitate the international exchange of goods and services and the efficient use of productive resources throughout the world. Moreover, the prospect that countries will resort to these devices in times of balance-of-payments stress imposes on foreign commerce and foreign investment risks comparable to the risks of exchange depreciation. Once again we have, therefore, a clear danger of inverting ends and means. Exchange parities may be defended, but by means which subvert the whole purpose of defending them.

From this standpoint, recent actions of countries facing exchange crises are not altogether encouraging. Canada imposed in 1962 special import surcharges, which are only now being removed. The United Kingdom in 1961 tightened its controls over long-term capital exports. We ourselves have cut down the duty-free import allowances for returning tourists.

On the other hand, removal or liberalization of restrictions by surplus countries serves both to remedy imbalances in payments and to promote the basic objectives of the system. Indeed, so long as this course is open to surplus countries, one is not disposed to sympathize with their complaint that the deficit countries are forcing inflation upon them. The United States stands ready to supply Europe cheap food. It is, of course, a great achievement that the tight network of quantitative controls and bilateral trade and clearing agreements which governed European commerce in the days of dollar shortage has now been largely dismantled. But some discrimination against U.S. goods remains, and the Common Market confronts us with new discriminations, especially in the important field of agriculture. European capital markets are, by and large, either controlled or poorly developed or both. Most governments other than the United States still regard control of private capital movements as a legitimate tool of balance-of-payments policy.

GOVERNMENT TRANSACTIONS

Largely because of foreign aid, foreign lending, and defense, Government outlays and receipts now play a large role in international payments. They are obvious candidates for adjustment wherever a government faces a problem of imbalance. The principal reaction of the United States to its persistent deficit has been to economize on the Government account: tying foreign aid to purchases in the United States, increasing the preference given to American suppliers in defense procurement, cutting back outlays for and by U.S. troops stationed abroad, and negotiating for greater participation by our NATO allies in expenditures for the common defense. To a much lesser degree—reflecting the characteristic asymmetry between surplus and deficit countries—European surpluses have led European governments to increase their defense expenditures and their assistance to underdeveloped countries.

In practice the balance of payments has doubtless been the occasion for some economies and readjustments of burdens which were overdue on other grounds. These are certainly welcome. But in principle these methods of adjustment are as objectionable on grounds of economic efficiency as the imposition of discriminatory controls or taxes on private outlays in foreign currency. A dollar of Government outlay in foreign currency should not have to pass a more, or less, severe test than a dollar spent domestically. Nor should a dollar of Government outlay in foreign currency have to pass a test more severe than a dollar of private outlay in foreign currency. One of the paradoxes of our present balance-of-payments difficulties is that stringent economies and controls are placed on Government outlays abroad serving national purposes of the highest priority, while private individuals and firms can buy foreign currencies freely for any purpose—recreational travel, competitive investment abroad, or even speculating against the dollar. Nationalistic restrictions on Government outlays may be justified as a temporary expendient. But such measures as aid-tying and "Buy American" preferences will build up vested interests and be difficult to reverse.

The relative burdens of defense and development assistance of the various advanced countries should be related to their basic capacities to bear these burdens—as reflected in national income and wealth. I was glad to notice that Professor Mason concentrated on these variables in his discussion of burden sharing; he did not list the balance of payments as a criterion. Participation in these programs should not vary with the vagaries of national currencies. We cannot turn these programs on and off as balances of payments change. The effectiveness of the programs will be greatest, for a given collective cost to the participating countries, if the goods and services needed to implement the programs are bought in the cheapest markets.

CHANGES OF ECONOMIC STRUCTURE

Under favorable circumstances certain basic economic processes will work toward the restoration of international balance. Let me give several examples.

Specific industries challenged by foreign competition at home and abroad respond with better design, lower prices, or increased sales effort. The response of the American automobile industry to European imports is a case in point.

High profits attract capital overseas and contribute to payments deficits. But these profit rates decline as the most obvious technological and market opportunities are grasped and as labor shortages are encountered. At the same time, repatriated earnings on the initial surge of foreign investments eventually strengthen the balance of payments. The United States already appears to be enjoying some relief of this kind, as Mr. Lary mentioned.

As comparative advantage shifts, a country suffers from new foreign competition in a particular industry, call it industry A. But as the surplus country favored by the change shifts resources to industry A in order to exploit this opportunity, it leaves itself vulnerable to competition in other products. The deficit country can restore its overall payments position by shifting to these products the resources displaced by competition from industry A.

These fundamental adjustments depend on changes in relative prices and wages within countries rather than on dramatic inflations or deflations of national price levels. They require changes in the composition of output rather than in aggregate production and employment. Adjustments of this kind may be the most important acceptable mechanism for correcting payments imbalances. But they cannot be achieved without mobility of labor and other resources within each country. They may be assisted by Government policies. But they are certainly neither easy nor quick.

ADJUSTMENT OF EXCHANGE RATES

Finally, the IMF agreement does not contemplate that exchange rates are eternally fixed. Rather the Bretton Woods system is a system of "adjustable pegs." A country can unilaterally alter its originally declared rate as much as 10 percent. Further adjustment is permitted in case of "fundamental disequilibrium," with approval of the IMF. In practice, advance consultation with the IMF is considered impossible because of the dangers of speculation, and the approval of the IMF is perfunctory ratification of a fait accompli. Although each exchange rate adjustment is a specific national policy decision, dominated by the circumstances and needs of the individual country at the time, the frequency of such adjustments is an important property of the system as a whole. For it determines with what confidence or suspicion the world looks on any existing structure of exchange rates.

Frequent alterations of exchange rates between convertible currencies rob the system of its principal advantage over a system of freely floating rates. The merit of fixed exchange rates in promoting international trade and investment is to remove from these transactions the risk of exchange loss. But this risk is not removed if exchange rates are only temporarily pegged. Needless to say, exchange rate stability is especially important for a currency, like the dollar, which is used as an international unit of account, medium of exchange, and store of value both by private individuals and businesses and by governments throughout the world.

The possibilities of devaluation under the "adjustable peg" system inevitably lead to speculation, first against one currency, then against another. Any currency can be suspect, as we in the United States have been reminded several times during the past few years. The private resources available for such speculation in a regime of convertible currencies stagger the imagination. There is always a danger that speculative rumors and whims will be self-fulfilling. To guard against such danger, the central banks, governments, and international institutions which manage the "adjustable peg" system must command large counterspeculative resources.

Here is a dilemma for exchange rate policy. If the pegs are adjusted from time to time, currency speculation will be a major factor aggravating or even originating imbalances in international payments. If the pegs are never changed, on the other hand, we deny ourselves the use of an important instrument of adjustment, in many ways the simplest, most powerful, and least costly instrument. This means that the burden of correcting imbalances has to be assumed by more far-reaching and time-consuming processes of adjustment. Whichever exchange rate policy is followed, large international reserves are necessary. In the one case, they are necessary to withstand the waves of speculation endemic to a system in which rates do in fact change from time to time. In the other case, they are necessary to permit a country to ride through a period of deficit which it must correct by slower and more difficult processes than devaluation. Thus I return to the conclusion with which I introduced this survey of possible mechanisms of adjustment: A system of stable exchange rates can work, but it can operate consistently with our basic national and international objectives only if it is lubricated by an ample and well-regulated supply of international reserves.

Representative REUSS. Mr. Tobin, the proposal you make in the last page of your paper—that IMF drawing rights ought to be increased through some kind of IMF certificate, open market policy, or through some other method—that there ought to be a method of increasing the total international money supply—has been, as you know, a recommendation of this committee for more than 2 years now, without, so far as I know, any visible dent upon the executive branch, though one hopes that the meetings of the 10 so-called Paris countries, and the research that is now being conducted by the IMF, will produce something before too long. I say all this to indicate my complete agreement with your recommendation and I think the agreement of most members of this committee.

You talk a little bit, though, as if this need were in the future. Is it not a fact that the need is right now and that if the IMF were now able to do the things which you recommend at the end of your report,

this country would be in a less unfortunate position than it now is in terms of accelerating its domestic growth rate, combating its domestic unemployment, and being able to refrain from undesirable and autarkic things internationally, like tying its aid and making uneconomic purchases of defense procurement and so on? My question is, if eventually, why not now?

Mr. TOBIN. Well, the sooner the better, in my opinion. If this kind of improvement in the Fund had been undertaken some time ago, we would be in a better position now; the world would be, and the United States in particular. I do not think that right now we can expect a change in the International Monetary Fund or any other device for improving the world monetary system to solve completely our own balance-of-payments problem and remove the constraint that it puts upon us.

To a certain extent, the liquidity problem for the world as a whole and the U.S. balance-of-payments problem are connected. But they are also distinct.

Representative REUSS. Yes; I recognize that. I would like to sort out the various segments of this problem with you. Would you agree with the following statement, that quite apart from achieving the reform in the international monetary mechanism which you outline on the last page of your report, the United States ought to get certain elements in its international payments into prompt balance. Among those elements where there ought to be balance as quickly as possible are items such as our expenditure on defense overseas, our foreign aid program, and our long-term capital investment and our exports and imports, immigrant remittances and so on. I do not have any very good title for all these items and I do not want to use misleading titles like basic items, and so forth. What I am trying to do is describe all the items except short-term capital movements.

My question is this—is not what you are saying that we ought to get all items except short-term capital movements into balance quite promptly? I will come to short-term capital movements in a moment, but I wanted to separate that out.

Mr. TOBIN. Well, it would be desirable if we could get those elements of our international transactions into balance as soon as possible. But I do not think you can appraise policy just by saying that it would be nice if this happened. You have to consider what you would have to do in order to make it happen. The burden of my remarks is that it is inconsistent with the basic purposes of the system if, in order to get these things into balance rather than using our reserves, we have to do things which are at odds with the whole purpose of the system of fixed exchange rates.

Representative REUSS. Yes; but I wanted to walk through this with you, and step one, we agreed, is that there ought to be a new and better international monetary mechanism so that there are not only greater credit facilities available to this and other countries, but pieces of paper which symbolize those credit facilities which come to be accepted as international money, and a way of increasing those pieces of paper so that the total international monetary supply is not dependent just upon gold and upon dollar and sterling deficits.

That was your point one. I thought you went on to say that yes, we should do that, the sooner the better, but that there were other things that had to be done, too.

Mr. TOBIN. Could I explain what I had in mind there?

Representative REUSS. Yes.

Mr. TOBIN. What I had in mind there was that any general system of the type that I was outlining—in the briefest and most succinct form—is directed to the world supply of reserves as a whole and not to aiding any particular country, even the United States, which happens to be in balance-of-payments trouble at the moment. I think that a good international monetary system would have two parts to it, as far as the liquidity side is concerned. I am not speaking of the adjustment side, which Mr. Mundell was emphasizing.

On the liquidity side, it would have two parts to it. One is a way of increasing the general supply of international liquidity on a fairly anonymous or impersonal basis as between countries to meet the needs of the world as a whole. Second there must be a way for countries in difficulties to get assistance beyond what they will get as a byproduct of the general monetary expansion of the world supply of reserves. The International Monetary Fund is really set up on this basis. It provides some unconditional reserves which could be counted as international money, especially if certain things were done to make it clearer to everybody that this is international money, a part of reserves. Then beyond that, as Mr. Mundell emphasized, the International Monetary Fund provides conditional drawing rights for countries which have particular problems at the moment.

Now, we are not going to be bailed out by the first of these two categories. We are, and indeed we will be for some time to come, in need of a way of financing the deficits that we will have until our accounts are restored to balance. These require specific financing measures directed to the U.S. problems.

Representative REUSS. Or the problem of any other country which might find itself in our unhappy position.

Mr. TOBIN. Exactly. That may involve our using the conditional facilities we have at the International Monetary Fund or other lines of credit we have with other countries, and it may involve our continuing to use our reserves to a certain degree. And it may involve some kind of understanding or constraint on the part of our short-term official creditors, that while we are getting back into balance and while the new international monetary system is being developed, they will not rock the boat too abruptly and heavily by all of a sudden appearing in Washington and asking for gold in exchange for all the dollars that are already outstanding.

Representative REUSS. Yes. I think I can say I heard you the first time, because that is what I understood by your initial presentation. We need, in short, for our specific problem longer and bigger standby agreements, more tolerance in whatever institutional form from our foreign exchange creditors.

That is what it comes down to?

Mr. TOBIN. Yes.

Representative REUSS. Fine. But then I think you had something else to say. I think you suggested there are also some things that can and should be done, other than what we are now doing, about our payments imbalances.

Did I hear you right, and if so, what are those things?

Mr. TOBIN. No. I did not mean to indicate that. I think the main thing that should be done about our payments imbalances should be done by somebody else, not us. We have done quite a bit.

Representative REUSS. Then you reject the proposition that has been advanced at some of these hearings, at least, that the United States should not expect any iron lung, any oxygen tent, or any crutch from other people?

What you are saying is that we do need an iron lung supplied by other people?

Mr. TOBIN. I would not put it quite that way. I referred to the desirability of a deficit country, and that would include the United States, avoiding to the extent possible adjustment policies or adjustment actions which are damaging to the whole purpose of the world economy, of economic progress, and facilitating trade and capital movements across national boundaries.

It seems to me the surplus countries have it in their power to take some actions. They could make their capital markets more open, eliminate some residual restrictions on trade, and these would be mechanisms of adjustments that are both helpful to the current imbalance between the United States and the surplus countries and consistent with the basic objectives of the system. I would rather see actions of that kind than to see us forced to take, more than we have already, actions which are either damaging to our domestic economy or to our foreign policy or to the kind of international economic world that we have been trying to build for the last 30 years.

Representative REUSS. What you call a mechanism of adjustment seems to me to be largely action by our friends and allies to liberalize their trade, remove other nontariff restrictions, free up their capital markets, take over a fair share of the foreign aid and defense burden, encourage their tourists to travel here and let them take money out of the country to do it with, and similar measures? That is what you are saying, is it not?

Mr. TOBIN. Yes, sir.

Representative REUSS. Of course, I completely agree with you. I wanted, however, a definition of this adjustment, because so often it turns out that people who use the word "adjustment" mean vast changes in our domestic price structure or employment structure or whatever.

What you are saying is that, as far as you are concerned, we are pretty well adjusted right now. It is up to France and Germany and Italy and Japan and some other countries to start making a few adjustments to our position. Is that not what you are saying?

Mr. TOBIN. Yes.

Representative REUSS. And I agree and I thank you.

Senator Miller?

Senator MILLER. I would like to ask Professor Tobin whether or not in any solution to the liquidity problem, including ours, there would not be some implication of a sort of international trusteeship over the world's monetary gold supply?

Mr. TOBIN. No, I do not think I would——

Senator MILLER. Just as in each individual country, the central bank or the central government is the trustee over the nation. You project that analogy into the international sphere, such as you laid out very well in the forepart of your paper. I am wondering if you would not have that implication extended to the international scene.

Mr. TOBIN. Well, the international institution involved, probably the International Monetary Fund, would be a trustee of the supply of the kind of money which it is creating. It would not be providing gold, but an equivalent to gold. The International Monetary Fund does have a gold reserve of its own, and in part you could regard that as playing the same role as against its liabilities that the gold reserve of a nation plays against its international liabilities.

Senator MILLER. But since the essence of any of these plans is this acceptability in the community, and since you are not advocating doing away with the gold base, you are merely advocating supplementing this by, in your particular proposal, the use of the conditional lines of credit, might we not find that by the time we get into the implementation of this, we are going to have some type of control with respect to gold in the member countries?

Mr. TOBIN. I do not think——

Senator MILLER. You do not think it is necessary?

Mr. TOBIN. I do not think we need any more control of the use of gold in the member countries than we now have. The important thing is that in creating a new supplement to gold or equivalent to gold as international money, the process of creation would be safeguarded so that it is not expanded too much, any more than it is expanded too little.

It seems that is the control which the countries which govern the International Monetary Fund would impose on the process that I suggest.

Senator MILLER. Thank you.

I would like to ask Professor Mundell this question.

You refer to a colossal figure of $200 billion representing accumulated loss of GNP since 1958.

Mr. MUNDELL. Yes. sir.

Senator MILLER. How did you arrive at that figure?

Mr. MUNDELL. Well, the Council of Economic Advisers estimates that a level of unemployment averaging 5 percent a year or 5.5 percent a year costs the economy about $30 to $40 billion, based both on loss of the work force and loss of productivity of the work force, as well as loss of the people who were in the work force who are now unemployed. This is a figure that, as $30 or $40 billion, has gone on for something like 5 or 6 years in the United States. This is the accumulated total over this period.

Senator MILLER. In other words, it is apparently arrived at by taking the productivity of 5.5 percent of the work force on an estimated average——

Mr. MUNDELL. Of the excess unemployment.

Senator MILLER. And building it up on an annual basis. Is that the idea?

Mr. MUNDELL. Approximately; over and above the 3 and 4 percent unemployment that apparently appears to be necessary at any rate. It is the cost of the excess unemployment over your 3 or 4 percent.

Senator MILLER. Well, as you probably know, the full employment definition being used by the Council of Economic Advisers is 4 percent unemployed. If you are using 5.5 percent, then it would be the excess of 1.5 percent. It is on that basis that this $200 billion loss of GNP is computed, or is it on the basis of 5.5 percent?

Mr. MUNDELL. No; it is on the basis of the excess. This figure is very rough. It may be somewhere between $150 billion and $225 billion. But I would say this is according to what the Council has argued. The excess cost would apply to the excess over 4 percent.

Now, I might add that as I have read the Council's reports, the 4 percent figure is not full employment, but the 4 percent figure is only an interim full employment goal. They certainly take things in stages and they want to get back down to 3 percent.

Senator MILLER. Well, whether it is an interim full employment or long range, it is still called full employment. I think there has been a general feeling that full employment meant zero unemployment. I just wanted to make sure that it is the excess from which that $200 billion estimate was devised.

Have you explored the makeup of the Council of Economic Advisers' computations of this $200 billion?

Mr. MUNDELL. Yes. Well, I have to admit that when I read the argument of the $30 billion to $40 billion, I felt that there was some slight exaggeration, partly because it does not take into account the leisure of the unemployed, even though it is unwilling leisure. There are other aspects that may in fact mean that it is even more serious because there is certainly a racial bias in the unemployment. In terms of loss of real income, probably $30 billion is not a bad figure.

But I would not go to the stake on $200 billion. It is, whatever it is, over $100 billion; $150 billion, $175 billion, something in this order of magnitude is what can be attributed to the deflationary policies the United States has had to follow in the past years.

I regard that as an enormous, a frightful cost in terms of the use of other programs to pay for international trade. It is just an incredible thing that people can worry over small amounts on questions like foreign aid, that American policy has to be dictated by this, and that defense goals have to be changed because of the balance-of-payments cost. This is an incredible cost by comparisons with anything else. And it is the cost that lies at the heart of the existing adjustment mechanism. We do not have an adjustment mechanism other than the inflation-deflation methods, and it is not good. It is just too expensive. We can buy other systems at much cheaper prices.

Senator MILLER. I invite your attention to the fact that Professor Freeman of the Hoover Institute, I am told, testified recently before the Senate Finance Committee. I presume our chairman, Senator Douglas, was present. I understand that he made quite an effective presentation in analyzing this unemployment rate which you might care to look at, because apparently there are some deep differences of opinion regarding the makeup of this unemployment, and also, in turn, its effect on GNP.

Now, I am a little confused when you talk about inflation of 1 percent a year. Then you say we have deflated so much. That sounds inconsistent to me and I wish you would explain it.

Mr. MUNDELL. Yes. Well, first, we do not know exactly. Our price indexes do not really tell us. We can afford to make mistakes with price indexes. One percent a year may be an appropriate increase in measured price levels to reflect changes in quality. This, in combination with the fact that you have a continual upward pressure on wages that is always going to push the price level higher—I call this deflation in the sense that monetary policies and fiscal policies have been less than sufficient to maintain full employment. It is not a fall in the price level, although in fact, 1 percent may very well be equivalent, when you take into account changes in quality, to a fall in the price level, if we could find an index of the price level that would appropriately measure these changes in quality.

Senator MILLER. It is my understanding that quality, while it may be reflected somewhat, is related to goods and products, while the bulk of this increased cost-of-living index is in the field of services. So granted what you say about quality, it would probably relate only to the products which have not undergone as much of a rise as services have.

I doubt if we could use as an excuse for the increase in the price index or an offset to that increase quality itself.

Mr. MUNDELL. Well, yes. There is certainly no question but that the better you can restrain price increases, the better off you are. Of course, the question is the extent to which, leaving aside the international problems involved in this, the extent to which you can do this without causing excess unemployment.

Senator MILLER. Well, if we have an inflationary situation, as I understand we have printed more money—we have not borrowed all the money to finance our deficit. I understand there is an increase in the amount of dollars in one way or another. To me this inflationary. Then for you to say we have deflated so much sounds inconsistent with that. I might have gone along with you if you said we have not inflated enough, but instead of saying that, you said we have deflated, which is contrary to what the economic indicators suggest has happened.

Mr. MUNDELL. I would call the current policies which result in excess unemployment, severe excess unemployment, a form of deflation. Now, perhaps it is better to say we have stagnated than to say we have deflated, since deflation has direct price level connotations when we do not have precise knowledge of what the price level actually is. And of course, there are many different price levels, as you point out, and problems of aggregating these price levels.

This is a form of deflation, but certainly we can agree that Europe has been inflating and the prices have definitely been rising there; and in the United States, prices have risen by 1 percent.

So if we want to think in the comparative sense of European adjustment as compared to American, it is a differential rate of inflation.

Europe has been inflating at quite a reasonably rapid rate while the United States has been keeping its price increases down to 1 percent. In any case, in comparison with previous years, this is a remarkable feat, to have kept the rate of price increase down to 1 percent. But it has, as I say, been at a very high cost.

Senator MILLER. Thank you very much.

Representative REUSS. Senator Proxmire.

Senator PROXMIRE. Before I ask questions, Mr. Mundell, I might say it is interesting to get your appraisal of this country permitting the relatively small sector of our economy, the foreign trade sector, about 5 percent of GNP, to wag the dog as you say.

Do I understand that you are a Canadian?

Mr. MUNDELL. Yes.

Senator PROXMIRE. And you are a professor at McGill University at Montreal, so you can view this with objectivity not only greater than that of a Member of Congress, but also greater than our own economists who may have their own localized predispositions and biases. So it is especially valuable to hear from you.

I would like to ask Mr. Blough to give his appraisal of the report in this morning's New York Times:

> The Federal Reserve Bank of New York reported two developments yesterday that reflected the success the United States has enjoyed recently in stemming its net loss of dollars to other countries.
>
> * * * * * * *
>
> Extension to 13 weeks of stability in the Treasury's gold stock, the longest period of no loss since the dollar-drain problem emerged a half dozen years ago and probably the longest stable period in the history of the United States.

Then it goes on to say:

> So far since the beginning of 1963, the decline in the Treasury's gold stock has been $395 million. In the corresponding months of 1962, it was $912 million.
>
> Shrinkage of the dollar outflow shows up most meaningfully in the Commerce Department's third-quarter figure of $385 million, seasonally adjusted for regular transactions—exports, imports, tourism, private capital movements, scheduled repayments of foreign debts owed the Government, Government spending abroad and so on. The like figure for the June quarter was $1,281,000,000.

My question, Mr. Blough, is whether in your view this represents a turning point and maybe a fairly permanent improvement, or whether it is an incident that emerged in this quarter and perhaps will pass.

Also, I would like you to comment on the effect of the announcement of the interest equalization tax at the beginning of this quarter in relationship to this improvement.

Mr. BLOUGH. As to the first question, it is really much too soon to have any judgment about the permanence of this shift. I think it is clear that the Federal Reserve and Treasury between them—I don't know how the credit should be divided, if it should be—have done an excellent job in putting the United States in a position to keep down the outflow of gold. What special conditions developed during the quarter, aside from the interest equalization tax—maybe we do not know all of those things at this time. Clearly, it is a matter for satisfaction that there has been this much stability. But the gold in the Exchange Stabilization Fund has been reported only through the end of August and the operations of the London gold pool, in which we have a large share, have not been reported at all as far as I can determine. Also, the nature of our cooperation with other central banks may mean they are only delaying their demands for gold. I do not know, but I would like to wait and see what happens over several more quarters before assuming the improvement is permanent.

Of course, I am pleased to see the signs of improvement. It is a source of satisfaction that things are moving in this direction, but I would not like to put very much weight on the results of one quarter as an indication of a permanent turning point.

Now, as to the interest equalization tax on long-term capital. Of course, the outflow of gold could go up or down without much, if any, direct relationship to the movement of long-term capital to which the interest equalization tax is intended to apply. From the conversations I have had with people who keep abreast of this, the threat or expectation of an interest equalization tax has had a substantially repressive effect on the sale here of foreign-owned long-term securities, and some observers have suggested that perhaps it is having more effect before it is passed than it will have after it is passed, because once it is passed people will know precisely what it is. Fiscal specialists will immediately begin to find ways to get around the law and there will be a constant battle over months and years between finding and plugging loopholes if the tax continues to be needed.

Not knowing what form the tax will take, I think people have been cautious because they do not want to find themselves caught retroactively.

So I would say it is conceivable, perhaps probable, that there is some connection between the interest equalization tax and the stability of gold stocks, but it would be primarily in the feeling on the part of foreign central banks and foreign governments that the United States had now shown some seriousness in tackling its capital movements problem. Of course, to the extent that the interest equalization tax has reduced the outflow of dollars, it has reduced the accumulation of more dollars abroad and the accumulation of more dollars does, of course, inevitably put some greater pressure on gold.

Senator PROXMIRE. At any rate, you would construe this improvement as resulting, at least in part, from the announcement of the interest equalization tax? And I take it from that at least partial interpretation and from your statement that the effect might not be as great after the tax is passed, that if we do not pass this tax, then we may be in quite an unfortunate position. Perhaps the Congress is now put into a spot where we pretty much have to act. Give me a brief analysis of what happens if we do not pass the interest equalization tax, having had the assumption on the part of investors that we would pass it.

Mr. BLOUGH. I see no reason not to believe that this would be taken as an indication that the Congress was not disposed to support a rather modest measure of control over the outflow of capital, and that it would encourage the same developments which had earlier led the Treasury to the position where they felt they had to take some step to slow down the use of our capital markets for longer-term financing. I think it would make our situation worse. There are, of course, other ways that one could approach the outflow of capital than the interest equalization tax. But as I understand it, the Treasury's idea was that this came closest to fitting in with the market mechanism and made it least necessary for someone to judge the desirability or undesirability of some specific capital outflows, and that this was the reason the method was chosen.

Now, if this method is not adopted by the Congress and if the capital outflow is resumed—and I see no reason why it should not be—and if then it appears that something is needed, presumably we would have to move in the direction of some type of voluntary, semivoluntary, or compulsory control of capital movements, through a capital issues committee or in some other way. Whether this would be expected

abroad if Congress rejected the milder measure, I do not know. I think the failure to pass the interest equalization tax would have a tendency to confuse world thinking about the earnestness with which the United States approaches this problem.

It is not so much that I think the interest equalization tax has great intrinsic merit either as a tax or as a control but that, having been put forward and being now before the Congress, it ought to be passed. The reaction abroad to a failure to pass it could hardly be good.

Senator PROXMIRE. Well, you express yourself very guardedly. I would say the failure to pass it now would have disastrous effects on our balance of payments, at least for a short period.

I would like to ask Mr. Mundell if it is true that his proposal that the gold price be allowed to vary a minimum of 7.5 percent——

Mr. MUNDELL. At least 7.5 percent on either side of par. That is 15 percent.

Senator PROXMIRE. How does that compare with the floating exchange rates which Dr. Friedman advocates?

Mr. MUNDELL. The proposals are very similar. If you make the margins very wide, more than 7.5 percent—10, 15, or 20 percent, which also would be an enormous improvement over the present system—then the two are essentially equivalent. They are fundamentally equivalent measures to simply freeing the exchange rate. How much you free them is a moot question. I do not think that freeing them any less than 7.5 percent would do any good.

Senator PROXMIRE. This meets the problem of adjustment. You still need liquidity as trade grows, as population grows, and so forth.

Mr. MUNDELL. No; the wider you move the margins, the less liquidity you need.

Senator PROXMIRE. We are not then tied to gold production, not tied to key currencies. I understand.

Mr. MUNDELL. I think I can agree with what Professor Friedman said yesterday—his proposal was very forcefully argued back in 1953. There would not be any necessity to adjust the gold stocks of individual countries if the margins are wide enough. After all, flexible exchange rates are just no margins at all—if you make them very wide, they converge to the same thing. There is no reason, if the margins are wide enough, for central banks to have to adjust their gold stocks in any way. There is no need for liquidity, if they are willing to allow the market to set the appropriate price for a currency, which would be the price at balance-of-payments equilibrium.

Senator PROXMIRE. Thank you very much. My time is up.

Representative REUSS. Senator Jordan.

Senator JORDAN. I am sorry I was detained in another committee and missed most of the formal presentation, but I do have a question to put to Professor Tobin.

It seems to me, Professor Tobin, that you ended your paper on a most interesting note. You are speaking about the liquidity gap which, in your opinion, will need to be filled by a new species of international money. You go on to say that automatic drawing rights of the member nations of the IMF do provide some means for filling that need. You say further that these devices do not require radical or abrupt changes in the IMF or other existing institutions.

Would you elaborate on that, because it seems to me you have hit upon a very ingenious device for expanding liquidity without undue violence to the existing systems.

Mr. TOBIN. Well, the automatic drawing rights that I referred to there are the drawing rights which correspond to the subscriptions which the member countries of IMF have made in gold, 25 percent of their original quotas and of the increases in their quotas which have occurred, and to the further drawing rights which they have received in the IMF when their currencies have been used to make loans to other countries, and in particular to the underdeveloped countries. Actually there is one further source of these automatic drawing rights which occurred when the IMF, a few years ago, sold gold to the United States in return for U.S. Treasury bills.

Now, the extent of these automatic rights could be expanded in a number of different ways. One way is to have an increase in quotas, for example, and possibly to find some device to avoid accompanying the increase in quotas with payment in full of the 25 percent in gold. This is important because to the extent that automatic drawing rights are just a counterpart of gold subscriptions, then they take away from countries gold reserves to the extent that they add to their drawing rights.

Another way would be to extend automaticity to further parts of the drawing right of Fund members, so that they could draw beyond the so-called gold tranche more or less automatically. Another way would be to build on the precedent that I referred to a few moments ago, the purchase of U.S. securities. The Fund might purchase securities of a whole list of countries, perhaps all its members, in some proportions that were agreed upon. This also would give in return to those countries an increase in their automatic drawing rights.

So there are a number of different ways in which this could be done, and I was not advocating one of them here as against the other.

Senator JORDAN. Well, I was interested, because you suggest a means of creating, in a sense, a species of international money by expansion of those rights and the flexibility that you would ascribe to that expansion.

Mr. TOBIN. Yes. It is quite a flexible system. But it could be subject to agreed rules and procedures, so that it does not have to become a battle between the members of the Fund as to what is done under particular circumstances. But it does seem to me to offer a way of providing increases in owned reserves, in automatically available liquidity, to member countries through an existing institution, the Fund, building on a mechanism which is already there.

Another aspect of it, to which the chairman referred, would be to improve the transferability of these rights so that they could perhaps be transferred at the initiative of the members from one country to another without even going through the formal procedures of making a drawing from the Fund.

Senator JORDAN. And you conclude if the major monetary countries have the will to do it, the technical means are at hand, available, not hard to find?

Mr. TOBIN. That is right. As I say, there have been a number of technical proposals, a variety of technical proposals as to how to do this.

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It can be done.

Senator JORDAN. Thank you.

Thank you, Mr. Chairman.

Representative REUSS. Senator Douglas?

Chairman DOUGLAS. First, I want to apologize for being so tardy in coming this morning. I had some unexpected contingencies come up, and I apologize both to the witnesses and the members of the committee. I have had a chance to read a large portion of the testimony. I would like first to address a question to Mr. Mundell.

We are very glad to have you here. I take it that your suggestion of widening the buying and selling limits on gold to at least 7.5 percent, plus or minus, could only be done by agreement through the International Monetary Fund, because section 2 of article IV states that the Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin or sell gold at a price below par value minus a prescribed margin.

Now, I have had Dr. Pollack go into the question as to what these margins actually are. While there is one complication which I shall omit, in practice, all countries now are limited to a maximum of 1 percent variation from par. So there would have to be an agreement of the Monetary Fund to provide this. Is this not true?

Mr. MUNDELL. Yes. I might add that an agreement was provided in the case of Canada in 1950, that the International Monetary Fund did not refuse permission to the request of Canada to allow their exchange rate to fluctuate completely, according to the market.

I have to add, they did this with some reluctance.

Chairman DOUGLAS. Well, this brings us to the question of the International Monetary Fund. I must admit I am ignorant about this. Is a majority vote of the Governors required, or a two-thirds vote? Does anyone know?

Mr. MUNDELL. In this case, you could make a distinction between two things. If one country decided to do this, to expand its limits, they could go to the Executive Board and request permission. It would be accepted or refused.

Chairman DOUGLAS. How many members are there on the Executive Board?

Mr. MUNDELL. All the members are represented, but there are only 17, I think, Executive Directors.

Chairman DOUGLAS. Is that decided by a majority?

Mr. MUNDELL. Yes; but in practice, the votes are never taken. Decisions are always reached by unanimous consent. As I recall, I think there has never been a vote before the Executive Board that has not been carried by unanimous consent.

Chairman DOUGLAS. Does this mean that there is an unwritten law or rule which differs from the published statutes, that decisions really require unanimous consent, or does it mean that the minority always gives in?

Mr. MUNDELL. In practice, this would be the case for one single country. But I think that if you implemented a new scheme of this kind, or if you followed Professor Friedman's proposals of flexible rates, I think that it would be better simply to amend the articles of agreement to do this straightforwardly and frankly, and not try to——

Chairman DOUGLAS. You mean that every country could do it rather than individual countries asking for permission?

Mr. MUNDELL. Yes; I think this would be better.

Chairman DOUGLAS. Do you have any practical hope that such a change in the basic policy of the IMF would be followed? As I remember very imperfectly, the question of fixed exchange rates versus floating exchange rates was debated at the Bretton Woods Conference and almost universally rejected. All the major powers were opposed to it, including ourselves, I think. Are you saying that for the United States to have the freedom to act in this matter, we probably would have to get the consent of the overwhelming majority of the members of the International Monetary Fund?

Mr. MUNDELL. Well, this is partly a tactical question. As I say, Canada did do this, and it is my hope that in the future Canada will go back to this system.

Chairman DOUGLAS. Was not that regarded as sort of a sin on the part of Canada that would be temporarily forgiven but not as an expression of sound Government policy?

Mr. MUNDELL. Yes; it was regarded as a sort of international sin.

Chairman DOUGLAS. Large countries can be forgiven these sins, whereas small countries are not given this degree of tolerance. Is that correct?

Mr. MUNDELL. Yes; I think so.

Chairman DOUGLAS. To use a slang expression, is this not kissing your plan goodby?

Mr. MUNDELL. As part of the IMF, and certainly the United States has 25 percent of the votes already in the IMF——

Chairman DOUGLAS. That is very different from having a majority.

Mr. MUNDELL. Yes; it is far from the majority.

Chairman DOUGLAS. Americans who deal in international monetary matters are seldom robust in the treatment which they adopt toward foreign monetary authorities. They have a distinct inferiority complex and a habit of subservience.

Mr. MUNDELL. Yes; although I do think that the United States is sufficiently large so that it does not need to continue to make its international decisions as if they had an inferiority complex.

Chairman DOUGLAS. You would encourage the United States, therefore, to have a more robust self-assurance?

Mr. MUNDELL. Absolutely.

Chairman DOUGLAS. This, coming from a Canadian, is very pleasant, indeed.

Mr. TOBIN. Senator, could I say something?

Chairman DOUGLAS. Yes, indeed.

Mr. TOBIN. If it were an amendment to the articles, it actually requires four-fifths of the voting powers. That is four-fifths of the weighted votes and three-fifths of the members.

Chairman DOUGLAS. I should think that they would be very difficult to obtain.

Mr. TOBIN. Now, actually, it looks as if the gold margin is not in the articles, however. That is a bylaw. But what is in the articles, the 1 percent which you referred to, has to do with the margins of currency exchanges.

Chairman DOUGLAS. That is the next question I was coming to.

Section 2 deals with gold purchases. Section 3 is concerned with foreign exchange dealings based on parity. And this does provide in the case of spot exchanges a variation of 1 percent from the supposed par or the gold convertibility of American dollars.

Now, I would like to ask whether a change in section 2 would automatically carry with it a change in section 3 or whether there would have to be simultaneous treatment of section 3 as well as section 2, or the bylaws, to make this effective. Is it not, after all, exchanges that are the primary question? Gold purchases are important only to the degree that they affect the exchanges.

What do you say to that, Mr. Mundell?

Mr. MUNDELL. I would say this, that the Fund is unique in having its own judicial review system. They have been quite flexible in the past in the interpretation they have given to various proposals that have come forward.

Chairman DOUGLAS. Do you think they would be flexible in this case?

Mr. MUNDELL. I think in this case that if you could change the article, widening the gold limits, this is sufficient. After all, there is an article that says——

Chairman DOUGLAS. You do not need to change section 3, then?

Mr. MUNDELL. Well, I am not a lawyer, and I can certainly not predict what the Fund's lawyers would say in this respect. But I might note that in the past the Fund has interpreted the articles flexibly. The Fund does not have a right to conduct open market operations, but, in practice, the Fund does hold $800 million of U.S. securities which have been acquired in open market operations.

Chairman DOUGLAS. Then you are developing the plot that the basic Bretton Woods charter is being disobeyed by the Managers of the Fund when it suits their convenience?

Mr. MUNDELL. I would not go that far, but I would say there has been some flexibility in the interpretation, as there is flexibility in any constitution.

Chairman DOUGLAS. That is a great and wondrous term, meaning permitting authorities to do what they wish and disregarding statutory permission.

Mr. MUNDELL. That is sometimes the case.

Chairman DOUGLAS. I would, if I were revising Johnson's dictionary, propose that as a definition of flexibility.

Mr. MUNDELL. This is widening the margins, approaching it as a tactical measure, not eliminating them altogether, not moving to a new system of flexible rates, but simply widening the margins to whatever is necessary.

Chairman DOUGLAS. Mr. Mundell, I have a great deal of sympathy with your practical proposals. For years I have urged the Federal Reserve, the Treasury, and our representatives on the IMF, to consider the flexible exchange rates, and I have been deeply disappointed by their refusal even to consider or study the matter. It has been an automatic reaction and, to tell the truth, I have not seemed to generate any real argument. It has been a sort of tropismatic response, even below the level of instinct. So I have a great deal of sympathy with what you are proposing. But we have to be carpenters as well as architects, and the problem is how to make this change, because we have

become—I shall not say entangled; I think of it as a necessary involvement—we have gotten ourselves involved necessarily in the International Monetary Fund. We are not the sole power of the world.

Mr. MUNDELL. But the first thing that is necessary, of course, is to convince the Executive that the proposal, this kind of proposal, has merit. How you approach it is another matter. It does seem to me that the U.S. Executive Director could be persuaded—I would wish one could persuade the Canadian Executive Director, too—to offer this proposal to the Executive Board and to at least suggest that a serious study of flexible exchange rates be carried out within the Fund.

Chairman DOUGLAS. Thank you; my time is up.

Representative REUSS. Senator Jordan?

Senator JORDAN. No questions.

Representative REUSS. I would like to ask an additional question of Mr. Mundell.

In your paper, in speaking of the horribles visited upon this country because of the lack of an efficient adjustment mechanism—and you mention tied aid, and so forth—you speak of the blow to New York as a world capital center. My question to you is this: Is not one of our troubles, with all due respect to the New York Chamber of Commerce, that New York is too much of a world capital center? Would not the free world be a more effective place if Milan, Frankfurt, Zurich, Paris, Montreal, and various other cities carried a larger portion of the free world's capital issues? Is not that what we should be aiming for, and if a necessary consequence is that New York does a smaller percentage share of the total business, so be it?

Mr. MUNDELL. No; I would not agree. There are economies of scale in the development of a capital market. In this country there were originally capital markets in Boston and in Philadelphia that were truly important capital markets. But everything gravitated toward New York, partly because of economies of scale. You may be aware of an interesting article by Professor Kindleberger, who analyzed the history of this in some detail.

In the case of Europe, I would quite readily agree that there will develop a single dominant capital center within Europe at the present time under present restrictive laws, which ultimately will, of course, impede the flow of capital between the United States and Europe. I do not know whether it will be Frankfurt or Paris or Milan or Zurich, but I do think that one will develop.

Now, in the United States, a very interesting thing happened over the past 5 years. New York was becoming a capital center in the sense that not just foreigners were floating bonds in New York, but also foreigners were buying and selling their own bonds in New York, which was an interesting feature and which worked to the advantage of the United States.

Representative REUSS. To the extent that that second factor comes into play, it does not distort or hurt our balance of payments. But to the extent that foreigners invade Wall Street for purposes of selling bonds or stocks to Americans, then to the extent that these securities could be sold in Europe but are not because it is easier to find purchasers through the New York market, this disadvantages our balance of payments and adds to the troubles of the free world, does it not?

Mr. MUNDELL. Yes; it does worsen the balance of payments, but I might add that throughout the 19th century, London developed as a world capital center, and London also became an exporter of capital—exporter of capital in much larger proportions than the United States at the present time, when you take into account the growth of world trade and payments. It does seem to me that the U.S. policy, with respect to its equalization tax, is doing the wrong thing. What is needed is to adjust the trade balance to the capital account in this case, and not the capital account to the trade balance. You want a larger trade balance in the United States, a larger export surplus, both to balance the international financial accounts and to increase employment. They are twin problems. You cannot look at the capital account alone.

Now, I agree that this interest equalization tax is an effective tax. It is not, as it is commonly called in the press, a 1-percent addition to interest—it is a prohibitive tax, because it is a temporary tax. No one is going to pay an extra 15 percent for foreign bonds when there is a chance that in a year or 2 years it is going to be removed again. It becomes a 7.5- or 8- or 9-percent additon to the interest cost. It is in addition to the capital value which, over a short period of time, becomes an addition to the interest cost. It is a prohibitive tax.

Representative REUSS. Granted it is prohibitive, so long as it remains on the books; nevertheless, until this country does so expand its exports vis-a-vis its imports so it can cure it balance of payments that way, we have to do it some way, do we not, as Professor Blough was saying?

Mr. MUNDELL. Yes.

Representative REUSS. And if this means that New York does a smaller percentage of the world's flotation business, this is the way it has to be.

Mr. MUNDELL. I have to admit that it is effective. I might just, though, put in this comment, that I find it deplorable that it be a discriminatory tax, that it discriminates against countries like Japan, and so forth. I think there is no reason at all for a tax that discriminates in favor of Canada and against Japan. If you are going to impose the tax, impose it on all countries.

Representative REUSS. You would have favored, I gather, a capital issues committee or something like it which would have forbidden flotations in New York, the proceeds of which would be used in surplus countries without balance-of-payments problems like the continent of Europe.

Mr. MUNDELL. No; you misunderstand me. I would not have favored this at all. I would not have favored any tax. If there are 15 measures for correcting the U.S. deficit, this would be somewhere near the 15th measure. I find this an extremely repugnant tax.

Representative REUSS. What would you have favored? We have a $3 billion a year deficit and have had for the last 4 or 5 years. How are we going to shut this off?

Mr. MUNDELL. My first choice is, without any question, flexibility in the exchange rates. My second choice, from the point of view of U.S. interests alone, would be an export subsidy. The United States already has export subsidies on agricultural products, and foreign countries have export subsidies. An export subsidy would both increase

exports and improve the balance of payments, and subsequently, increase employment, which is what the United States needs to do at the present time. Far above an interest equalization tax or any variant of this, I would prefer an export subsidy on manufactured goods in the United States. This has an advantage of simultaneously increasing employment and correcting the balance of payments. It represents also a move toward a freer trade arrangement, because an export subsidy is one way of canceling off tariffs. It is efficient in the sense that it is a movement toward a freer trade position. I would find this far superior to a capital issues tax.

Representative REUSS. Mr. Blough, did you have a comment?

Mr. BLOUGH. I was disposed at one point to intervene, but maybe I had better let it ride.

Representative REUSS. Thank you very much.

Senator Proxmire?

Senator PROXMIRE. Well, I just want to follow up this last idea with Mr. Mundell. The notion of an export subsidy would strike at the one phase of our balance of payments which is highly favorable. That is, we have a very favorable balance of trade and consequently the other nations of the world have an unfavorable balance of trade. Where the balance is lacking is in the capital field. We are exporting a disproportionate amount of capital and, of course, importing very little. Therefore, the interest equalization tax would seem to hit the aspect of our balance of payments which is most out of balance. It would have that advantage, and have the other advantage of leaving the resolution to the market and not have it determined, as it might be with a capital issues committee, on the basis of some political pressure.

Mr. MUNDELL. I know this is not a popular view.

U.S. capital exports have been a very, very small fraction of U.S. gross national product. The U.S. capital exports, if I am right, are something of the order of $2 or $3 billion a year, which is perhaps less than half of 1 percent of the gross national product and is not a large capital export for the wealthiest nation in the world, where the marginal return on capital is maybe getting to be slightly lower. Quite apart from all this, the capital exports pay huge dividends in terms of building up the U.S. long-term capital position, and interest payments and dividends being returned in this case are significant. I think for sake of the immediate short term, you are creating incredible long-term problems in disrupting the world financial markets in this way, looking at the problems today and tomorrow and the next day, while sacrificing long-term international objectives that are extremely important.

Senator PROXMIRE. This tax was conceived as strictly a temporary expedient, and it is to last only as long as we have this difficult position in capital flows.

Mr. MUNDELL. Which simultaneously makes the tax so much more severe. That is what makes it a prohibitive tax, the fact that it is a very short-term tax.

Senator PROXMIRE. That is right.

I would like to ask Mr. Tobin one question. Mr. Tobin, will you compare your proposal on page 15 of your prepared statement (see pp. 555–6) with the Posthuma plan, or the Bernstein plan which I un-

derstand is being very seriously considered by major countries in Paris now?

Mr. TOBIN. What I have on page 15 does not deserve to be dignified by the name "proposal" because it is not specific as to how this can be done. As I have said, there are a number of ways in which it could be done. The Bernstein proposal is one of them in the respect that it does create new liabilities of the International Monetary Fund, although in this case, the Fund is acting as a trustee for a few of its members, rather than in its normal capacity. So to that extent, the Bernstein plan is one variant of the general kind of proposal that I was talking about on that page 15.

What Bernstein has in addition, which is similar to the Posthuma proposal, is an agreement by the major countries as to the proportions of gold and the nongold part of their reserves, especially in this new form, which they will hold. That is the key thing there, that they will be in agreement henceforth that gold and this substitute for gold will be held in reserves in certain proportions to each other. The object of that is to prevent the kind of instability which could arise by sudden shifts in preferences by the countries from gold to the reserve units, whatever they are called, or vice verse, the kind of instability that plagues the gold exchange standard when there are shifts back and forth between dollars and gold.

Senator PROXMIRE. Thank you.

Representative REUSS. Senator Douglas?

Senator DOUGLAS. I have only one question which I would like to ask the other members of the panel; namely, whether they believe that if we were to have a flexibility of exchange rates within limits, it would be necessary to modify sections 3 and 4 of article IV of the IMF Articles of Agreement, or whether we could simply do it through section 2.

Mr. BLOUGH. I have nothing before me which would permit me to give you a legal opinion.

Chairman DOUGLAS. Mr. Mundell was advocating a fluctuation of not less than 7.5 percent as a gold margin.

Mr. TOBIN. I will try on that, Senator.

It seems to me that Professor Mundell's proposal would not work unless it were possible for exchange rates to vary by the larger margins which he suggests, that it would not accomplish his proposal simply to have everybody's price of gold have wider margins between the buying and selling prices.

It seems pretty clear to me, if language means language, and I am not a lawyer, so I assume that language does mean language, that it would require an amendment to the articles of the Fund.

I certainly think—quite apart from the legalisms involved—that everyone recognizes that the Bretton Woods agreement was meant to set up a system of fixed exchange rates adjustable under certain conditions, and therefore that a change of this kind would be a change in the whole system, which should not be adopted without amending the articles.

Chairman DOUGLAS. But is it not true that Bretton Woods was adopted under the fear of inflation? That is, the flexible exchange rates which followed World War I were in those countries which went off the gold standard, which printed large amounts of paper

money and had runaway prices—under those conditions you had flexible exchange rates—and it was feared that this is precisely what would happen after World War II. So it was to guard against runaway inflation that the fixed exchange rate provision, ultimately based on gold and on the dollar, was put into effect? But what we in the United States face now is not inflation. To correct misapprehensions, I put often into the record the fact that the wholesale price index has been constant over the last 5 years. There has not been a 5-percent inflation which Professor Mundell alleges. There has been a 5-percent increase in the Consumer Price Index, but not in the Wholesale Price Index, which has been steady. I have always thought that that was the primary index to be considered.

What we do face is not inflation in this country but high unemployment and unused resources. Some of us have felt that at least one factor in the creation or continuation of this unemployment was the obsessive concern of the monetary authorities with the balance of payments and with the fear of a speculative raid upon the dollar by possibly Switzerland or France or Germany. Now, under those conditions, should you reject out of hand this possibility of flexible or partially flexible exchange rates and, if necessary, the modification of the IMF? After all, we propose constitutional amendments. My memory goes back a long time. I was for the constitutional amendments which legitimized the income tax and the direct election of Senators and a number of other amendments.

Mr. BLOUGH. Senator, may I speak to this?

Chairman DOUGLAS. Yes, indeed.

Mr. BLOUGH. Is it quite fair to say that here is a subject which has not been given consideration?

Chairman DOUGLAS. All I can say is that I have been unable to get any lucid discussion on this subject from any representative of the Federal Reserve Board. I want to say I think they are capable of giving this a lucid discussion. I do not wish to denigrate their ability. But as this question has been put time and time again to Mr. Martin there has only been a bland parry.

Mr. MUNDELL. I might add that there is one sense in which the spirit of the Bretton Woods Conference has not been carried out, and this is with respect to the adjustable peg mechanism. There is not even any means by which countries can devalue the major currencies in accordance with the adjustable peg mechanism that was created, when they do have a fundamental disequilibrium.

Mr. TOBIN. May I say something?

Chairman DOUGLAS. Yes.

Mr. TOBIN. First I would like to say if there could be achieved a sufficient consensus in the world to shift to flexible exchange rates, then there could also be achieved a sufficient consensus in the world financial community to make the fixed-rate system work. I agree that if you are not going to have sufficient reserves and sufficient liquidity, it is very difficult to have the fixed exchange rate system work. But the same kind of agreement, the same kind of determination and consensus about objectives is necessary to substitute a system of flexible exchange rates as would be necessary to take the steps to make the fixed-rate system work better.

In a sense, we may have had the worst of both worlds in that we have not had the full benefits of a system of fixed rates and neither have we had flexible rates.

I am not so sure that an adjustable peg system is a good idea, at least with respect to major currencies, because the whole rationale of the fixed-rate system is that it removes from international transactions, particularly from international capital transactions, the risks of changes in exchange rates, which would perhaps retard international transactions under a system of flexible rates. But as long as we have the prospect that the fixed rates may be adjusted, then those risks are present anyway.

Perhaps we should aim one way or the other; we should aim at having a really fixed system in which we will take the steps necessary to make that work—and those steps include a greater coordination of monetary and fiscal policies among the various countries—or we should go in the other direction. But either way is going to require an international consensus.

Chairman DOUGLAS. Well, that is just the point. I am all for an international consensus if it can be obtained. But I think I revert to the point that Congressman Reuss was raising when I came in some time ago. I think there has been a real inability to get any international help aside from minor adjustments given to the United States by the European bankers. On the contrary, they have denounced and reviled the United States for running unbalanced budgets, although their own budgets have been as unbalanced as ours, with some exceptions. They have denounced the United States for having an unfavorable balance of payments, although that unfavorable balance of payments has furnished the dollars which alone, supplementing gold, have made the international system work. In my judgment, they have been extremely uncooperative with us. They refuse to allow their price levels to rise more rapidly than they have, though this would be a corrective for the situation. They expect us to bear the full burden of making the system work. And it may be that this is psychologically understandable, because perhaps we did psychologically lord it over them for some time.

But we are in a very serious situation. If you take away the possibility of independent national action, you take away one of the great reserve strengths that we have.

I would like an international system. But suppose we are not able to obtain it?

Mr. MUNDELL. Senator, I might add that——

Chairman DOUGLAS. Now, be careful in what you say, because I want to protect you from excessive internationalism on your part.

Mr. MUNDELL. Well, I was about to disagree with one thing you had said; namely, that the Europeans have not been inflating. Their price level has been rising over the past, and I do think that they might very well say, what happens if we allow our prices to rise so much and then, because of lags in the system, our balances get into trouble? Will the United States then turn around and resume its own inflation? They may very well be skeptical about the willingness of the United States to inflate. This is the paradox in the system. This is the thing which means that the adjustment mechanism is just an inappropriate one. This is the basic argument that Professor Friedman has already laid out, even if the shoe is on the other foot.

I very much doubt myself the U.S. willingness, if it gets into a position of surplus, to deliberately allow its entire price level to rise solely for the sake of a part of national income that is only 5 percent or so of its income.

I would like Professor Tobin to tell us, if he would, if he does think a fixed exchange system can work, what is the adjustment mechanism? How do countries correct balance-of-payments problems? People can continue to talk about an increase in liquidity, but you finally have to get to the point that you spend no more than you earn, ultimately. If you do not, if you want to rule out inflation and stagnation and you want to rule out interest equalization taxes and controls, what is the adjustment mechanism that Professor Tobin would recommend?

Senator DOUGLAS. Before he answers, let me say that in the normal process of time, under the old gold standard, countries in a position such as ours would export gold; price levels in other countries would rise, price levels would fall here. This would stimulate our exports and reduce our imports and you would have an ultimate balance. But now we have largely nationally managed currencies, and despite the situation of large dollar reserves held by Europe, these are, not wholly, I grant, but largely sterilized by not permitting the expansion of domestic credit abroad to proceed very far. The possession of dollars abroad does not lower the American price level. And I agree, this would be pretty severe medicine to take. I hate this word, but the automaticity of the old gold standard has been greatly impaired. I don't think that the present gold exchange system, plus nationally managed currencies, plus the care of the good Governors of the IMF, has created an adequate substitute.

I do think that flexible exchange rates would help, and your suggestion that the amount of flexibility be within limits appeals to me very much. If it means we have to get out of the IMF that would be a terrible price to pay. But I do not think we can continuously offer our labor force and our gross national product as a costly sacrifice upon the altar of internationalism.

I had a great deal of sympathy with President Roosevelt in 1933 when he sent delegates to the London Economic Conference. He was attacked for breaking up the international conference. If you look at the history you will find that he proposed an international program of public works, a simultaneous international program of public works and reemployment of labor, with the price levels of all countries rising in proportion to each other. This was rejected by France—I think by Great Britain, too. Faced with that, he then embarked upon his domestic program and there quickly followed the various public works programs. He was attacked by a section of the financial writers for breaking up the London Economic Conference. I think he had to act.

I do not like to contemplate the idea of monetary nationalism on the part of the United States, but if we get no cooperation or little cooperation, little response from European central banks and monetary authorities, we may be driven to do this, much as we dislike to do it.

Excuse me for taking so much time, Mr. Tobin. I am told my time is up.

Mr. TOBIN. First I should like to say that I am not sure by any means that the sacrifice that you refer to is a necessary one; that is, I am not sure that our balance of payments would be worse if we

were at full employment. It might well be better. The main reason for expecting that, or at least considering that to be a possibility, is that our domestic profit prospects and needs for funds for domestic investment by business firms would be greatly improved by operating——

Chairman DOUGLAS. Excuse me, Mr. Tobin. I do not think I said that, or if I did, I was certainly very inept in the way I spoke. I did not say that the balance of payments would be worse if you had full employment. Quite to the contrary. I do not think that I said that the cause of our unfavorable balance of payments is full employment. Quite to the contrary. Whatever the effect of full employment on the balance of payments might be, that is another thing. But I did say our monetary and fiscal authorities and their efforts to protect the balance of payments had, in my judgment, restrained employment and production here at home.

Mr. TOBIN. Senator, I am glad that this time when you said that, you said monetary and fiscal authorities. The previous time, you said only monetary authorities and it seems to me the fiscal authority is the Congress and it has been open to Congress to take measures which will restore full employment.

Chairman DOUGLAS. Now, Jim, I like you very much and I have great respect for you, both as a man and as an economist. But it is the favorite method of any administrator or anybody connected with the executive department to blame Congress when, as a matter of fact, you know the policies are made in the executive department, at the Federal Reserve, in the White House, at the Treasury, and we have very little to do with it. We are faced with accomplished facts. But the President complained the other day that he always had to take the rap. I say we always have to take the rap, at least on the part of the Executive, for the fundamental decisions made by the Executive.

Mr. TOBIN. I am a professor, not an executive.

Chairman DOUGLAS. Well, you have been and I am afraid you have contracted the habits of thought of the executive. The whole professorial profession is riddled through with executivitis and the bias in favor of the executive.

Mr. TOBIN. I just say that the monetary policy, however good or bad it may be, is not the only route that is available to us to achieve full employment. The fiscal route has been open to us and very likely it would not lead to a worsening of our balance of payments to have a full capacity economy and a full employment economy.

Chairman DOUGLAS. I know. I am all for it.

Senator PROXMIRE. I hate to interrupt, but I do think the key question by Mr. Mundell was just asked of Mr. Tobin and I am eager to get an answer. It is the same question Mr. Friedman asked. That is, what adjustment do you make with a fixed rate system rather than a floating rate system.

What adjustments?

Mr. TOBIN. There are still some mechanisms of adjustment available. I would not rule out entirely some differential movements in price levels such as we have been observing between Europe and the United States in the last few years. And I do not think the countries are ruling those out entirely as a mechanism of adjustment under fixed

rates. They take time, but they can help to adjust the balances of trade.

As far as adjustment of the capital accounts is concerned, there are several possibilities. First of all, if capital movements are inspired by differences in profit rates as between countries, then in time, the accumulation of investment in the more profitable countries will lower the rates of return there and the rates of return in the other countries will be more competitive.

On top of that, we have the returns from investments themselves. We have been a capital-exporting country and one of the strengths of our balance of payments is and will be further the income on the capital investments we have made abroad. In time, that helps to offset the outflow on the investment side.

Beyond that, going back to the trade account, there are adjustments in the composition of trade and in the structure of the economy. Trade is responsive to comparative advantage in different countries. If something happens which gives Europe, for example, a comparative advantage in things where they did not have it before, the counterpart of that is that we have a comparative advantage in something else, maybe something we were not so strong in before. That again is an adjustment in economic structure, it will take time. It is the kind of adjustment that goes on all the time within the United States, within a country which has fixed rates, within a continent which has fixed rates. And that can occur.

So I do not think that the fixed rate mechanism is entirely without acceptable mechanisms of adjustment. But they are not fast. That is why we need a substantial amount of liquidity.

Senator PROXMIRE. They are painful. A substantial amount of liquidity, there is no question, is absolutely essential. Perhaps international liquidity must be more substantial than it is now. But there is no question that these adjustments do require painful increases in prices abroad or deflation here, or both.

Mr. TOBIN. I was not referring to general deflation as one of the mechanisms.

Senator PROXMIRE. Then it requires more inflation abroad.

Mr. TOBIN. I think there can be some modest differences in price trends between countries.

Senator PROXMIRE. And therefore, we are at the mercy of their particular governmental policy decisions. If they do not inflate, we just have to make adjustments or lose our gold or lose our international financial leadership; is that not right?

Mr. TOBIN. There are some other mechanisms which are more or less fortuitous. That is, there are always, in an imperfect world, a number of restrictions on trade and on capital movements which still exist. It would be opportune to take advantage of surplus positions to remove these, because it would both help in the balance-of-payments adjustment and be a blow in a good cause.

The same thing is true of burden sharing. To the extent that it would be proper, in any case, for European countries to share a larger part of the burden of defense and aid, now is a good time for them to do that. That is an adjustment mechanism which is not only good in itself, but also helps the balance of payments.

Chairman DOUGLAS. But suppose they do not? For years the Treasury, under both administrations, has been saying Europe ought to bear a larger share, France ought to bear a larger share, Britain ought to bear a larger share, West Germany ought to bear a larger share. What is the result? France has 1.5 divisions under centralized control, NATO control, compared to our six divisions. We have more men defending the soil of France under unified control than France has itself. Great Britain has, I believe, something like 40,000 uniformed men on the Continent, we have something like 400,000, whereas the ratio, according to population, would be roughly 175,000, 160,000. As the European countries have increased in strength and prosperity, and we are happy to see that they have and wish to help them, they have not borne their proportionate share of this burden. We have been urging them and urging them and urging them. When some of us raise this question, the reply will be just as you have made, "Well, we ought to make adjustments." But you get no results.

Senator PROXMIRE. If the Senator would just permit one additional note on that. Many of us deplore what has been happening on the floor to foreign aid. I am one of the guilty parties. I might say one of the reasons is because there has not been adjustment on the part of our allies in Europe to lift some of this burden off our backs; so Congress is taking what to some people is a pretty brutal recourse. A lot of Senators, many—I could name them; I won't—have been taking this position very largely, and they say it on the floor, because of the balance-of-payments problem. This is used again and again in the foreign aid debate. People who have been firm friends of foreign aid have voted for reductions because they say we simply cannot afford this program, even if our aid is tied to procurement in the United States, because our balance-of-payments situation is so serious.

Chairman DOUGLAS. They have taken us for granted. They believe we are so firmly committed to them that we will not make any alteration. So they go ahead, making disproportionately little contributions themselves and in many cases reviling us with the most bitter denunciations, and it becomes extremely hard to take.

Now, I have—well, we shall not go into that.

Representative REUSS. You could a tale unfold, too.

Let me get back to the question which Mr. Mundell answered, and I think we have kept our panel almost long enough, but the question was, I believe, from Mr. Mundell to Mr. Tobin, if you have fixed exchange rates as you now do and if the United States gets into surplus, how can equilibrium be restored without the United States inflating, with all its attendant disastrous economic consequences. Was that your question?

Mr. MUNDELL. That is one part of it, yes.

Representative REUSS. Let me try a partial answer to that, because I suggest that you really are forcing the answers of that question into a false dilemma.

I do not think the only way out of that box is the ungodly one of the United States inflating. Perhaps I should put this to Mr. Blough, who I think wants to comment on this.

Why are not constructive solutions to that problem the following two, at least:

One, let us then lower our tariffs and other barriers against trade and cut down our unholy surplus, which action, far from hurting the

American consumer, would make him happier because he will have more goods to buy; and secondly, why do we not at the same time give a larger measure of foreign aid and progressively untie it? Both of those methods will help to rid ourselves of this embarrassing surplus, without inflation. I would like Mr. Blough's comment on that with any additions he can make.

Mr. Blough. Mr. Chairman, thank you. I find this conception that we are going to have again a problem of a dollar shortage, of a U.S. surplus, which will be an embarrassment to us to be rather far-fetched for the reason that you have pointed out. We showed how to get rid of a dollar shortage once before, to the very great advantage of other parts of the world. We did not do it in any large degree through inflation. I see no reason for believing that our inflation was in any substantial degree due to the fact that there was a shortage of dollars in the rest of the world. It is very simple to get rid of a surplus if you have a willingness to invest abroad privately, to provide foreign aid, or to free your trade to imports. These may have an indirect inflationary influence, but they are not policies to achieve inflation.

Now, I think the real problem, and the one that bothers Professor Friedman and many other people, is not a surplus but the continuation of the deficit, the conditions under which we are faced with the surpluses of other countries. If they do not act to reduce and eliminate their surpluses, how can the deficit country by itself make the necessary adjustment?

It seems to me there are two things to bear in mind. One is that free rates of exchange are far from being a perfect system. They involve very serious problems. The real question is where does the balance of seriousness lie?

There are various methods available for making adjustments under a system of fixed exchange rates. Relative rates of inflation or deflation certainly is a major method, but there are other methods open. The promotion of productivity in suitable industries through tax measures, and other types of measures, is available to us. We have done relatively little along this line. The promotion of exports is an important method. Our whole trade promotion program is still in its early stages. I think it can be greatly expanded and improved. Restrictions on the outflow of capital are available to us. When capital is flowing out, not because people want dollars to buy our goods and not because they want dollars to finance trade, but merely because it is the easiest and cheapest way of getting their own local currencies, I do not see that we have any responsibility. Why should we supply them with dollars to help them get their own local currencies?

If the situation became even worse, general exchange controls would be available and at the very worst, of course, devaluation is a measure which has been open to other countries. I do not see any reason why we need to contemplate it, but it is certainly a possibility.

Now, fixed rates of exchange have great value. They work very much better in some respects than free rates. I would like to quote briefly from the article by Mr. Roosa in Foreign Affairs, October of this year:

> Fluctuations in the price of a country's currency create costly uncertainty for the pricing of its exports and imports by the people who actually sell and

buy them and make more complex the investment decisions that ultimately determine how and where the goods will be produced.

That is an understatement, I think, of the situation.

He also goes on to make another point which I think is important:

Moreover, depreciation of the currency as a method of adjusting deficits in the balance of payments of any one country may be resisted by competing countries, leading to protective trade restrictions or a series of competitive depreciations through officials' actions to preserve national export markets.

In view of the fact that most other countries do not feel that we are in a difficult position with regard to trade and, in fact, think we are ahead of the game, we would not get very far, in my opinion, in trying to solve the problem through freeing exchange rates.

There is also a very important problem which has not been mentioned. If as economists we are prepared to accept continuing inflation within a country, then flexible rates of exchange is an excellent method of assuring that result. Flexible exchange rates would greatly reduce the pressures inside a country against those groups who want to see prices rise, wages rise, and all the rest. You would probably have a succession of competing inflations, with country after country depreciating its currency for the purpose of promoting its exports and reducing its imports. It seems to me that flexible exchange rates would not solve the problem but would rather create a more difficult problem. I believe our energies ought to be directed to making a fixed system work through international cooperation, which you point out we have not been getting.

Chairman DOUGLAS. Do you think no matter how strong our talk, this will have the slightest effect?

Mr. BLOUGH. I do think it has an effect.

Chairman DOUGLAS. What is the definition that the Bible gives to faith? Faith is the substance of things hoped for—the evidence of things not seen.

Representative REUSS. At the risk of seeming to disagree with my chairman, I am going to try to ask a leading question of you, Mr. Blough.

Is not part of your faith, that better results than we have so far obtained from Europe can be obtained, based on the idea that if those in charge of our foreign policy made more articulately the point that has been made here by Senator Douglas, among others, in words which somehow got through to the people of those countries, which are democratic countries, after all, the people might then demand a more outward looking standard of performance by the finance ministers, the central bankers, and other cabinet officials? So far, I am afraid, the officials have been as guilty of inward looking noncooperation as Senator Douglas feels they have.

Mr. BLOUGH. I think the outlook is by no means as bleak as Senator Douglas suggests, but I do think it is going to take all kinds of pressure and I would include in this congressional pressure to get the results you are after.

Chairman DOUGLAS. Do you think that the members of the State Department or the monetary authorities have enough virility to really turn the heat on sternly?

Mr. MUNDELL. I might just add that we may get into a basic inconsistency here if we say, as Professor Tobin was saying, that he is

in favor of some more inflation in Europe. There has already been substantial inflation in Europe—Europe's main problem over the past 30 or 40 years has been inflation. Now, if the balance-of-payments cycle turns around and the United States gets into a surplus, then it certainly seems hypocritical to say that you should not inflate, because you would be rejecting the advice that you want to give to Europeans at the present time. This really reveals that it is always and again the adjustment mechanism. There is no adjustment mechanism under this system that any of us want. We do not want inflation; we do not want stagnation.

Mr. Blough has made a persuasive case for fixed rates, and no one says any system is perfect. Flexible exchange rates are not perfect. No adjustment is painless. It is only that the adjustment that goes on under fixed rates is so incredibly expensive that if we really stopped to think about the enormous costs that have been paid over the past for this and will be paid in the future for this, of stagnation in the deficit countries and inflation in the surplus countries, we will ultimately get to the point where we have to reject fixed exchange rates.

Representative REUSS. Mr. Tobin, a moment ago when you were heard to raise a mild cheer for inflation over in Europe, I take it that the only reason you did that is that you are so appalled at the stupidity and shortsightedness of European statesmen in raising their tariffs against the rest of the world at the time that they should be lowering them, and in failing to give adequately in untied foreign aid. Is this the reason you are forced back to this inflationary acquiescence? You do not really suggest that their inflation was a better way for them to proceed, in terms of the good of the free world, than for them to have lowered their tariffs, turned the Common Market outward instead of inward, and done a decent job on untied foreign aid?

Mr. TOBIN. There are so many rabbits loose now that I do not know if I can catch them all. I do not think I raised a cheer for inflation in Europe. I do think that they have a number of possible ways of adjusting to the surplus that they have been enjoying. One of them is to permit their price levels to rise as has been happening, although I notice that these rises in price levels somehow never get transmitted to their export prices. It is the domestic prices that rise. If they do not want that, there are a number of other alternatives open to them, some of which you have enumerated. But even in terms of domestic economic policy, they could combat inflation by a combination of fiscal tightness and monetary ease. This would mean that their capital and money markets were less competitive for funds and would help the capital account of the balance of payments without presenting them with a domestic inflationary problem. They have this possibility just as we have the possibility of using the fiscal tool as the main way of getting out of our deflationary problem to the extent that the monetary tool is immobilized by the balance-of-payments situation. And the happy even of a U.S. return to surplus, which I do not think is so fantastic, then we would not necessarily have to accept inflation. We could use fiscal tightness and monetary ease as our combination of stabilization policies, and this combination might be good for domestic purposes as well as for external balance in that situation.

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I do think, by the way—Senator Douglas, has gone—that Europe deserves a bit more credit than he is giving them, because there have been some offset agreements on military procurement and this sort of thing. There has been an increase in foreign aid from Europe, and there are a number of other things that could be mentioned as responsiveness to the sorts of pressures that he is talking about.

Representative REUSS. Well, gentlemen, thank you all very much for your great contribution and your patience.

We will now stand adjourned and this phase of the Joint Economic Committee's hearings is now at an end.

(Whereupon, at 1:05 p.m., the committee adjourned, subject to the call of the Chair.)

(Subsequently the following communication was received from Professor Mundell:)

McGILL UNIVERSITY,
*Montreal, November 22, 1963.*

Senator PAUL H. DOUGLAS,
*Chairman, Joint Economic Committee, Congress of the United States, Washington, D.C.*

DEAR SENATOR DOUGLAS: I want to thank you for the most enjoyable and stimulating morning spent with the Joint Economic Committee, and for the opportunity to discuss problems of the international monetary system.

It was clear from the transcript that we did not answer at all adequately your query about the need for a change in the Articles of Agreement of the International Monetary Fund in the event that it was decided to widen the gold margins, as I had proposed. It is true that article IV(2) gives the Fund itself permission to set the margins:

"The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin."

The trouble is that this apparently conflicts with article IV(3):

"The maximum and the minimum rates for exchange transactions between the currencies of members taking place within their territories shall not differ from parity * * * by more than 1 percent * * *."

As you will have noted, I had argued for widening the margins *and* for a cessation of intervention in the foreign exchange market at the conventional buying and selling limits, the latter component of the proposal being necessary to ensure that the widening of the gold margins did in fact impart the desired flexibility to the exchange rates. But the Fund has the right, apparently, to alter the *gold* margins *without* having the right to widen the *exchange* margins beyond the 1 percent limits. If sections 2 and 3 of article IV are interpreted *by themselves* it would mean that if the *gold* margins were widened beyond the maximum allowable *exchange* margins countries would have to intervene in the exchange market at the 1 percent limits and the desired exchange rate flexibility could not be obtained. Since the two sections can conflict, I should presume that a lawyer would have to insist upon compliance to both sections.

Fortunately for my proposal, the articles seem quite explicit about which of the two sections has dominion in the event of a conflict. Article IV(4)b states:

"Each member undertakes, through appropriate measures consistent with this Agreement, to permit within its territories exchange transactions between its currency and the currencies of other members only within the limits prescribed under section 3 of the article. *A member whose monetary authorities, for the settlement of international transactions, in fact freely buy and sell gold within the limits prescribed by the Fund under section 2 of this article shall be deemed to be fulfilling this undertaking.*"

The italicized passage seems to settle the issue, establishing dominion of IV(2) over IV(3), provided a country is freely buying and selling gold within the limits established in IV(2).

Upon reflection, this interpretation is obvious. The United States does not peg the price of foreign currencies, it pegs the gold price. In the early years of the Fund, and even today, exchange transactions in the New York foreign exchange market, outside the 1 percent maximum on either side of par, have been common. The United States does not feel obliged to peg foreign currencies and the Fund does not require that it do so because it freely buys and sells gold within the margins prescribed by the Fund.

It seems clear, then, that the Fund does have the right to establish gold margins as wide as appears necessary or desirable, and that any country which contracts to buy and sell gold within these margins is exempt from the requirement in article IV(3) that exchange margins be limited to 1 percent on either side of par. Although final judgment would have to rest with the Fund's legal staff, it would seem that my proposal could be implemented without any change in the articles of agreement.

With apologies for not amplifying on this point at the hearings, and best wishes to you and the other members of the committee.

Yours sincerely,

ROBERT A. MUNDELL,
*Professor of Economics.*

# APPENDIX

## STATEMENTS BY ECONOMISTS, BANKERS, AND OTHERS

ON

## THE BROOKINGS INSTITUTION STUDY, "THE UNITED STATES BALANCE OF PAYMENTS IN 1968"

**MATERIALS SUBMITTED TO THE JOINT ECONOMIC COMMITTEE BUT RECEIVED TOO LATE FOR INCLUSION IN ITS COMPENDIUM RELEASED IN NOVEMBER**

# APPENDIX

## STATEMENT BY WILLIAM S. BUTLER

Vice President, Chase Manhattan Bank, New York, N.Y.

So much expert scrutiny has been applied to the Brookings study that I feel it would be superfluous to run through the detailed assumptions and projections presented in the study. For example, I find myself in general agreement with Hal Lary's statement before the Joint Economic Committee on July 30, 1963, as well as with many other commentaries on the Brookings report which I have seen. Consequently, I propose to offer only a few general observations in the hope that they may supplement the more careful and detailed analyses presented by others.

Since the burden of my comments will lie on the critical side, I should state at the outset that I have great admiration for much of the analysis in the Brookings report. The authors faced an extremely difficult assignment and displayed a high order of competence and imagination, as well as commendable courage. As one who engages in the perilous practice of forecasting, I believe it is a necessary and useful exercise, and one which can become more constructive with experience. Thus, I salute this attempt to make forecasts of the Nation's balance-of-payments position as one of the pioneer efforts in a crucially important field.

Moreover, I tend to agree with many of the analytical conclusions of the report, though not with most of its policy recommendations. My feeling is that we may have passed the worst period in the U.S. balance-of-payments problem and that we can achieve a viable balance in the foreseeable future. An underlying reason for this belief is the improvement in the competitive position of the United States which has already taken place.

At the same time, I would stress the fact that we cannot count on inflation in Western Europe to bail us out if we do not deal effectively with the very real problems confronting us. I would also warn those who are responsible for formulating policy that they should keep a careful eye on what economic forecasters assume to be equal. The Brookings report is exemplary in emphasizing the very great problems of forecasting in a field where the basic data leave much to be desired, and where heroic assumptions have to be made. In appraising the report's conclusions, one should pay careful attention to the many cautionary notes contained in the analysis. In particular, it should be stressed that we know far too little about international price trends and the factors influencing international capital flows to explain what has happened in the past, not to speak of making reasonably reliable forecasts of future trends.

GOVERNMENT CAPITAL EXPORTS

The most serious criticism I would levy against the report's analysis is that it tends to minimize the role of Government economic aid and military expenditure programs in our balance-of-payments problem. While the analysis of the leakage involved in foreign aid is most intriguing, I believe it understates the dimensions of the problem. Another way of looking at this problem is provided by an excellent analysis by Alexandre Lamfalussy ("The Thirty-Five Dollar Question," Lloyds Bank Review, October 1963).

Lamfalussy's point is that a major part of the gain (and in 1961 and 1962 the entire gain) in Western Europe's gold and dollar reserves came from a surplus in transactions with third countries. These third countries financed their deficit with Western Europe from a surplus with the United States which was almost entirely due to the receipt of U.S. aid (some funds came from the IBRD and IDA). It is clear that without U.S. aid, these third countries could not have financed deficits with Western Europe which averaged $800 million a year from 1953 to 1961 and which rose to almost $2 billion a year in 1961 and 1962. We can tie aid dollars, but we cannot tie other dollars earned by these countries.

In addition, U.S. transactions with Western Europe on government account still involve significant outflows. While the total drain declined to $1.1 billion in 1961 and to $400 million in 1962, a good part of the improvement was due to repayment (in some cases advance repayment) of loans by Western Europe, and thus cannot be regarded as permanent.

None of this means that we are compelled to reduce our economic and military aid programs. However, I believe it does mean that we must reduce the dollar drain involved in such aid. In the final analysis, this means that other industrial nations must increase their contribution to the common effort. One way for them to do this is to untie their aid.

To my mind, one important point stands out in the report's analysis of the leakage from economic aid. The leakage is significantly smaller when aid is given to nations, such as most of those in Latin America, which trade chiefly with the United States (or with Canada and Japan). The dollar loss is significantly larger when aid is given to nations which trade primarily with Western Europe. While aid cannot be tailored solely to the requirements of the U.S. balance of payments, this suggests that the problem could be eased if we could shift the weight of our effort toward dollar-trading nations while Western Europe stepped up its effort in nations within its trading sphere. Specifically, the relatively small amounts of aid (too small to be effective) which we supply to a great many nations which trade mostly with Western Europe involves a total dollar drain which is disproportionately large in relation to its contribution to development.

On final observation on this matter is that Western Europe's surplus with third countries might decline considerably in the years ahead. I have not made a detailed study, but two broad considerations suggest that recent trends may be altered in the future. For one thing, Western Europe has enjoyed unusually favorable terms of trade with the raw materials producing nations. Current developments in a

number of raw materials fields point to the possibility of a rise in prices. At the same time, the improvement in the competitive position of the United States might lead third countries to spend more of an increase in their export earnings here rather than in Western Europe.

### FISCAL AND MONETARY POLICIES

To shift to an entirely different point, I wish the report had attemped more in the way of analysis designed to help in the difficult decisions as to the optimal mix of monetary and fiscal policies in our search for expansion in domestic production and viable stability in our international payments.

Economists are divided on these matters as is shown in the results of a recent survey of academic economists conducted by the economic research department of the Chase Manhattan Bank. A series of questions were posed to 460 academic economists, and 308 supplied answers. Here are the results on the three questions which pertain to the balance of payments:

What do you consider the most pressing economic problem now facing the United States? Unemployment, 31 percent. Inadequate growth, 36 percent. Balance-of-payments deficit, 19 percent. Automation, 3 percent. Other, 11 percent.

Do you think there is a conflict between (1) solving the balance-of-payments problem and (2) achieving full employment? Yes, 50 percent. No, 50 percent. If your answer is "yes," do you think: More emphasis should be put on correcting balance-of-payments difficulties? 28 percent. More should be put on reaching full employment? 56 percent. Present policies hit just about the right balance? 16 percent.

What would be the best way of solving the balance-of-payments problem? Tighter monetary policy, 19 percent. Exchange controls, 4 percent. Tariffs and import quotas, 2 percent. Devaluation, 11 percent. Other, 64 percent.[1]

I believe that at least part of the confusion among economists (as well as the general public) reflects the lack of careful and definitive studies which would narrow the area of disagreement and point to sharper conclusions for policy. As an example, I do not believe we know what the relationship is between short-term interest rates and short-term capital movements. While the two pieces of research I have seen represent commendable efforts, I do not feel they yield conclusive results. By the same token, we need more intensive study of the factors underlying long-term capital movements (direct and portfolio) and the Euro-dollar market.

This Nation is undoubtedly destined to be a capital exporter for many years. And yet we exported more capital (public and private) than we could afford to finance by borrowing short abroad—at least until the third quarter of this year when the uncertainties surrounding the interest equalization tax virtually eliminated the export of long-term private capital outside of the direct investment area. It should be pointed out that a drying up of the export of portfolio capital does not represent a satisfactory solution of the problem.

[1] Included in other: Cut foreign aid or military spending abroad, 22 percent; increase exports and cut imports, 19 percent; improve U.S. growth rate and productivity, 7 percent.

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It seems to me that we need much greater flexibility in the use of monetary and fiscal policies. I believe we must be willing to cut taxes and control expenditures when such actions seem likely to contribute to attainment of our economic goals—and I cannot recall a period where the case for such actions was comparably as strong as it is at the present. We must use monetary policy more flexibly and in closer concert with fiscal actions. To look at the other side of the coin, I believe we must also be prepared to deal with inflationary forces through policies of fiscal, monetary, and wage restraint. This could well mean that we would have to raise taxes at some future date if inflationary pressures become acute.

A flexible use of monetary and fiscal policies should contribute both to our objective of domestic growth without inflation and to that of a satisfactory balance-of-payments position. It seems to me that many have confused our inept handling of monetary and fiscal policies in the past few years with a basic conflict between internal and external factors. Because of our failure to cut taxes and contain Government spending to spur domestic growth, we have been placing the entire load on monetary policy, and asking of monetary policy that it seek to serve two masters. Had we combined fiscal and monetary policies, I believe we would have achieved more rapid domestic economic growth and dealt with the balance-of-payments problem at the same time. Thus, I do not see any basic conflict between domestic and international economic objectives of economic policy.

Having stated all these seemingly dogmatic conclusions, I hasten to emphasize again that there is need for more research in these critically important areas. While I believe we know something about the directions policy should take, I think we know far too little about the relative sizes of the dosages of monetary and fiscal policies which would prove effective under different circumstances.

### THE PROBLEM OF INFLATION

As a concluding note, I should like to add another word of caution. One of the key assumptions underlying the Brookings report is that the United States can accelerate its rate of economic growth without setting the wage-price spiral in motion. While I hope this assumption will prove correct, and am in fact reasonably optimistic on this score, I think it is possible that the Nation may again confront the problem of dealing with cost-push inflation.

The remarkable price stability of the past 5 years has been accompanied by a relatively high rate of unemployment, though the extent of the problem is exaggerated by the intriguing methods we use to define and measure unemployment. Nonetheless, labor market conditions have not been such as to place much upward pressure on wages.

If we are successful in achieving a more rapid rate of economic advance, labor markets could tighten, particularly for trained and experienced workers where shortages in many lines are now evident. Under such conditions we would face a new test of our ability to hold the average advance in wages and salaries in line with our capacity to afford such increases without pushing up prices, or reducing the volume of employment.

I believe we have made progress in spreading understanding of the fact that wage and salary increases which are too large do no one any good. And yet I wonder if the lesson has been learned well enough. In fact, the Nation's balance-of-payments, and economic growth, prospects may be less optimistic than is implied in the overall assumptions and conclusions of the Brookings report's analysis.

It was said recently that the answers to the Nation's balance-of-payments problems can be found in the textbooks, particularly the older ones. While I think we have learned many things since the older textbooks were written, I do not believe the so-called revolution in economics has demonstrated that there is any new way to achieve domestic prosperity while ignoring international developments. Experience here and abroad shows that an appropriate application of the following measures will carry us to the goals we seek:

(1) Restraint on Federal spending and tax cuts to stimulate private saving and enterprise;

(2) Restraint on wage and salary increases to hold them in line with the advance in productivity;

(3) Use of monetary policy in a flexible fashion, and without artificial ceilings, to provide the money and credit needed for domestic expansion without inducing inflation; and

(4) Finally, and this is implicit in the above points, use of the market to channel funds into domestic and international employment in response to interest rate movements.

I submit that such a program would work. I find nothing in the Brookings report that demonstrates that it would not work, and much of the analysis in the report seems to me to suggest that the above line of approach is the correct one.

## STATEMENT BY H. CHRISTIAN SONNE

**Chairman of the Board of Trustees, National Planning Association, Washington, D.C.**

In the first seven chapters of the study directed by Walter S. Salant of the Brookings Institution an appraisal is made of the U.S. balance of payments in 1968 at the request of the Chairman of the Council of Economic Advisers.

The projections are made on two sets of assumptions for the United States and Western Europe with regard to such factors as growth, gross national product, changes in prices and costs, and so forth.

The Council of Economic Advisers gave most of the "initial assumptions," viz:

*For the United States*

(1) Growth rate, 4.8 percent, resulting in a gross national product in 1968 of $743 billion (in 1961 prices);

(2) Price rise, as measured by GNP deflator, averaging 1.5 percent a year; but U.S. export prices will rise by only 0.5 percent per year.

*For Western Europe*

(1) Growth rate, 4.2 percent, yielding a GNP in 1968 of $441 billion (in 1961 prices);

(2) Prices, measured by GNP deflator, will rise 2.75 percent a year; export prices will rise an average of 1.5 percent per year.

Alternative assumption by the Brookings study group:

*For the United States*

(1) Growth rate, 4.5 percent, GNP, $710 billion (in 1961 prices);

(2) Price rise, measured by GNP deflator, unchanged; export price unchanged.

*For Western Europe*

(1) Growth rate, 10 percent lower than OECD targets, or 3.8 percent.

(2) Price rise, measured by GNP deflator, approximately 1.6 percent per year; export price rise averaging 1 percent per year.

On the basis of the initial assumption an improvement in balance of payments of $2.7 billion is projected, which would shift the basic balance from a deficit of $850 million in 1961 and a deficit of $2.1 billion in 1962 to a basic surplus of approximately $1.9 billion in 1968.

The alternative assumption leads to a projected basic deficit in 1968 of about $600 million, which approached the basic deficit of 1961 but is nearly $1.5 billion smaller than that of 1962.

The report implies that the "initial assumptions" may be regarded in some quarters as political; moreover, throughout the chapters statements are couched in protective clauses. This is a wise precaution when dealing with such an unusual assignment. Nevertheless, a great many useful facts and figures are presented. The reader also is given certain definite impressions which no responsible organization would convey unless the members of its study group felt reasonably certain of their ground.

The document therefore calls for a careful analysis. Two main questions suggest themselves:

A. Can we rely on the forecasts—summarized in chapter VIII—as being substantially correct? And, if so,

B. What conclusions should we draw and to what extent should we follow the policy recommendations of chapter IX?

*Regarding A*

Forecasts of this kind rest to a great extent on assumptions because world events during the coming 6-year period are unknown.

Moreover, the actual outcome will depend greatly on what the U.S. Government does meanwhile and that, too, is unknown. For instance, if the United States has large deficits—which is likely in the beginning—will Government bonds and obligations be absorbed by the Nation's savings, or will they, in effect, be financed in whole or in part by our banking system? The answer to these and many other questions will have a great influence on our balance of payments.

Aside from such intangibles, a number of weaknesses and misunderstandings appear in the arguments actually developed in the study, among which the following may be mentioned:

(1) The basic assumptions in chapter II (pp. 39–40) and the conclusions seem unreasonable. A growth rate for the United States of between 4½ and 5 percent during the period up to 1968, an annual price rise of 1.5 percent, and an export price rise of 0.5 percent annually are desirable targets, but can only be achieved if appropriate measures are taken to keep costs down.

For Western Europe, on the other hand, the assumptions are made on a different basis; cost pressures are taken into account which provide for a yearly price rise of 2¾ percent and an export price rise of 1½ percent.

The alternative assumptions may also be regarded as too optimistic, bearing in mind that Western Europe countries are likely, in the face of cost pressures, to apply measures in time to limit cost increases.

(2) Under the heading of competitiveness (ch. III), it appears that:

(*a*) The report makes projections on the basis of existing cost differentials, but fails to take into account the fact that the present difference in costs already constitutes a severe handicap which is still to show its full effect. Moreover, a 10-percent increase in the lower European wages may, in reality, amount to less of an increase in actual costs than a 2-percent increase in our higher wages. Thus, it may take 8 to 10 years before a more rapid increase in the European cost of labor would catch up with our percentagewise lower increase in labor costs. (A 4-percent increase in the 1962 U.S. hourly wage, say $4.13, equals 17 cents; a 10-percent increase in European wage of say $1.20 hourly equals 12 cents.)

(*b*) It is not sufficiently recognized that the Common Market is entering a period when great savings in costs may be expected to result from that very economy of space which enabled the United States to compete so successfully several decades ago.

(*c*) It is less difficult for Western Europe than for the United States to curb costs of labor and management in case of need. This is partly because European labor unions are better able to accommodate to such a policy and partly because Europeans have still a vivid recollection of the horror of breadlines and poverty, while we in America have been blessed with constant rises in living standards and find it more difficult to persuade management and labor to call

a halt—temporarily, at any rate—to continuing relatively large improvements in incomes.

(3) In considering our competitiveness and the U.S. balance of payments (chs. III and IV) as well as foreign economic assistance, continuation of (ch. VII) our predominance in exports to Latin America is taken for granted, presumably because it has existed in recent years. Such an assumption is not sound because:

(*a*) Europeans, before the world wars, proved themselves able to handle Latin American business as well as or probably better than we. Competitiveness is not always a question of price but also depends on political likes or dislikes, personal relations, intermarriages, etc. Once Western Europeans solve the more pressing African and other problems, they are apt to become serious competitors in Latin America if its markets are kept open to the free world.

(*b*) The Cuban situation, coupled with the chaotic conditions prevailing in South and Central America and Russian propaganda and interventions, should warn us against taking Latin America for granted.

A substantial loss of Latin American trade can affect our balance of payments adversely under a number of headings, particularly if we follow the suggestion of operating on a worldwide purchasing basis.

(4) The observations about private foreign investments (ch. V) look convincing in theory, but suffer from a lack of practical experience, for the following reasons:

(*a*) A private smaller concern or bank that can rely on credit facilities elsewhere can afford at times to owe money repayable at short notice against long-term assets, which may take quite some time to collect or liquidate.

But a very large institution—which has no lender of last resort—cannot adopt that attitude. Its inability to meet its current obligations may result in a severe crisis as a result of which its fixed assets or long-term investments are apt to depreciate tremendously in value.

Similarly if the United States has short-term obligations in excess of its liquid short-term receivables and gold, and if a world crisis or a gold outflow panic should develop that might require liquidation of foreign long-term investments, our losses would be appalling at a time when we can ill afford them.

(*b*) Even if we avoid serious world upheavals, losses are nevertheless bound to occur from time to time as shown by Old World experience—notably England (but also other Western European countries). Such losses occurred even at a time when the British navy endeavored to protect pound sterling investments. Can we rely on any equivalent protection in the period under review (1962–68)? What have we done to protect American property and investments in Cuba, or counteract government seizure—which often amounts in effect to confiscation (e.g., compensation in practically worthless paper money)—in Brazil and other countries?

Twenty to thirty years ago a number of Brazilian, Colombian, and other foreign government and municipal bonds were defaulted. Finally, after several years, payment was resumed on some of them after cutting the principal and interest owed to about one half. It was on such an occasion that our Secretary of State under President Franklin Roosevelt sent a cable to Brazil and congratulated the debtors for having resumed payment.

The idea that interest and amortization can be expected regularly and without losses even on what appears to be sound foreign investments is unrealistic even in normal times—more so in the immediate period ahead of us.

(*c*) Turning next to private capital that has been exported and invested abroad successfully by individuals: Are we sure that the United States eventually will get back the interest, profits, and capital? Past experience of British and Western European countries whose citizens invested in the New World (often in the United States) tends to indicate that while individuals did well for themselves, the mother country often got gypped. The owners would become residents or, later, citizens abroad, and the capital and/or taxes on income were lost in whole or in part by the mother country.

That happened to countries whose citizens probably had a high regard for and attachment to their mother country. If taxes here remain relatively high and business and labor conditions become increasingly complicated, we should be prepared to see a great percentage of American investments abroad somehow disappear.

(*d*) On the average the return on foreign investments over the years, after deducting losses, has not been attractive in the past and is not likely to be so in the immediate future.

The "estimate of the balance-of-payment effects of a single direct investment in European manufacturing" as shown in table V–8 (p. 144) does not alter this situation. The example tends to indicate that the original investment has in effect been returned before the end of the sixth year. By the end of the 10th year, the sum of the inflow is more than double the original outflow, while the equity continues to grow.

There may be some such cases, particularly during the period when European industry, after being almost completely crushed, revived fantastically as a result of Marshall plan aid. (Incidentally, how many of our billions spent on Marshall plan aid to Europe could properly be booked as an offset, in the U.S. balance of payments, to these isolated profitable investments?)

While we hear of people who buy securities in the stock market during a depression and double their money in a few years, that does not provide us with a guide as to how the average investor fares. We don't know how the fortunate investor fared in later depressions, nor do we hear much about those that lost.

Similarly, it is the huge losses that occur as a result of dishonesty (for example, Kreuger and Toll), miscalculations, world upheavals, wars, and confiscations or seizure (as in Mexico in the 1930's, Russia and the Eastern European countries taken by Russia after World War II, China, and, quite recently, Cuba and Africa), which can run into billions of dollars and are apt to reduce the average profit on foreign investments or, over the decades, may even turn such profits into losses.

Bearing all these investment risks in mind it is somewhat startling to read on page 121 of chapter V phrases like these:

> If the current period of balance-of-payment weakness reflected nothing more than the exchange of $6 billion of gold for an equal value of profitable foreign investments, then the United States would not have a serious longrun problem, although a shortrun liquidity crisis still might plague it.

Or, on the same page:

The longrun evolution of the U.S. balance of payments may well require that a higher percentage of the U.S. receipts be earned by investments abroad.

The first statement shows a forgivable lack of knowledge and experience in the foreign investment field, but the second statement is contrary to commonsense and economic soundness. It is not only naive but thoroughly unsound even to suggest that an individual, organization, or nation that faces the difficulty of being unable to repay short-term creditors out of proceeds from short-term assets and finds it difficult to improve yearly earnings sufficiently to gradually accumulate enough to meet all obligations, should calmly convert a large part of the remaining free assets into fixed long-term investments in the hope that the expected additional interest earnings will save the situation.

Table V–9–10, pages 150 and 151, shows the projection for 1968 as follows:

[Dollars in billions]

| | Long-term private investment | Dividend and income flows | Percentage of income |
|---|---|---|---|
| 1961 | $49 | $3.5 | 7 |
| 1968 | 73 | 5.5 | 7½ |

We are, in other words, expected to increase our long-term investments during the next 6 years by approximately $24 billion, from which we are to anticipate a return of $2 billion in increased income. If this additional income all came from new investments it would equal about 8½ percent. The return of 7 percent on our total oversea investments in 1961 is already high, probably due to the prosperous world trade conditions then prevailing and, to a great extent, to liberal U.S. loans and grants. To expect an even higher return during the 6 years ahead is extremely optimistic.

As stated, on the average and in the long run, foreign investments in the past have not been profitable and probably will be less so in the future, but this does not mean that wealthy creditor nations should withdraw from such transactions. They should contribute in this way to the development of other countries, provided they can afford it.

This is not the place to argue whether the United States can or cannot afford such foreign investments, but to point out that large reserves must be set aside yearly against investment income and contingencies if we desire to make any projection of future balance of payments meaningful.

(5) Chapter VII (defense transactions) describes how approximately $100 million was expected to be saved by cutting the number of dependents overseas and how an alternative program was adopted that saved only $50 million, leaving a miscalculation of approximately $50 million to the detriment of our balance of payments. Such occurrences cannot be criticized and are bound to occur from time to time. But the incident raises this question: Will nothing now unforeseen happen before 1968 which will force us—in enlightened self-interest—to incur large expenditures that affect our balance of payments?

In these uncertain times such situations might arise under this very heading of "Defense Expenditures"—be it in connection with Korea, Laos, India, the Near East, the Caribbean, Latin America, Berlin, or elsewhere.

The study states on page 197 under "Prospects for 1968": "We assume that there will be no changes in the world political situation over the next few years so fundamental as to change defense requirements dramatically," etc.

If that assumption happens to prove correct, is it not almost inevitable that other emergencies will occur that are apt to call for extra expenditures?

Optimism seems to prevail in the study, while reserves for disappointments and contingencies seem to be lacking.

We now seek to answer our first question; namely, whether we can rely on the forecasts which are summarized as follows on the basis of the initial assumptions (p. 215) in chapter VIII:

> The improvement in the basic balance is projected at $2.7 billion. It consists of increases in net exports of goods and services of $4.2 billion (*including a rise in receipt of income from private investments of $2 billion*[1] and a decline in net military expenditures of nearly $1 billion), and a decline in the net outflow of private long-term capital of over $600 million. These gains are offset only partially by an increase in expenditures for foreign aid. The net improvement is sufficient to shift the basic balance from a deficit of $850 million in 1961 to a surplus of nearly $1.9 billion.

On page 226 it is stated:

> The alternative assumptions lead to a projection of a basic deficit in 1968 of about $600 million, which is not significantly smaller than the 1961 basic deficit (which was $0.9 billion)[2] though nearly $1.5 billion smaller than that of 1962 (which was $2.1 billion)[2] * * *.

There is added:

> The estimated effects of changes in private long-term investments, and in interest and dividends on such investments *is the same*[1] under the alternative assumptions as under the initial assumptions, for reasons given at the end of chapter V.

We find, in other words, for 1968, a possible surplus of $1.9 billion (under initial assumptions) and a deficit of $0.6 billion (under alternative assumptions) after figuring on $2.6 billion improvement over 1961 as a result of long-term private investments, or after figuring on receipt of dividends and interest of $5.5 billion on our foreign investments.

If the argument were made (*a*) that the United States would be fortunate indeed if the return of investment income flow remained the same in 1968 as the favorable return of 1961, there would follow at first sight, a considerable reduction in estimated receipts.

Or if one argues (*b*) that large reserves are needed against the projected dividend-and-interest income amounting to $5.5 billion on total foreign investments (projected at $73 billion)—based on the knowledge that the United States would be fortunate to get its money back in the course of time with an average of 5 percent interest or profit—it follows that 2½ percent of the estimated 7½ percent, or one-third, of the projected income must be deducted, or approximately $1.8 bil-

[1] Italic supplied by writer.
[2] Added by writer.

lion. This is calculated on the total income without deducting the approximately 3½ percent ($1.125 billion), which we must pay under the 1968 projection on $30 billion belonging to foreign investors in the United States. We assume we must pay what we owe abroad under all circumstances.

If we thus attempted to project on a reasonably sound basis the income from these foreign investments, by deducting $1.5 billion from the receipts, we would face a projection of $400 million surplus in 1968 under initial assumptions and a deficit of $2.1 billion for 1968 under alternative assumptions, or practically the same deficit as that of 1962.

This is only a rough sketch of what either Government action (in setting a ceiling on additional foreign investments) or a realistic appraisal of the advantages or disadvantages of such investments can do to the projections made in the study for 1968.

We have limited ourselves here to analyzing only one of the five weaknesses or misconceptions in the study. If the effects of all five factors were properly injected into the calculations, it might well throw out of gear, completely, the projection of a basic balance or even a basic surplus.

I consider it futile to make such an attempt, but choose instead to proceed to the second question, and rephrase it as follows:

B. The argument has been advanced that projections of this kind conceivably may do more harm than good and may lead to false notions and misconceptions because, in order to succeed in the task, the members of the study group must possess not only unusual proficiency in economic theories but also unique broad practical worldwide business experience, coupled with an almost superhuman ability to predict future events.

A preliminary study of the projections of the Brookings Study Group tends to confirm this view. In spite of evidence of theoretical economic proficiency, zeal, and resourcefulness, I do not feel justified in assuming that the conclusions as presented even approach the goal of a somewhat reliable approximate projection for 1968.

However, this view does not prevent us from attempting to answer the following question: "What conclusions would we draw if we were convinced that the basic yearly deficit would be eliminated by 1968 along the lines described by the Brookings Study Group and that there would be pressures toward a basic surplus. To what extent would we then follow the policy recommendations of the last chapter, IX?"

Chapter IX devotes a great deal of space to showing that the forces making for improvements in the U.S. balance of payments will cause a deterioration in Western Europe's payment ability, and that no position of the U.S. balance of payments—whether surplus, deficit or balance—would simultaneously free the United States from undesirable constraints and provide for needed expansion of international reserves. A monetary mechanism is called for that will enable countries to finance deficits over periods long enough to reach equilibrium by slower means which would not jeopardize "vital" objectives, and so forth. Comes then the question: What is "vital"? And so continue this and similar arguments quite familiar to those who have followed the complaints of other nations that faced similar shortages of reserves after long periods of deficits. These arguments often show a tendency to mix cause and effect and an unfortunate lack of understanding of the practical working of the domestic economy.

However, these complaints are usually more justified during periods when, as at present, the value of the world's gold stock admittedly is far too low to provide enough reserves to take care of world trade based on the high prices.

Certain statements are made or implied with which we and probably most Americans certainly would agree. For instance:

(1) The following four national objectives have high priority for the United States, and should not be subordinated to balance-of-payment discipline if it can be avoided. These are:

(*a*) Achieving domestic economic stability and sustained growth at full employment.

(*b*) Maintaining the military strength for defense of the free world.

(*c*) Supporting economic development of lesser developed areas to the extent that we can afford it.

(*d*) Strengthening and encouraging international economically productive transactions of the free world.

(2) There is probably at present, or there will be by 1968, a shortage of reserves of approximately $20 billion. If U.S. dollars no longer were used or available, the shortage would be approximately $40 billion, meaning that present gold reserves under such circumstances would appear to represent only about half of world requirements.

(3) Simplicity is a virtue in taking steps to improve our present economic situation.

It is not worthwhile to interfere with, or regulate, a number of those traditionally accepted transactions and practices which make only a relatively small contribution to our balance of payments; indeed, such action may be costly, cause great inconvenience to trade, and perhaps jeopardize our position as world leaders.

A few large, simple, not undesirable measures are preferable, if easily understood and acted upon, provided they make a real contribution to the solution of our problem.

In general the study group does not recommend that the Government at this time take any steps to improve the balance of payments except by measures which seem desirable in themselves. Indeed, it is suggested that as the balance-of-payment deficit gradually declines, certain present restrictive measures—such as those on foreign aid and certain types of military expenditures abroad—should gradually be relaxed.

A continuing effort to restrain wage and price increases is recommended. Beyond that it is suggested, in effect, to let domestic issues drift and to concentrate vigorously on measures to improve the arrangements for international liquidity.

It is repeatedly asserted in the study that the present monetary mechanism does not provide enough liquidity to enable countries to finance deficits over periods long enough to reach equilibrium and that recovery nowadays is a slower process than it was in the past. This assertion would not appear to have validity—rather the reverse, since world developments and, consequently, world trade opportunities change faster than in the past. It is astonishing to see, for instance, the speed with which certain countries such as Japan, Germany, and other realistic Western European countries—including France—have recovered and changed their trading position for the better. Indeed, urging that time be given would appear to be prompted less by the

slow pace of world economic developments and changes than by our own fumbling and lack of foresight.

Nevertheless, the study stresses the need for a longer term international monetary mechanism and two alternatives are mentioned, viz:

1. "Institutional arrangements should be proposed that will permit the liquid claims of surplus countries and the liabilities of deficit countries to be denominated in an international unit of account, either with the IMF or with a new international payment union associated with it"—or,

2. "If such a mechanism should prove to be unobtainable * * * the adoption of a modified flexible exchange rate system."

Re 1: The first alternative would move along the lines of various past proposals, such as those of John Maynard Keynes, Robert Triffin, and several others.

The basic plan would involve the reconstruction of the International Monetary Fund, making it an active central bank for central banks. It would allow this new institution to continually expand the reserve base for the world's monetary system through the process of creating loans and receiving deposits in line with the procedures of any regular bank. Deposits at the new central bank would become a new international medium—the counterpart of gold reserves and a substitute for national currencies and reserves.

All member countries would cease using other reserve currencies. They would be required to keep a minimum percentage (perhaps 20 percent) of their total national reserves (both gold and foreign currencies) with the bank. On such deposits they would earn interest commensurate with what the IMF bank decided upon with due regard to its earnings from loans to be given to countries that may need funds for their balance of payment or for other purposes.

These plans have all several objectional features, including:

(*a*) That nations in effect permit their reserves to be lent out and to thus become subject to liens (often outside their control);

(*b*) That this would mean, in fact, a surrender of national economic sovereignty to an international body; and

(*c*) That it might lead to gradual and continuous inflation as the IMF loans continued to grow faster than world output.

Proposals have been made to rectify the objections described under (*b*) and (*c*) by (under (*b*)) restricting IMF bank authority, leaving nations to fix their own policies, and (under (*c*)) by setting narrow limits on annual increases of IMF bank loans.

Such proposals have not removed the fears of prospective sovereign depositing countries and rightly so. These countries know by experience that theory is one thing, practice another. In practice, even big depositors like the United States would find it difficult to influence decisions, because:

(i) If the bank is to be successful, it must have able managers.

(ii) An able management will almost invariably succeed in getting its plans through when negotiating with a divided board.

(iii) Moreover, powerful countries do not wish to face such endless debates and differences of opinions as are apt to be experienced in this kind of international body.

(*d*) That such a scheme of necessity must be based on long-term considerations, which would require that we consider carefully such questions as which countries should be granted credit and how we can ascertain which countries will still be on our side of the table several decades from now. This is a difficult task. Would Cuba have borrowed huge sums if the proposed IMF bank had been established say 3 years ago?

The change in alinement over the relatively short 18-year period since 1945 when Germany, Italy, and Japan were against us and Russia was with us is not encouraging.

(*e*) That it is doubtful whether the United States would agree to such a scheme before the expiration of the relatively short time to the end of this century; it seems certain that several creditor nations would continue to oppose such pipedreams on the grounds that—as with the concept of the original League of Nations—the world will not be ripe for their practical application for several generations.

Realists know that it would be utterly impossible to obtain now the necessary international agreement to organize a new international liquidity mechanism which could function satisfactorily in practice. At any rate, preliminary and preparatory discussions would require a much longer period than would suit our present purposes.

In these circumstances, analysis of the Brookings Study Group proposals really only leaves us the alternative of 2, the adoption of a modified flexible exchange system.

This system is not new; it was proposed here over 30 years ago and has been recommended as a "miracle drug" by such economists as Frank D. Graham and Charles R. Whittlesey (1934), Milton Friedman (1953), James E. Meade (1955), and others.

The most radical version would avoid the need for international monetary reserves altogether. Quotation of the exchange rate would be left in the hands of the free market in the hope that speculators would buy currency when it was low, sell it when high, and thus contribute to making it stable—except perhaps when structural maladjustments exist. It is often asserted that the scheme, if successful, must be modified and combined with wise monetary and fiscal policies. Under such circumstances the exchange rate would be expected to remain fairly stable anyway and private speculators would face a less difficult task. But the countries' monetary authorities could probably handle the stabilization better.

Although the country itself does not tie its money to gold, the currency is nevertheless linked temporarily to gold each time foreign transactions take place. A flexible exchange system can be adopted by one country alone or by a group of countries; the report suggests a group consisting of the United States, the United Kingdom, and countries whose economies are closely alined to theirs, such as those in the Western Hemisphere and Scandinavia, et cetera. In this case, all members of the group would from time to time agree on a mutually satisfactory ratio which in effect would mean a temporary gold price.

The system has the advantage of great flexibility, enabling a country to depreciate its currency almost without limit (Hitler's Germany,

and France before 1958 are past examples; while some South American countries, for instance, Brazil, at present, may be said to have a somewhat similar system). Objectionable features involve not only the great temptation—especially in a democracy—to exaggerate the depreciation, with consequent ultimate inflation, but also (and more immediately) the great difficulties and additional costs in carrying on business, particularly in the import and export sectors of the economy.

Moreover, the system invariably brings suffering to the low and fixed income groups, while the well-to-do maintain their living standards—mainly through speculations, often based successfully on the almost inevitable depreciation of the currency.

The system generally starts under conditions which call for a reasonable depreciation. Speculators generally overdo such a move. When subsequently the country's monetary authorities attempt to appreciate their currency, they encounter strong resistance to downward costs and wages which, in turn, is apt to impart a "devaluation bias" to any system of exchange rate flexibility. This bias—as Robert Triffin put it—could not fail to make private exchange speculation far less "stabilizing" than envisaged by the proponents of exchange rate flexibility.

The system has been tried and failed. A number of European countries adopted it after World War I and abstained in whole or in part from intervention on the exchange market. In most cases the final result was either a currency collapse—as in Germany and Central Europe—or a driving down of exchange rates well below the real value of the currencies, in France and Belgium, for instance.

The recommendations and advantages of the flexible rate proposal described in chapter IX (pp. 259–261) of the Brookings study may sound attractive on paper, but the invariable failure of the system has led serious thinkers to discard it long ago.

There are other better and more practical ways of giving worthy deficit countries ample time to reach equilibrium without jeopardizing really vital objectives.

To recapitulate, the Brookings proposal for a new international payments union, or what in effect amounts to a central bank's bank, must be rejected on the ground that it is impractical. Moreover, it would appear unlikely that any agreement could be reached among the many central banks on such a scheme for several decades.

The alternative proposal of a "modified flexible exchange rate system" must also be rejected, unless it is modified to such an extent that it becomes meaningless. The system has frequently been tried and invariably failed. Moreover, I consider it dangerous—particularly for the low income groups—and costly and unsuitable for our type of democracy.

I turn finally to the recommendation of the Brookings study group (p. 253) to the effect that our Government at this time should abstain from taking any steps to improve the balance of payments other than measures which seem desirable in themselves.

I would not follow that advice, although I recognize that some arguments could be presented in its favor if one were certain that Brookings' projections after allowing for all our needs and for contingencies could stand the test of time.

My first objection is, that in dealing with very serious matters that have an important bearing on our Nation's future, we must err on the safe side and be prepared for miscalculations or unexpected reverses. To act differently would be irresponsible and unbecoming—the more so because we expect the world community to so arrange the international monetary system that ample time is given deficit nations to reach equilibrium. The creditor countries in this world community may well be influenced by the extent to which such deficit nations actually show responsibility and a will to eliminate their deficit.

My second objection may be more important, and also seems to be recognized by the study group which states (p. 261), "Failure to maintain the present gold parity would do far less to damage U.S. prestige than continued failure of the economy to operate at or near capacity." A solution of our employment problem is very important.

We have less time than the study group indicates or seems to be aware of.

The reason is that of the four national objectives (mentioned on p. 244), which most citizens would agree have high priority, the first, namely: "Achieving domestic economic stability and sustained growth at full employment" is much more costly than is generally realized.

To reduce unemployment below—say—4 percent is a tremendous task that requires the breaking of new ground and involves the spending during the first few years of large sums, which is in the beginning apt to have an unfavorable effect on our trade balance, but which eventually—after some years—will pay handsome dividends and should contribute greatly in time to strengthen our Nation and its economy.

The Brookings study group is evidently not aware of the magnitude of this problem; and I do not see, nor would I expect to see, any evidence of these expenditures and their repercussions having been taken into account adequately by the group.

If these costs were superimposed on the projections, the assumed balance which the study group expects in 1968 might be delayed 2 to 4 years.

Such a possible delay makes it still less likely that we can finance our deficits satisfactorily until a basic balance can be shown—by which time our net short-term indebtedness may have increased by $10 to $15 billion.

For these reasons I am of the opinion that we should now prepare ourselves to meet all contingencies and for the steps that can be taken if—as I expect—it proves impossible to find a reasonably quick way of increasing world reserves along the lines suggested by the Brookings group.

If it really becomes necessary, several helpful steps could be taken "without any sacrifice of high priority objectives." For instance:

(*a*) Our balance of payments could be helped by taking appropriate measures to limit loans abroad on the ground that it is contrary to commonsense that a nation which is short of liquid funds ties up the limited amounts which are left in long-term loans to foreign countries which do not urgently need such support. However, such action should be accomplished not by special legislation, which complicates markets and jeopardizes our position as the financial center of the world, but simply by letting long-term inter-

est rates find their natural level, as a result of which foreigners temporarily would be automatically discouraged from borrowing in the United States. (It is a fallacy to believe that higher interest rates necessarily would discourage growth and employment in our home market.)

(*b*) More drastic steps can be taken to improve productivity and our ability to compete.

(*c*) Renewed efforts are now being made to induce our friends abroad to share more adequately in our mutual defense efforts.

(*d*) We must strive to give as much foreign assistance and aid abroad as possible. It is a fact, however, that while one does one's utmost to help a friend in dire need, it serves no purpose nor does it do him any good that one starves oneself to death in the process.

Therefore, even though we may have to reduce our assistance programs we must not forget that there are good and valid reasons for our dilemma. Although we have been a capable and hard-working Nation, we are not as rich, as economically consolidated, and as strong as we, and the world, have been in the habit of thinking.

During World War I we were still a debtor Nation. Great accumulation of American wealth followed during and immediately after the two World Wars. But, with our characteristic generosity, we gave enormous sums away while spending ever-increasing billions on armaments which also served to protect our friends abroad.

Such a performance seemed incredible, and it has been achieved only at a considerable sacrifice that has a decided bearing on our present difficulties.

The recipients of our assistance abroad have a vital long-term interest in seeing us arrange for a breathing spell during which our assistance is somewhat reduced, so that once our economy has recovered we can resume our larger assistance programs.

Several other constructive steps could be taken to improve our balance of payments without subordinating higher priority objectives. Moreover, though some of these measures might carry some temporary unpleasantness in their wake, they would at the same time contribute to improve the morale and virility of this Nation.

## CONCLUSIONS

Question A: Can we rely on the forecasts being substantially correct?

The answer is "No."

Projection of our balance of payments to 1968 is an almost impossible task in itself. Having undertaken it, the study group undoubtedly has made great efforts to make a plausible rough estimate. They have failed less on account of lack of technical ability and skill than because of an apparent lack of practical experience and understanding of our domestic needs and of international economic problems. In a study of this kind only a combination of theoretical and practical knowledge can lead to a satisfactory result.

Modified question B: To what extent would we follow the policy recommendations of the study group (ch. IX) if we had faith in their projections?

Answer: I. I agree that a substantial increase in the international reserves is needed; but

II. I consider it both undesirable and futile to attempt to organize a new international liquidity mechanism (a central bank's bank) sufficiently promptly to be of any use in our present situation.

III. I consider the study group's alternative; namely, a modified flexible exchange system as a poor device that invariably has failed in the past, has proved to be particularly disastrous to the lower income groups, has been costly, and has hampered particularly export and import business. I reject it as incompatible with our democratic system.

IV. I believe that there are other solutions for our problems than the alternatives mentioned by the Brookings group. But even if such were not the case, I would not recommend following the advice (p. 253) of having our Government in effect do little or nothing while our country faces a very difficult and serious 6-year period. Such a passive attitude could prove to be a costly, an unintelligent and an unnecessary gamble with our Nation's destiny. It certainly would not be compatible with American character and virility.

This very American spirit may well rebel against such a passive attitude toward the many difficulties which the public reads and hears about.

To encourage action, the public may remind us that—

> Sitting still and wishing
> Makes no country great.
> The good Lord sends the fishing
> But we must dig the bait.

Yes, we must dig the bait; but the task may not be as difficult as it appears on the surface, for there are other and better roads toward the rehabilitation of our economy than those mapped out by the Brookings study group.

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# STATEMENT BY ROBERT W. STEVENS

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COMMENTS ON THE REPORT'S BASIC ASSUMPTIONS

I. A scholarly and a refreshingly candid approach.
II. The "initial assumptions" are not economic forecasts.
III. The "alternative assumptions" may be regarded as forecasts.
IV. The price assumptions appear somewhat optimistic.
V. Even so, the projections show a deterioration in net commercial exports.
VI. The main improvement projected is in net private investment.
VII. The critical questions here are "How soon and how much?"
VIII. Complacency in the chapters on foreign aid and military spending.

COMMENTS ON THE AUTHORS' INTERPRETATION OF THEIR PROJECTIONS

IX. Is the prospect for "no change" or "improvement"?
X. The dollar and the pound sterling as reserve currencies.
XI. Continuous deficits in the balance of payments.
XII. Financing continuous deficits out to 1968.
XIII. The report could be used to support conclusions directly opposite to those reached by the authors.
XIV. The authors allowed their initial sense of urgency to be dissipated.
XV. Going even beyond the "initial assumptions" they were given, the authors assume away the problems of the present.

## COMMENTS ON THE REPORT'S BASIC ASSUMPTIONS

### I. THE STUDY BRINGS SCHOLARSHIP TO BEAR UPON A TOPIC THAT HAS BEEN RELATIVELY NEGLECTED

The authors of the Brookings study have undertaken a very ambitious task, that of appraising the outlook for the U.S. balance of payments over the next several years. They have conducted a thorough investigation into the complex, and often elusive, economic forces that play upon the large gross inflows and outflows of dollars which lie behind the net balance of payments. In doing so, they have brought great skill to bear upon an aspect of our national economic life which, in the past, has been a relatively underdeveloped area of study by American economists.

The report sets out very explicitly the assumptions that the authors made and the methods that they followed. Moreover, it displays a refreshing candor in discussing both some of the uncertainties which becloud the foreign payments outlook and the inadequacy of reliable data and systematic relationships upon which to base judgments about the future.

### II. THE OPTIMISTIC "INITIAL ASSUMPTIONS" WERE SUPPLIED BY THE GOVERNMENT AND ARE OF VERY LIMITED USEFULNESS

The authors were supplied with most of their "initial assumptions" about the key variables by the Council of Economic Advisers. In other words, most of the key assumptions were made by a Government agency, and as the authors candidly remark:

> The Council * * * was interested in knowing how the balance of payments in 1968 would look if unemployment were rapidly reduced to 4 percent of the labor force and the government's long-term growth objectives were achieved. (p. 40)

Thus, the implications of these initial assumptions for the basic-balance of payments should not be regarded as a forecast of what is likely to happen. Instead, they indicate that, if growth targets on both sides of the Atlantic should be met by 1968, if the authors' cost and price expectations are correct (this is of crucial importance), and if there is no loss of confidence in the dollar due to, say, short-term capital flows—about which they say nothing—then there would be an improvement in the U.S. basic balance of payments by 1968.

### III. THE AUTHORS' OWN "ALTERNATIVE ASSUMPTIONS" FOR REAL GNP GROWTH ARE SOMEWHAT MORE USEFUL

By adopting a set of alternative assumptions the authors acknowledge that the governmental targets given them provide unsatisfactory assumptions for use in forecasting. The alternative assumptions embody slower growth in real terms—especially in the United States, and less inflation in Europe. With these assumptions to work with, the authors arrive at real GNP figures for 1968 that look more like genuine forecasts of most probable values. Since real growth in the United States is assumed to be greater than in Western Europe, however, the real growth assumptions imply a deterioration in the U.S. trade balance. This worsening is only partly offset by an assumed shift in competitive position favorable to the United States.

### IV. THE AUTHORS' PRICE ASSUMPTIONS, HOWEVER, APPEAR OPTIMISTIC

As the authors candidly state, the price projections underlying the assumed improvement in the U.S. competitive position are quite subjective. By the year 1968, they might prove to have been quite reasonable, but at present they appear optimistic from the viewpoint of the United States. In the first place, they assume that Western Europe will be forced by circumstances beyond its control to accept a significant worsening in its competitive position. But European governments may combat price inflation and the accompanying deterioration of their balances of payments by restricting demand (as the United Kingdom Government has done) by devaluing (as the French Government has done), by introducing new "incomes policies" (as several governments are now doing) or in various other ways. Secondly, a very modest average price increase is projected for the United States (1.5 percent per year). This is the actual rate for the period 1957–62 when the American real GNP rose at a rate of only 3.2 percent a year. It seems probable that somewhat more price inflation than this might accompany the higher rates of growth contained in both the initial and alternative assumptions.

Finally, some of the vagaries which characterize the available export unit value indexes are resolved by the authors in favor of showing increased competitiveness for U.S. exports. For example, the unexplained and somewhat mysterious rise in this index for the United States since 1959 is discounted (p. 76) and so is the fact that export prices are often shaded by European firms as a matter of policy, particularly in the downward phase of a business cycle (pp. 71 and 76). Indeed, an improvement in the price competitiveness of U.S. exports is the dominant force favorable to the United States

which the authors foresee affecting the current account balance of payments between now and 1968, and they assume a very sharp improvement. The following tabulation, prepared from figures contained in different places in the study, shows that under the alternative assumptions the average rate of increase in European export prices relative to the average rate of increase in U.S. export prices projected for 1961–68 is more than nine times as great as it was in 1953–60 (1.0/0.6 compared with 0.2/1.1). As the authors state very candidly, they have made these export price projections on the basis of very little solid evidence.

*Export prices, United States and Western Europe*

[Percent increase per year]

| | 1953–60 (actual) | 1961–68 (alternative assumption) |
|---|---|---|
| United States | 1.1 | 0.6 |
| Western Europe | .2 | 1.0 |

Source: Pp. 39, 88, and 214.

### V. THE AUTHORS' PROJECTIONS SHOW A DETERIORATION IN NET "COMMERCIAL" EXPORTS OF GOODS AND SERVICES

The composition of the increase in U.S. merchandise exports which the study projects is as follows:

| | *Billions of dollars* |
|---|---|
| Increases in real income | +4.63 |
| Gain in U.S. competitive position | +2.04 |
| Increase in U.S. foreign aid | +2.04 |
| All other factors | −1.09 |
| Net change | +7.62 |

Source: Appendix table 10, p. 289.

In their chapter on foreign economic assistance the authors point out that under their assumptions concerning the tying of economic aid they expect the increase in foreign aid which they project to have "a nearly negligible" net effect on the balance of payments (p. 190). This expectation is supported by their projection of a $2.4 billion increase in foreign economic aid, offset by the $2.04 billion increase in U.S. exports financed by the aid increase, shown above.

The $2.04 billion increase in exports to be financed by economic aid, in other words, is really an offset against most of the increased outflow of economic aid on Government account. It should not, therefore, be confused with the other types of changes shown above, which are mainly of an economic or commercial character. By the same token, it is likely to be misleading to show the $2.1 billion increase in economic aid as a factor of deterioration in the balance of payments between 1961 and 1968, as the authors do in their tables. The authors correctly state in the text, as noted above, that the change in the net balance due to an increase in economic aid is "nearly negligible," but the reader of the report might draw a very different conclusion from

the summary table on page 216 which shows a $1.7 billion improvement in net exports of goods and services but a $2.4 billion deterioration due to economic aid transfers.

When the balance-of-payments accounts as shown in the report for 1961 and 1968 are appropriately adjusted for a netting out of the projected rise in aid-financed exports, they may be summarized as follows:

| *Item* | *Change from 1961 to 1968 (billions of dollars)* |
|---|---|
| Merchandise exports, excluding increase in aid-financed exports | +5.6 |
| Merchandise imports | +7.9 |
| Trade balance | −2.3 |
| Investment income | +1.9 |
| Other services, net | +.1 |
| Net exports of goods and services | −.3 |
| U.S. long-term investment: | |
| Direct | +.7 |
| Other [1] | −.2 |
| Foreign long-term capital | +.1 |
| Government grants and loans, net | −.1 |
| Basic balance | +.2 |

[1] Portfolio investment and long-term bank loans.

Source: Ch. V and pp. 216–217.

This way of summarizing the changes projected in the report has the advantage of clarifying the minor role played by changes in economic aid in the authors' projections. It also reveals the fact that, when their projections are adjusted for the anticipated rise in aid-financed exports, the authors are shown to be expecting a deterioration in net exports of goods and services due to the operation of commercial factors.[1] The above table shows, in short, that on current account the authors expect that a deterioration in merchandise trade of some $2 billion (after adjustment for an expected rise in aid-financed exports) will be offset by a roughly equivalent increase in receipts of income from U.S. foreign investments.

## VI. AFTER THE DOUBLE ENTRY FOR THE EXPECTED INCREASE IN ECONOMIC AID IS NETTED OUT OF THE MERCHANDISE TRADE BALANCE THE MAJOR IMPROVEMENTS SHOWN IN THE PROJECTIONS ARE IN THE INVESTMENT ACCOUNTS

The $2 billion-odd increase expected in investment income is referred to above, and as the table brings out, the other major factor of improvement which the authors foresee between 1961 and 1968 is a decline of $0.7 billion in the outflow of direct investment funds from the United States.

The anticipated rise in the inflow of investment income to the United States is expected to be partially offset by an increase of $0.5 billion in the outflow of investment income, leaving a $1.5 billion increase in the net flow of investment income to the United States.

[1] The table shows a deterioration of $0.3 billion; the net improvement of $0.1 billion in "Other services," however, includes a projected reduction of $0.5 billion in military expenditures. Thus the total worsening in net exports on commercial account which they foresee is $0.8 billion.

This forecast underscores the strength which the increasing flow of income on foreign investments contributes to the U.S. balance of payments.

The authors' expectations concerning the outflow of private long-term capital from the United States are summarized in the following table (in millions of dollars):

| | 1961 | 1968 | Difference (+benefits, −worsens B/P) |
|---|---|---|---|
| Direct investment: | | | |
| 1. Western Europe | 724 | 500 | +224 |
| 2. Other areas | 874 | 350 | +524 |
| 3. Subtotal | 1,598 | 850 | +748 |
| Portfolio, etc., investment: [1] | | | |
| 4. Western Europe | 368 | 325 | +43 |
| 5. Other areas | 643 | 900 | −257 |
| 6. Subtotal | 1,011 | 1,225 | −214 |
| 7. U.S. capital outflow (line 3 plus line 6) | 2,609 | 2,075 | +534 |
| 8. Foreign investment inflow | 466 | 575 | +109 |
| 9. Net capital outflow (line 7 minus line 8) | 2,143 | 1,500 | +643 |

[1] Includes long-term bank loans.

Source: Tables V-2, V-10 and p. 148.

It will be noted that the authors expect a very substantial decline in the outflow of direct investment capital from the United States and a considerable increase in the outflow of portfolio and other capital. After taking account of a moderate rise in the inflow of foreign long-term capital to the United States, they show an improvement in the balance of payments on capital account of $643 million from 1961 to 1968.

However much of a decline there proves to be in the outflow of new U.S. direct investment funds to Western Europe between now and 1968 (and the authors assume a 30 percent decline) the shrinkage by 60 percent in the outflow to the rest of the world (from $874 million in 1961 to $350 million in 1968) hardly seems plausible. The high average rates of growth which the authors forecast for the United States and Western Europe in the 1960's should strengthen export markets, incomes, and investment opportunities in many underdeveloped countries which now produce mainly primary commodities. A considerable part of such an implied increase in the demand for capital would presumably come from the United States, but it is difficult to reconcile this prospect with the author's forecast of a decline by more than half in the outflow of U.S. direct investment capital to non-European countries between 1961 and 1968. In fact, I suspect that the Brookings study contains—as an implicit assumption—the persistence of a degree of economic stagnation in many underdeveloped parts of the world that would not prove to be compatible with the survival of liberal, market-oriented institutions.

### VII. THE PROBABLE DECLINE IN THE OUTFLOW OF U.S. PRIVATE LONG-TERM CAPITAL MAY PROVE TO BE LESS THAN PROJECTED IN THE REPORT

The authors' projection of both a decline in the outflow of private long-term U.S. capital to Western Europe and an increase in the flow of European capital to the United States depends mainly upon their expectation that profits will increase relatively more in the United States than in Europe between now and 1968. Their expectation about profits, in turn, rests upon (1) a speeding up of real GNP growth in the United States and a slowing down in Western Europe, compared with recent years and (2) a rise in the share of wages in national income at the expense of profits in Western Europe but not in the United States, due to a shortage of labor and the cumulative effect of the postwar expansion of the capital stock in Western Europe.[2]

Both of these underlying expectations may prove by 1968 to have been well-founded, but they need not be decisive in determining a shift in private capital flows favorable to the United States. Under the alternative assumptions concerning real GNP growth in the United States and Western Europe—and only the alternative assumptions are acceptable as forecasts—average growth in the U.S. (4.5 percent) would be higher than in Europe (3.7 percent), but the favorable effect of this difference on profits might easily be counteracted by other factors. Governmental policies in Europe to raise the level of interest rates in order to combat domestic inflation, which would encourage the flow of United States portfolio capital to Europe, might be one such factor. The authors, however, draw back from making a firm forecast of interest rates (p. 126).

A more fundamental objection to the optimism of their capital flow projection is that, over the next 4 or 5 years the United States is certain to continue to be the world's largest source of investible funds while the demand for capital in Europe is almost certain to remain high. The labor shortage in Western Europe, which the authors expect to continue, will keep the demand for capital high, and if there should be any shortfall in the U.S. growth rate below the one projected in the authors' alternative assumption, the investment opportunities for capital in the United States would almost surely be weaker than in Europe. Consequently, it is possible the net flow of private capital from the United States to Europe will remain high, or even increase further. The figure projected for 1968 in the study, however ($1.5 billion for both portfolio and direct investment), is about a third less than the 1956–62 average rate of $2.3 billion, and very much lower than the apparent rate in the first half of 1963.

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[2] The authors may have been unduly influenced in a direction favorable to the prospect for our balance of payments by the fact that they carried out their work in terms of the "initial assumptions" rather than the "alternative assumptions" (p. 154).

### VIII. THE REPORT'S TREATMENT OF FOREIGN AID AND FOREIGN MILITARY SPENDING REFLECTS GREAT COMPLACENCY ABOUT THE BALANCE-OF-PAYMENTS PROSPECTS

The authors have very great confidence in their opinion that the U.S. balance of payments is certain to improve. On the subjects of foreign aid and foreign military spending this confidence leads them to conclude that actions which have already been taken in these fields to improve the balance of payments, such as tying much of foreign aid to U.S. exports and restricting some types of military spending abroad, should definitely be regarded as temporary. In fact, they even observe that "further restrictive measures of this type would be of negligible benefit, if not positively harmful" (p. 253).

In the case of foreign aid, despite their basic optimism, they nevertheless assume that it will continue to be tied to U.S. exports, much as it now is, as far ahead as 1968. On the basis of this assumption their conclusion follows correctly that the considerable increase in foreign aid which they project would have little significance for the net balance of payments.

The authors' permissive attitude toward untying U.S. foreign aid is in sharp contrast to frequent assertions by the administration that the tying of our foreign aid still remains necessary. A statement to this effect appeared in Secretary of the Treasury, Douglas Dillon's, testimony before the Joint Economic Committee on July 8, 1963 as follows:

> It appears to us, on the basis of our evaluations of the specific development programs financed by American aid, the types of goods involved, and the availability of alternative sources of supply, that a very large proportion of this aid, if not tied, would find its way into the reserves of other industrialized countries rather than result in exports from the United States.

The report's treatment of foreign military spending [3] is rather perfunctory and, in fact, the chapter entitled "The Effects of Defense Transactions" is the only one in the study for which individual authorship is not specified in the report's foreword. The author of this chapter made a forecast that military expenditures would decline by $357 million from fiscal 1962 to 1968; however, in a special message dealing with the balance of payments President Kennedy reported on July 18 a target of cutting military spending by $500 million between 1962 and the end of the calendar year 1964. At present measures for even further reductions in military spending appear to be under discussion in Washington, a development which is in sharp contrast with the treatment of this subject in the Brookings study.

There have been some large Government-sponsored sales abroad of American-made military equipment over the past 2 years which are now being offset in the official statistics against the large $3 billion annual gross outflow of funds for military spending. The subtraction of such exports from gross foreign military spending to obtain a concept of net military spending is quite different from the automatic offsets which U.S. exports provide in the case of both foreign aid and private foreign investment. Such sales cannot be meaningfully projected into the future because they depend upon particular deals

[3] The following discussion refers to foreign military spending by and for the U.S. Armed Forces. Military aid to U.S. allies is excluded because it has no effect on the balance of payments.

which the Government can arrange from time to time covering very large transactions. Facing such a problem, the author of this chapter put down such sales at a value of $1 billion in 1968. This compares with receipts from such sales of $375 million in 1961, $899 million in 1962 and $1.275 billion in 1963 (p. 202).

The authors do not bring out the important fact that, since exports do not automatically increase with foreign military spending, a reduction in such spending would tend to improve the net balance of payments on a dollar for dollar basis. They do, however, recognize that since military spending is "largely directed toward Western Europe" (p. 224) reductions in it would benefit the net balance of payments more than reductions in foreign aid, scarcely any of which goes to Western Europe. It is because of these two aspects of U.S. foreign military spending that it always figures prominently in official discussions of economizing measures which the Government itself might take to improve the balance of payments. The authors do implicitly acknowledge that a reduction in foreign military spending would be a relatively quick and financially effective way to improve the balance of payments when they observe that such spending "conceivably could be cut substantially more" subject to certain economic and political preconditions (p. 225).

## Comments on the Authors' Interpretation of Their Projections

### IX. THE BASIC DATA OF THE STUDY COULD BE INTERPRETED DIFFERENTLY

The alternative assumptions, which could be presumed to represent the authors' views of the most probable outcome for the U.S. basic balance in 1968, yield a small marginal gain of $0.2 billion in the basic deficit, from $0.8 billion in 1961 to $0.6 billion in 1968 (p. 216). Such a small change is, however, easily within the wide margins of error inherent in balance-of-payments forecasting and thus the alternative assumptions may be regarded as yielding essentially no change in the $0.8 billion basic deficit between 1961 and 1968.

The authors, however, do not seem content to accept this interpretation. Instead, they tell us that—

> * * * the projections indicate an improvement in the basic balance of the United States, although the degree of the improvement must be regarded as uncertain. Our best guess is that the basic deficit will be eliminated (p. 230).

Thus, although as pointed out above they have made several relatively optimistic underlying assumptions, the net result of these assumptions on the basic balance does not fully reflect the authors' great expectations, and so they shift the final result by some $0.6 billion in a direction favorable to the United States, and report that they expect the basic deficit to be eliminated by 1968.

A quite different conclusion could have been reached, using the same basic data and the authors' alternative assumptions. Given that the projection shows no significant reduction in the U.S. basic deficit is likely by 1968, it might have been recalled that the sum of short-term capital and unrecorded transactions (which are not considered in the

report) were larger than the basic deficit in 1960–62 and, therefore, that total U.S. deficits of the order of $2–4 billion a year may be expected to continue right on out to 1968.

### X. THE DOLLAR EXCHANGE STANDARD COULD BRING INSTABILITY TO THE UNITED STATES AS THE STERLING EXCHANGE STANDARD BROUGHT IT TO THE UNITED KINGDOM

By continuing to run such large deficits the United States would, in effect, continue to supply liquidity to the rest of the world. The report does show concern that such additional liquidity may need to be created continuously in order to finance a growing volume of international trade, but the effect upon the United States of continuing to supply it does not seem to concern the authors. For the United States it would mean a continuous piling up of short-term foreign debt, and it would mean subjecting the dollar more and more, in the future, to the same kind of pressures that have plagued the pound sterling. The United Kingdom's short-term liabilities far exceed its short-term assets and some of the postwar sterling crises have occurred at times when the United Kingdom's own balance of payments was in surplus. The authors seem to recognize this danger for the dollar early in their study (p. 9), but they completely lose sight of it later, when interpreting the results of their work.

### XI. UNLESS CHANGES UNFORESEEN—AND UNCALLED FOR—BY THE REPORT OCCUR, THE UNITED STATES MAY CONTINUE TO HAVE A CHRONIC BALANCE-OF-PAYMENTS DEFICIT

In the 7 years 1951–57 the average U.S. basic deficit was $1.3 billion a year, while it was $2.6 billion a year in 1958–62.[4] It is difficult to find an equilibrium balance in either period, but it is clear that in both periods the main forces have made for deficits and that the deficits have been much larger in the second period. In years when the U.S. economy is expanding the deficit seems to be associated with a shortfall of exports below imports, whereas the problem seems to be a larger outflow of capital than can be accommodated when Europe is expanding more rapidly than the United States. But whatever the immediate cause seems to be, and in whichever phase of the business cycle we may be, the payments balance keeps showing a deficit.

### XII. THE REPORT FAILS TO RECOGNIZE THAT A NEW DETERIORATION IN THE BALANCE OF PAYMENTS MAY PROVE DIFFICULT TO FINANCE

The authors calmly contemplate perhaps five more years of deficits, in diminishing amounts during the years 1963–67 (p. 238), and state their belief that the average deficit in the years 1963–64 may be about $1.5 billion (p. 230). However, figures which have become available since the report was completed indicate that the deficit in

[4] The turnaround in the total deficit was greater than this because in the first period short-term capital flowed into the United States and in the second period it flowed out.

1963 will be far greater than $1.5 billion. Already the U.S. Government has found it possible to finance the deficits without unduly cutting into the gold stock only by resorting to a whole series of ingenious improvisations. But presumably there is some limit to how long foreign central bankers can persuade their own political leaders that it is advisable to continue holding dollar instruments while forgoing the legal right to convert them into gold. This presumed limit will be lower, and will be reached sooner, if the U.S. foreign payments deficit continues at its present high level.

The report correctly points out in several places that net payments balances are subject to very wide swings, and the worsening which we have seen in the first half of 1963 may prove to be only one such temporary wide swing. The authors completely fail to point out, however, that the United States is becoming highly vulnerable to unfavorable effects following from such large adverse swings. After this most recent adverse swing, most observers will surely conclude that the time has come when the fundamental trend in the balance of payments must now begin to show definite improvement.

## XIII. EVIDENCE PROVIDED BY THE REPORT COULD BE INTERPRETED AS CALLING FOR SPECIAL POLICIES TO IMPROVE THE BALANCE OF PAYMENTS

The report's major conclusion is unmistakable:

> 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 (p. 253).

A directly opposite conclusion might have been reached on the basis of the evidence and analysis supplied, however.

The improvement in the U.S. competitive position vis-a-vis Western Europe is, as the authors point out, "a movement that has already begun" (p. 218). In fact, the movement of national costs and prices favorable to the United States was underway by 1960 and it has been continuing right through the period of our large balance-of-payments deficits. As the following tabulation shows, the U.S. share of world exports of manufactures has fallen during this period, while the share of the leading Common Market countries has continued to rise:

*Shares of leading industrial countries in world exports of manufactures*

[Percent of total countries shown]

| | United States | Germany, France, Italy | United Kingdom | Japan | Six other countries [1] |
|---|---|---|---|---|---|
| 1958 | 23.4 | 31.4 | 17.7 | 6.0 | 21.5 |
| 1960 | 21.7 | 34.3 | 15.9 | 6.9 | 21.1 |
| 1962 | 20.4 | 35.4 | 15.1 | 7.5 | 21.6 |
| 1963 [2] | 20.1 | 35.8 | 15.1 | 7.4 | 21.5 |

[1] Belgium, Luxembourg, Canada, Netherlands, Sweden, Switzerland.
[2] First half, seasonally adjusted.

Source: Brookings Study, P. 65; data are revised and up-dated according to National Institute Economic Review, August 1963.

The authors' optimism is undaunted by the failure of the movement of cost and price trends favorable to the United States to halt, or to reverse, the unfavorable trend in our share of world exports of manufactures thus far. They even remark that—

> If a substantial improvement [in the U.S. balance of payments] occurs, we consider it likely to show up clearly in 1965 or 1966 (p. 231).

The fact that, in their view, such a long period would be required for underlying cost and price factors to assert themselves could only mean that some of our export prices must have been quite noncompetitive in the first place. Among particular products the study mentions high export prices for automobiles, trucks, iron and steel, and industrial machinery (p. 67). These are traditionally important U.S. exports, and if they had become so noncompetitive as the report's analysis implies they had, some corrective policies would seem to be called for—either to guard against a repetition of such price increases in the future or to expedite adjustments today in other parts of the balance of payments so that solid improvement can be brought about before 1965 or 1966.

### XIV. THE AUTHORS LOST THEIR INITIAL SENSE OF URGENCY IN THE COURSE OF ANALYZING THE PROBLEM AND WRITING THEIR REPORT

In the foreword to the report its purpose is stated in terms of finding an—

> accurate diagnosis of the cause of the difficulty [with the balance of payments] and a reliable prognosis of developments to be expected in the next few years (p. XV).

Continuing in this vein, the report states in chapter 1 that—

> the large and continuing balance-of-payments deficit is * * * an urgent problem for the United States to which an appropriate solution must be found (p. 2).

In the course of writing their report, however, the authors appear to have become so absorbed in the favorable long-term trends which they found that they allowed the tone of their report to take on a note of complacency. It is doubtful whether the Brookings study—despite its sober beginning—will impart a sense of urgency about the U.S. balance-of-payments problem to many of its readers. And this, despite the fact that balance-of-payments deficit is already setting limits upon what the U.S. economy can afford to accomplish—limits that can only become more restrictive as time passes if the deficit is not brought under control.

Instead of addressing itself to the serious policy choices which must be made by the United States in 1963 and 1964, the report devotes its only solemn passages to the problem of increasing international liquidity which its authors believe will confront the whole world—in 1968.

XV. THEIR PRINCIPAL ERROR LAY IN ALLOWING THE "INITIAL ASSUMPTIONS" THEY WERE GIVEN FOR 1968 TO INFLUENCE THEIR APPRAISAL OF PROBLEMS WE FACE IN 1963

The authors seem to have been more influenced by their "initial assumptions" than by their "alternative assumptions," even though they chose the latter themselves while the former were derived from governmental targets. This must be the explanation for their tendency to lapse so frequently into optimism.

Here and there throughout the report they enter the proper caveats—balance-of-payments projections are notoriously unreliable; their price projections are largely guesses; large and erratic swings frequently occur in net balances; short-term capital flows are very important although they were excluded from the study; European countries might defend themselves against deteriorating balances of payments instead of using the large reserves they have; the American people may continue to operate their highly productive economy at rates below its optimum efficiency—and so on and so on. But the caveats are too often left behind when the authors draw conclusions which, because the data supporting them are so slim, cannot stand without the caveats. Finding that their conclusions about 1968 are very comforting, the authors offer soothing reassurances about the problems of 1963.

But, as the report points out several times, the basic problem may not be the state of the balance of payments at any particular time, but the degree of confidence people feel about holding dollars. Therefore, the basic danger today is that there might be an acceleration in the world's loss of confidence in the dollar. Such confidence can hardly be strengthened by the appearance of a quasi-official study of the problem which may appear, especially to Western Europeans, to exude complacency.