297

GUIDELINES FOR INTERNATIONAL MONETARY REFORM

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

EIGHTY-NINTH CONGRESS

FIRST SESSION

Part 1—Hearings

JULY 27, 28, AND 29, 1965

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
52-324 WASHINGTON : 1965

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C., 20402 - Price 50 cents

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

WRIGHT PATMAN, Texas, *Chairman*
PAUL H. DOUGLAS, Illinois, *Vice Chairman*

HOUSE OF REPRESENTATIVES	SENATE
RICHARD BOLLING, Missouri	JOHN SPARKMAN, Alabama
HALE BOGGS, Louisiana	J. W. FULBRIGHT, Arkansas
HENRY S. REUSS, Wisconsin	WILLIAM PROXMIRE, Wisconsin
MARTHA W. GRIFFITHS, Michigan	HERMAN E. TALMADGE, Georgia
THOMAS B. CURTIS, Missouri	JACOB K. JAVITS, New York
WILLIAM B. WIDNALL, New Jersey	JACK MILLER, Iowa
ROBERT F. ELLSWORTH, Kansas	LEN B. JORDAN, Idaho

JAMES W. KNOWLES, *Executive Director*
JOHN R. STARK, *Deputy Director*
MARIAN T. TRACY, *Financial Clerk*
HAMILTON D. GEWEHR, *Administrative Clerk*

ECONOMISTS

WILLIAM H. MOORE	NELSON D. MCCLUNG
GERALD A. POLLACK	DONALD A. WEBSTER (Minority)

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

HENRY S. REUSS, Wisconsin, *Chairman*

HOUSE OF REPRESENTATIVES	SENATE
RICHARD BOLLING, Missouri	PAUL H. DOUGLAS, Illinois
HALE BOGGS, Louisiana	WILLIAM PROXMIRE, Wisconsin
WILLIAM B. WIDNALL, New Jersey	JACK MILLER, Iowa
ROBERT F. ELLSWORTH, Kansas	

GERALD A. POLLACK, *Economist*

CONTENTS

PRELIMINARY MATERIAL

Page

Major background questions for hearings to develop guidelines for international monetary reform ... 3
Material submitted by Senator Javits ... 5

CHRONOLOGICAL LIST OF WITNESSES

Tuesday, July 27, 1965

Lester V. Chandler, professor of economics, Princeton University ... 11
August Maffry, senior vice president, Irving Trust Co., New York ... 15
Judd Polk, manager, International Projects, National Industrial Conference Board ... 18

Wednesday, July 28, 1965

Robert A. Mundell, the Brookings Institution ... 48
Warren L. Smith, professor of economics, the University of Michigan ... 54
Henry C. Wallich, professor of economics, Yale University ... 70

AFTERNOON SESSION

Hon. Vance Hartke, a U.S. Senator from the State of Indiana; accompanied by Eliot Janeway ... 99

Thursday, July 29, 1965

Richard N. Cooper, associate professor of economics, Yale University ... 109
James C. Ingram, professor of economics, University of North Carolina ... 123
Lawrence B. Krause, the Brookings Institution ... 135

STATEMENTS

Chandler, Lester V., professor of economics, Princeton University ... 11
Cooper, Richard N., associate professor of economics, Yale University ... 115
Hartke, Hon. Vance, a U.S. Senator from the State of Indiana ... 99
Ingram, James C., professor of economics, University of North Carolina ... 130
Javits, Hon. Jacob K., a U.S. Senator from the State of New York ... 5
Krause, Lawrence B., the Brookings Institution ... 135
Maffry, August, senior vice president, Irving Trust Co., New York ... 15
McCarthy, Hon. Eugene J., a U.S. Senator from the State of Minnesota ... 99
Mundell, Robert A., the Brookings Institution ... 48
Polk, Judd, manager, International Projects, National Industrial Conference Board ... 18
Smith, Warren L., professor of economics, the University of Michigan ... 60
Wallich, Henry C., professor of economics, Yale University ... 70

APPENDIX

Additional Statements

Salant, Walter S., the Brookings Institution ... 161
Triffin, Robert, Yale University: "Guidelines for International Monetary Reform" ... 164
Letter: Chairman Reuss to a number of organizations ... 184
AFL–CIO: Statement by Nat Goldfinger, director, department of research ... 185
Foreign Investment Committee of the Investment Bankers Association of America: Statement by Nathaniel Samuels, chairman ... 187
Committee on International Monetary Relations, U.S. Council of the International Chamber of Commerce: Statement by Norris O. Johnson ... 190

GUIDELINES FOR INTERNATIONAL MONETARY REFORM

TUESDAY, JULY 27, 1965

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

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

Present: Representatives Reuss, Bolling, Ellsworth; and Senator Proxmire, of the subcommittee.

Also attending: Representatives Curtis, Moorhead, Hanna, Ottinger, and Halpern.

Also present: Gerald A. Pollack, economist; James W. Knowles, executive director; John R. Stark, deputy director, and Hamilton D. Gewehr, administrative clerk.

Representative REUSS. Good morning. The Subcommittee on International Exchange and Payments of the Joint Economic Committee will be in order.

We are delighted to have here with us this morning some members of the House International Finance Subcommittee of the House Banking and Currency Committee which has legislative jurisdiction over the subject matter.

We meet this morning to begin the important job of developing guidelines for international monetary reform. This is not our first visit to the subject matter. Back in 1959 the Joint Economic Committee hearings on employment, growth, and price levels probed into the payments problem. At that time, Professor Triffin of Yale presented us with his proposal for internationalizing the foreign exchange component of the world's monetary reserves. And since then hearings of this subcommittee in 1961 and 1962, and of the full committee in 1963 have been held. These earlier efforts have begun to bear fruit, and we are now ready for the next step, which is to consider the specific, particular characteristics that the monetary system of the future should possess.

If the effect of these hearings is to help construct a model for the upcoming negotiations, so much the better.

Recent events have made it clear that our task is timely as well as important. We are clearly not speaking of a future far beyond the horizon. Instead, we really do stand on the threshold between the old and the new.

Just a month ago, former Secretary of the Treasury Dillon said:

> There is an urgent need to strengthen the international monetary system, so as to insure that the needed increases in reserves will be forthcoming. * * * There is no longer any time to dally.

And his successor, Secretary Fowler, on July 10 called for an international monetary conference to secure substantial improvements in international monetary arrangements.

Both the former Secretary and the present Secretary spoke after plans for these hearings were underway, so that our work here this week acquires added significance.

We gave consideration in planning these hearings to requesting from the executive branch the so-called Ossola report, mentioned by Secretary Fowler in his speech, which report is said to set forth various specific proposals for the creation of reserve assets. We chose in the end not to make that request because we wish to approach this hearing with an open mind and without limiting our purview to what has been said by any particular international group.

We are attempting, then, to overcome the paradoxical nature of the present international monetary system; the paradox being that the world's needs for additional liquidity have been met chiefly by dollars pumped into the reserves of other countries by our own deficits, but these very deficits have served to bring into question confidence in the dollar and the willingness on the part of other countries to hold dollar reserves.

The International Monetary Fund has increasingly demonstrated its usefulness. We will be interested to learn whether our witnesses will favor an expanded role for the Fund, or whether you think we should look elsewhere for the reforms that are needed.

In any case, we have an open mind. We have asked our witnesses only to rule out the subject of completely flexible exchange rates and changes in the price of gold, for these alternatives seem to us not to have any reasonable chance of adoption. And now, let us begin these hearings. We are fortunate in having as our witnesses today three gentlemen of great distinction and expertise, Prof. Lester V. Chandler, of Princeton, Dr. August Maffry, senior vice president of the Irving Trust Co., New York, and Mr. Judd Polk, manager of international projects for the National Industrial Conference Board.

We are very grateful to you gentlemen, and I think I will follow alphabetical order and ask you, Professor Chandler, to start out.

Your statements, gentlemen, have been gratefully received in good time and will be made a part of the record, and you may proceed either by reading the statement, by summarizing part of it and going beyond it as you will, or in any way that suits you best.

(At the direction of the chairman, the following set of questions is made a part of the record. The questions were prepared for the use of the subcommittee and provided to all of the witnesses when they were invited to appear.) Chairman Reuss wrote to the witnesses:

"Your contribution to our hearings would be especially valuable if you made the identification of major guideposts the central organizational theme of your prepared statement. * * *

"We have prepared a paper listing major questions, grouped in broad subject areas, which may be useful in this task. Any guidelines we may favor will necessarily imply answers to a number of these ques-

tions. I do not suggest, however, that your statement should primarily focus on these or other questions and attempt to answer most of them. We conceive of them only as building blocks in our basic objective of spelling out the characteristics of an improved international monetary system."

Major Background Questions for Hearings to Develop Guidelines for International Monetary Reform

I. THE FUTURE ROLE OF THE DOLLAR

What should be the international role of the dollar in the future—as a reserve unit and medium of exchange in private transactions?

Should we seek greater stability of the international monetary system by sacrificing some of the "voluntarism" of present arrangements (i.e., the present right of monetary authorities to cash in their dollars for gold at their discretion)? What about the proposal of Posthuma to restrict conversions into gold by agreeing to fixed proportions of key currencies in reserves? Would this be advantageous for us even though we would have to give up some flexibility for financing our deficits with dollars? How would we adjust the composition of our own reserves?

Can we limit the use of the dollar as an official reserve unit without discouraging its use as an international currency in private dealings?

Given the importance of the United States as a trading nation, is the international role of the dollar in private dealings likely to change short of interference by governments? Are continuing increases in privately held dollar balances abroad compatible with exchange rate stability? Should we and could we do anything to discourage increases in privately held dollars abroad?

Can the United States continue to serve the world as its major banking center if the monetary authorities of other countries are unwilling to add to their dollar holdings? Is the objective of internationally integrated money and capital markets desirable and practicable?

What is the proper scope of exchange guarantees? Should we extend their application?

II. BENEFITS AND BURDENS OF THE KEY CURRENCY SYSTEM

Should the United States in the future have the same latitude as other countries to run balance-of-payments deficits? Will the United States ever again be able to run a sizable balance-of-payments deficit in view of the large "overhang" of dollars?

Can we reduce asymmetries in the international monetary system that stem from the large size of the United States? For example, the United States can provide large balance-of-payments support to other countries directly, organize consortiums, and satisfy the needs of others through its large International Monetary Fund quota. But the system is not now well equipped to provide rapid and sizable assistance to the United States. In the future, can there be true "reciprocity" for the United States?

Can we retain some of the advantages of the key currency role (principally the ability to finance deficits by having other countries acquire dollars) while freeing ourselves from the ever-increasing limitations on our freedom to pursue domestic monetary and other policies because of the threat that other countries will cash in their dollars for gold?

III. ADEQUACY OF LIQUIDITY AND ITS COMPOSITION

What are the appropriate criteria for determining whether international liquidity is adequate as to amount, composition, and distribution? Are U.S. reserves too low and European reserves too high? Would increasing world reserves so that U.S. reserves were optimal result in optimal reserves for other countries?

What is the proper balance between international credit availability and owned reserves? Between automatic and conditional credit facilities? How important is the distinction between owned and borrowed reserves? What criteria should be applied here?

IV. CREATION OF OWNED RESERVES

How should owned reserves other than gold be created in the future? Should we work toward a new composite reserve unit, supported by the credit of numerous countries? If we create a new reserve unit, how can we assure that it will be a supplement to, not a substitute for, the dollar? Should we favor a plan which protects us against conversions of dollars now held by foreign monetary authorities into the new reserve unit but rules out future increases in official foreign dollar holdings?

Should the IMF be authorized to create a new international reserve unit, adjusting the supply by accepting deposits or engaging in open market operations? Or should the new unit be created through the Group of Ten or elsewhere? How can all countries be assured of benefiting if the power is lodged outside the IMF? If the Fund is to create the new unit, should dealings in the new unit replace or merely supplement the Fund's present technique of using national currencies? If the IMF is permitted to generate new reserves, what criteria should determine who benefits, and by how much?

What principles should govern the amount of new reserves to be created each year? Should there be a fixed percentage each year over a period of years, or should the amount be determined at the beginning of each year, or what?

Should new reserves be created proportionately for all countries, or should the present concept of giving credit according to need be applied to reserve creation? What should be the balance between rules and discretion? Would there be a restrictive bias on the part of the Fund? If so, how could the world be safeguarded against it? How could the countries in balance of payments surplus be protected against massive demands on their real resources?

V. RESERVE CREATION AND THE LESS-DEVELOPED COUNTRIES

If a new reserve unit is considered desirable, is it needed in the developing countries as well as in the industrial, or are there basic differences between the needs and problems of the two groups of countries? Should reserve creation be used directly to benefit the less developed countries, as by allowing IMF investment in World Bank securities for at least a portion of the new liquidity creation? What should be the limitations on "foreign aid" uses of the new reserve creation—perhaps the apparent ability of developed nations to supply needed real resources without their incurring inflation?

VI. EXPANDING INTERNATIONAL CREDIT FACILITIES

In expanding international credit facilities, how much should be done through the Fund and how much through bilateral or other arrangements? Are we making the best use of the Fund as it now exists?

Would it be desirable to give Fund members automatic access to greater amounts of their drawing rights than they now have? To make automatic drawing rights transferable among countries? To allow the Fund to create automatic drawing rights through investments in member countries? To allow members to pay to the Fund the gold portion of their quota increases with gold certificates rather than gold?

If any of these proposals were adopted, how would the Fund acquire the usable currencies necessary to validate the additional drawing rights? Could the Fund, like the World Bank, sell bonds to private investors?

Can the procedure for increasing Fund quotas be improved? If so, how?

What criteria should be applied to judge the appropriateness of individual country quotas?

Should we work to change the terms on which Fund credit is made available? Does the 3-to-5-year repayment period allow sufficient flexibility? If not, under what circumstances should credits have longer maturity? Would lengthening the repayment period require increasing the Fund's resources? How would this affect the Fund's effectiveness in promoting appropriate policies in member countries?

VII. IMPROVING THE ADJUSTMENT PROCESS

If additional reserves are provided, how can one assure that countries will not take unreasonably long to eliminate their deficits? In a world of fixed exchange rates and managed domestic economies, is it realistic to speak of strengthening the international monetary system to cope with temporary short-run fluctuations

in balances of payments, or must we reckon with long, protracted deficits by important countries? How would the adjustment process be different under alternative methods of increasing reserves and credits?

Are there criteria to apply to the length of time for correcting balance-of-payments deficits? What assurance should surplus countries have that deficit countries are taking sufficient measures to restore balance? What assurance should deficit countries have with respect to the measures of surplus countries? How much demonstrable progress should there be? How successful has the Fund been in enforcing conditions on countries drawing on its facilities?

Are there any important defects in present arrangements for cooperation and consultation? If so, how could they be remedied? Which desirable changes in the international monetary system require international cooperation and agreement? Which could the United States do unilaterally?

Should there be greater resort to exchange rate adjustments by countries without reserve currencies? Are the Fund's provisions for exchange rate alterations adequate and workable?

Without going to flexible exchange rates, can greater insulation be provided the domestic economy by some broadening of the present IMF limits on permissible exchange rate variations?

Are there better "mixes" of policies which could be applied to reduce deficits without selective controls, without dampening the domestic economy, and without unfavorably affecting other countries? Will we ever see the end of tied aid, interest equalization taxes, and the like, or are such selective instruments permanently necessary?

Should there be an international code governing adjustment policies—for example, should there be agreement that interest-equalization taxes ought to be applied to movements of capital so that greater freedom is permitted funds for promoting trade and physical investment than funds simply in search of higher interest rates?

Does it make a difference for the urgency of adjustment whether a country incurs a deficit through capital exports, despite a current account surplus, or whether its deficit arises from imports in excess of exports?

VIII. TIMING AND NEGOTIATING TECHNIQUE

If international monetary reform is desirable, how urgent is it? Why? Even if it isn't necessary to establish new machinery immediately, what are the pros and cons of developing a blueprint now?

Is an international monetary conference as distinguished from regular IMF meetings an apt instrument for achieving international monetary reform? Should heads of state participate as well as finance ministers and central bankers?

Is unanimity of the leading industrial nations necessary for progress? What techniques are available for moving ahead without the intransigents?

Is it desirable to explore inclusion of Communist bloc countries (with their incontrovertible currencies) in international monetary arrangements?

(At this point, by unanimous consent (see p. 48) the opening statement of Senator Javits, and supplementary materials submitted therewith, are made part of the record.)

STATEMENT OF HON. JACOB K. JAVITS, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator JAVITS. The Republican members of the Joint Economic Committee have long believed that reform of the present, antiquated international monetary system is essential for world prosperity, the development of the underdeveloped countries and the maintenance of full employment. As early as July 10, 1963, my Republican colleagues and I on the Joint Economic Committee submitted Senate Concurrent Resolution 53 calling on the President to convoke an international monetary conference to study and discuss improvements in the world payments system. At the beginning of this Congress, we introduced similar resolutions in the Senate and House (S. Con. Res. 14, H. Con.

Res. 127) again calling for the administration to take the initiative in this field.

In our minority views on the President's 1965 Annual Economic Report, we again stressed the importance of world monetary reform and made several suggestions as to improvements that should be discussed. And as recently as June 28, Representative Robert F. Ellsworth, of Kansas, himself a member of the Subcommittee on International Exchange and Payments, made an unusually convincing case for international monetary reform in a speech on the House floor on behalf of himself and 11 other Republican Congressmen. Further support for a world monetary conference to reform the existing system has been given by Representative Thomas B. Curtis, of Missouri.

I, myself, have made several statements on the floor of the Senate pointing out the urgent need for world monetary reform. In my most recent statement, I praised the wisdom of the administration in announcing, through Treasury Secretary Fowler, that the United States is now ready to participate in an international monetary conference to determine what steps might be taken to secure substantial improvements in international monetary arrangements. I am very pleased that, after a long, hard effort, the Joint Economic Committee minority has been successful in helping to convince and now to join with the administration in the determination it should take the initiative in modernizing the world payments system.

I am convinced that such an international monetary conference can be successful only if it is effectively organized and well prepared. To this end, I support the formation of a preparatory committee to outline the terms of reference of the international monetary conference. And I am sure that the present hearings of the Subcommittee on International Exchange and Payments under the distinguished chairmanship of Congressman Reuss will also help lay the groundwork for an effective and successful conference.

Mr. Chairman, I ask unanimous consent that the text of the materials to which I have referred in my remarks be printed in the record of these hearings.

(The materials referred to are as follows:)

88TH CONGRESS
1ST SESSION

S. CON. RES. 53

IN THE SENATE OF THE UNITED STATES

JULY 10, 1963

Mr. JAVITS (for himself and Mr. MILLER) submitted the following concurrent resolution; which was referred to the Committee on Foreign Relations

CONCURRENT RESOLUTION

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

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

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

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

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

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

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

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

89TH CONGRESS
1ST SESSION

H. CON. RES. 127

IN THE HOUSE OF REPRESENTATIVES

JANUARY 25, 1965

Mr. CURTIS submitted the following concurrent resolution; which was referred to the Committee on Banking and Currency

CONCURRENT RESOLUTION

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

Whereas, largely as a result of these deficits, United States short-term dollar liabilities to foreigners totaled an estimated $27,976,000,000 at the end of October 1964; and

Whereas these liabilities constitute a potential claim against the United States gold stock of $15,200,000,000, of which less than $1,400,000,000 is "free gold" not required to serve as backing for our currency; and

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

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

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

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

Resolved, That the President be requested to call for an International Economic Conference to review the long-term adequacy of international credit; to recommend needed changes in existing financial institutions; to consider increased

sharing of economic aid for development and military assistance; and to consider other pressing international economic problems placed before it by a preparatory committee for such Conference.

89TH CONGRESS
1ST SESSION

S. CON. RES. 14

IN THE SENATE OF THE UNITED STATES

JANUARY 28, 1965

Mr. JAVITS (for himself, Mr. MILLER, and Mr. JORDAN of Idaho) submitted the following concurrent resolution; which was referred to the Committee on Foreign Relations

CONCURRENT RESOLUTION

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

Whereas largely as a result of these deficits, United States short-term dollar liabilities to foreigners totaled an estimated $27,976,000,000 at the end of October 1964; and

Whereas these liabilities constitute a potential claim against the United States gold stock of $15,200,000,000, of which less than $1,400,000,000 is "free gold" not required to serve as backing for our currency; and

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

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

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

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

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

INTERNATIONAL MONETARY REFORM

Reform of the existing international monetary system is urgently needed. We are pleased that the administration has embraced this broad objective, but we regret its lack of specific proposals as well as the disposition to delay action until the U.S. balance-of-payments deficit is corrected.

Because liquidity for the existing system is largely supplied by U.S. balance-of-payments deficits, the system could break down when the United States finally eliminates its chronic deficit. Although there is no shortage of liquidity at this time, a shortage could result in the future both for this reason and because of the growth in the volume of world trade and payments. We believe that positive action should be taken now to reform the system before a crisis leading to world economic collapse can arise.

In a resolution which we have introduced in the Congress, we urged the convocation of a well-planned and well-organized international monetary system. The limited results of the deliberations of the Group of Ten and that conference to find a basic solution to the weaknesses of the world monetary of Western financial leaders in Tokyo in 1964 only underscore the need for a conference on the scale of the Bretton Woods Conference.

The recent Tokyo meeting of the financial leaders of the West has resulted in but a modest beginning toward the reform of the system which was established to meet conditions in the immediate post-World War II period. The decisions made there, together with the ad hoc improvisations of recent years, have succeeded in avoiding the breakdown of the system but have not produced the fundamental reform which is dictated by existing conditions.

We do not wish to deprecate, however, the very real contribution that the existing system has made during the past 20 years in the area of international monetary cooperation. The International Monetary Fund and the International Bank for Reconstruction and Development have been most helpful in easing the transition toward the convertibility of all major currencies, in reducing reliance on bilateralism, and in stabilizing swings between inflation and deflation in many areas of the world.

Our own dissatisfaction with the attitude of the world's financial managers is that their approach to adapting the system to current world conditions has been timid, being more disposed toward tinkering than facing such basic questions as these: Is the adjustment mechanism built into the existing system flexible enough to bring about a correction in the imbalance in international payments within a reasonable time? Does the existing adjustment mechanism place equal burdens on the countries which are in a temporary surplus position and those which suffer temporary payment deficits? Does the existing system generate sufficient credit to meet the needs of developing nations? Will it be adequate in the future to meet the needs of the developed countries?

At the present time, imbalances in international payments take years to eliminate and require, particularly on the part of deficit countries, measures which may hamper their economic growth and the expansion of world trade. The existing adjustment mechanism does not place equal burdens on surplus and deficit countries, but at times is contrary to the best interests of all concerned.

The chances for securing European cooperation for a conference to consider these questions are improving. Even while pressing the United States to eliminate its balance-of-payments deficit, European financial leaders are growing increasingly concerned about the impact that success in this endeavor will mean for their own international balances and for the stability of the world monetary system itself. Although enlarging the International Monetary Fund quotas is helpful, it in no way diminishes the need for a more basic reform.

The alternative to basic reform is the continuation of the existing system with more stringent forms of financial "discipline" added. The free world has already paid a high price for the existing system in terms of restrictions on trade and capital movements—such as the U.S. interest equalization tax—and in Government procurement policies which are undermining 30 years of progress toward trade liberalization.

The international monetary system has an enormous impact on economic conditions in both the developed and developing nations of the non-Communist world, on the well-being of their citizens, and on their ability to meet the many and varied challenges of Communist power. It determines, to a large degree, our freedom to pursue appropriate domestic economic policies, and it has a major impact on domestic political stability in many Western nations.

A well-functioning and flexible international monetary system has a major impact on our ability to supply an ever-increasing volume of economic assistance to the developing nations, which is essential to insure them a satisfactory rate of economic growth in a democratic framework.

For what distinguishes the free world from the Communist world and gives freedom its greatest inducement is the opportunity to extend credit to, and confer ownership on, the individual.

In order to bring about the required improvement in the performance of the existing international monetary system, the international conference that we have suggested should consider the following points:

(1) The availability and expansion of the world's supply of international credit should be managed and not left to such haphazard factors as how much gold is mined and how big the U.S. balance-of-payments deficit is. The

appropriate role of the IMF and other international organizations in the management of international credit should be thoroughly reviewed.

(2) IMF and the Group of Ten should cooperate closely in developing new forms of international credit along with safeguards to insure that credits are used to give deficit countries time to correct imbalances and not as a substitute for such correction.

(3) The need to increase availability of long-term, low-cost credit to the developing nations.

New forms of organization and new methods of channeling private capital to developing countries must be found if private enterprise is to retain a major role in the economic development of less developed countries. The example provided by the newly organized multinational investment group called the ADELA, the Atlantic Community Development Group for Latin America, should be ample proof that given sufficient energy and determination new devices and methods can and will be found.

The initial success of this venture in attracting major corporations and financial institutions in North America, Europe, and Japan is indicative of the will that exists in many countries of the world. Its power to attract additional public and private capital is great and its potential in proving that there exists widespread confidence in the potentiality of one developing region of the world—Latin America—is even greater.

In this connection, it is important that study be devoted to determining the effect of Government aid on private investment flows into the developing nations. Although Government aid need not inhibit private investment, this may be the result if the Government aid is given and administered in a manner prejudicial to private capital.

The existing system does not meet the credit requirements of the developing nations. According to the 1964 Annual Report of the Council of Economic Advisers, the total long-term receipts of developing countries from public and private bilateral and multinational sources now total in the area of $8 billion a year. On the other hand, estimates made by a number of highly reputable experts place the capital needs of the developing countries at between an additional $7 to $11 billion per annum. This gap is based on the modest assumption that such additional funds would be required to permit developing countries to grow at an overall rate of between 4½ and 6 percent per year. Given the present 2.1 percent annual increase in the world's population, the increase in per capita gross national product that will result from this additional flow of capital would amount to between 2.1 and 3.9 percent per year. The average per capita GNP of developing countries is now estimated at $130 per year. The need for additional capital indicated above is, therefore, by no means exaggerated.

There is a related problem which should be considered: the interest cost and duration of credit presently being extended to developing nations. Today these countries are paying about $2½ billion a year, or one-fifth of their gross capital inflows, for servicing their externally held public debt; and the charges are mounting rapidly. Still worse, the charges are mounting much more rapidly than are the export earnings required to service the total debt. Between 1956 and 1962 debt service rose from 3 to 7 percent of the value of developing countries' exports of goods and services. The need for an increase in the volume of long-term, low-cost credits—both public and private—is, therefore, very real.

The opportunity for private enterprise in the United States and in other OECD countries to play an increasingly significant role in providing substantial credit is enormous; but this role requires a basic change in attitude by business and Government and new devices to meet the problems of the day.

We must begin devising an international payments system which takes cognizance of changes in the world economy since the Bretton Woods Conference in 1944 and which will be flexible enough to fit into the economic order of 5 to 10 years from now. A well-planned international monetary conference, in our view, is a necessary—and vital—first step toward such a workable system.

POLICY RECOMMENDATIONS OF CONGRESSMAN ROBERT F. ELLSWORTH, OF KANSAS, CONTAINED IN HIS SPEECH, "THE INTERNATIONAL MONETARY SYSTEM," DELIVERED ON THE FLOOR OF THE U.S. HOUSE OF REPRESENTATIVES ON JUNE 28, 1965.

* * * * * * *

1. The primary emphasis in U.S. policy must be placed on achieving early and long-term balance in our international payments. Balance should rely on more long-term policies than the current artificial "voluntary" and "temporary" controls on U.S. investment abroad.
2. As the U.S. payments come into balance, the administration should implement its declared intention of holding a substantial percentage of its international reserves in foreign currencies. Such a policy would promote acceptance of new international reserves in addition to the dollar.
3. The President should declare U.S.'s willingness to attend an International Monetary Conference to resolve the "liquidity crisis."
4. The administration should immediately call for the creation of a permanent preparatory commission which can meet now to lay the groundwork for such a conference. In preparing for a conference through such a preparatory commission, the United States should be willing to accommodate and encourage responsible change, including expansion of current IMF quotas and drawing rights; creation of new currency reserves; gradual evolution of the IMF into an authority with the power to create international reserves as they are needed.

* * * * * * *

STATEMENT OF LESTER V. CHANDLER, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. CHANDLER. Thank you, Mr. Chairman.

As the committee requested, I shall address myself to the general guidelines or principles relevant to the international monetary system and shall have little to say about specific plans that have been advanced for monetary change or reform.

You have requested us to refrain from discussing flexible exchange rates or changes in the price of gold. Rejection of these two possible instruments has certain implications which, though perhaps obvious, should be noted briefly. Rejection of flexible exchange rates in favor of a system of relatively fixed exchange rates means that this device cannot be used to reduce the world's present needs for international liquidity or to meet future increases in the world's needs for international liquidity. I do not pretend to know how fast these needs for liquidity will grow, but the growth will surely be large in view of the potential growth of the world's production and trade. If the supply of liquidity does not grow in line with these requirements the results will be deflationary pressures on national economics, or restrictions on international trade and capital movements, and probably both.

Rejection of an increase in the price of gold means that this device cannot be used to meet future increases in the world's demands for liquidity. All of the needed increases in supply will have to come from other sources. This brings us to crucial questions: what forms should the increased supplies of liquidity take and how should they be supplied? I offer these observations.

1. The international monetary system should include both international credit availability—or lending facilities—and owned reserves, but the secular rise of the world's demands for liquidity should be met by increases in owned reserves, by reserves acquired by nations without having to borrow. It should not be met by borrowing on relatively short term, with implications of early repayment and possible discipline by lenders. I suggest an analogy with central banking within a nation. To permit commercial banks to borrow from the central bank is highly useful. It permits individual banks to meet unexpected drains or special situations. It also enables the central bank to discipline those banks that try to expand too fast or otherwise misbehave. But to force the entire banking system, or major parts of it, to go ever more deeply into debt to the central bank to meet needed and desired permanent increases in the money supply is dangerous. For one thing it may be deflationary; the banks may not be willing to expand sufficiently if they can do so only by going ever more deeply into debt. Where permanent increases in a nation's money supply are wanted, it is more effective for a central bank to supply banks with more owned reserves through open market purchases or otherwise. Similarly, nations may feel under deflationary pressure if they can maintain their needed liquidity only by large and continuous borrowings from the IMF or foreign central banks. There can be no assurance that the total supply of liquidity for the world as a whole will behave acceptably if it must depend substantially on the willingness of individual countries, each looking to its own needs and interests, to borrow and remain in debt. If most of the world's increasing needs for liquidity are met by expanding owned reserves, the principal purposes of lending facilities would be to meet the needs of individual countries and special situations. Under these conditions it would be more feasible to impose discipline on borrowing countries than it would be if large numbers of countries always had to be heavily in debt to the IMF or other foreign lenders in order to supply the necessary amount of liquidity for the world.

2. Increases in the needed supply of owned international reserves are unlikely to be met either dependably or adequately by increases in the world's monetary gold stock, with gold at prevailing prices. Predictions of gold production are faulty enough and nonmonetary demands for gold even more so, but it seems quite unlikely that future additions to the world's monetary gold reserves will be sufficient. Some part, and probably a large part, of the needed increase in owned reserves will have to be in the form of assets other than gold. These nongold assets, whatever form they may take, should be capable of being regulated in quantity, so that the total of gold and nongold international reserves could be made to behave in some acceptable fashion.

3. It is neither feasible nor desirable that future increases in nongold international reserves be in the form of claims against individual national currencies, such as the British pound sterling or the U.S. dollar. It is most unlikely that the pound can plan an increased role as an international reserve currency in the future. The central banks of other countries show no willingness to hold significantly larger amount of sterling as reserves. About the future role of the U.S. dollar as an international reserve currency, several things can be

said. One is that the United States cannot in the future contribute to the gold and dollar reserves of other countries as it has done since 1949. Even if we were able and willing to continue such deficits in our balance of payments the other countries would not be willing to accumulate and hold dollars as they have in the past; they would demand more gold. Moreover, it is not good for the world or the United States for the behavior of international reserves to depend so heavily on the state of the U.S. balance of payments. This point has been made so often that it need not be elaborated. Some have suggested that the problem might be alleviated, if not solved, by adding one or more national currencies to the list of those held as reserved by foreign central banks. I see little hope in this direction for solving the basic problems. What would the currency or currencies be? The deutsche mark, the French franc, the Swiss franc? To date the governments of these countries have shown little interest in having their currencies held in large quantities by foreign central banks, and the latter have shown little interest in expanding largely their holdings of these national currencies. Moreover, a step in this direction would increase the danger of adverse shifts of holdings from one national currency to another. Also, it is not clear that the supply of international liquidity would behave much more acceptably if it depended on the balances of payments of four or five countries instead of those of only the United States and Great Britain.

4. It is not in the interest of the United States for the central banks of other countries to hold more dollars as international reserves, and it would probably be beneficial to reduce the role of the dollar as an international reserve currency. What are the supposed advantages to a nation of having its currency used as an international reserve by the central banks of other countries? The principal advantage to the United States is usually said to be its ability to borrow large amounts on favorable terms subject to little or no discipline, as central banks of other countries finance our deficits in part by increasing their holdings of dollar claims. Whether this was an advantage in the past may be debatable; the important point is that it is not available for the future to any important extent. Foreign central banks are simply not willing to lend us much more by increasing their holdings of dollar claims. Some even want us to pay off at least a part of the claims they already hold. Nor is it true that we are left free of discipline by our foreign central bank creditors. They are in at least some cases reluctant creditors, concerned about their investments in dollars, watching our every move, offering advice as to our domestic economic policies, and even nagging. Whatever may have been true in the past, I suspect that in the future some of our larger foreign central bank creditors will become more reluctant and try to exercise more discipline. The major point, however, is that in the future we simply cannot count on increases in foreign central bank reserve holdings of dollars as a major method for financing deficits in our balance of payments. We shall have to rely on other sources.

It should be noted that the vulnerability of the present gold exchange system, so heavily reliant on sterling and dollar claims, stems from the large holdings of these claims by other powerful industrial countries. There would be no such danger if only the underdeveloped

52-324—65—pt. 1——2

and poorer countries held their reserves in these forms. Their holdings are small, individually and in the aggregate. The real threat comes from the 10 or 12 more powerful industrialized countries whose holdings of dollars are very large.

5. The United States should join with the 10 or 12 other financially most powerful countries in an agreement to set up a revised international reserve system. This agreement would have several parts. The first would be to agree on a new nongold reserve unit which the participating countries would agree to hold as a reserve, receive in payment, and use to redeem their national currencies. I would prefer that this nongold reserve be in the form of claims against an expanded IMF, perhaps against a special trust account there. I do not care to specify whether it should be issued against contributions of the currencies of the participating countries or against security purchases, but it should have certain attributes. One is that its total quantity should be subject to management by the representatives of the participating countries and that this quantity should be managed primarily with an eye to the world's needs for liquidity in the form of reserve assets. In determining the total quantity and in allocating the newly created nongold reserves, only a minimum of attention should be given to the needs of individual countries. The latter should be met primarily by the international lending facilities and with the usual sorts of discipline applicable. Also, the creation of the new nongold reserves should not be tied in any direct way with aid to underdeveloped nations. I say this in no spirit of opposition to aid to these areas; in fact, I want to see such aid continued and even expanded. But I do not want the pursuit of this objective to spell the doom of international monetary reform. To get conservative finance ministers and central bankers to create and accept a new nongold reserve will be difficult enough in any case, but it is almost inconceivable that men so accustomed to the idea that money should be issued only against "sound and liquid asset" would agree to create and receive money issued against the types of debt claims that most underdeveloped countries would be in a position to issue.

Another provision of the agreement should be that the central banks of the participating countries will not increase their holdings of reserves in the form of claims against the currencies of the other participating countries. All net accretions to their reserves should be in the new nongold reserves, or gold, or some combination of the two to be agreed upon by the participating countries.

The agreement should also provide for the conversion of at least part of the present central bank holdings of sterling, dollars, and other national currencies into the new nongold reserve units. For example, the U.S. Government might agree to deliver to the trust account at the IMF, over a suitable period of time, obligations to pay gold or to pay convertible currencies of the participating countries of equivalent gold value, in return for which the trust account would issue new reserve units to the central banks formerly holding dollars. Thus the United States would be relieved of its "overhang" of short-term liabilities to the central banks of the participating countries and the latter would receive claims against an IMF trust account so that there would be no decrease in total international liquidity if the United States did not have to pay to the IMF an excessive amount of gold.

6. To reduce the role of the dollar as a currency reserve of central banks in the other participating countries, or even to eliminate this role, should not reduce the role of the dollar as an international medium of payments or reduce the willingness of foreign private banks and others to hold dollar claims. Private foreign entities surely do not hold dollars or use them in international payments because foreign central banks hold dollars as reserves. They use dollars for various reasons: the magnitude of the U.S. trade with the rest of the world; the efficiency of our money markets and payments mechanisms; freedom of dealings; the soundness of the dollar relative to other national currencies; and so on. To the extent that international monetary reform enabled us to improve our policies and lower restrictions it should support and perhaps even enhance the position of the dollar in private transactions.

Mr. Chairman, I have touched upon only a few of the major issues involved, but I hope I have indicated the general direction in which I think international monetary reform should go.

Thank you.

Representative Reuss. Thank you very much, Mr. Chandler.

We will withhold our questions until all three gentlemen have had a chance to give their papers.

Mr. Maffry, would you proceed?

STATEMENT OF AUGUST MAFFRY, SENIOR VICE PRESIDENT, IRVING TRUST CO., NEW YORK

Mr. Maffry. My name is August Maffry. I am a senior vice president of the Irving Trust Co. of New York. In other days, while in Government service, I served as a technical adviser to the American delegation to the Bretton Woods Conference. I was also at one time the official compiler of the balance-of-payments statistics of the United States.

I appear before you today in my personal capacity. Accordingly, the views that I am about to express are strictly my own and not necessarily those either of my company or my associates.

The strengthening of the international monetary system has now become a matter of great urgency. This is because the United States has determined to eliminate the deficit of long standing in its balance of payments. The United States will thus cease to provide the rest of the world with the annual increment of international reserve money that is essential to the growth of world trade and to the continued economic development of the free world. I take this determination as given, since it is the announced policy of the U.S. Government and is being pursued with the strongly induced cooperation of industrial corporations and financial institutions doing international business. I assume that it will be successful, as it has already been to a very substantial degree.

This does not mean, of course, that the policy is necessarily correct either from our point of view or that of the free world. I regard the sudden and drastic reduction in the deficit in the U.S. balance of payments which is now in progress as a highly dangerous expedient under the present international monetary system. An abrupt shift from deficit to equilibrium or surplus cannot fail in the

long run to have severe repercussions on world trade and world economic growth. The only reason that it has not already had serious consequences is that the shift came at a time of relatively high liquidity in the international monetary system. I believe that the more prudent course would have been to aim for a balance on the "official-settlement basis" as a measure of the balance-of-payments position of the United States. This would have permitted a continued growth in the dollar "working" balances of foreign commercial banks and other nonofficial foreign entities. These working balances are the holdings of dollars which serve to lubricate world trade and economic development. Since they are required holdings in one sense or another of working balances, they have little or nothing to do with losses of gold by the United States as do additions to holdings of dollars by foreign central banks and other foreign official entities.

I appreciate the argument that it was necessary for the United States to eliminate the deficit in its balance of payments before it could negotiate on equal terms with other leading countries for international monetary reform. Whether the argument is valid or not depends upon the definition of "deficit" for one thing; but in any case I think the point has been overemphasized and has delayed unnecessarily the beginning of negotiations. Thus, I say again that the reform of the international monetary system has become urgent, and I believe there is a growing consensus that further delay would be hazardous.

I have no pet scheme of reform to put forward. I am convinced that one day, which I hope will not be too distant, the free world will establish a full-fledged international central bank for national central banks with the capacity to create international reserve money just as at long last our own Federal Reserve System was established for the purpose of regulating the money supply of the United States. However, I think it is quite clear that such a move is not politically possible at this time. One must seek, therefore, other ways of strengthening the international monetary system.

The elements of the required reform are reasonably evident. One is that it should be done by modifying the statutes of the International Monetary Fund as an existing successful organization already playing an important role in international monetary arrangements. Another is that the reform should involve a further mobilization and centralization of international reserve money. A third is that members of the modified Fund should be given increased access to its resources. The fourth is that reserves in addition to pooled reserves must be available under standing credit arrangements between the IMF and the leading industrialized countries of the world. The fifth is that international monetary reserves must increase in some systematic way in order to underpin a sustained growth in the world economy at a satisfactory rate.

These are general principles that will have to be translated into specifics at the forthcoming international monetary conference. I believe that there is much to be said for the establishment of a new international reserve unit as proposed by Bernstein. (I refer, of course, to Edward Bernstein.) A new unit has become necessary because neither gold nor the dollar nor sterling can serve adequately under present circumstances either individually or collectively as

reserve money. Gold obviously cannot so serve because of the small annual increment of newly mined gold going into monetary reserves. Sterling cannot so serve because of its chronic weakness and because of the present determination of the United Kingdom to eliminate the deficit in its balance of payments. The dollar could so serve in my opinion because of its basic strength in all respects but is now deficient because of the present unwillingness of the U.S. Government to carry out the functions of a reserve currency.

The new international reserve unit as proposed by Bernstein would be a composite unit as a logical and evolutionary extension of the existing general arrangements to borrow. It would be composed in agreed proportions of the currencies of the major industrialized countries. It would be held as reserves by participating countries in an agreed ratio to their holdings of gold. The participating countries would agree to convert their currencies into the new unit in the same ratio. They would agree further to deposit their currencies in the International Monetary Fund in predetermined amounts over a period of years in exchange for credits with the Fund in terms of the composite unit. The increment in international reserve money achieved in this way would be calculated to maintain a level of international liquidity adequate to effect settlements among participating countries. Finally, a portion of the annual increment would accrue to the International Monetary Fund as an addition to its resources available to participating countries.

These proposed arrangements strike me as being politically feasible and as providing at least the essential elements of international monetary reform now so urgently needed to maintain the health of the world economy. The establishment of a new composite reserve unit would not materially impair the role of the dollar as an international currency. We are talking here about "reserve" money in the hands of the monetary authorities of the leading industrial countries of the free world and in the hands of the International Monetary Fund. The dollar (and sterling, too) would continue to be widely and, in the case of the dollar, increasingly used as transaction money in financing world trade and economic development. Nor are the monetary authorities of participating countries likely to hold the new unit in amounts beyond an agreed ratio to gold in preference to holding dollars. Dollars will still be generally preferred to a composite unit for a number of reasons—because they must be made available from time to time to the commercial sectors of national economies as transaction money, because they serve as a base for credit obtained in the United States, because they can be invested in a broad money market in a variety of ways as earning assets. In short, the dollar will not be dethroned as the principal international currency of the world so long as the economy of the United States is strong and so long as the international financial position of the United States is strong, as it has been right along despite the deficits of long standing in the U.S. balance of payments.

This leads me to my final point, which is: even if a new international reserve unit is established and put in working order to provide a systematic increase in international monetary reserves, there will remain the problem of maintaining the volume of international "transaction" money—which means mainly dollars—at a level which will adequately lubricate world trade and economic development on an ascending scale.

For this purpose, the United States should allow a supply of dollars to the rest of the world by means of capital exports and otherwise sufficient to make possible a continued increase in dollar working balances held by foreign commercial banks and other nonofficial foreign entities. This would permit an approximate equilibrium in the U.S. balance of payments on an official-settlements basis but would require a "deficit" on a so-called regular basis equal to the increase in nonofficial foreign holdings of dollars. In my view, this is not a deficit in any true sense but rather a necessary increase in the world's working balances in dollars.

Thank you, Mr. Chairman.

Representative Reuss. Thank you, Mr. Maffry.

Mr. Polk.

STATEMENT OF JUDD POLK, MANAGER, INTERNATIONAL PROJECTS, NATIONAL INDUSTRIAL CONFERENCE BOARD

Mr. Polk. Mr. Chairman, my only intention was not to read this statement, but I see, particularly from my colleagues here, that there is enough difference in point of view. I rather suspected that I would be in the "I also" position as tail man, but I think perhaps with your indulgence I would like to read the major part of it.

Representative Reuss. Please do.

Mr. Polk. The National Industrial Conference Board is a fact-finding institution which neither has opinions nor takes stands on issues. The board is prohibited by charter from attempting to influence legislation. The personal views I am expressing here are necessarily limited to comments on trends in our balance of payments and in the context of the dollar's present role in international finance.

In expressing the personal views I have derived from long professional interest in problems of international finance, I have tried to follow the chairman's suggestion that witnesses be explicit as to their beliefs about the objectives of the international monetary system and identify major guidelines they consider essential to attaining these objectives.

The question, What improvements in financing are practicable? still leaves us with a wide spectrum of interpretations and judgments, and the individual views of any of us must be summarized without benefit of the intricate arguments one might feel would supply coherence. But this territory of intricate argument is familiar ground to the committee, and thanks to the committee's work is more familiar to all of us. So, I get the feeling that the most helpful procedure is to move along quickly, indicating the way the overall facts appear to me, and the priority factors which, to my mind, ought to be kept in mind in policy decisions.

Although the proper aims of a system are almost impossible to state satisfyingly, I have no sense that the current international financial debate, in this country at least, involves any real sense of difference as to ends. The existence and integrity of separate nations must be accepted as the main broad political context of any practicable financial arrangements and subject to that limit, possibly a severe one, the

proper objective of a system must be to work well as an accommodation to expanding production and trade in the various national economies. I put production first in the thought that effective production is necessarily specialized, hence dependent on credit as a basis for producers' confidence that readily spendable funds can be borrowed to meet costs until earned funds are forthcoming from trading the resultant products. Workable arrangements providing for the credit essential to extensive production and facility in carrying out the payments implicit in extensive trade—these are the aims of any monetary system. To be workable, arrangements must be varied, fair, and dynamic. To be acceptable, they must be regularized, and they must fit the varying circumstances of producers.

Defects in present international arrangements are to be approached, in my view, as relatively minor shortcomings in an impressive and intricate structure which has, after all, been the financial profile of an extraordinary postwar period of world economic expansion. More to the point, modifications introduced into the system, if running counter to current credit availabilities and currently acceptable payments facilities, are certain to be literally counterproductive, counter national production, and counter international production. Moreover, it is hard to conceive of any change in the forms of international payments that will not call on us to consider their effects on present payments facilities and in turn credit availabilities.

To begin with, as a matter of interpretation of facts, our balance of payments throughout the postwar period seems to me to be saying:

1. The formidable and growing stream of dollars flowing to foreigners (nonresidents) is composed both of amounts earned from us (through our imports and military operations) and amounts (now formidable) we lend or give, the latter becoming increasingly important as our savings, our interests in foreign markets, and our international banking function have grown. The proportions of estimated earnings and borrowings by nonresidents in 1964 were:

Dollars to nonresidents:	*1964*
Earned from—	
Sales of goods and services	24.3
U.S. military expenditure	2.8
Investments in United States	1.3
Total	28.4
Proceeds from—	
U.S. private lending	7.3
U.S. Government grants and loans	4.3
U.S. remittance	.8
Total	12.4
Total	40.8

Source: Department of Commerce.

2. The use of these dollars, which is not within our direct control, is (*a*) to buy goods and services from us (*b*) to hold as private or official working balances against a growing trade and investment volume, and (*c*) to hold as official or private reserves.

The (*b*) and (*c*) portions of dollar use by nonresident accounts for the growth of private and official dollar balances:

Growth and liquid dollar holdings

	1950	1964	Increase
Private	4.1	10.6	6.5
Official	7.1	13.2	6.1
International institutions	1.5	5.0	3.5
Total	12.7	28.8	16.1

Source: Federal Reserve.

The outpouring of private loans, investment funds, and aid money during the period were several times the size of the growth of dollar balances and the question whether foreign dollar balances were earned (and thus not of credit origin) by them or loaned or given to them disappears in the mists of assumptions and counter assumptions. But clearly dollar cash is not independent of dollar credit. The circumstances which one concludes would account for their accrual are matters of judgment, and even more the circumstances accounting for the accumulation rather than expenditure. One judgment, put bluntly, is that the dollar balances are reluctantly held and are attributable to excess of U.S. spending or lending; another, also put bluntly, is that the reluctance is largely trumped up, primarily by certain foreign governments whose holdings are excessive, if so deemed by them, only because of their anxious preference for (*a*) generally high liquidity; i.e., a high proportion of short-term assets to total receivables and (*b*) for liquidity in the form of gold.

Without argument, I would say (bravely) that the truth is somewhere in between, but in the last few years closer to the latter. Described more objectively, I would express it that foreigners, especially official agencies, in their views about reserves, have not yet grown sufficiently accustomed to the dollar to give it the universal reserve status implicit in the virtually universal recourse to the U.S. market for credit facilities. The unilateral gold policies of the United States both in buying gold and selling dollars at a fixed dollar-gold parity fosters the belief, perhaps illusion, of reluctant dollar holders that gold is a better reserve, and affords them a choice between gold and dollars which they in their policies do not in turn vouchsafe to foreigners with respect to their natural currencies. More than that, no modern national economy gives to residents a legal choice of liquidity in a form other than the fiat instruments expressing the government's assurances that the instrument is good money (of legal tender status). In contemporary national monetary technique, liquidity is assured by the flexibility of cash supply and the evolution of confidence in the assurances of the government. As I see it, there is much in the view that the growth in dollar holdings reflects the expansion of dollar cash supplies in response to international liquidity preferences, broadly comparable to the expansion of dollar cash resources which would respond to an increase in domestic liquidity, preferences, in the United States. But no nation can guarantee the international status of its cash held outside its borders. That status depends on laws, customs, and state of confidence as accorded by foreigners. Hence, the con-

tinuation, even exacerbation, of a cash dollar problem internationally at a time when a corresponding national cash problem would be anomalous. I would also add here (and return to the point later) that foreign dollar holders do have an understandable concern that their dollar holdings should have some economic ceiling other than the political convenience of the United States.

1. ROLE OF THE DOLLAR

Dollar permeation of worldwide tills, private and official, goes with the international recourse to dollar credit; were it otherwise, we would be faced with an economic oddity—how so much credit could be supplied without any ready assignability in bearer form. Cash and credit go together. The greatest importance must, in my opinion, be attached to the preservation of the dollar's current flexibile cash-and-credit role and potential for future growth in the market structure of international finance. The New York market, in which our international transactions are centered, but by no means monopolized, represents an institutional asset of fundamental importance to the expansion of international trade and production, without any substitute.

In the almost universal preoccupation of countries with the imbalances that develop in their international financial posture, some of the solid virtues of a national currency get overlooked. For example, a dollar is a legally enforcible claim by any bearer (resident or nonresident) on the U.S. production; gold is not. Similarly with other national currencies considered as claims against their production. Legal tender, though only national in scope, vouchsafe to currency holders a legal status beyond any available assurance that could be constructed by intergovernmental agreement in the absence of supranational sovereignty over the allocation of national resources.

The size, variety, and flexibility and above all, freedom of the U.S. money and capital markets, make up a formidable and unique asset not just of this country but of the international financial system. The further growth of this asset is, in my view, a condition—certainly not an obstacle to ready further progress in the international system. Accordingly I infer as a guideline in the debate that we should shun proposals which arrest recourse to U.S. credit or inhibit the use of dollars in payments traffic or reserves, but that we should be hospitable to any measures which bolster confidence in the dollar and overcome foreign reluctance to hold dollars. It may be conceded that determining which is which, is a matter of art for which no ready guidelines comes to mind.

2. LIQUIDITY

"Liquidity," of which we hear probably too much nowadays and certainly too much that is hard to define and communicate about, means and can usefully mean, various things to various people. At one time during early post-World War II years of real European and other countries' deficits it meant that the means of international payment fell short of the cash needed for settlements of workaday—or workamonth balances. In 1949 the United States held all the gold, and, of course, most of the dollars as well; world gold holdings outside the United States were $10 billion and U.S. holdings $25 billion. That is no longer the case, with world holdings of gold at $28 billion (plus

$18 billion) and of dollars at $30 billion (plus $10 billion), the total of which has grown apace with growth of international transactions. If liquidity is taken to be a quantitative notion and is equated with aggregate world holdings of international cash, and if it is taken to include gold, dollars, sterling, IMF drawing rights, and so on, then the adequacy of this available international cash (or some defined portion of it, say, gold) may be compared in growth potential to some measure (say, world trade) of needs for international cash, and appropriate observations made as to when the cash will get tight in terms of need.

But liquidity in this mechanical sense is not, in my opinion, what could legitimately give rise to the widespread concern today over international liquidity. Obviously the concern must be more over the terms and character of available international credit, and the nature of the appropriate mixture of policies to meet the needs of production and enforcing needed national economic adjustments. Rather than call the present debate one over liquidity (international cash), we could just as well—better, in fact—call it a debate over international credit availabilities and limitations. At least, that is what we ought to be debating; liquidity or cash position, has no meaning, except in relation to credit of which it is a marginal, though critical aspect. The more effective a credit system, complete with central clearing facilities and with built-in disciplines, the less the need for cash.

The achievement of an adequate clearance and credit mechanism with a nice balance between accommodating the international requirements of production and restraint on excessive particular expenditures is the desideratum, internationally as clearly as nationally. But to state the similarity between the international goal and the national ones which most countries have come to deal with in a highly sophisticated manner obscures the crucial difference: there is no soverign international power to arbitrate the terms of credit, and hence, the tried-and-true techniques of the large national economies are not availing in the conglomerate sphere of differing international policies. Nor, can financial initiative however ingenious, achieve a degree of universality that goes beyond the limits legally sanctioned by national political determinants, and practically sanctioned by usages tolerable in public custom.

No study groups, no conference, is going to invent an arrangement side-stepping the slow process of evolution in international confidence in any source of cash, although the thrashing out of new departures in such studies and conference contributes substantially to the sort of mutual understanding which fosters the evolution of confidence. And since in money matters we are dealing for better or worse with a traditionally sensitive and potent instrument of sovereignty, we are dealing with problems that are significantly political, not technical, in nature. This does not mean that all politics are equally workable, but merely that what is workable is not necessarily politic.

Accordingly, the second point—the first was that international arrangements should be compatible with the crucially important credit functions now almost uniquely associated with the use of dollars—the second point of emphasis, as I see it, is that in lieu of neat credit and payments arrangements that would necessarily go beyond the present scope of political authority or present usage, the emphasis should be on further national contributions of international credit availabilities.

These almost certainly focus on two possibilities: (*a*) the encouragement of greater flexibility in medium- and short-term financing in developed countries besides the United States and (*b*) more to the moment, the similar increase in national credit facilities available through intergovernmental institutions.

This latter is commonly taken to mean primarily the IMF, which is unique in international experience and stature, and apparently would alone command the degree of confidence imperative for the success of new facilities. It is essential that any increase in the credit functions of the IMF be secondary to the responsibilities assumed directly by sovereign national monetary authorities, and that the IMF's gold conversion responsibilities continue to be clearly safeguarded against the state of various members' gold preference moods. These observations about the IMF's role internationally emphasize both its unique suitability as the chosen instrument for multinational arrangements and its properly and necessarily secondary role at this stage of world political development to national credit policies as effective instruments for international requirements.

In regard to the family of proposals which have to do with establishing a collective reserve unit (CRU) there are clearly some offhand attractions. In breaking the so-called Anglo-Saxon monopoly in supplying international reserves and thereby allegedly enjoying a unique escape hatch from balance-of-payments discipline, a collective unit would invite other countries capable of capital export to share in the process. It would, furthermore, seem to recognize and underline the existing parity structure of major currencies, making subsequent changes of parity even more difficult in practice. It would provide, as do dollars, a basis for expanding reserves that is not subject to the physical production limits which have for so long caused misgivings about the adequacy of gold. Perhaps above all, the unit would go some of the way toward overcoming the political restiveness of developed countries who feel that the present sterling-dollar superstructure of reserves is not only jerrybuilt, but rules them out.

But, in my opinion, these attractions are unlikely to match the strains over readying the new machinery, and in any case are quite readily attainable, by simpler means. Given greater willingness of present reserve-hoarding countries to accept more responsibility for the credit requirements of international trade and production, larger reciprocal holdings could be achieved and multilateralized as preferred, through further evolution along the lines of the swap network and special borrowing arrangements in the Fund. Certainly in the evolution of present arrangements there is at present no reason at all why nations should not hold growing balances of other countries' currencies, providing those currencies are attractive in terms of their stability and ready usability. An international treaty to achieve this seems both unnecessary and self-defeating. The widespread use of dollars as a basis for national reserve or cash holdings is subsidiary to the availability of dollar credit. To focus on alleged reserve shortage and the possibility of covering it via a motley unit with no clear bridge to resources and no sovereign authority to safeguard it is to miss this point. Rather than responding to the need for flexible credit to cover international trade and production requirements, we would through the CRU merely bring into being an international fiat element in the

currency structure of the world, without enlisting the various countries in direct efforts to meet world credit requirements. Its adoption would not introduce either a cash unit preferable to dollars, or any new element of discipline in securing the correction of national imbalances (plus or minus) which might be considered excessive by going world financial standards. Were it accompanied by an implication (or explication) that the U.S. dollar would not otherwise enter into international holdings, we would be backtracking indeed and out of the realm of the realities of dollar cash and credit.

A third and final point needed, I think, has to do with the ticklish problem already mentioned of how to achieve adequate assurances to nonresident dollar holders that the dollar, in being preserved (as it must be) in its unique international role will not be abused—that the United States national conveniences, either economic or political, will not singly determine the limits, either too narrow or too broad, to the availability of dollars.

Here there is no pat formula to be suggested. It is the essence of sovereign power that in the last analysis it will be used as the country sees fit, and it is the familiar condition of such power that it cannot be exercised at one time in a way that prevents subsequent review and revision. The problem of the sterling balances especially as accumulated in World War II, is an ever verdant reminder to the modern world that urgent national requirements and international circumstances can lead to a prejudicial buildup of holdings which, though still enjoying status as valid claims against national production, can lose all semblance of being validatable on demand. In short, even though it is conceded—as I would argue it should be—that the world has not been inundated in short-term United States I O U's—what is to prevent such a situation from developing if priority political objectives draw United States into financing internationally on the cuff, in abuse of the international status accorded its banking facilities and ancillary short-term debt instruments?

That the question should be asked is understandable, but the mere phrasing of it projects as plausible the nightmarish conditions under which it would be pertinent. Apart from the political chaos implied in the hypothesis, just in financial magnitude we are talking about foreign dollar balances equivalent to a third of national production ($225 billion, not less than $30 billion as now), as were the United Kingdom's liabilities to foreigners at the end of World War II. Moreover, a recollection of the war circumstances and the British imperial banking system under which the sterling accumulations accrued reminds us that the physical problems of transport paralyzed deliveries to the areas which were hosting and provisioning the Allies and were accepting sterling promises in lieu of present deliveries. Under peacetime conditions, strained though they may be as in our times, no such urgency has inflated dollar holdings or rendered them unrequitable. On the contrary, the present power of dollar holders to force review of circumstances attending their accumulation has been very much in evidence. Nor has the United States discovered any secret method of neutralizing the market constraints which through price, interest rates, and income movements enforce conformance to the principles of solvency, of limitation of debt margins to demonstrated

capacity for repayment, not to mention the political constraints which we feel at the hands of outspoken foreign critics.

These opinions lead me to conclude:

1. The United States would be doing a disservice to its international responsibilities if it accepted any general arrangement which lessened the role of the dollar in international reserves.

2. We could, consistently with this principle, welcome further national or bilateral or intergovernmental arrangements increasing the participation of other countries in the mutual responsibility to provide adequate credit to finance balance-of-payments deficits which, without such credit, could be corrected only by unnecessarily deep interruption of production. International cooperation already has reached the realistic stage where reasonable translation of qualitative notions like "unnecessarily deep interruption" can be made.

3. We can, consistently with this principle, be open to limited experiments which relate other nations' greater participation in the world's cash reserves to their greater participation in the world's credit needs.

If I have expressed myself reasonably in accordance with my intentions, these views should place me with those who think no radical departures in international finance are required, that the present system of international arrangements is evolutionary in an appropriate and encouraging direction and will improve as it grows more conventional and as it is further backstopped.

Thank you.

Representative REUSS. Thank you, Mr. Polk.

Since I gather, Mr. Polk, you are more or less content with the present evolutionary system of bilateral agreements, swaps, and other measures that have been adopted in the last few years, and do not feel the necessity of a new international reserve medium, I am going to direct my immediate questions at your two colleagues here because they do see the need for something new and I would like to pin down as much as possible where we stand on it.

Therefore, let me ask Mr. Chandler and Mr. Maffry some questions.

You both feel that the International Monetary Fund is the appropriate agency to issue these new pieces of paper, reserve units, whatever they may be called——

Mr. MAFFRY. Or to be custodian of them.

Mr. CHANDLER. I agree.

Representative REUSS. I might ask you your reasons for your view that the IMF should be the custodial or issuing agency.

Mr. CHANDLER. Well, it seems to me that we have here a well-established, well-accepted institution which has been doing very fine service for the world, and I see no advantage in creating a new type of institution to perform this particular function.

Furthermore, it seems to me that if, as I hope, we devise some sort of a new international reserve unit, this should be administered in conjunction with an international credit system or lending facilities separate but related to, and it would probably be easier to get coordination of the two types of activity in one international institution than it would be to coordinate two different international institutions.

Those would be my principal reasons.

Representative REUSS. Mr. Maffry, would you have additional reasons?

Mr. MAFFRY. I have perhaps a somewhat different approach.

It seems to me that we have developed a number of devices to supplement the International Monetary Fund as it now stands: the bilateral arrangements, the General Arrangements To Borrow, and so forth. It seems to me that these are much too much on an ad hoc basis. The time has come to institutionalize these arrangements. This, I think, is not a radical departure from what exists. And the obvious institution in which to institutionalize these arrangements is the Monetary Fund. It exists. It functions. It enjoys high respect. It is efficient. I do not see the need of contemplating an alternative.

Representative REUSS. All right. Then to get down to brass tacks on how we do it, and I think we have to get down to brass tacks because that is what our executive branch is allegedly about to get down to: how do you create these new units and what guidelines should there be toward the amount of their creation each year? Your views may be different on how it should be done. Mr. Chandler rather sidestepped part of this one by saying that he did not care to specify whether these new units should be issued against contributions of the currencies of the participating countries or against security purchases. I suppose there you are talking about Mr. Schweitzer's statement some time ago that, as I recall, a new unit can be achieved by accepting deposits or by open market purchases.

Mr. CHANDLER. That is right.

Representative REUSS. Let us talk about that. Can it be done in either way in the opinion of you gentlemen, or is there a better way of doing it?

Mr. CHANDLER. It seems to me that it could be done either way; either by accepting contributions of national currencies in some agreed-upon ratio, or by purchasing securities of some sort in the open market.

I think I have a slight preference, maybe more than a slight preference, for the open market purchase technique, and I would like to see this tied in, to the extent possible, with the purchase of types of securities that have international markets, and to try to get away a bit from the idea of each individual country giving its own particular currency in some stated amount. I would like the reserve unit that comes out of this to be acceptable anywhere. But it can be done either way. It seems to me the important thing is not exactly how it is done but the method of managing its change over time—setting up the rules for its change—but perhaps you want to save that for a second question.

Representative REUSS. I agree that this is important, too. The fact is there are seven or eight important things about it, but I would not like to brush over the method of creating it. And before I turn to Mr. Maffry on this, why do you say that you prefer the open market purchases by the IMF of Treasury bills of the United States, Britain, Germany, whoever it may be?

Mr. CHANDLER. Bonds of the International Bank, or something of that sort?

Representative REUSS. I am glad to hear you say that latter, incidentally, and I am going to return to that when we discuss how to help the developing nations. You may be helping them despite yourself, by this portfolio of investments.

Mr. Chandler. I have no objection to helping them if it is done in such a way that the full credit of the industrialized countries would be behind whatever obligations were accepted by the monetary institution. My objection to taking direct obligations of the underdeveloped countries is that at this stage of thinking internationally the unit simply would not be acceptable, or if acceptable would be reluctantly accepted and could hardly hope to achieve the status of as good as or better than gold with this sort of background.

Representative Reuss. But if, just as in our domestic situation, FNMA beautifies and enobles a lot of mortgages which investors wouldn't otherwise want to buy, so you think that maybe a world bank imprimatur on a lot of promises to pay by soft currency countries would make them acceptable assets on which to base holdings?

Mr. Chandler. May I just make a comment here about the fundamental difference between my position than that of Mr. Polk. It may not be fundamental, but it is important; and that is between an international money which serves, as Mr. Maffry put it, the transactions purposes and the meeting of the needs for capital by either underdeveloped or developed countries.

It seems to me that these functions need to be separated to at least some extent. We need a bulk of money which serves transactions purposes, either in buying goods and services or in international lending, and it can be a very serious mistake to tie the need for money for this purpose to the need for credit transactions.

Representative Reuss. The distinction you make is between so-called owned reserves and so-called borrowed reserves. I thought both you and Mr. Maffry made that distinction very clearly.

Mr. Chandler. This is, I think, one of the reasons for a difference of position between me and Mr. Polk on this. As far as the underdeveloped countries are concerned, we need to be concerned about the supply of capital to them, but I see no reason at all to tie the source of aid or the amount of aid to the amount of world money, if I may put it that way.

For example, suppose that by some good or bad fortune we could meet all international liquidity needs through an unexpected rise in gold production. This might well give us the kind of behavior of the world money supply we want, but it presumably would not give any direct benefit to anyone except the gold mining countries. I would like to make that kind of distinction. I would like to differentiate the new reserve money from the need for credit in developing other countries in the same way that it would be differentiated if gold were involved.

Representative Reuss. I did not mean to divert you into the subsidiary question of the place of foreign aid in this discussion, but it saves us returning to it later.

But let us get back to the question: How do you create these new owned reserve units we are talking about—new money—at the present time?

You have expressed, Mr. Chandler, a preference for doing it by open market policy rather than the deposit of currencies by member countries. Why that preference on your part?

Mr. Chandler. I should like to ask my colleagues here whether this point has any substance or not. I have a feeling that if it were,

if this new unit were created through the contributions of national currencies in specific amounts or proportions, that this might create the impression that the responsibility of each country to make its resources available in exchange for the money might somehow or other be tied to the amount of its currency contribution.

Now, this may not be a point with substance. If not, I would withdraw it and say that I do not much care there whether it is through contribution of currencies or open market.

Mr. MAFFRY. To come back to your first question, it seems to me that a new international reserve unit could be created either by way of contributions of national currencies of industrialized countries to the Monetary Fund, or through the purchase by the Fund of the national securities of industrialized countries. I think the first method is more feasible both technically and politically. I think it is a more familiar method of creating pooled international reserves.

The second method would have the advantage—and I agree here completely with Professor Chandler in principle, but perhaps not in practice—of creating owned reserves, or at least reserves which carried the semblance of being owned reserves as distinguished from reserves that are available by borrowing.

Representative REUSS. Would not the deposit of currency, though, also create owned reserves?

Mr. MAFFRY. Well, it depends upon the arrangements; that is, upon the agreed access to these pooled reserves.

Representative REUSS. Well, let us see how this works. We negotiate like mad and so we have a new Bretton Woods with four classes in it.

Mr. MAFFRY. Not necessarily because under the present articles governing the operations of the Monetary Fund there is limited access to the resources of the Fund.

Representative REUSS. Under the new dispensation, how would the reserves be created? I take it from what you two gentlemen have said that there would be some treaty arrangement whereby every year, up to a limit which would be some percentage of existing free world owned reserves, there would be created additional owned reserves in either or both of two ways; that is, West Germany and other countries putting in deutsche marks—of course Germany would put in deutsche marks—and getting back pieces of paper or book entries from the International Monetary Fund saying that on such and such a day on demand we will pay to—repay to Germany the amount she has put in in deutsche marks, so there is in effect a gold guarantee. Or conversely, the Fund itself could buy German bundestag notes or other negotiable German securities.

Mr. MAFFRY. I do not think they are quite the same. If the reserves are created by contributions of national currencies, then you must agree upon the access to those pooled national currencies by the contributing countries. It could be easy access or it could be very limited access.

On the other hand, if the Fund bought securities denominated in national currencies, the countries selling the securities would immediately acquire owned reserves to an equivalent amount, and this, I agree, would have certain advantages.

I think, however, it is not technically possible. You can do this in the United States because of our broad money market. You could do

it in the United Kingdom. I do not know of any other country in which you could do it on a scale that would meet the requirements for additional reserves. Their markets are simply too limited unless, of course, some special instrument were created for this purpose.

And I say again I think it would be much more difficult to get agreement on the open market type of operation than on the more familiar technique of contributing national currencies to the Monetary Fund, which is now done under the quota system.

If I may return to another point which is quite basic, I was trying to make a distinction between "reserve" money and "transaction" money. Reserve money is divided in turn into "owned" reserves and "borrowed" reserves. I think that the distinction I was trying to make is quite different from the distinction that Professor Chandler was making.

Representative REUSS. Yes; although I would think that there is nothing to stop you gentlemen from getting together on this.

Mr. MAFFRY. No; I do not think so.

Representative REUSS. Governmental reserves are divided into two parts, owned and borrowed, though the distinction is not always as clear cut as that. And equally there is an international use of national currencies which you call transaction money. I do not think Mr. Chandler or Mr. Polk differ from that analysis. I hear no disagreement, at least.

Mr. CHANDLER. I would not.

Representative REUSS. My first round is up.

Mr. Ellsworth?

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

Well, I gather that all three of you gentlemen agree that something needs to happen. Even you, Mr. Polk, while you do not agree with the necessity for creating a new composite reserve unit, nevertheless think that something either must happen or is about to happen along the lines of facilitating the creation of international reserves.

Mr. POLK. That is correct.

Representative ELLSWORTH. Now, let me ask all three of you, when it comes to creating additional international reserves, should the creation, should that process, should that action require unanimity?

Mr. MAFFRY. I think this is a very important question. If we conceive of a new international monetary conference to be attended by representatives of, say, 120 countries, it becomes a really formidable undertaking. I think it would be much more feasible and much more promising to convene a formal conference of representatives of a selected number of countries, the major industrialized countries of the world, say, from 10 to 12, because it seems to me that what needs to be done and what can practically be done at this stage is to superimpose on the present Monetary Fund a new fund, a new fund that will hold the pooled reserves of the industrialized countries that will be available to these industrialized countries on agreed terms.

The reserve problem is a problem for the industrialized countries primarily, not a problem for the underdeveloped countries.

Representative ELLSWORTH. Do you agree? Mr. Maffry, I see you nodding your head.

Mr. MAFFRY. You could also, under these arrangements, maintain the present voting system in the Fund which is a highly ingenious vot-

ing system. You could have a different voting system for the superimposed fund that would give much greater weight to the Western European countries which they want and should have in accordance with their much greater weight in the world economy as compared with what it was at the end of World War II.

Representative ELLSWORTH. In your 10 to 12 member Fund, with the Western European nations having greater weight than they have in the IMF, do you think that the creation of additional reserves should require unanimity so that any one country could have a veto over the creation of any new reserve?

Mr. MAFFY. No; I do not see how it could work on that basis. It would have to be an agreement as to the annual contributions over an agreed period of time.

Representative ELLSWORTH. Do you think the United States ought to have a veto, in such a club, over the creation of new reserves?

Mr. MAFFRY. I do not. I see no need for it.

Representative ELLSWORTH. Do you think that in the club of 10 or 12 the voting should be on a one-nation, one-vote basis?

Mr. MAFFRY. No; I think it should be weighted, but the weights would be quite different than they are in the Monetary Fund as now constituted.

Representative ELLSWORTH. Do you have any comment on all that, Mr. Polk?

Mr. POLK. I agree that the voting should be weighted, and that this is a most likely form in which we will encounter pressure for some sort of new form of reserve. The more it resembles present procedures in expanding quotas under the IMF the more practicable, I think, it would be, the easier, and, I guess, the more I would like it.

I have, I think, some difference with Mr. Maffry. There is something that is unappealing to me about the mystique of the group of 10 which, of course, is 11. I am not quite sure, you know, whether this just is the right roster, particularly given my feeling that reserves somehow for better or worse are the excrescence and periphery of basic credit relations. I am not quite sure that I would like to see this particular screening group riding herd on what the actual needs of the whole international community are. I certainly have, I think, like most people, welcomed the fact that countries of some wealth and international inclination, as the group of 10 or 11 are, have been available to work more cooperatively and increasingly so over recent years to avoid critical situations; notably the severe sterling problem that we had to wrestle with since last fall, which one can imagine 30 years ago might not have been—indeed, was not—handled in a similarly satisfying way.

But as a general guideline I think I would like to work toward the sort of thing that I believe Mr. Maffry is saying: that once you envisage a type of facility and a ceiling, a range of expansion, that you would expect the Fund executives to be able to reach—that this would be somewhat flexible. It would give them some leeway, some discretion, as they have now, and that would be enough. You could not force a nation to join. I think we are all thinking of what happens if—well, it is hard to predict the particular mood of, say, France, which, after all, is very important in this. It seems to me you might need to find a negotiated position that permits a nation to opt out.

What the penalties of opting out are I do not know, but this is not equivalent, I think, to insistence on unanimity. As to why the United States would need unanimity, we have not had it in the past and I think things have gone very well in the Fund. So I would like to see this approach broadened, I would like to see the authority a flexible one and without veto.

Representative ELLSWORTH. Given your emphasis on the importance of the dollar maintaining its role in the reserves of the nations of the world, and given your agreement that you feel something has to happen or is about to happen in the world so far as the creation of reserves is concerned, and given what I understand is France's attitude toward the dollar as a reserve currency, how do you visualize these three things resolving themselves in a consistent way with each other?

In other words, what do you suggest doing about France?

Mr. POLK. We have, I believe, an extremely long history of difficulties with France. I can remember as a high school student that a book came to us in a course in international current affairs. It was called "France—Our Genial Enemy." It was very exciting. It showed that we really had an underlying problem on our hands. So I think we have to have a certain historic perspective on France. I am sure that most of us realize that the air at times—certainly on the east coast—seems to vibrate with unspoken irritations and we sort of win the award for not saying everything that is in our hearts about France. The truth of the matter is it is extremely hard to crack down on France without really doing things that we would dislike far worse than France does. I suspect that France—it is hard to answer this question without getting a little afield—but I suspect France, in mood and inclination, and apart from various significant differences in basic political objectives, has certain technical differences. Their notions of a neat household are somewhat different from ours. I think France, for instance, in the trade field, when they talk of the "organization" of markets—this all tends to approach human phenomena, I think, with a more exacting and precise series of standards than we are accustomed to in the give and take of competitive markets as we know them and as we have confidence in them.

So, continuously there is the problem of constraints we impose on ourselves. Let's not for the sake of putting pressure on someone with whom we disagree, in this case France, find ourselves going down a line of rather strict quotas on things that may be done financially, and so find ourselves, in effect, faced then with something more like the European Payments Union's regional clearances, with its spelled-out quotas which come to be immediately exhausted and then making us distinguish between the weak and the strong, and this sort of thing. But let's ride with arrangements on a broader basis, as we have learned to live with the problem in the Fund.

So I think I have a rather weak answer to your question, that I have considerable confidence from the way things have developed in spite of the restiveness over the U.S. deficit, that bit by bit these things are being put in place. I suspect later in these hearings when Dr. Ingram is here you will hear a great deal again about the freedom of capital movements. This is something that to me is important, that was not drawn out too much in the line of questions that I

looked for at this meeting. I can well imagine that the problem of the IMF in facing the possibility of broadening reserve notions will actually become one of addressing itself to broadening the point of view now embodied in the charter where fixed exchange rates and "current account" convertibility were enshrined. I can imagine the next step being not just current account convertibility, but facing up honestly to the problem that we have great difficulty in distinguishing between current and capital account. And one of the real problems in international economic growth is the wayward obtrusion of sanctioned interferences with needed capital transfers. Incidentally, I believe that in the terms of what Professor Chandler felt were disagreements between us, there is also room for composing those differences, that in creating a more politically sound reserve base, we also tackle as a subsidiary matter—not necessarily through setting actual conditions, although this might be—incidental means of easing the capital flow side of the picture, easing the problems of capital markets which, as Mr. Maffry has mentioned, are fairly peculiar so far to the United States.

I would welcome more talk of capital market development throughout the world.

Representative ELLSWORTH. Thank you very much.

My time is up, Mr. Chairman.

Representative REUSS. Mr. Bolling?

Representative BOLLING. No questions, Mr. Chairman.

Representative REUSS. Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

First let me say, Mr. Chairman, that we members of your International Finance Subcommittee of the Banking and Currency Committee deeply appreciate the courtesy you afforded us by inviting us to these sessions.

I would like to ask you gentlemen one question. When we talk about the international liquidity or the lack thereof at the present time, are we talking about a lack of liquidity in reserve money or transaction money, and what is the difference, I mean in the liquidity problem?

Mr. MAFFRY. May I respond to that?

Representative MOORHEAD. Certainly.

Mr. MAFFRY. We are talking about both, Mr. Moorhead. I think they are two different things, as I tried to make clear. There is a problem of reserve money liquidity. There is a problem of transaction money liquidity. At the present time I think there is no immediate lack of reserve money liquidity. I am concerned about that more in the longer run than in the short run. But, even as regards the problem of reserve money liquidity, I would rather be 10 minutes early than too late. As regards transaction money, I think we have an immediate problem because the deficit in the balance of payments of the United States as presently defined consists of two parts. It consists of the increase in dollars held by foreign official holders, principally central banks. It also consists, quite illogically, I think, of the increase in the holdings of dollars by foreign commercial banks and other private entities.

Now, it is the second type of money which really finances the world's business. It finances not only our trade, but also interna-

tional trade. It finances investment and capital movements and economic development throughout the world. The immediate pressure, it seems to me, is on the volume of transaction money, which has been very sharply and suddenly curtailed by restrictions laid down by the U.S. Government. Now, this, I think, is a matter of immediate concern.

Representative MOORHEAD. Are the two interrelated? In other words, if we increased reserve liquidity, would that flop over and affect the amount of transaction money?

Mr. MAFFRY. There is, of course, some movement between the two categories of money. There is movement from transaction money into reserve money. There is movement from reserve money into transaction money. Perhaps I could give you a practical example. Let's take the case of the Philippines. Let us say that because of an increase in imports into the country, Philippine banks require additional dollars to finance them. They may take pesos to the central bank and obtain dollars for this purpose, which has the effect of reducing the dollar reserves of the central bank. This is a movement from reserve money into transaction money. Then, if the central bank contracts the local market as an anti-inflationary measure, let us say, the demand for imports is reduced and the banks have surplus dollars from exports which they may return to the central bank for pesos, which has the effect of increasing the latter's dollar reserves. This is a movement from transaction money into reserve money.

There are instances in which central banks have induced the commercial banks of their countries to take dollars out of official reserves and invest them in the United States. This has been done in Austria. It has been done in Germany, to take another example. Generally speaking, however, in our experience, the movement between the two categories of money is relatively limited. They are in more or less separate compartments.

Mr. CHANDLER. Might I just add one thing to that?

Representative MOORHEAD. Certainly.

Mr. CHANDLER. If you get, though, a tendency toward a shortage of reserve money in a number of countries, the central banks may well be led to take actions either in general monetary restriction or restrictions on international capital movements, or something of the sort, so that the shortage of official reserve money will lead to a shortage of the transaction money either through general credit restrictions or restrictions on capital movements.

Representative MOORHEAD. Mr. Maffry, if I understand it correctly, sir, for future supplies of international transaction money, you anticipate the bulk of that coming from United States balance-of-payments deficits as presently defined and not as you would prefer them to be defined, is that correct, sir?

Mr. MAFFRY. That is correct.

Representative MOORHEAD. Now, gentlemen, on the establishing of the new reserve unit and the difference between the national currency contributions or the open market operations, would not the logical compromise be to establish the unit by the contributions method and then for continuing operation or expansion use the open market method?

Mr. MAFFRY. It makes sense to me.

Mr. CHANDLER. As a matter of fact, there are all sorts of intermediate stages. You could have as one extreme deposits of relatively short-term money in terms of national currency. At the other extreme, purchases of quite long-term bonds, or somewhere in between here purchases of combinations of these types of things, just as you would have in the case of a national central bank.

Mr. MAFFRY. Mr. Moorhead, I might suggest that much could be learned in this respect from the traditional operations of the Bank for International Settlements, which operates as a central bank for the European central banks. It accepts deposits. It makes investments in the countries which are members of the BIS. It is a system that works very well. It is flexible. It does not have the scope that is required to meet the problems that we are now discussing, but the techniques are completely applicable.

Representative MOORHEAD. Thank you, Mr. Chairman.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. I apologize, Mr. Chairman, for having to step out and I am sorry I missed the previous questioning. I did hear all three papers read.

Mr. Maffry, I do not know if you have been questioned about this. If you have, just let me know and I will try another question.

You have made a pretty strong statement, and it is good to get this kind of a strong statement. Usually bankers and economists and others who testify are very gentle as far as criticizing the Government is concerned.

You say:

> I regard the sudden and drastic reduction in the deficit in the U.S. balance of payments which is now in progress as a highly dangerous expedient under the present international monetary system. An abrupt shift from deficit to equilibrium or surplus cannot fail in the long run to have severe repercussions on world trade and world economic growth.

Now, this is exactly what has happened, as I understand it. It is an abrupt shift. We are told that in the last few months at least we have come into equilibrium or close to it. I am wondering if you could spell out for us at the present time just what you see the dangers to be. Has this been deflationary? Are we already in difficulty? Has it had an impact on the Japanese economy or on the various European economies? Certainly it has not affected us, yet.

Mr. MAFFRY. I pointed out in the following sentence, Senator Proxmire, that I think it has not had serious consequences so far because the shift from deficit to surplus came at a time when the liquidity in the international monetary system was relatively high.

Senator PROXMIRE. I recall that sentence, but it seemed to me that what I have read recently about the monetary policies, for example, in Japan and elsewhere has indicated that they are engaging in somewhat deflationary policies.

Mr. MAFFRY. I do think that there are symptoms of a gathering crisis, both in certain national economies and internationally. I think the tightening of the European markets is one of these symptoms which if carried far enough could have a severely dampening effect on the European economies. I think the Japanese will within a relatively short period of time run into real difficulties in financing their

trade, and to some extent their industrial expansion. I think Australia is faced with even more immediate difficulties. There are many instances which have come to our attention in which credit needed to move staple commodities in international trade has been very difficult to come by under present arrangements. And all of this, it seems to me, is symptomatic of what could happen if the restrictions are long maintained. I am frightened.

Senator PROXMIRE. Well, now we have had so much warning, you know, in the Congress and in this committee, in the press and elsewhere, that the balance-of-payments problem is an enormously serious, very dangerous force and that we are losing our financial control. Many Senators, I know—they have told me—have voted contrary to their instinct and to their record on our participation in international loans and even on the foreign aid bill and on domestic matters because they feel that our international balance-of-payments situation is so serious.

Do you feel that a course which seems to have succeeded brilliantly should be moderated right now, as soon as possible?

Mr. MAFFRY. I do, sir. I think we have trapped ourselves into what I conceive to be a grave error because of a highly prejudicial definition of the deficit in the balance of payments. If the deficit were defined on the official settlements basis, that is, measured by the increase in holdings of dollars by foreign official entities, we could then focus on that problem. And I am prepared to agree that there may have been something of a problem in that area.

As regards the rest of the deficit, I say that there was no problem whatsoever. The rest of the deficit represented only an increase in working balances in dollars required to finance international trade and economic development.

Senator PROXMIRE. I am chairman of the Joint Subcommittee on Economic Statistics, and we have had hearings on this very issue before this subcommittee. Mr. Bernstein appeared and some critics of Mr. Bernstein appeared also. We had several days of hearings. We also have had hearings in the Senate Banking Committee, simply having Mr. Bernstein explain his position there not on the statistical aspect quite as much. You feel then that a reliance on the official settlement concept which would have made a big difference last year, as I understand it—instead of having a $3.1 billion deficit we would have had a $1.5 billion deficit—would have given us a more accurate picture and also probably would have resulted in policies that would have been much better. You believe the statistic would have made that difference?

Mr. MAFFRY. If the authorities had taken steps to eliminate the deficit on an official settlements basis, I would have no serious quarrel with that.

Senator PROXMIRE. And this year I understand that there is very little difference—in fact, the deficit may look a little less, or the equilibrium may come quicker under the liquidity definition than under the official settlement definition.

Mr. MAFFRY. It may be, yes.

Senator PROXMIRE. Maybe for this reason this is a good year to change or a good year to use the new system.

Mr. MAFFRY. At any rate what has been done, it seems to me, accentuates the need for international monetary reform and the sooner the better. As I said to Congressman Moorhead, I would rather be 10 minutes early than too late.

Mr. CHANDLER. There is another issue aside from the statistical one, and that is the reaction of the foreign central bankers to the behavior of our balance of payments, however it may be defined. That goes to this question: if we had not tried to balance the balance of payments in the way that we did, would they have continued to be willing to hold dollars, or would we have been faced with larger demands for redemption in terms of gold? I think there is some evidence, at least, that we might have had considerably larger withdrawals of gold had we not taken the types of actions that we did in fact take. It would seem to me that the moral of this might well be that it was unfortunate for the world that we had to place such strictures on our balance of payments as we did, given the present monetary system. But if we had some other type of monetary system, the adverse effects on the rest of the world would not have been so great.

Senator PROXMIRE. But you say that the course we followed was a desirable and wise course, although from our standpoint the effects on the world are unfortunate because we had a monetary system that required us to do this.

Mr. CHANDLER. Given the present international monetary system, the effects on the rest of the world were unfortunate, and, I suspect, will become more so in the coming months. But if there had been a different kind of international monetary system, there would have been ways of providing liquidity to take the place of the liquidity we did not provide.

I think that would be my position.

Senator PROXMIRE. Let me just get you two gentlemen in a little further controversy on this.

When you talk about the new reserve, rather, the proposed kind of improvement in the international reserve system, as I understand you, Professor Chandler, you argue that we should not rely on currencies, either the dollar, the pound sterling, or a combination of currencies; and I understand Mr. Maffry to suggest that while we should not rely on specific currencies as we do now, the dollar or the dollar and pound sterling, we should rely on a combination of currencies.

Do you gentlemen disagree, or do I misunderstand you?

Mr. CHANDLER. Let me make a couple of distinctions here.

What I said was that I did not think we should rely on national currencies individually, either a single national currency or several of them, say, four or five, or to allow the international liquidity situation to depend upon the balance of payments of the international currency countries.

This would not, however, hold as an objection to having some sort of a new reserve unit which might be created in exchange for some sort of composite currency unit.

Senator PROXMIRE. I see.

Mr. CHANDLER. If you had ways of managing the supply of this currency that did not depend upon the balance of payments of those countries. In other words, you would take this out of the realm of what happens to our balance of payments plus Britain's, plus, say,

two or three others, and instead subject it to some other sort of management. But I would think a composite currency unit would be quite different from simply relying on, say, four independent national currency units.

Mr. MAFFRY. I do not think we are in disagreement basically. There is one point that might warrant further comment.

It seems to me that the required increase in reserve money in the form of a composite unit could be provided by a deposit with the Monetary Fund on the part of participating countries of their own currencies in predetermined amounts aggregating, say, a billion dollars a year over a period of 5 years. After that the arrangements would be reviewed. This may not be adequate. Or it may be more than adequate to meet the need for international liquidity.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up.

Representative REUSS. Mr. Hanna?

Representative HANNA. Thank you, Mr. Chairman. I would take it from what I have heard here that Mr. Maudling's statement in 1962 at the meeting of the IMF, in which I think he made two points—first, they were satisfied that reliance on gold alone to provide for long-term liquidity is not intellectually a sustainable proposition; and, second, that reliance on key currencies such as the pound and dollar is subject to limitations which will inevitably inhibit world trade, world production, and, therefore, world economic expansion—is a statement which finds acceptance on the part of all three of you gentlemen.

I would like to go to the matter of the environment in which any change must occur, first, because I think that is very cogent here in a political hearing. And if I get the tenor of your statements correct, gentlemen, you have indicated that you appreciate that environment includes two very important items. No. 1, the question of sovereignty of nations. No. 2, although this wasn't coming through quite as loud and clear to me, I think you indicated you appreciated the fact that in terms of the domestic versus the international position of any nation the tendency of nations is to be in a position for quick convertibility of their international commitments back to their domestic requirements.

Would you agree that those two things are very fundamental here?

Mr. CHANDLER. Yes.

Mr. MAFFRY. Yes.

Representative HANNA. Then in further pursuing that, Mr. Chairman, and trying to get the position of France a little better in focus, which I think we all are concerned about, it seems to me that in the matter of sovereignty we should be very much aware—and I think you gentlemen would agree that where you are in the position of a key currency you are already in a position where your sovereignty has eroded by the demand that is made upon you by your position of key currency; is that not correct?

Would any of you disagree with that statement?

Mr. MAFFRY. No, sir.

Mr. CHANDLER. I would not.

Representative HANNA. Then, I would make a further statement. That it would be rather reasonable to assume that a nation in a position of a key currency nation would be more ready to make concessions on sovereignty which they are already having eroded than would nations

who are not in the position of key currency, and this I suggest may throw some light on France's position, not being a key currency, not having the intrusions of the international situation so immediately impinging upon them, they are likely to be less ready to give up sovereignty than are we.

Mr. CHANDLER. I think if a French representative were here he would say that France had already given up a great deal of sovereignty in that her own reserve position and that of other non-key currency countries was determined to a great extent not by France or some sort of international agreement, but simply by the United States and Great Britain.

Furthermore, that supposedly she has claims to gold which she is free to cash on demand, but de facto she knows she cannot exercise this sovereign power without wrecking the world's monetary system.

So I think France would feel that her sovereignty was already seriously impinged upon.

Representative HANNA. Would the rest of you gentlemen agree with that statement?

Mr. MAFFRY. I think your statement is correct. I also agree with what Professor Chandler has said. I am not greatly concerned about the position of France in all of this. The Minister of Finance of France, speaking for his Government, has himself proposed the creation of an international reserve unit of which the French franc would be an element, which indicates to me that at least to that extent France is prepared to assume some of the burdens, if you wish, of a country with a reserve currency. And I see no insuperable difficulty in getting the French into a new international monetary agreement.

Representative HANNA. And would that include ready acceptance of some basis for a new unit of reserve?

Mr. MAFFRY. I should think so, yes.

Representative HANNA. Would you agree with that, Mr. Polk?

Mr. POLK. If I understand Mr. Maffry, I think my feeling is rather that we might well have more trouble with France, and I think there will turn out to be financial issues that are tremendously oriented to other problems of economic policy. It is extremely hard to read how France "relates" right now, with their apparent boycotting of the Common Market and the fact that the Common Market has seemed to have idled off on sort of a plateau of accomplishment in the industrial customs union without really implementing other aspects, notably the financial aspects.

I guess it adds up to the fact that I just would not be surprised to find that when the chips are down right in this season, by this I mean the next year or so, France may not see the political advantage of payments arrangements that seem to go beyond the design of French politics.

Mr. MAFFRY. May I make another comment?

Representative HANNA. Yes.

Mr. MAFFRY. I think that France would be very much interested in the voting rights which would govern the use of the new pool of reserves. I think this may be a crucial point.

Representative HANNA. Might it possibly be part of the political expedience of this thing to indicate that the United States and Great Britain are ready and willing to reappraise the position of their other friends in this IMF——

Mr. MAFFRY. I would hope so.

Representative HANNA. Then would you say that looking at the matter of the country's domestic interests relative to their international position, that the history has shown that sometimes the government is placed politically in a position where it serves a short-run, or short-term domestic interest at the expense of its long-term international interests, and that we have a problem here of trying to place the thing so that everybody can see the costs of observing these short-term interests? Is that not something that we have got to bring about an understanding on?

Mr. CHANDLER. Yes, sir.

Mr. MAFFRY. Yes.

Representative HANNA. It would also appear that, because of the fact that we have underdeveloped nations, we have another problem, the problem of enforcing domestic discipline for developing nations and at the same time serving international credit needs. These two do not necessarily find an easy compatibility—is that an accurate statement? How will this affect the decision as we go along?

Mr. CHANDLER. If I understand you, what you are saying is that we would still be left with the problem of equilibrating balance of payments if we opt for fixed exchange rates. We will also still have the problem of trying to reconcile domestic and international objectives in the various countries. The most that can be accomplished by the things that I referred to would be to create a more favorable international reserve situation within which to carry out these equilibrating operations, but you do not solve the equilibrating problems simply by creating new reserve units.

Representative HANNA. Would you agree with that?

Mr. MAFFRY. Yes.

Mr. POLK. I would, yes.

Representative HANNA. In terms of what you said about the fixed exchange rates, though, and here is a point I thought was cogent, although I may be wrong about this, but I cannot get out of my mind the independent "Goldfingers" around the world who, as I understand it, hold about $15.3 billion worth of gold, which is sort of isolated at the present time. But I think the "Goldfingers" are holding the bet that we will not go the route of the fixed price on gold and the fixed exchange rate. And I think that has something to do with arousing the emotions in a country like France to talk in terms of France's national parochial interests when really I suspect that behind some of that there is the position of the "Goldfingers." I may be wrong about that. Maybe I am cynical, but I have that feeling.

Is there any merit to that?

Mr. MAFFRY. Well, I have only one comment. People hoard gold for two reasons, mainly. They hoard it in various countries traditionally as a hedge against the depreciation of the local currency. And some sophisticated people hold it against the possibility that the international value of gold will go up and they will make a profit out of it. You have both types.

Representative HANNA. My time is up.

Representative REUSS. Mr. Curtis?

Mr. CURTIS. No, no thank you. I have no questions.

Representative REUSS. Mr. Ottinger?

Representative OTTINGER. Mr. Chairman, I very much welcome the opportunity to be here. This is my first appearance.

Perhaps you could help me to understand a couple of things. I take it we are talking about creating a new kind of chip to play the international monetary game, so to speak, and one thing I do not quite understand about this chip is whether it is going to be a new ultimate currency as you conceive it, that is, something into which everything is translatable as we hold paper dollars in the United States which are not redeemable, or whether this chip is going to be capable of being turned in for gold or for the other currencies which you have talked about as being contributed in the course of its creation.

Mr. MAFFRY. Well, in my conception a new composite reserve unit, for a long time, perhaps for a very long time, would be a supplementary reserve unit. I do not think it would replace the dollar as the principal international money of the world, and indeed this composite reserve unit if created would be defined in terms of the U.S. dollar, or its gold equivalent, which comes to the same thing. I do not think it would become the chip to be used in international settlements. I think it would be a supplementary means of settling international balances.

Mr. CHANDLER. We face a very neat trick in the transitional stage. The new unit must be considered as good as gold, and the only way you can do that is to say that this new unit is in fact convertible into gold, but at the same time get some sort of an international convention under which the various countries agree that they will not demand convertibility into gold except under certain circumstances. I would not see any possibility of making this the ultimate chip unless you started out with the idea that it was equivalent to gold, but then created conditions under which excessive demands for conversion would not in fact occur. This seems to me the reason why it is so important to have agreement among at least 8 or maybe 10 or 12 countries that they will in fact accept it under defined circumstances.

Representative OTTINGER. How, then, can you expand the supply or liquidity in world transactions if you have nothing but a substitute for gold that you end up with, or something which is redeemable in terms of national currencies? What is the advantage of creating the chip if it does not create something in addition to that which is now available?

Mr. CHANDLER. The whole history of things of this sort within countries has been that of getting initial acceptability for something because it is believed to be fully convertible into gold or silver, more recently gold, and then gradually expand the supply relative to gold. In other words, you are quite right that you cannot add to liquidity unless you can increase the supply of this relative to gold, or increase the supply of gold plus this.

Representative OTTINGER. It seems to me, and maybe I am not fully understanding, that it must be somewhat analogous to what we have done with the dollar. The dollar is no longer convertible into silver. The dollar is no longer convertible into gold and, in fact, today under a controlled system we issue more dollars than could be convertible into any of these accepted media. Do you not have to do the same thing?

Mr. MAFFRY. I think that is correct, Mr. Congressman. I think that just as gold has been largely demonetized in national economies, including the United States, the creation of a new reserve unit would be a step in the direction of the demonetization of gold in an international sense, which I am sure will happen one day, but the transition period may be quite long.

Representative OTTINGER. If I may, just one other thing that I would like to ask about, and that is the significance of your distinction, both Professor Chandler and Mr. Maffry, between reserve and transaction currencies. Why is this important? It seems to me that whenever we need money for our transactions we call upon our reserves. Wherein lies the importance of this distinction as you have both drawn it?

Mr. CHANDLER. Could I make a first stab at this? If I may do this by analogy, consider a situation in which central banks held a good part of their reserves in terms of gold, in terms of gold bars, but the actual money is made up of checking deposits, paper money, and fractional coins. For various reasons they may hold these things as ultimate reserves but they would not think of using the gold bars for transactions purposes. Similarly, in the international sphere there is no particular reason why dollars and pounds that are used to transact business internationally should be held as central bank reserves by other countries. So long as they hold something that can be freely translated into dollars or pounds, you have the requisite for making the link between reserve currencies and transactions money. I want to make it perfectly clear that I see very little prospect or desirability of using a new reserve unit as actual transactions money internationally. I would contemplate that that function would still be served by national currencies.

Representative OTTINGER. Mr. Polk, do you have anything to say on that?

Mr. POLK. I think the distinction, which I accept, is clearer in principle certainly than it is in statistics. It is extremely hard to distinguish, in fact. You will recall that most countries with rare exceptions, notably the United States and Germany, still do not permit unlimited free private holding of dollars under their laws. Beyond this, there is a certain general bias institutionally toward a flow of transaction money into official channels at which point it then becomes, I suppose by definition, official reserves. And official reserves themselves to the extent that they are thought of more or less regularly as backstopping balance-of-payments requirements vary from season to season because of transactions. I suppose these reserves are in the nature of transaction money rather than reserve money. I find the distinction in principle between a money held only briefly for transactions and money held at length for contingent later needs in transactions is hard to trace out in practice, and it does bring us up against one of the really formidable problems in the creation of new reserve money; that is, how to get any circulation in it; how to get the sort of "transaction potential" side of the coin into the actual functioning of new reserve money. I believe that in some of the very current thinking about what this reserve unit might be, as I understand it—for example, in Mr. Roosa's thinking—there is particular emphasis on trying to take steps to assure actual usage—this is no

little thing. Let's be sure that countries participating in reserves are also participating in the process of contributing credit for the economic expansion to which those reserves are relevant. How do you get the things used? Another way of putting it, after adding some billions of dollars to reserves, does this mean a 3-month, a 6-month, a year interval before you simply find that in addition to the present reserves of the reserve holding countries you now have these additional reserves accumulating? They are bound presumably by agreement to accept a certain position in the new reserves, and they do, but once the position is reached, and quickly, they go on holding it, suggesting that the problem behind their reserve holding is what I think Mr. Kindelberger before this committee has emphasized—the basic high liquidity preference of the holders. I think this is a very real problem and I think it is the sort of thing that we would want to remain extraordinarily alert to in the negotiations for such a unit.

Representative OTTINGER. Thank you, Mr. Chairman.

Representative REUSS. Mr. Halpern?

Representative HALPERN. I have no questions.

Representative REUSS. A question is suggested by the discussion of France—after all, France's Finance Minister has said that he thinks the time for an international monetary conference is not opportune. We do not know exactly what that means, but let us suppose that it means that France would either not participate in such a conference or, if one were held, would not enter into any agreement which would be acceptable to the other conferees. Would France's operating outside of a new international monetary arrangement, designed to set up some new reserve currency along the lines discussed today, be such as to defeat the effort to set up such a new currency, or could such a new arrangement be made to operate satisfactorily with France outside of it; just, as for example, Switzerland is not a member of the International Monetary Fund today?

Mr. MAFFRY. I think it would be very desirable to have France as a participant in any new arrangements that are worked out. I do not think her abstention would be fatal. France does not carry an economic weight which would make her abstention fatal to a working agreement.

Representative REUSS. Would you agree, Mr. Chandler?

Mr. CHANDLER. I would agree with that. I would think it desirable to have as many of the industrialized powerful countries in at the beginning as possible, but if the other Common Market countries would come without France it would still have a good chance of success.

Representative REUSS. Mr. Polk?

Mr. POLK. I would agree with Mr. Maffry.

Representative REUSS. Let me ask this question. We have discussed a new reserve unit, whether it is a composite unit, à la Bernstein or some other type is a detail. What are the pros and cons of proceeding in that direction; namely, to create a new liquidity instrument as opposed to reforms in the gold tranche arrangement in the existing IMF along the lines of lengthening the repayment period, extending the automatic drawing rights beyond, possibly far beyond, the present 25 percent of quota, and so on? What can be done with a

composite reserve unit, a new piece of international reserve currency that cannot be done by tinkering with and broadening the automatic borrowing rights? Here we get into the distinction between owned reserves and borrowed reserves. It is pretty blurred, because the gold tranche borrowing right is awfully close to money, but I would like to hear any opinion you might have.

Mr. MAFFRY. I would say, Mr. Chairman, that, although a good deal could be done by modifying and liberalizing the arrangements under the Monetary Fund as it now exists, I think it would still fall short of what the situation requires. By introducing a composite unit, it seems to me that you could get at the same time an agreement on a systematic increase in the amount of reserve money held in this form, either by the participating countries or by the Fund itself. This, it seems to me, is the principal point of difference. Actually, if you had a regular and frequent increase in quotas in the Fund you might achieve much the same result, but it does not work that way.

Representative REUSS. Mr. Curtis?

Representative CURTIS. Thank you, Mr. Chairman. I want to apologize for not having been here during the reading of these papers. I have had a chance to go over them, and I certainly appreciate the efforts you gentlemen have made in helping the committee in its deliberations.

A question comes to my mind not only from reading these papers, but also from the dialog that seems to be going on in regard to international monetary reform. I think that the fundamental problem comes down to differences in theory of the use of monetary policy. There are the neutralists—and I regard myself as one—who essentially believe that money should be used as best it can as an economic measuring stick, and monetary policy should not be used to accomplish expansion or anything else that a political government might find a desirable social end. This debate is going on constantly between what we call the easy-money people and those who hold, as Chairman Martin of the Federal Reserve Board indicates, the neutralist theory. Is it not true that if we do not agree on what purpose monetary policy should be devoted to in international agreement, that we are not going to come up with any real international monetary reform? For example, I notice the constant talk about whether country "X" is going to use monetary policy to help improve its unemployment situation or economic expansion? Well, if that is the way it is going to be used, how can there be this international agreement? Do not we have to agree ahead of time on the neutralist theory, or else have as many political decisions as there are governments as to what is the value of money?

Mr. CHANDLER. I think you are quite right, that some of the disagreement does turn on the questions of the proper role of monetary policy. However, my guess is that if one accepted the neutralist position—I am not quite sure I understand that—but I gathered that you meant to keep the purchasing power of the unit stable.

Representative CURTIS. Retain a measure of savings and services. As Chairman Martin often says, the Federal Reserve Board tries to lean against the wind, anticipating as best it can what the level of economic activity will be. Then it provides the amount of cash and credit necessary to meet that level of economic activity. It is a very

difficult process, but nonetheless with the object in mind of keeping money as a measuring stick, as an accurate weight and measure——

Mr. CHANDLER. I suspect that the monetary authority would have to be rather unneutral and follow some very positive policies on occasion. My guess is if we continue the present international arrangements there will develop, as my colleagues have pointed out here, a shortage of national liquidity which, if those countries try to maintain stable exchange rates, will force them into deflationary actions. In other words, country after country will feel its international reserves are not sufficient——

Representative CURTIS. To carry on its level of economic activity?

Mr. CHANDLER. Well, they will simply find for one reason or another that their ability to defend their national currency with free trade and payments will be threatened so that they will tighten credit at home or put on controls of capital movements and this sort of thing and bring in deflationary pressure not only at home but in the rest of the world. But I think if one took this very limited view of the purpose of monetary policy——

Representative CURTIS. But what I would point out is that the country would really have to determine its own monetary policy according to its level of economic activity. There is no sense in kidding yourself. If you have not got the level of economic activity that justifies x amount of cash and credit, then you are going to have an inflation of the currency, and, conversely, if you have a great deal of economic activity and insufficient cash and credit you are going to have deflation. In other words, the guidepost that I would think would be used is the level of economic activity.

Mr. CHANDLER. But you have two guideposts. The moment you operate for fixed exchange rates, you may find that, with the existing exchange rate on your currency, you have an adverse balance of payments and then you have to make up your mind as to whether you are going to let the exchange rate depreciate or put on direct controls of foreign trade or deflate your national economy to the point where your price levels and incomes fall enough so you can defend that exchange rate. And I would think that unless monetary reform comes more and more countries will face just that kind of a dilemma.

Representative CURTIS. But I would say here, countries are kidding themselves by attacking a symptom rather than the real cause. The real cause in my judgment would go back to the level of economic activity. If they want to be a bigger nation and most successful in their balance of payments, they have got to do something to sustain an optimum level of economic growth. Why would this not divert them from attacking the basic cause of an adverse balance of payments and hurt them in the long run? Maybe there is not enough entrepreneurial activity. Maybe there isn't enough research and development in the society. But I think it is distracting if you think you can use monetary policy to get at the real causes of the imbalance in the payments.

Mr. CHANDLER. Well, the case I was posing was one in which the country may have all sorts of entrepreneurs and initiative and this sort of thing, but the very growth of this economy might lead them to buy more abroad and put their balance of payments into disequilibrium.

Representative CURTIS. But that would be what I regard as the neutralist theory. You are trying to measure the amount of cash and credit needed within that society by the amount of present and potential economic activity. Therefore, your mistake would be that you have not had enough increase in cash and credit necessary for the level of economic activity. There is your guidepost; at least that is the theory I am trying to advance.

Mr. CHANDLER. I think I could only reply that this country would likely be looking at two guideposts which are off in different directions under those circumstances; namely, their employment situation, and their balance-of-payments situation.

Representative CURTIS. Well, I would hope that we would not use the elevator indicator as a method of trying to raise the elevator. We should rather use it to find out where the elevator is and then get to work. If we wanted to move the elevator up, then determine what really will move it up. And I regard money really as one of our best indicators. There is no sense in trying to fool with the indicator, I would argue, to try to produce these results in the field of employment. You could do it temporarily. You could do it vis-a-vis other societies and get away with it for a while, but I think you must ultimately come back to the realization that money is merely an economic indicator.

Mr. CHANDLER. I think my general approach to money would be rather different from that. I think it can be much more than an indicator, and that even if one has limited faith in its ability to carry us on to high goals, at least one thing seems very clear from history, and that is that a badly acting money can keep you from achieving your goals.

Representative CURTIS. Yes; I think we share that opinion.

Any other comments? I notice we do have——

Mr. MAFFRY. I wonder if you do not confuse an activist as regards money with easy money.

Representative CURTIS. I tend to, yes, although, as I say, Bill Martin—and I hate to quote him because he probably would deny the conclusions I have drawn from him. But as I understand it, an activist in his sense believes in expanding cash and credit as indeed I do, but the basis on which you judge the necessary amountof expansion is the level of economic activity.

Would you comment here, to help me in my confusion, if I am indeed confused?

Mr. MAFFRY. I think that is an important element of monetary policy, yes. I do not think that anything that has been suggested here today would relieve the monetary authorities of any country from following sound monetary policies, whatever they may be conceived to be.

Representative CURTIS. Mr. Polk, do you have any comments?

Mr. POLK. Congressman Curtis, I certainly agree, I am sure we all do, that you are raising absolute fundamentals in policy. I think that what we are dealing with, and with some hope, are international political circumstances far short of a coherent political situation, like the U.S. internal situation, where you can truly accommodate for better or worse various views on monetary policy. We do not have anything like that internationally. So what we are trying to do is to make minor building progress, it seems to me, rather than a solution

with the kind of sanction that we would certainly hope to have in a final determination of a given domestic debate. On this I can just say as a matter of faith, I think we have seen progress in international arrangements and we hope that there is room for more without getting this high degree of agreement.

Representative CURTIS. I appreciate your comment and, from my standpoint, I think you have stated it very well, too, because I have been urging, and the minority on this committee has been urging for years, that we meet to consider international monetary reform. But each time, we have inserted a caveat lest anyone think that this is going to solve basic international balance-of-payment difficulties, and I do not think many do, but it is a warning. Well, thank you very much.

Representative REUSS. We will stipulate nobody does.

Representative HANNA. Mr. Chairman, may I ask a question that these gentlemen might address themselves to in writing on this thing?

Representative REUSS. Yes.

Representative HANNA. It has occurred to me out of the discussions that this committee could look at two things which are not mutually exclusive. First of all, guidelines for creating more flexibility in the existing sources of liquidity which I take to be first, gold; second, foreign exchange; third, the swaps, these special certificates and bonds, such as the United States has recently used in issuing bonds in foreign countries in terms of foreign currencies. It would seem throughout this discussion that we might add to that what your thinking is in terms of the guidelines to be used on this unit, this new unit, and then I would add another one, and that is what are the possibilities of increasing the facilities of the market in other countries, that is our financial markets in other countries than Great Britain and America. Because I think this will interrelate. In other words, if Germany and France and some of these other countries can create a better finance market within their financial centers, this will take the heat off somewhat on the requirements for international moneys.

Representative REUSS. Gentlemen, thank you very much indeed for helping us today. We will now stand adjourned until 10 o'clock tomorrow morning in this same place. And at 2:30 tomorrow afternoon also in this place we will hear a statement from Senators McCarthy and Hartke on the same subject.

Thank you very much.

(Whereupon, at 12:20 p.m. the subcommittee adjourned to reconvene Wednesday, July 28, 1965, at 10 a.m.)

GUIDELINES FOR INTERNATIONAL MONETARY REFORM

WEDNESDAY, JULY 28, 1965

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

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

Present: Representatives Reuss, Ellsworth; and Senator Proxmire, of the subcommittee.

Guests attending: Senator Javits; Representatives Hanna, White, Ottinger, Halpern, and Mize.

Also present: Gerald A. Pollack, economist; James W. Knowles, executive director; John R. Stark, deputy director; and Hamilton D. Gewehr, administrative clerk.

Representative REUSS (presiding). The Subcommittee on International Exchange and Payments will be in order for a continuation of our hearings to develop guidelines for improving the international monetary system. We were off to a fast start yesterday with three excellent witnesses who made a real contribution to our studies, which, of course, are of great current importance because of the administration's decision, announced by Secretary of the Treasury Fowler, to pursue this matter with some vigor in the months to come.

We are glad to welcome again members of the House Banking and Currency Subcommittee on International Finance who share the legislative responsibility for whatever may be done in this area.

This morning, our three witnesses are Dr. Robert A. Mundell, of the Brookings Institution; Prof. Warren L. Smith, of the University of Michigan; and our old friend and former member of the Council of Economic Advisers, Prof. Henry C. Wallich.

Gentlemen, we are all very much in your debt for being with us. In accordance with the usual procedure, your excellent statements are herewith included in the record. And we would like now to ask you to proceed to either read those statements, summarize them, go beyond them, or conduct yourself in any manner that you think will be most helpful.

Senator Javits?

Senator JAVITS. Mr. Chairman, I would like the indulgence of the Chair to make about a 3-minute statement which I should have made at the opening of the hearings yesterday. But I was engaged in a markup session yesterday, so I would like to make it today.

May I do that?

Representative REUSS. Without objection, I will welcome Senator Javits' statement.

Senator JAVITS. Mr. Chairman, I ask unanimous consent that in the printed hearings this statement may appear at the point where it should have been made, to wit, at the opening of the hearings after the chairman's statement.

Representative REUSS. Without objection, both unanimous consent requests are ordered.

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

Representative REUSS. And I want to express my commendation to Senator Javits, Mr. Ellsworth, and others of the minority who have taken a constructive and, in my view, entirely right-minded approach to this.

Senator JAVITS. Thank you.

(Senator Javits' statement and supplementary materials are printed in the first day's proceedings. See pp. 5–11.)

Representative REUSS. Mr. Mundell, would you start off?

STATEMENT OF ROBERT A. MUNDELL, BROOKINGS INSTITUTION [1]

Mr. MUNDELL. With your indulgence, I will simply read my statement.

THE COMPOSITION OF INTERNATIONAL RESERVES AND THE FUTURE OF THE DOLLAR

I. THE WORLD ECONOMY AND THE DOLLAR STANDARD

The most exceptional characteristic of the world economy in the past 15 years is its unaparalleled prosperity and stability. I can think of no comparable period in the whole of modern history, excepting neither the prosperous years of the gold standard nor the relative prosperity of the years preceding the French Revolution.

During this period the dollar standard, or the gold-dollar exchange standard, or the gold-dollar-sterling exchange standard—however we want to characterize to—has served the needs of prosperity and trade admirably. Although it is not beyond the ingenuity of economists to invent a more elegant system, the one we have has worked much better than its reputation and would suffice for the future provided it worked no worse than it has in the past. Who could complain if the world economy in the next 15 years were as prosperous as in the last 15.

II. ALLEGED DEFECTS OF THE DOLLAR EXCHANGE STANDARD

The alleged defects of the dollar exchange standard fall into two categories: its unfairness, and its instability. It is held to be unfair because it allows the United States to run a deficit at a zero or low cost—Jacques Rueff calls it a "deficit without tears"—besides allowing the United States a disproportionate influence over world monetary policy. And it is held to be unstable because the increasing overhang of dollar balances relative to gold must ultimately create a crisis of confidence in the gold convertibility of the dollar.

[1] The views expressed are those of the author and do not purport to represent the views of the officers, trustees, or staff members of the Brookings Institution.

Both objections can easily be overstated. The U.S. deficit is not entirely a "deficit without tears," as past hearings of this committee testify to. In the first place, the United States pays interest on the borrowings with which it acquires resources or claims through its deficit, so that the "gains from seigniorage" do not entirely accrue to the United States. And, second, a reserve center country is inhibited in its choice of balance-of-payments adjustment measures, especially with respect to exchange rate alterations.

The charge of instability is more serious. There are two potential causes that may lead to collapse: the first could come from a premeditated attack on the system by a foreign central bank or group of banks—we can call this "collapse by design"; the second is an inadvertent crisis brought about by decentralized and uncoordinated decisions—we can call this "collapse by miscalculation."

I do not believe the danger of collapse by design is as serious as the danger of collapse by miscalculation. France, for example, might make a concerted attack on the system but its success would depend on French ability to muster support from other important central banks. Moreover, it seems probable that France would stop short of bringing the system down even if she had the power to, bearing in mind the particular power positions of debtors and creditors in the short and long run.

In the short run, countries holding dollar balances can convert dollars into gold and discipline U.S. monetary or trade policy; they tend to do this when they have surpluses and are inflating because it is a device by which they can shift more of the burden of international adjustment onto the United States. (This may, incidentally, run counter to the basic principle that the burden of adjustment should be divided in inverse proportion to the size of the country; a relatively small country can force a disproportionate share of the adjustment burden on the United States, a defect of the present system.)

But in the long run, the power of control does rest with the United States. As long as the United States sticks to the rules of the game, power rests with the short-term lending countries, but the United States alone has the ultimate power of changing the rules of the system. I do not support proposals that would dispense with the use of gold in international payments but it must be recognized that U.S. gold policy might be fundamentally changed if the United States is "disciplined" past the endurance of U.S. patience. From all this, I conclude that the lenders exert control in the short run, while the United States can dominate policy in the long run.

III. COLLAPSE BY MISCALCULATION

I regard the possibility of collapse by miscalculation as more serious than the danger of collapse by design. A first danger has already been hinted at: lenders may overestimate their short-run power (as they did in 1931) and induce a change in the rules of the system to neither their liking nor benefit. While no one may wish to see the boat upset, lenders may miscalculate with respect to the amount of rocking it takes to upset it.

More serious is the possibility of collapse as a result of a major crisis—whether a war in Vietnam or sterling devaluation. A sterling

devaluation could bring heavy selling pressure on the dollar, and there is no evidence that sleepless nights of Treasury and bank officials would forestall chaos, as each nation acted separately to protect the value of its reserves.

I should say at once parenthetically that sterling devaluation would be an entirely inappropriate policy at the present time—against the interests of the world community and against the interests of Britain. It is contrary to the interest of the world community because it would bring the risk of exchange rate changes throughout the world. It is no accident that advocates of gold interests are beginning to advise sterling devaluation because they see that as the best chance, after a period of chaos, of getting the price of gold up.

Nor is it in British interests to devalue at the present time. Devaluation for a deficit country with considerable slack in the economy can be a correct policy adjustment, but the British economy is currently suffering from inflationary pressure. At the present time Britain should deflate (by means of a tighter monetary policy and a more restrictive fiscal policy) in order to improve the external situation and give "incomes policy" a chance to work. Incomes policy can never be effective in a situation in which there is an excess demand for labor. Only after some deflation has taken place—and only if incomes policy proves ineffective even in a situation with some unemployment—should devaluation even be contemplated. Remember that devaluation would inflate the British economy and require tight money anyway to make it effective, so why not start off with tight money (which has a lag in its effectiveness) and resort to devaluation only if incomes policy fails.

A third type of danger of crisis by miscalculation is that the U.S. authorities may take an exaggerated view of the deficit as they measure it—perhaps because they pay too much attention to foreign advice—and overadjust, bringing unnecessary pressure on sterling and many other countries. Would it not be ironic if the United States allowed restrictive measures on trade and capital flows to force devaluation on other countries, restoring a new balance-of-payments equilibrium involving the U.S. restrictions as a permanent feature of the U.S. economy? The United States has adjusted partly by measures that are undesirable in the long run, and it can be hoped that these measures will be quickly reversed as the situation improves.

The possibility of crisis by miscalculation is sufficiently important to take seriously and to prepare against. My teacher and friend, Charles Kindleberger, urges the rule: "Discount freely in a crisis." I agree but am skeptical that countries will. They did in 1964 for Britain. They did not in 1931. Countries, especially France, have an old tradition of attaching political strings to lending, and these may prove unacceptable.

IV. A CONTINGENCY FUND AT THE B.I.S.

What we need to avoid this danger is a sum of money committed in advance—temporary aid that could move from country to country in a time of crisis. The IMF provides such a fund, and it is probably large enough for all countries except the United States and Britain. It is not large enough, or available enough, even with the special borrowing arrangements, to tide over a massive attack on sterling or the

dollar, as the 1964 sterling crisis showed. An additional remark I might make is that the United States is the only country that ever acquired a "standby" in the "gold tranche" of the IMF, a line of credit to which the overwhelming benefit of the doubt was supposed to be given. But a standby appeared to be necessary when the United States wanted to borrow.

Why couldn't European central banks, whose currencies are most needed in support of the reserve currencies, pledge in advance, for use in emergencies, a sum of domestic currencies as insurance against a run on the dollar or sterling—a sum of the order of $5 billion lodged with the Bank for International Settlements. This may seem at first a one-sided affair, but it need not be. Interest rates could be penalty rates for short money—as high as 5 percent—and as much as 1 percent could be paid by the United States and the United Kingdom for the insurance thus provided.

But I would not stress the quid pro quo aspect of this. There is no harm in a one-sided arrangement. After all, Marshall plan aid was one sided. In any event, it is worth investing some money in insurance against the disorder that would result from a collapse of the dollar standard. If it proves unnecessary, we should no more complain about it than we would about not cashing in on flight insurance.

V. THE FUTURE OF THE DOLLAR

I now want to turn to questions relevant in the long run. It is my view that the international use of the dollar will increase, rather than diminish, in the future. Just as the pound sterling dominated the world payments system up to 1914, so the dollar is likely to dominate the system in the second half of this century.

I cannot fortify this prediction in any detail here. Suffice it to say that stable, familiar, and convenient units of account drive out bad moneys—Gresham's law, in a sense, upside down. There is no single international legal tender in the world today, and I doubt that a formal one will be adopted in the next 20 years. But the hunger for a common unit of account is so great that a de facto unit of account in a world of increasing integration is inescapable. The dollar will provide this de facto unit, I believe, in the future, because of its familiarity, the power of the U.S. economy, and the relative stability of monetary policy in the United States.

The dollar grants to gold its current importance just as sterling granted gold its presidial power in the 19th century. Gold was the monarch, but the pound ruled; today gold presides, but the dollar governs. Gold would go the way of all defunct constitutional monarchs if it were allowed to usurp power.

There is no case in history, to my knowledge, where a synthetic currency has been artificially created unconnected with a dominant political unit. I do not believe in the possibility of a new CRU replacing the dollar or even of gold replacing the dollar as the basic international standard. Just as, historically, political unions developed mainly and most successfully under the hegemony of a dominant state—just as dominant languages drive out weaker languages in international communication—world moneys are most likely to evolve from dominant currencies. The CRU has about as much chance of

replacing the dollar as a world currency reserve as Esperanto has of replacing English as the language of the sea.

It is in the light of this tendency—a tendency I consider inexorable—toward the use of a dominant national currency as an international money that we should consider international monetary reform. The dollar simply cannot be dislodged from its international importance while the United States maintains its leading role as a world power and the United States retains its economic and financial preeminence throughout the world.

Nor should it. Current exchange standards develop from mutual convenience. Why should countries be deprived of the benefits of holding reserves in dominant national currencies if these currencies meet the needs, in their respective spheres, of international moneys? Why should many Latin American countries, Canada, Japan, and others be deprived of the great convenience to themselves, and the mutual benefit to the United States of being able to hold reserves in the dollars to which their own currencies are pegged for obvious practical reasons?

This applies also to other central currencies. Why should sterling area countries be deprived of the benefits of holding reserves in sterling, and lending short and borrowing long in the London capital market? The same applies to a lesser extent to the French franc, which, at least since 1958, has again proved to be a viable international currency over a limited area. All these relations have developed out of custom, habit, and convenience, and we should not dispense with the conveniences the system offers, lightly.

The pound sterling, and to a smaller degree the French franc, are of course, subdominant currencies with respect to the dollar. These currencies are pegged to the dollar, which is the unit of account in the system. It is true that it is the 1944 gold dollar that is the de jure unit of account at the IMF, but it is surely obvious that the 1965 paper dollar is the de facto unit of account. It is highly unlikely, for example, that many exchange rates would be changed if the United States raised the price of gold.

VI. A PLAN FOR INTERNATIONAL REFORM

The U.S. dollar is perfectly capable of providing the reserve asset for central banks that peg to the dollar. Barring a change in the dollar price of gold, gold reserves have no advantage over dollars and even the disadvantage of not yielding interest. It is politics, not economics, that reduces the international official demand for dollars.

For reasons of prestige some countries prefer gold to dollars. Gold is anonymous in the sense that it has no identification with another power (except gold-producing countries). For reasons of form, therefore, a dollar standard that left no alternative for other countries would be unacceptable. An alternative is necessary.

The alternative proposed would preserve all the advantages of national currencies as international reserves and yet allow countries the option of holding, and pegging their currencies to gold. The key element in the proposal is to link the asset held as the external reserve, and the international asset to which national currencies are pegged.

I propose that we gradually move toward a system in which countries hold reserves in the same asset as that to which their currency is pegged. Thus, if the United States pegs onto gold (as it does) her international assets should be in gold; if Canada pegs to the U.S. dollar (as she does), her reserves should be in dollars; if Australia pegs to the pound (as she does), her reserves should be in pound; if Tunisian pegs to the franc her reserves should be in francs; and so on.

Dominant currencies could be expected to peg to gold while other countries would peg to dominant currencies. This would mean that balances within currency areas would be settled in the currency of the dominant center while balances between areas would be settled in gold. An illustration may help to make it clear.

Suppose three countries—the United States, Britain, and France—peg to gold, while all other countries peg to the dollar, the pound, or the franc. Then the dominant currency countries will hold external reserves in gold while the outer countries will hold reserves in the dominant currency to which they are pegged.

The system could emerge with a minimum of complication and change out of existing arrangements. At the present time only the United States pegs to gold, while other currencies are either pegged to the dollar directly or pegged to the dollar indirectly through the pound sterling or the French franc. In other words only the United States is on the gold-pegging clause of article IV (4–b) of the Fund Agreement, which exempts the United States from the need to peg foreign currencies within the 1-percent margin. But any country wanting to hold gold rather than dollars has the right to shift over to this clause alongside the United States.

I am not suggesting that we move into this system overnight. A large part of the world would automatically be in the dollar area, and it may be that the United States would not want to increase suddenly her gold stock (with a matching increase in dollar liabilities) to the extent that would be implied by the conversion of gold into dollars. What I propose for now is that countries that continue to peg to the dollar gradually increase the proportion of dollars in their reserves, while countries that shift onto the gold-pegging clause of the IMF increase the proportion of gold in their reserves.

It is important to realize that a measure of agreement should be easy to obtain. General de Gaulle, for example, has already urged that some version of the gold standard be restored. I believe that France should be encouraged to move onto a gold standard. As France moves to the point where she holds the bulk of her reserves in gold, she should also shift away from pegging the dollar to pegging the price of gold within the gold margins, in accordance with article IV–4–b of the IMF Agreement.

VII. A MORE CONTROVERSIAL POINT

There is, finally, one other change I would make, as a desirable companion to my proposal. But I recognize that it is more controversial. I hold that it is useful to make dominant currencies and gold less perfect substitutes. The best way to do this, I think, is by widening the gold margins substantially. This would increase the flexibility of the adjustment process between countries going onto the gold-pegging clause and at the same time provide the incentive for

making a clear commitment to hold a particular dominant currency or to hold gold.

The transition to this new arrangement would be simple and the United States could, unilaterally, consistent with the regulations of the IMF, at once widen the gold margins from the present one-fourth of 1 percent on either side of par value to the permitted 1 percent, buying gold at $34.65 and selling it at $35.35. This would be a small step in the right direction pending a petition to the Fund for a change in the regulations to permit a margin more substantial than 1 percent. As the dollar becomes increasingly strong on the exchange markets the attractiveness of this change in the regulations is enhanced.

I have elaborated on my proposal in detail in a monograph: The International Monetary System: Conflict and Reform (Canadian Trade Committee, Montreal, July 1965), which I apologize for not being able to present to the committee at this present time due to the Canadian postal strike.

Representative REUSS. Thank you, we will look forward to it on arrival.

(The publication referred to was subsequently received and appears in "Part 2—Supplement" of these hearings.)

TESTIMONY OF WARREN L. SMITH, PROFESSOR OF ECONOMICS, THE UNIVERSITY OF MICHIGAN

Representative REUSS. Mr. Smith, your statement has been received into the record. Would you proceed to give your views either by reading, summarizing, or interpolating, any way you like.

Mr. SMITH. Thank you, Mr. Chairman. Because of its length I am going to try to summarize some of the main points in my paper.

Representative REUSS. If you could key them as much as possible to the copy we have in front of us, it would be helpful.

Mr. SMITH. I am going to follow it, but skip parts of it.

First of all, any proposal for reforming the international monetary system has to be based on a diagnosis of what is wrong with the present system.

I am going to start by trying to explain what to me seem to be the main problems with it. I think they are very serious problems. I classify them under three headings. The first is—and this is well-known, it has been discussed almost ad nauseam in the newspapers—that there is no systematic arrangement in the present system for supplying reserves. Everybody is worried about the fact that if, as now appears perhaps imminent, the U.S. balance of payments goes into surplus, the supply of dollars entering international reserves will be shut off. So there is no systematic arrangement for providing reserves. I think something needs to be done about that.

The second problem that troubles me about the system is that it is inordinately subject to speculative instability. I find it useful to distinguish two aspects of this instability in the system.

To begin with, there is the instability that results from the fact that in the past a series of U.S. deficits has built up a large stock of dollar claims held by foreign official agencies and central banks and has also drawn down the U.S. gold stock, so that a large overhang of claims against the U.S. gold stock has been built up. Thus we are somewhat in the position of a bank whose reserve position has been deteriorated. The difficulty about this is that when the United

States does run a deficit, and this overhang of claims builds up, the position of the dollar begins to come into question, and confidence in the stability of the dollar and its exchange parity may weaken.

In addition, and in my opinion at least as serious as the first element of instability—in fact, I would say basically more serious—is the problem of private speculation. The present international monetary system is built around an exchange rate arrangement in which exchange parities are fixed at any particular time, but there is a provision for making adjustments in those parities under the IMF rules if a country has what is called a fundamental disequilibrium in its balance of payments. In practice, these adjustments in exchange parities are extremely difficult to make, and everybody tries as much as possible to avoid making them. But, nevertheless, there always is the possibility that a country will be forced to make an adjustment in its exchange parity.

The problem of speculation here is that as a country runs a deficit and uses up its reserves—or, in the case of the United States, builds up an overhang of claims against those reserves—confidence in the stability of the parity of that currency declines and this tends to create speculative runs, because exchange rates aren't permitted to move around parity except within very narrow margins. This makes it almost costless for a private holder of a currency to speculate against it by shifting into some other currency and he can usually find an asset in another country that yields a sufficiently high return to be attractive.

These two aspects of speculation, I think, are related, but have some distinct characteristics. The first one, the overhang of official claims, is a problem only for reserve currencies, and it is especially serious in the case of the dollar. The second problem of private speculation based on the possibility that an exchange parity will have to be changed is present for all countries, not just reserve currency countries. A non-reserve-currency country that runs a deficit in its balance of payments for a period of time and runs down its reserves to a point where private holders of the currency begin to fear a devaluation can experience a run. I would like to point out that all the assets denominated in a particular currency, whether they are held abroad or whether they are held at home, are eligible to participate in such a run. As a consequence, the possibility of a speculative run against a currency is practically unlimited in the present system.

So there are these two problems of speculative instability.

There is a third problem that I think is as serious as the second. And that is the fact that the present system contains, at least in my opinion, no really acceptable procedures or techniques or mechanisms for correcting a balance-of-payments disequilibrium once one arises. In a system such as the present one where we would like to adhere to the principles of free movement of goods and capital, and where exchange rates are for all practical purposes fixed because everybody is scared to change them, there is really only one thing left, at least in the classical way of looking at it, to adjust the balance of payments; namely, an adjustment in the level of aggregate demands in the countries involved. That is, the customary procedure is for a deficit country to contract its demand and a surplus country to expand its demand, and this is supposed indirectly to bring about corrective adjustments in the balance-of-payments positions of those countries.

But today countries are firmly intent on achieving goals internally that are important and that are politically almost inviolable. It is extremely difficult for a country to give up the objective of full employment in order to deflate its economy to correct a balance-of-payments deficit. I do not think there is any point in expecting countries to do this to any appreciable degree. They have, it is true, in the last few years on occasion been forced to do this kind of thing, but unwillingly and without great vigor. And the result is that to the extent that the adjustment mechanism works through this process, it works grudgingly, slowly, and ineffectively.

The result is that if some shock hits the system and generates a deficit in a country's balance of payments that deficit can persist for a long time, because the adjustment mechanism is weak. It can drain off the limited supply of reserves available to that country, and it can create speculative strains that will balloon the deficit in that country's balance of payments into very large magnitudes. Perhaps the problem is more serious in the case of reserve-currency countries like the United States, but I think the same problems are present for all countries.

The question is what we should do about this. I think any program to reform the system has to make some stab at dealing with all of these problems, not just one or two of them—not just create more reserves, but try to do something about the instability of the system and try to do something to shore up the techniques for adjusting the balance of payments.

Now, I would like to talk for a minute about the contribution of what I would like to call financial reform. I think a great deal of emphasis—in fact, I would say too much emphasis—in the discussion of reforming the international monetary system, has been placed on what I would call reorganization of the financial machinery—that is, schemes for reorganizing the IMF and making it into something that could be described as a world central bank, or for creating some new reserve asset, or other adjustments of this kind. I am not saying that these are not important and even necessary as a part of reform programs. But I do not think they would solve the whole problem.

I have really laid down four problems here: One is the fact that the system does not create reserves in a systematic way, the second is the official overhang, the third is private speculation, and the fourth is the weak adjustment mechanism. It seems to me that financial reform proposals cannot deal with anything more than the first two; that is, the creation of reserves and possibly the threat imposed by the official overhang.

Now, in approaching such reform proposals, and in deciding its position on them, it seems to me that there are three guidelines the United States should follow. One is that it should oppose any reform proposal which promised to increase to any significant degree the amount of discipline placed on deficit countries to undertake deflationary policies to correct their balance-of-payments position. I think the system is biased in a deflationary direction already. There is more pressure on a deficit country to adjust than on a surplus country. And I might add that I believe the world needs not a deflationary bias but a mild inflationary bias if we are going to maintain adequate use of resources on a worldwide basis. All of the historical evidence of

recent years suggests that you cannot have a healthy world economy with falling or even stable prices, that there are a number of ratchet mechanisms in the price determination system that mean that when we have high level of utilization of resources we are going to have some mild rise in prices. We have to face up to that and develop a system that recognizes it.

The second guideline I would suggest is that we should strongly prefer a system that involves unlimited participation. I am skeptical of proposals that would place reform of the monetary system in the hands of a handful of advanced countries. I think this is too important a problem to be settled by, say, the Group of Ten, although obviously the problems of the industrial countries are somewhat different from those of the underdeveloped countries. It might be all right to have an arrangement under which, by some kind of automatic exclusion principle, certain countries were involved at first, but every country ought to be eligible to get into the game at some point by satisfying some condition.

My third guideline is that we ought to look very warily at any proposal that would be likely to undermine the reserve-currency status of the dollar. That does not mean that we ought necessarily to refuse absolutely to have anything to do with such a proposal, but we ought to examine it pretty carefully to see that the benefits exceed the costs. It does seem to me that there are advantages as well as disadvantages in the dollar being a reserve currency. In fact, I believe we have been able to finance the large deficits which we have had in the last 5 years or so more efficiently and with less strain on the United States as a result of the fact that the dollar is a reserve currency than would have been the case had we not had such an arrangement.

It seems to me that any proposal for financial reform that both systematizes the creation of reserves and deals with the official overhang, when you think it through, is pretty likely to violate one or more of the guidelines that I just laid down; that is, the avoidance of increased discipline, the avoidance of exclusive limited participation, and the avoidance of an undue deterioration in the reserve-currency status of the dollar. I think we ought to be very wary of some of these so-called CRU plans and Posthuma-type plans, although the way in which a CRU type plan would work would depend a great deal on the details of the particular proposal. It would depend primarily on the basis on which CRU's were to be issued and the basis on which they were to be used. For example, if CRU's were to be issued in proportion to each country's holdings of gold, the plan would be likely to set up an incentive for countries to convert dollar balances into gold in order to qualify for CRU quotas, with the result that the reserve-currency position of the dollar would gradually decline, and we would move in the direction of something that would resemble the old-fashioned gold standard with an increase in the deflationary bias in the system.

On the matter of financial reform, my own preference would be for a very simple arrangement which would extend the automatic drawing rights under the IMF. This is a simple proposal that can be put into effect without making any amendment in the IMF Articles of Agreement. It can be used to provide the world with a one-shot increase in reserves by, say, raising automatic drawing rights through the first

credit tranche, and as quotas are increased in the future, it will also provide a mechanism by which those quotas will add directly to world reserves. We would have to get countries to be willing to regard the automatic drawing rights under the Fund as reserves in the same sense in which their own reserves are so regarded, but I cannot see that there would be great difficulty in achieving that result.

This is the approach to providing reserves that would tend to appeal to me, largely because it is simple. But it would not do anything to deal with the overhang problem. With respect to that problem, the proposal I would advance is perhaps not very acceptable to U.S. financial officials. But I think there would be much to be said for the United States attempting to fund some of the outstanding official overhang by issuing gold-value guaranteed medium-term securities under a provision in which those securities would be convertible on the initiative of a country that experienced a balance-of-payments deficit. This would permit a one-shot funding, provided we could negotiate it, of a substantial portion of the existing overhang. And I do not have any objection to the United States making similar securities available on tap to provide a protected source in which foreign official agencies can invest future accumulations of dollar claims.

It seems to me that the United States performs many of the functions of a banking center for the international monetary system, and I cannot see any reason why it should not provide protection both for itself and for the system as a whole by issuing a security of this kind.

There are two points I would like to make on the growth of reserves. First of all, I do not think anybody can predict how fast reserves need to grow. This is an extremely complicated problem. When it depends on is how powerful the forces are in the world in the next few years that generate deficits, and how fast the adjustment mechanism works to correct deficits. No one can predict these things. And consequently, it seems to me that the procedures for creating reserves have to be made flexible so that they can be adjusted to deal with the situation as it develops.

The second is—and this is a point I would like to stress, it is developed a little more in my paper—I do not think the creation of reserves, per se, is likely to have any simple and direct effect on the level of expenditures. If you create reserves under most methods that have been proposed, it would do nothing to inject the reserves into the spending stream of the world economy immediately. It might tend to have an inflationary effect because some countries were under pressure resulting from deficits, and availability of additional reserves would permit them to follow more expansionary policies. But there are circumstances in which the creation of reserves would have no immediate effect on anything, because no country was under restraint to hold back its economic progress because of a lack of reserves. There is even less validity to the quantity theory as applies to international reserves than to domestic money creation.

Let me say just a little about the other two problems of the private speculation and the weak adjustment procedures in the present system. I think these problems are at least as serious as the other two. And none of the financial proposals that I know of would do anything to deal with them.

With respect to private speculation, I would advance the proposition that the adjustable peg exchange rate system under the IMF has proved to be completely unworkable and unacceptable. It is a source, I think, of a great deal of the speculative strain in the system, because, as I said before, when a country gets into deficit and its currency is under pressure, the expectation that the country may be forced to devalue tends to generate speculation against that country.

The result is that I think we must do our best to work away from the adjustable-peg exchange rate system. Exchange rates either have to be flexible or they have to be fixed. They cannot be halfway between as they are under the present IMF system. Since we are not willing to discuss the possibility of adopting a system of flexible exchange rates, I believe we have to try to deal with our problems without making any adjustments in the pegs and to work our way gradually toward a de facto fixed exchange rate system.

Now, in that connection, I would suggest that there would be some advantage without going to anything like a flexible exchange rate system, in widening the margins around which exchange rates can fluctuate each side of parity—or at least in permitting them to fluctuate within the present 1 percent limits that are technically allowable. As it stands, intervention has occurred in the foreign exchange market to keep exchange rates from fluctuating even within that plus or minus 1 percent range.

It is not easy to suggest ways to improve the adjustment mechanism. The suggestion I would make is that we might use the mix of monetary and fiscal policies to achieve some headway in this area. We might rely primarily on fiscal policy to maintain stability of the economy internally and use monetary policy to a considerable extent to try to cope with the balance-of-payments problem. That is, when a country had a serious balance-of-payments deficit, it would raise its interest rates and attempt to attract private capital to the extent necessary to cover a substantial portion of the deficit. It would be necessary to improve the functioning of international capital markets to make this arrangement work effectively.

I think we could codify some crude rules about this; when a country had, for example, a deficient level of internal demand and a balance-of-payments deficit, the appropriate policy would be for that country to raise its interest rates as a means of reducing its deficit, while cutting its taxes enough not only to offset the domestic impact of the rise in interest rates but to expand demand beyond that in the direction of full employment.

We could, I think, draw up some rules of this kind as to the directions in which countries ought to adjust their monetary policies and their fiscal policies under various combinations of internal demand being above or below target and the balance-of-payments position being in deficit or in surplus. We would need to have effective arrangements for consultation in order to avoid competitive increases in interest rates which contributed nothing to improving the balance-of-payments position while having an adverse effect on investment and growth. We would also probably need to make more use of fiscal instruments as a means of influencing investment. It is possible, in principle anyway, to have any desired level of investment within a considerable range at any level of interest rates we want, provided there are sufficient fiscal incentives to stimulate investment.

In a general way, we are going to have to move in the direction of placing more emphasis on fiscal policy for domestic stability anyway, even if we do not try to do anything as elaborate as I am suggesting because we are already hamstrung in using monetary policy in a flexible way to achieve domestic goals.

This cannot be a full solution. Obviously a country cannot run a balance-of-payments deficit for 15 years and deal with it by induced foreign borrowing. But it might shore up the balance-of-payments adjustment mechanism enough so that it will work reasonably effectively and give more time to bring about the necessary underlying adjustments in price movements, and so on.

Just one concluding remark. First, I want to stress again my belief that we must attack as best we can all of these problems, not just some of them. And secondly, we must not expect too much from international monetary reform. I do not think that we are going to be able to do anything to the international monetary system that will make the balance-of-payments problem go away. No matter what we do, at least within the constraints of what we have been discussing here, we are likely to be faced with the same tough problems and hard decisions in this area that we have been forced to cope with in the last few years. I do not think that there are any panaceas that we can adopt that will simply make these problems disappear.

Thank you.

Representative Reuss. Thank you, Mr. Smith.

(The prepared statement of Mr. Smith is as follows:)

Prepared Statement of Warren L. Smith

I. THE PRESENT SYSTEM AND ITS DEFECTS

Any program for reform of the international monetary system must necessarily be based on a diagnosis of the ills of the present system. Accordingly, I shall begin by presenting my own view of the relevant features of the system and its weaknesses. As I see it, the basic principles of the system are as follows:

1. Each country is quite jealously insistent on its sovereign right to regulate internal demand for the purpose of maintaining suitable economic conditions at home in terms of employment and the behavior of its internal price level.

2. Free international movement of goods and of capital as a means of achieving efficient use of resources is a generally accepted goal, and substantial progress has been made in achieving it. In particular, since the advent of general currency convertibility in 1958, controls over the international flow of capital have been relaxed and investors have become increasingly inclined to shift funds internationally in response to differential changes in expected rates of return.

3. Trade is conducted under a system of fixed exchange parities at any particular time, with actual exchange rates fluctuating only within very narrow limits around these parities. The maintenance of fixed parities is a highly prized objective; nevertheless, provision is made for parity adjustments under the rules of the IMF as a means of dealing with "fundamental" balance-of-payments disequilibria.

4. Countries hold limited supplies of monetary reserves in the form of gold, dollar balances, and (to a lesser extent) sterling balances. In addition, lines of credit are available at the IMF; portions of these credit lines are available virtually automatically and are practically the equivalent of "owned" reserves, while the remaining portions are available on conditions that become increasingly stringent as the amount borrowed increases. The reserves available and potentially obtainable set a limit—though a somewhat elastic one—on the cumulative size of a country's balance-of-payments deficit. Thus, each country operates subject to a "balance-of-payments constraint"—not in the sense that payments must always be in balance but in the sense that there is some limit on the size and duration of deficits that can be tolerated. It is important to note that there is no corresponding limit for surpluses.

A little more needs to be said concerning the goal of internal stability (item 1 in the above list). It is often said the countries seek the twin goals of "full employment" and "price stability." However, a more accurate way of describing the situation is as follows: There is in each country a "trade-off" between employment (or unemployment) and price stability; that is, over a considerable range the more unemployment is reduced by policies to expand the aggregate demand the higher is the price that must be paid in terms of inflation. This relation holds primarily because of the tendency for money-wage increases to outstrip increases in productivity even under conditions of substantial unemployment. The trade-off varies from country to country, depending on the organization, traditions, and aggressiveness of the labor movement, the price policies followed by industry, and so on, and from time to time depending upon the attendant circumstances. The trade-off may be influenced by policy measure—wage-price guideposts, income policies, etc.—but I am not aware of any cases in which efforts to change it have been notably successful. Not only does the trade-off between price stability and employment vary from country to country but so also do the relative weights attached to these two objectives in the hierarchy of values that govern the behavior of the authorities responsible for economic policy in the various countries. As a consequence, to the extent that each country is left free to decide what combination of price inflation and employment to select from the many choices open to it, price trends may vary from country to country.

Price stability is often given a high priority in the list of objectives of economic policy, not only for individual countries but for the world as a whole. It seems to me that the evidence is overwhelming, however, that price stability can really be attained on a continuing basis only at a cost in terms of unemployment and underutilization of economic resources that is not only politically unacceptable but probably socially undesirable in most countries. This is true not only because the wage-price determination mechanism tends to set in motion a "creeping" rise in the price level before an acceptable level of unemployment has been reached, but also because prices are much more prone to rise in times and at places in which demand for goods and services is rising than to fall under conditions where such demand is declining. I believe that the achievement of an acceptable rate of utilization of economic resources requires that the world be willing to accept—and, indeed, underwrite—a mild upward drift in the general level of prices, unless, of course, some as yet undiscovered means can be used to damp the tendency toward price and wage increases without reducing the overall level of demand.

There are three grave difficulties with the existing system as described above—admittedly in a slightly idealized way—which are relevant to the question of international monetary reform.

1. The first—and in many ways the most fundamental—difficulty is that the system contains no mechanism that can be depended upon to eliminate a balance-of-payments disequilibrium brought about by such disruptive forces as changes in tastes or technology. There are three possible ways of correcting a deficit or surplus by adjustment of the current account: through the use of trade or exchange controls, through an adjustment of exchange rates, and through internal price and income changes. Since all of these violate the principles of the system, they are ruled out. Consequently, when a country experiences a deficit, there is no assurance that the deficit will be eliminated before its limited supply of reserves is used up.

2. The system as it is now constituted is subject in extreme degree to destabilizing speculative tendencies which greatly complicate the problems of balance-of-payments adjustment. Although, as indicated above, fixed exchange rates appear to be one of the generally accepted goals of economic policy, we do not now have a system of really fixed rates. Indeed, the present arrangements, under which exchange rates are fixed within very narrow limits at any particular time but are subject to readjustment from time to time to correct "fundamental" disequilibria in national balances of payments, seem ideally calculated to encourage speculation. Since opportunities for the investment of capital, viewed broadly, do not ordinarily vary widely as between major countries, even a mild suspicion that a country may devalue its currency can cause a speculative outflow of capital from that country. And, as more and more investors become familiar with the possibilities of transferring capital internationally, it seems probable that the potential size of speculative capital flows may become even larger. The result of this situation is that most countries will entertain the possibility of devaluation only in the most dire emergency, but the threat is

nevertheless sufficient to induce speculation. And there is always the possibility that speculation will exhaust the country's reserves and force the devaluation that speculators are hoping for.

3. The third difficulty—and the one that I regard as least serious because easiest to correct—is that the present system contains no orderly arrangement for generating in a predictable way the increased quantities of international monetary reserves that are needed to meet the demands of a growing world economy. Increments to the world's monetary reserves are provided primarily by gold production (less the amount of gold that is absorbed in consumption and in hoards) and by additional dollars that are pumped into official reserves by U.S. deficits. Gold production is generally agreed to be capable of producing only a relatively small fraction of the additions to reserves that are needed, and the end to U.S. deficits, which may now be imminent, will shut off the flow of dollars.

The matter of speculative instability—the second of the three problems referred to above—merits some further amplification. The speculative threat to the stability of the sysem, which I believe is very serious, has two distinguishable aspects: (1) the threat imposed by the "overhang" of convertible claims against the monetary reserves of the reserve-currency countries—especially the United States—that are held by the monetary authorities of other countries; and (2) the danger of private speculative "runs" against currencies that are under pressure. The first of these dangers is present only in the case of reserve-currency countries. It has been an important factor in accentuating the difficulties of the United States, because as our continuing deficits have been settled partly in gold and partly through increases in the dollar holdings of foreign central banks, the ratio of our gold reserves to our outstanding dollar liabilities to foreign official agencies has declined, and fears that the dollar might have to be devalued have increased. This generates pressure for foreign central banks to convert outstanding dollars into gold and to insist on the settlement of current U.S. deficits in gold. This depletes U.S. gold reserves and weakens confidence in the dollar.

The second of the two dangers referred to above, that of private speculation against a currency that is under pressure, is, in my judgment, more fundamental and serious than the first and also more difficult to correct. In the first place, this threat is not confined to reserve-currency countries, although it may be more serious for such countries partly because it may be stimulated by reserve drains resulting from conversions of official holdings of reserve currencies. Under the present adjustable-peg exchange rate system, as long as there is some limit on the available supply of monetary reserves, any country whose currency comes under pressure as a result of a serious balance-of-payments deficit can easily get into a position where a devaluation of its currency (or the application of direct controls) is regarded as a serious possibility by private investors. This can quickly generate a speculative "run" which will reduce its reserves still further, thereby strengthening the fears of devaluation and leading to a self-generating increase in the rate of decline of its reserves. It is important to recognize that the entire stock of claims denominated in a particular currency is potentially available to participate in a private run on that currency. Since this includes claims held internally as well as externally, the possibilities are practically unlimited.

Of course, the system, which in its present form dates from the restoration of convertibility in 1958, has functioned after a fashion; indeed, in general, the world economy has prospered and international trade has expanded remarkably during this period. Actually, however, the system has survived only because its fundamental principles have been violated in various ways.

1. The underlying principle of free movement of goods and capital has been compromised through the imposition of trade restrictions for balance-of-payments reasons by Canada in 1962 and the United Kingdom in 1964. The United States has also persistently violated the principle by tying foreign aid, by discriminating in favor of American suppliers in its defense procurement policies, by the enactment of the so-called interest equalization tax, and, most recently, by the adoption of the voluntary program for limiting foreign loans by commercial banks initiated by President Johnson early in 1965.

2. Some minor use has been made of exchange rate adjustments in the Dutch and German revaluations of March 1961. Such adjustments, however, probably do more harm than good by weakening confidence in the overall stability of exchange rates and encouraging speculation.

3. In practice, domestic monetary and fiscal policies have not been entirely unaffected by the balance-of-payments situation. In part this is because, due to the less than perfect effectiveness of domestic monetary and fiscal tools, it has not always been feasible to offset completely the automatic corrective effects of deficits and surpluses on internal demand. Beyond that, deficit countries have found it necessary to adapt their domestic policies to the exigencies of the balance of payments—albeit reluctantly—when their international reserves have been seriously threatened. The leading example here is the United States, which has suffered from an unnecessarily high rate of unemployment and an irrecoverable loss of output amounting to perhaps $150 billion in the last 5 years, partly as a result of its balance-of-payments deficit. Actually, there is little evidence that policies to expand aggregate demand have been held back by fear that they would worsen the Nation's balance-of-payments position. But sufficiently expansionary fiscal policies have proved to be difficult to put into effect (as a consequence, in part of public antipathy to budget deficits and the growth of the public debt), while the need to avoid an accentuation of short-term capital outflows has acted as a constraint on monetary policy—the one flexible and acceptable instrument that might in the absence of a balance-of-payments constraint have been used to expand aggregate demand. No doubt similar considerations have to some extent operated in European countries to limit the use of restrictive monetary policies to check excessive inflation in the face of balance-of-payments surpluses. But it is quite clear that the present system has an inherent deflationary bias. The limited supply of reserves sets some upper bound on the size of a nation's cumulative deficit, whereas there is no equivalent upper bound to the size of a cumulative surplus and the associated expansion of monetary reserves.

Techniques of central bank cooperation through the use of currency "swaps" and intervention in foreign exchange markets to deal with minor speculative crises have been progressively developed and refined. To deal with more serious crises, massive supplies of foreign exchange have been mobilized to support threatened currencies and combat the activities of speculators. So far, these efforts have been successful in fending off disaster, but there is even now much concern about the position of sterling, and the financial world lives in fear of a forced devaluation of sterling or the dollar.

II. GUIDEPOSTS FOR REFORM OF THE SYSTEM

In my opinion, effective reform of the international monetary system requires a program which takes account of all of the problems referred to above. That is, a reform program should accomplish the following objectives:

1. Systematize the creation of monetary reserves and disconnect it from the vagaries of gold production and deficits of reserve-currency countries.

2. Eliminate or at least reduce the potentially dangerous speculative instability that is inherent in the present system. It is useful to separate this objective into two parts (alhough there is, of course, some connection between the two):

   (*a*) Tie down the "loose cargo" of officially held convertible claims which now constitute a threat to U.S. gold reserves.

   (*b*) Eliminate or reduce the propensity for private destabilizing speculation to develop in anticipation of devaluation of any currency that comes under pressure.

3. Take steps to strengthen the procedures that are available to maintain or restore balance-of-payments equilibrium.

It is not easy to devise a program that will achieve these results, but I shall discuss some of the possibilities.

A. Possible contribution of an overhaul of international financial arrangements

In much of the discussion, reform of the international monetary system has been viewed largely in terms of purely financial readjustments: reorganizing the IMF along one of several alternative lines, multilaterilizing the reserve-currency function now performed almost exclusively by the dollar and sterling, introducing some new form of international reserve asset to supplement gold and foreign exchange, and so on. While some financial reorganization must form a central part of any feasible program of reform, no proposal of this kind can by itself provide a full solution. Financial reforms along this line are capable of accomplishing only two of the objectives listed above: objective (1), the systematization of reserve creation, and objective (2*a*), the tying down of

the overhang of official dollar claims. None of them would deal directly with either objective (2*b*), the curbing of private speculative propensities, or objective (3), the establishment of an effective balance-of-payments adjustment mechanism.

In deciding its stance with respect to proposals for international financial reform, I believe the United States should adhere to the following guideposts:

1. *The United States should oppose proposals which would move in the direction of imposing greater "discipline" on deficit countries to adopt generally restrictive domestic policies.*—The present system contains a deflationary bias in the sense that the pressure on deficit countries to undertake restrictive policies exceeds the pressure on surplus countries to adopt expansionary policies. If anything, this represents precisely the opposite kind of bias from that needed to achieve a healthy world economy. It would be most unfortunate if this bias were strengthened.

2. *The United States should oppose plans which limit participation in an arbitrary way to a small group of countries, such as the Group of Ten.*—Determination of the supply of monetary reserves is too important a question to be decided by a small group of countries with no opportunity for participation by the rest.

3. *The United States should weigh with great care the probable effect of any proposed plan on the reserve-currency status of the dollar.*—I do not believe we should automatically reject any proposal which would weaken the dollar's position. But we should give very serious thought to the question: Is the increase in the stability of the system that might result from the adoption of the plan worth the associated cost in terms of deterioration in the reserve currency position of the dollar? In arriving at an answer to such a question, it is necessary to distinguish between the role of the dollar as a private payments currency and its role as an official reserve currency. Many of the concrete benefits that the United States derives from the special position of the dollar in the world are derived from its use as a private payments currency rather than as a reserve currency. For example, the leading position of U.S. banks and other financial institutions in the financing of international trade is related to the position of the dollar as a private payments currency. Indeed, the predominant position of the dollar in private international trade and finance is almost certainly a valuable byproduct of the unparalleled efficiency and magnitude of our money and capital markets. I cannot see that any of the proposals for reforming the international financial system would be likely to weaken the position of the dollar as a private payments currency. None of the plans would interfere in any way with current practices relating to the conduct of private international transactions, and, in particular, none would involve the creation of a new monetary unit that would be used in the conduct of such transactions.

Leaving aside the issue of the use of dollars in financing private international transactions, the reserve-currency status of the dollar has both advantages and disadvantages for the United States. It almost certainly gives the United States a strategic advantage when it comes to financing a series of large deficits such as we have experienced in the last few years. Using the "official settlements" concept of the deficit which is advocated in the recent Bernstein report, the United States experienced an aggregate deficit of $12.6 billion in the period 1960–64, of which $3.5 billion was settled in gold, $1.9 billion was settled through debt prepayments by other governments, $1.2 billion reflected a change in the IMF position of the United States, and the remaining $5.9 billion represented an increase in U.S. liabilities to foreign official monetary institutions. It seems to me that if any of the proposed plans that would weaken the reserve-currency status of the dollar had been in operation during this period we would probably have had greater difficulty than we, in fact, experienced in financing this large deficit and would have found it necessary to settle a larger share of it through gold payments. On the other hand, the reserve-currency status of the dollar under the present system certainly does subject the United States to a serious element of speculative strain and risk. In deciding whether to accept a plan which would weaken or eliminate the reserve-currency status of the dollar, we would have to make a judgment as to whether the reduction in risk that would result would be worth the cost that might be imposed upon us in terms of reduced freedom of maneuver in seeking financing for some future series of balance-of-payments deficits. How we would come out in making such a judgment would presumably depend to a considerable extent on the details of the particular proposal that was put before us.

One of the dilemmas of international monetary reform is that most of the plans that would accomplish objective 2(*a*), the stabilization of outstanding official dollar claims, would be likely to prove objectionable on the basis of at least two—and possibly all three—of the guideposts listed above. This would be true of a CRU-type plan under which CRU's were issued on the basis of the participants' holdings of gold.[1] Such a plan would probably undermine the reserve-currency position of the dollar by giving participants an incentive to convert dollars into gold in order to qualify for a maximum quota of CRU's. It would also be limited to a select group of countries, and would, I suspect, be likely to represent a reversion toward thhe gold standard with a sharp increase in the deflationary pressures on deficit countries. The same objections might well apply to a posthuma-type plan, which would eliminate the special reserve currency status of the dollar by multilateralizing the reserve-currency function among the participating countries.

A CRU-type plan of the kind proposed by Dr. E. M. Bernstein would not be subject to these objections, because it would provide merely a way of increasing the supply of reserves without otherwise changing the present system substantially. On the other hand, the plan would do nothing to stabilize the outstanding stock of official dollar claims. While participation would initially be limited to a rather small group of countries, it might be feasible to admit other countries to participation as their currencies became convertible. The establishment of such a self-qualifying principle would get around the "exclusive club" aspect and eliminate the objection to the plan under the second guidepost mentioned above.

Actually, however, I cannot see what would be achieved by such a plan that could not be accomplished much more easily by simply extending automatic drawing rights under the IMF beyond the gold tranche. Such rights might, for example, be extended through the first credit tranche; i.e., up to the point where the Fund's holdings of a country's currency were equal to 125 percent of its quota. Not only would such an increase in automatic drawing rights provide a one-shot increase in effective reserves at the time it was adopted, but, in addition, such a change would mean that any future increases in quotas would add to effective reserves by an amount equal to 25 percent of the quota increase. If it was felt to be desirable to maintain the same volume of conditional drawing rights that are now available from the Fund, the upper limit on the Fund's holdings of a country's currency could be increased from the present 200 percent of its quota to 225 percent. If this were done, it would be necessary for the Fund to obtain access to additional resources from member countries to maintain the same balance between members' drawing rights and the Fund's foreign exchange resources that now exists.

In order to make such an increase in automatic drawing rights a successful means of increasing effective reserves, it would, of course, be necessary to obtain acceptance by participating countries of the principle that automatic drawing rights from the IMF are to be used regularly in the same way as "owned" reserves. It may be noted that an increase in automatic drawing rights through the first credit tranche of member countries' quotas would provide no additional immediately available reserves to those countries who had already borrowed beyond the first credit tranche so that the Fund's holdings of their currencies exceeded 125 percent of their quotas. Thus, the proposal would contain an automatic self-selecting mechanism which would limit the immediate benefits to countries that were not making extensive use of the Fund's resources. In order to make provision for continuous steady growth of world reserves, I can see no reason why provision could not be made for a general review of quotas more frequently than the 5-year intervals now provided for in the Articles of Agreement.

As a means of regulating the growth of reserves to meet the needs of a growing world economy, this simple proposal has much to recommend it. It would

---

[1] Several proposals have been made for reform of the international monetary system through the issuance of so-called composite reserve units (CRU's) which would constitute a new type of reserve asset. Under such plans, each country would deposit a specified amount of its currency with a managing agent (which might be a division of the IMF) and would receive in exchange an equal proportional claim, in the form of CRU's (covered by a gold value guarantee and bearing a low rate of interest) against the pool of currencies established by similar deposits on the part of all participating countries. Further quantities of CRU's would be issued from time to time to provide for desired growth of world reserves. How such a plan would work would, in general, depend upon (*a*) the basis on which CRU's were issued; and (*b*) the way in which they were used after issuance.

not, however, do anything to immobilize the existing overhang of official dollar claims. This problem might, however, be dealt with through the issuance by the United States of intermediate-term securities bearing a gold value guarantee. Such securities might be used to fund the existing overhang or a substantial part of it. The securities might contain a clause under which they would be redeemable at the Treasury if the holder country needed the proceeds to finance a balance-of-payments deficit. Interest could be paid at a rate sufficient to induce holders of a large portion of existing dollar balances to accept the securities. This rate would presumably be somewhat lower than the rate these holders would expect to earn on other investments during the life of the securities because of the protection against the risk of devaluation. Beyond the funding of the outstanding overhang of dollar balances, I can see no reason why the Treasury should not offer similar securities on a tap basis at interest rates adjusted to the current market as an investment for foreign official agencies which came into possession of dollars as a result of future U.S. deficits.

The unilateral issuance by the United States of a blanket gold guarantee that would be available to cover existing official dollar holdings—which is what this proposal amounts to—has never been regarded with favor by most U.S. officials. However, it is a very simple proposal which might serve to tie down the overhang of existing official dollar claims at a minimal cost to the U.S. Treasury. One objection that is sometimes raised against it is that if the United States should ever find it necessary to devalue the dollar, the compensation that would be required under the gold value guarantee would be excessively costly. In rebuttal of this argument, it should be recognized that dollar devaluation would be an incalculable shock to the entire international monetary system, and the institution of such a guarantee might substantially reduce the likelihood that it would ever be necessary. Moreover, even in the absence of a formal gold value guarantee, dollar devaluation without compensation to official holders would probably be regarded as a breach of faith on the part of the United States, particularly in relation to those countries, such as Canada and Japan, which have been holding a large proportion of their monetary reserves in the form of dollars rather than gold. Hence, if devaluation should become necessary, it might be judged appropriate to make some kind of restitution for losses to foreign official holders of dollar balances even in the absence of a preexisting formal guarantee. The other main argument against a unilateral blanket guarantee is that the offer of such a guarantee to official holders of dollars might be taken as a sign that the dollar was vulnerable and lead to a speculative run by private holders of dollar assets. This seems to me to be an exceedingly farfetched argument, although conceivably whether it had any foundation might depend upon the circumstances existing at the time the guarantee was offered. It might be best, for example, to unveil the guarantee plan at a time when the United States was experiencing no serious balance-of-payments difficulties. The gold value guarantee proposal seems to me to have sufficient merit to be worthy of serious consideration. Under the present system, the United States performs to a considerable extent the banking function for the international monetary system, and I can see no reason why in its banking role it should not provide the protection both to its own position and to the stability of the entire system that would be given by the issuance of obligations containing a gold value guarantee.

With respect to the appropriate level and rate of growth of world reserves, I would like to make two comments. First, in the present state of knowledge, I do not believe anyone can specify a rule that should govern reserve creation. The need for reserves in the future depends upon the magnitude, duration, and distribution of future balance-of-payments deficits, which depend in turn on the strength of the underlying forces producing such deficits and the speed of the adjustment mechanism in restoring equilibrium. These are matters that no one can predict. It is therefore necessary to adjust the supply of reserves to meet the requirements of the evolving situation on a more or less continuous basis. And under present arrangements, the speculative strains are so great that practically an unlimited supply of reserves must be available on a basis that speculators will regard as dependable in order to avoid the speculative ballooning of deficits and a runaway loss of such reserves as are available—note, for example, that despite the vast support already provided for sterling, a crisis still threatens.

Second, there is no close relationship between the quantity of international monetary reserves and the level of expenditures on goods and services. Almost none of the methods of creating additional reserves that have been proposed would involve the direct injection of reserves into the spending stream at the

time they were created.[2] So far as I can see, the creation of reserves would generate inflationary pressure only if some of the recipient countries desired to follow a more expansionary internal policy but had been held back by a shortage of reserves which would not permit them to cover the balance-of-payments deficits that would result from the expansion. Creation of the additional reserves under circumstances in which no country's internal expansion was being held back by a lack of such reserves could be expected to have no immediate effect at all on aggregate demand in any country. Some discussions of the international monetary system seem to imply that if reserves are created at too rapid a pace, the world will immediately experience a soaring inflation. The quantity theory of money is of extremely dubious validity even as applied internally within a single country; it certainly has no direct application to international monetary reserves. Nor can I see any validity, at least as applied to the industrial countries, to the view that sometimes seems to be held that there always are a number of countries who are eagerly desirous of following a wildly inflationary internal policy and are only restrained from doing so by a lack of monetary reserves to cover the massive balance-of-payments deficits that would accompany such an inflation. On the contrary, as a general rule—to which there may, of course, be exceptions—I believe there is a strong distaste for inflation based on its actual or presumed deleterious effects on the internal distribution of income and wealth and on the efficiency of the economy so that the opponents of inflation have quite sufficient influence on domestic policy in most countries and do not need the reinforcement that would be provided by a shortage of monetary reserves. Indeed, I believe the world is much more likely to suffer from a shortage than from an excess of reserves, and I therefore believe it is safer to err on the side of liberality in providing them.

B. Exchange-rate arrangements and the problem of private speculation

As I have indicated, the instability of the present system is only partly due to the threat that hangs over reserve currency countries (especially the United States) as a result of the possibility of a drain on reserves resulting from a conversion of official claims. There is also a serious problem of private speculation—the curbing of which constitutes objective (2b) in the list given at the beginning of this section of the paper.

It seems to me that the adjustable peg exchange rate system that was established under the IMF has proved to be extremely unsatisfactory and has been a source of many of our recent international monetary difficulties. Exchange rates have to be either fixed or flexible; since we are unwilling to consider flexible exchange rates, the creation of a stable international monetary environment requires a vigorous effort to create a de facto system of fixed exchange rates. This can be accomplished only in the course of time if countries carefully avoid making any adjustments in exchange rates, thus gradually establishing confidence in existing parities. In order to accomplish this, it will be necessary to provide liberal supplies of monetary reserves and to take steps to shore up the adjustment mechanism.

Without advocating flexible exchange rates, which have (quite properly in my opinion) been ruled out of the discussion in these hearings, I wish to express my support for the establishment of a somewhat wider range of flunctuation of exchange rates around fixed parities than has recently been permitted. I would favor some widening of the margins of 1 percent either side of parity now permitted under the IMF rules. But even if such a change is not made, I believe that full advantage should at least be taken of the present 2-percent margin of fluctuation that is permitted. It has been common practice in the last few years for countries to stabilize exchange rates within much narrower margins than this.[3] If exchange rates were permitted to fluctuate at least within the full range of 2 percent now permitted, there would be somewhat greater risk in speculating against a currency that is presently the case. Indeed, if full confidence could gradually be established in the fixity of existing parities, even modest fluctuations around these parities within fixed limits might be expected to generate a stabilizing type of speculation such as took place in earlier times under the gold

[2] Certain plans that create reserves by making development loans directly or indirectly to underdeveloped countries would constitute an exception: such countries would be likely to spend the proceeds of the loans on imports thus promptly injecting them into the world expenditure stream.

[3] See R. Z. Aliber, "The Management of the Dollar in International Finance," Princeton Studies in International Finance No. 13 (Princeton University Press, 1964).

standard. For example, if exchange parities are fixed and the exchange rate rests at the lower limit of its permissible margin of fluctuation, the only possible direction in which it can move is upward. Under these conditions, an expectation of appreciation of the exchange rate might be expected to attract some speculative inflow of capital.

C. Improving the techniques of adjustment

Under a regime of fixed exchange rates, the traditional "rules of the game" for maintaining or restoring balance-of-payments equilibrium call for the adoption of a deflationary domestic policy by deficit countries and an expansionary policy by surplus countries. However, such a prescription seems plainly unacceptable today. Nearly all countries attach overriding importance to the achievement of domestic price-employment goals, and any substantial departure from these goals is usually politically unacceptable and in some cases plainly socially undesirable as well.

The problem is to find an arrangement which will leave individual countries reasonably free to regulate domestic demand so as to achieve their desired price-employment goals while at the same time providing some means of maintaining a reasonably satisfactory balance-of-payments position. I believe a significant improvement in this respect might be achieved by a more flexible and coordinated use of the instruments of monetary and fiscal policy.

The idea would be to develop a policy arrangement under which the Western industrial countries would agree to rely primarily on flexible fiscal policy, implemented chiefly through tax adjustments, to regulate internal demand to achieve domestic goals. Monetary policy would then be assigned the task of maintaining balance-of-payments equilibrium by establishing interest rates at levels which would induce a sufficient inflow or outflow of private capital to cover the deficit or surplus on current account (including Government military and foreign aid transactions) that would occur at target levels of income and employment.

Machinery would need to be set up to provide careful international coordination of the monetary policies of participating countries. The objective would be to establish a matrix of interest rate differentials among countries which would be sufficient to achieve approximate overall equilibrium in the balance of payments of each country. Marginal adjustments would need to be made in interest rates from time to time to preserve equilibrium in the face of changes in underlying conditions. Strong efforts would be needed in order to avoid competitive increases in interest rates which would raise the general level of rates without contributing to the maintenance of payments equilibrium. It would be highly desirable that steps be taken to increase the freedom of capital movements—especially of long-term funds—in order to make capital flows adjust more sensitively to interest rate changes.

Under such a system, the mix of monetary and fiscal policies would be used to achieve internal and external equilibrium simultaneously. The following table shows the direction in which taxes and interest rates should be adjusted in various situations.

Internal demand	Balance-of-payments position	Appropriate policy action
Below target	Deficit	Raise interest rates and lower taxes.
Do	Surplus	Lower interest rates and/or lower taxes.
Above target	Deficit	Raise interest rates and/or raise taxes.
Do	Surplus	Lower interest rates and raise taxes.

For example, if a country was experiencing excessive unemployment (internal demand below target) and a balance-of-payments deficit at the same time, it would raise interest rates by central bank action to attract an inflow of capital. This rise in interest rates would by itself depress domestic demand still further below the optimal level. Taxes should therefore be reduced to a sufficient degree not only to offset the restrictive effect of higher interest rates but beyond that to increase demand toward the desired level. By a sequence of marginal adjustments of this kind, it should be possible to approximate the desired employment level with a reasonably viable overall balance-of-payments position.

Of course, changes in Government expenditures could be employed rather than tax changes, but tax policy seems potentially a much more flexible instrument for making such fine adjustments. However, the administration of tax policy would have to be improved to permit more rapid adjustments than are now possible, not only in the United States but in many of the European countries. This might be accomplished here by giving the President some authority to initiate adjustments in personal income tax rates in accordance with the proposal advanced by the Commission on Money and Credit in its 1961 report or that recommended by the Council of Economic Advisers in its January 1962 annual report. Or, alternatively, some provision might be worked out for accelerated congressional action on tax proposals following an agreed pattern when such proposals were submitted by the President. No doubt the political difficulties of obtaining greater flexibility in fiscal policy would be substantial in some countries. But this problem will almost certainly have to be tackled anyway, because monetary policy is already sufficiently hamstrung by the balance-of-payments problem to make it an ineffective instrument of domestic policy in many countries. More use will have to be made of fiscal policy to achieve domestic goals even if no effort is made to achieve such far-reaching international coordination of policies as that described above.

One of the objections to this proposal might be that the use of the monetary-fiscal mix as a means of dealing with the balance of payments precludes its use to regulate capital formation for economic growth. Indeed, a country which experienced a chronic balance-of-payments deficit on current account might find that the high interest rates needed to attract capital to cover the deficit would deter investment and productivity improvement thereby weakening its competitive position still further. To overcome this difficulty and enable the country to regulate capital formation and thereby influence growth in the face of the adjustments in interest rates that would be needed to maintain balance-of-payments equilibrium, a second fiscal instrument could be employed. The best possibility for this purpose would probably be an investment tax credit, along the lines of the 7-percent credit introduced in the United States in the Revenue Act of 1962. The rate of tax credit could be adjusted periodically as seemed desirable—as, for example, to offset the restrictive effect on investment of a rise in domestic interest rates called for by balance-of-payments considerations. It is in principle possible to have—within limits at least—any desired level of investment in combination with any desired level of interest rates through appropriate use of fiscal incentives to shift the investment demand schedule.

It should be understood that this proposal for using flexible adjustments in the mix of monetary and fiscal policies is incapable of providing a full and permanent solution to the problem of balance-of-payments adjustment. If a country were to follow persistently an internal policy which caused its price level to rise too rapidly so that its competitive position deteriorated steadily, it would be forced to attract increasingly large inflows of capital to cover expanding current account deficits. This could scarcely continue indefinitely—for one thing, it would lead in the course of time to steadily increasing interest payments on the accumulating indebtedness, which would enlarge still further the current account deficit. What the proposal might hope to accomplish, however, would be to provide time to carry out the necessary underlying adjustments in an orderly way while preserving a reasonably viable balance-of-payments position in the meantime.

III. CONCLUDING COMMENTS

I have tried to outline the shortcomings of the present international monetary system and to suggest some ways of dealing with them. The most important point I have tried to make is that a coordinated attack on all the problems is necessary if success is to be achieved in improving the system. It may be noted that a coordinated program is likely to have some desirable cross effects that were not properly taken into account in my exposition. For example, a successful attack on the problem of speculative instability can be expected to reduce the size of balance-of-payments deficits and make the task to be performed by the adjustment mechanism less arduous than it would otherwise be. And, at the same time, an improvement of the adjustment mechanism should reduce speculative pressures and make them easier to cope with.

I want to emphasize that there is no program of international monetary reform—at least that can be discussed within the ground rules established by this subcommittee—that can "solve" the problems of balance-of-payments ad-

justment. If we were to succeed in putting into effect a program along the lines suggested by me—or I daresay by any of the other witnesses appearing at these hearings—we would still be faced with the same kinds of hard choices and tough decisions we have had to make during the last 4 or 5 years. The problems might be mitigated slightly but their fundamental nature would not be altered. It would be a mistake to expect miracles from international monetary reform. In fact, as I have tried to suggest, we should be extremely careful in this matter, because some of the reform proposals might make our problems more difficult rather than easier.

Having adhered sedulously to the ground rules of these hearings up to this point, I want to make a closing comment concerning flexible exchange rates. What we are really faced with is a situation in which there are more policy goals than there are policy instruments available to achieve them. As is widely recognized by economists, this is a situation that always creates a dilemma. If we were willing to give up the goal of fixed exchange rates, it might be possible to find a real solution to the problem.[4] While I can understand the fact that this possibility was ruled out of the discussion in these hearings, I hope it will not be dismissed completely.

Representative REUSS. Mr. Wallich?

TESTIMONY OF HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. WALLICH. Mr. Chairman, when I learned that this committee was doing me the honor of asking for a statement, I was about to take a trip abroad. I made a point of stopping by in Frankfurt and London trying to inform myself preparatory to making this statement.

The proposed monetary conference has some advantages, but also some dangers.

One advantage is that we have recovered the initiative previously passed to others.

A further possible advantage, in fairness toward the rest of the world, is that we have taken the issue before a broader audience; namely, the whole world, and not just the Group of Ten. We have partly extricated ourselves from the embrace of the Group of Ten, and I think with good reason. We are now facing publication of the so-called Ossola report. While I have not seen it, and have received no statement in any detail from anybody who has seen it, I am sure that it contains some proposals, stated as alternatives, that would be quite difficult for the United States to live with.

There are costs involved also in calling a conference at this time. One is that the world has expected the United States first to show the solidity of our balance-of-payments recovery. Having moved so fast we are still under suspicion of trying to solve our payments problems by getting easy credit from the reform of the international monetary system. This has been our problem all along. Hence, we have been negotiating from weakness.

We must also realize that we face powerful creditors, and that we cannot have everything our own way. In fact, as the committee is, I am sure, well aware, the utterances of distinguished Members of the Congress are read very carefully abroad. A statement that we

[4] I have argued elsewhere that there are only two ways of achieving a fundamental solution: (1) to give up the goal of fixed exchange rates and adopt flexible rates, and (2) to give up the goal of national sovereignty over economic policy and adopt full economic integration as the individual States and regions have done in the United States. These solutions can be combined in a system of integrated regional blocks of countries with flexible exchange rates between blocs. See my paper, "Are There Enough Policy Tools?" American Economic Review. Papers and Proceedings, LX, May 1965, pp. 208–220.

ought not to balance our accounts, but ought to seek more credit, has repercussions in Europe. It produces just the opposite result, for the Europeans become more concerned about our intentions and less willing to enlarge the world's payment system.

Now, if I may, let me trace the history of the previous negotiation. As you know, for a long time both administrations before and after 1961 held that we should first correct our balance-of-payments, and then seek reform of the international monetary system. In 1963, our situation took a turn for the worse after the payments system had improved for a while. It was then decided to negotiate.

The fruits of these negotiations are before us now. We have achieved a 25-percent increase in the quotas of the IMF. This is something, certainly. However, it coincides with the quinquennial review of IMF quotas, and in a sense, therefore, is not much better than routine. It means the IMF quotas rose by 5 percent per year, nothing very dramatic. Last time they were raised by 50 percent.

Certainly we cleared away a great deal of the underbrush, first, in the Group of Ten, and then in the Ossola Committee. The two sides got to know each other's positions. The technicalities of reserve creation, I think, were explored to a point where now this is a relatively simple thing. Once it is decided who is to control and who is to get the new reserves, it is not very difficult to decide on the mechanism. Previously, we had been much bemused about how we could create reserves. I think we have made progress.

At the same time, these negotiations have revealed a profound difference of opinion. It is not secret. The difference is principally with France, but there are other continental countries which in a greater or lesser degree share the French views. At one extreme, the other side would like to disestablish the dollar as a reserve currency. The new reserve medium should not supplement but supplant the dollar.

This means that we would have to repay our outstanding official liabilities either in gold or by running a balance-of-payments surplus. We would be put under very severe balance-of-payments discipline in order to accomplish this.

How do we face up to this situation?

One way of facing up to it is to emphasize the strengthening of our balance of payments. Had we not moved so fast, then perhaps time would have made the point for us. Over a year or so I think the drying up of the principal source of liquidity, which is the dollar, would have made its point around the world. It has already begun to do so, but not to the extent where it really hurts.

We also would have made the point that we are really willing from now on to control our balance of payments better. If that point were made, or if we found some way of making it credible other than through our conduct, we would have gained a great deal. That is really the crucial problem, to make credible to the world that we are not going to have $3 or $4 billion deficits hereafter.

The improvement in our accounts and such commitments as we can make to prove that we will conduct a tighter balance-of-payments policy hereafter, may have achieved a change in the international climate. If so, the new climate might help break the deadlock that the negotiations seem to have revealed.

But if that were not so and if we had to negotiate now on the basis of exactly where the 1963 negotiations left off, I think agreement could be had only on terms very close to those of the French. These terms are very onerous to the United States. I would much rather see a postponement of the negotiations than have us move fast toward acceptance of those terms.

A further caveat is needed. We have called for a conference, and no doubt some sort of a general meeting is necessary in order to put the final stamp on a successful negotiation. But I think that a conference of the kind of Bretton Woods is quite out of the question. At Bretton Woods, major issues were open among the British and ourserves, to say nothing of the Russians. Many of the other countries, the countries that today are principally powerful, were either occupied or enemy countries at that time. But there was power at Bretton Woods to settle the differences. Today there would be no such power to settle differences.

Such a conference cannot be allowed to fail once it begins, because it would set forth doubts about the future of the weak currencies. We must be quite sure that it will be a success. If we go to a conference like that with issues unresolved, we give hostages to fortune. Particular countries can then, by blocking agreement, extract major concessions. Therefore, at this conference there must be no loose ends, no "t's" uncrossed and "i's" undotted. Everything has to be signed, sealed and delivered before the conference. Otherwise, we expose ourselves to tremendous risks.

It is therefore the prior negotiations which are also provided for in Secretary Fowler's proposal on which the real emphasis must lie. I think this is wise. These negotiations are not in the public eye. They can take their time. And I should not be surprised if they would be very time consuming. After all, we spent 2 years getting to the end of the Ossola report, exploring the basic issues. Would it take another year, would it take 2 years to arrive at an agreed conclusion?

This is a reason why it may be fortunate that the conference was called early—the preparatory work may take long.

There is one further aspect. We have been talking about reform proceeding in an environment of U.S. payments balance, and hopefully that will be the case. But we cannot preclude the possibility that the discussion will proceed in an environment of sterling difficulties.

If that happens, two things must be born in mind. First, the new mechanism, whatever it is, cannot and should not solve the difficulties of sterling. We have raised $3 billion to help sterling. If there should be another crisis perhaps we can raise more than that. But we cannot establish a financial mechanism in which countries in advance put on the line x billion dollars to be used for the benefit not just of the United Kingdom but for countries Y and Z in case they get into difficulties. To Europeans such procedure means handing over money that could be used to bail out our friends in Latin America, our friends in Asia, or anybody. The creditors would have no control over the use of the money. That kind of an arrangement definitely would have to be made without the European creditor countries. In other words, it cannot be made at all.

Whatever has to be done to help sterling, if that issue should arise, has to be done ad hoc, outside the new arrangements. That is true whether we complete the new arrangement before that eventuality, or whether the negotiations are underway when and if it occurs.

We ought always to remind ourselves that while the British can work out their problem, and I believe they ought to work out their problem, there is this possibility of a sterling move in the background. This is very freely discussed in London, there is no problem of delicacy about it any more.

Turning now to the benefits of the key currency system, may I summarize briefly.

Recently, the impression has gained ground that the role of banker to the world is a burden. But every textbook says in effect the opposite; that is, that the gold exchange standard reduces discipline, because we do not have to make a balance-of-payments adjustment when we run a deficit. We just pay out dollars. This is what we have done, unfortunately, to excess. One of the reasons why the French would like to deprive us of our role of banker to the world is precisely this great deficit without tears, as Mr. Mundell called it, the power it gives us to conduct free policies, and the inflation it imposes upon them. They adjust to their surplus by inflation, while we do not adjust very much to our deficit.

If it is accepted that in this respect the gold exchange standard is an advantage, there remains the question of vulnerability to gold withdrawals as a result of the present volume of official dollars. I share Mr. Smith's concern about these balances. This world of ours is even more dangerous than that, however, because there are private balances of about equal magnitude, which could all go into central banks. The central banks could then ask for gold. Funding the existing official balances would therefore not protect us against danger from private balances. And there are hundreds of billions of dollars of domestic liquidity, some percentage of which could go abroad, if people here get sufficiently scared about the dollar. These dollars might go into foreign central banks, and there they might give rise to gold withdrawals.

In other words, funding would protect us on one flank but two other flanks would be uncovered.

The real reason why we are vulnerable is that we are convertible. Every other country that is convertible is vulnerable in exactly the same way, short of suspending the convertibility at fixed rates. We must not hold that against the gold exchange standard.

Later in my statement I have tried to answer the committee's questions regarding adequacy of liquidity. Briefly, I conclude that we have enough and perhaps more than enough. The appearance of inadequate liquidity is deceptive. There are a great many countries that are in dire foreign exchange straits but that have no true demand for liquidity. That is the case with many of the developing countries. Demand for liquidity means to want ready international cash that the country does not spend except in emergency, and that it reconstitutes immediately thereafter. The developing countries are in such need of resources that any additional reserves given to them would quickly be used to ease a little the tight exchange con-

trols under which most of them operate. In that way, the reserves would be spent for imports, and they would not be reconstituted. In any meaningful sense, therefore, the developing countries for the most part have no unsatisfied demand for liquidity.

Looking at the European countries, they have excess liquidity, and they could get by with less reserves.

That leaves a small number of countries that are really trying to build up their reserves, the United Kingdom, Canada slightly, but not much, and Japan. There is also the United States, but we want balance, not a surplus, that is, we are not strongly trying to increase reserves. The demand for added liquidity around the world, if you just look at it country by country, is surprisingly small. But there is excess supply. Germany has $2 billion excess supply. The French have perhaps $1 or $2 billion. If you look at the Italians, the Spanish, Portuguese, there are excess reserves across the board.

Therefore, I would conclude that the pressure to increase liquidity is not nearly so immediate as it is made to appear from the general statement that now that the United States deficit may have ended, we are up against a squeeze.

Let me turn to the future role of the dollar on page 10 of my statement.

I agree very much with both my colleagues who spoke before me that the role of the dollar should be preserved. I am not quite as optimistic as Mr. Mundell that we can strengthen it. I think that probably in some respect the creation of reserves by U.S. payments deficits, has to be circumscribed. In other words, we cannot have another 7 years of deficits of $2 to $4 billion a year.

Not only must we limit the use we make of our powers under the gold exchange standard, but we must establish greater regularity in the creation of reserves. Here again, I am very much in agreement with Mr. Smith. We must also secure the system against instability, another point made by Mr. Smith.

These two jobs are before us, and I think they will have to form the core of the negotiations into which we are going.

Briefly, the reserve system that I envisage looks like this. We have three sources of reserves. Two are familiar, newly mined gold and U.S. payments deficits. I think after a decent interval we can again run a deficit of half a billion to a billion a year.

The third is a new reserve medium that will have to be created. We shall have to try to regulate our deficit sufficiently so that it swings roughly in this area of one-half to 1 billion, and only very rarely swings far outside. We do have the chance of occasionally getting relief from balance-of-payments pressure by letting it swing far outside.

Because of this remaining irregularly in the supplies of reserves, the slack, positive and negative, would have to be taken by the creation of a new reserve medium. Whether this is within the IMF or outside the IMF is an important question. I will come to it in one second.

First, however, how do we regulate our balance of payments so that we do not again produce frequent large deficits, and maybe occasional big surpluses?

I think that interest rate policy in indeed the proper means. As Mr. Smith has pointed out, the domestic consequences of it we have

to offset by increasing flexibility in fiscal policy. We have made some steps in that direction, not very far yet, but I think we are on our way.

I know that to mention high interest rates disturbs some people. Let me just remind you that if we do not get to a negotiated new system, if we were to operate under a system such as the French would like to impose on us, we will have much higher interest rates at times, and we will then be under very tight payments discipline. We will have to do like the British, not go to 7 percent necessarily, but accept drastic increases.

My proposal for flexibility in interest rates, plus a negotiated system where we can use the dollar to pay for small deficits, is really on the easy money side.

The other need, besides making credible to the world that we will have a regulated small deficit and thereby create a modest amount of dollar reserves, is to protect the system against instability. This is the point Mr. Smith has been dwelling on.

Now, here is what I think we might try to do. If we continue to have small deficits, we will be weakening the dollar relative to its reserve base. I do not see ourselves gaining gold. One way of strengthening the reserve base would be to keep accumulating reserves out of the new reserve medium. If we set up the new reserve medium through the IMF or through a CRU fund, and if we continue gaining assets in this form, then the relation of reserves to international liabilities could perhaps be stabilized. That would remove a large part of future instability.

Perhaps that would not be enough, and perhaps it could not be negotiated.

In that case, I would suggest that we seek an agreement, perhaps not even negotiated, perhaps a gentleman's agreement, to reduce the proportion of gold in central bank reserves. This is bound to happen anyway, because gold does not rise as fast as reserves are likely to rise. Either by way of CRU's or by way of dollars, or some other reserve medium, we will see other countries holding relatively less gold in their reserves.

So, hopefully, we can arrive at an understanding that countries will not pull gold as easily from us as they did in the past, but will reduce the proportion of gold in their reserves.

One way of reducing gold conversions would be the proposal of Mr. Blessing, of the German Bundesbank, or that of Mr. Posthuma of the Netherlands Bank, establishing fixed gold ratios, whether 60 percent or 50 percent or 70 percent.

Another proposal which appeals more to me is to insulate short-term capital movements, and to arrive at an agreement, if that were possible, implicit perhaps, that countries that gain reserves from short-term capital movements should not ask for gold. Short-term capital movements are a sort of foam on top of international financial relations. They really give no justification for gold movements that compel the losing country to contract its economy.

Statistically, it isn't easy to say which dollars that arrive at a central bank come as a result of short-term capital movements and which come as a result of a basic balance-of-payment surplus.

But it is not impossible to arrive at an approximation. Because I anticipate this to be an understanding rather than a firm agreement, it seems to me we could perhaps arrive at a point where reserves created by short-term capital movements would not influence gold flows.

In that case Mr. Smith's problem of speculative short-term movement would very largely be taken care of.

Finally, I think we should perhaps also envisage a broadening of our guarantees. Guarantees are bad not merely because one may have to make good on them, but because they put the guarantor in a straitjacket. If we guarantee all our international liabilities we will do everything in the world but devalue, and we may get into terrible contortions in our international relations in order not to have to make good on that guarantee. Maybe unlimited guarantees are not even credible. Mr. Allan Sproul has said that.

But limited agreements, such as are implicit in the Roosa bonds, I think are feasible. We should be more generous in the terms of these bonds. I wouldn't go so far as to fund all our official liabilities, but we should perhaps go further than we have.

Now, in closing, a word on the creation of reserves.

I said before that this is really a technical thing. We have explored it ad infinitum. Any plan can be drawn up at short notice once two things are clear: Who is to decide how much of these reserves are to be created, and who is to get them.

It is very obvious that our friends in Europe think of the Group of Ten, not of anybody else, as the controlling group. And those who will control very largely will be those who get, also.

I think this is not a happy attitude. I hope we do not have to yield to them on this in the negotiations. It is bad to have a rich man's club. Developing countries ought to have some access, subject to safeguards. Because the developing countries for the most part, as I see it, have no real demand for liquidity, they should be entitled not to outright liquidity, to owned reserves, but to conditional reserves. This can be done through the IMF, which gives a country credit provided it does certain things. That kind of liquidity is helpful for a developing country.

As far as the industrial countries are concerned, there are some that absolutely seem to insist on owned reserves. The Dutch, for instance, just don't want larger IMF quotas in place of added reserves, they want something in their strongbox.

So some owned reserves will have to be created.

Possibly additional dollars will do it. A plan that provides a threefold source of liquidity, gold, dollars, and a new medium, might use only dollars and gold as additional owned reserves. This is a possibility.

Now, as to the group that might form the nucleus for the creation of the new medium, I don't really believe it can be the whole IMF membership. We can increase quotas again, maybe sooner than in 5 years. But you saw what happened in the negotiation. Quotas were increased 25 percent, whereas the previous time they were increased 50 percent.

So while technically an increase in IMF quotas is quite adequate, it isn't likely to be negotiable.

If we don't want a CRU based on the Group of Ten, then why not a CRU based on some Group of Ten plus IMF countries that have adequate financial strength?

If we go down the list of IMF members and look at their reserves, look at the history of their exchange rates, stability, and look at whether they have tight exchange control or have a reasonably relaxed position, we can isolate perhaps 10 countries, 15 countries beyond the Group of Ten, some of them in Europe, and some of them in this hemisphere, that would join a group that could issue a new CRU.

With that, I think we would have a possibility for a new reserve medium, in perhaps a group of 20 or 25.

With this, I conclude. I would like to say that these negotiations are going to be very difficult. I don't think we can settle all the issues in the world. I wish we could settle the adjustment mechanism and all the rest, but I think, on the contrary, that if we drag those in we are lost. The less we try to settle, the more we narrow the area of agreement, the better the chance we have of getting a solution on our terms.

(The prepared statement referred to follows:)

PREPARED STATEMENT OF HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

The broad circumstances calling for a reform of the international monetary system are familiar. Continued heavy additions to world liquidity through an American payments deficit would weaken the dollar. Ending of the American deficit, on the other hand threatens to cut off the principal source of new liquidity and might lead to a shortage.

It is important not to overdramatize this apparently simple logic. In the first place, had the liquidity created by recent U.S. deficits not been excessive, the dilemma now facing us would not seem nearly so acute, the gold exchange standard not nearly so unviable. In the second place, the need for additional liquidity is not proportional to the growth of world trade. All that can be said is that over the long run liquidity ought to rise. And finally, there are sources of liquidity other than the U.S. deficit or new gold production. Increases in IMF quotas, currency swaps, foreign currency bonds, all are means that can and have been employed. For the long run more systematic arrangements will be needed. But we must not fall into the trap of thinking that we face an immediate urgent need and are totally unprepared to meet it.

In this presentation, I shall try to deal with the principal questions proposed by the committee staff relating to guideposts for international monetary reform. But since the Secretary of the Treasury has recently issued his dramatic call for a world monetary conference, I shall take the liberty of changing somewhat the order of questions and begin with the subject of timing and negotiating techniques.

Timing and negotiating techniques

Once before in recent years the United States has initiated a negotiation of this kind. In the summer of 1963, when the payments deficit had taken a turn for the worse, we reversed the policy followed up until then of seeking payments balance first and reform afterward. We decided to negotiate, even though we were in a weak position, and even though our creditors were bound to suspect that we were seeking principally an easy means of postponing the pains of adjustment.

These negotiations bore two fruits. One was a 25-percent increase in IMF quotas, which hopefully will be finalized this September. Since the action coincides with the regular quinquennial review of quotas, this result is little better than routine. The second result was a thorough review of all the problems surrounding the international monetary system that was helpful in clearing the decks for possible reform. But the discussions, which have just been concluded, also revealed a difference of opinion between the United States and particularly France. The French, very probably, would like to disestablish the

dollar as a reserve currency. The dollar would be displaced, not just supplemented, by a composite reserve unit (CRU) outside the IMF. Veto power over creation of CRU's would be placed in the hands of the creditor countries, who have been arguing for stiffer discipline to be applied to debtors, primarily to the United States. Such is the result of 2 years of negotiations, the principal feature of which was that we negotiated from weakness.

In the new round of negotiations, which must precede a world monetary conference, we shall hopefully be negotiating from strength. Our international payments may be in balance, perhaps even in surplus, although neither is a foregone conclusion. Moreover, by issuing the call for a conference, we have regained the initiative. The French, who originally seemed to turn down the idea of a conference, now appear to be taking a more constructive attitude. Furthermore, we have opened up for ourselves the possibility of bringing into this conference the world outside the Group of Ten. Given the near deadlock reached in the latter group, this possibility may be an advantage.

Nevertheless, our position is by no means all favorable. Equilibrium in our international accounts is of very recent date and has not really been tested. Originally it had been thought that some time ought to elapse between the achievement of balance and the move to reform. This equilibrium has been achieved, moreover, by means of exchange controls and the interest equalization tax, both of which are intended to be temporary. We are therefore not yet free from suspicion of seeking credit to evade our adjustment problems. There has not been much time, furthermore, for the drying up of the principal source of liquidity to become apparent and for pressure for more liquidity to develop.

It is quite uncertain, therefore, to what extent the ending of our deficit has altered the difference of opinion with the French and to some extent with the other continental countries. Even if the conviction may gradually grow on the other side that new sources of liquidity must be created, their ideas about the form in which this ought to be done may not have changed. That the EEC countries, and even the British, are strongly opposed to participation in any new discussions by the developing countries is a familiar fact. By calling for a conference the United States meanwhile has acquired a stake in its successful outcome. It may be that agreement and success can be had only by accepting terms very close to those of the French.

The thought suggests itself that if the French alone do not find any alternative solution attractive, the rest of the world might proceed without them in the hope that they may later join. This possibility would seem to depend principally, however, on whether the other five EEC countries could be persuaded to go along. Despite the problems that have arisen within the Common Market, there seems to be enough agreement within the EEC on international monetary issues to make this chance fairly remote.

The negotiations that must precede the Conference may be quite time consuming, and this may be another reason for starting them early. Certainly they must be pushed to a point where agreement is complete and success of the Conference guaranteed. A failure of a conference like this one would have very damaging consequences, including vast speculation against weak currencies. This would give tremendous bargaining power to any major country choosing to block agreement at the conference. Such an eventuality must be guarded against.

This means that a conference such as that at Bretton Woods is out of the question. At the start of Bretton Woods there were major unresolved issues, but there also was power to settle them. There is no such power this time. The preparatory work for Bretton Woods was lengthy and intensive nevertheless. It will have to be more so now.

The path of negotiation may, therefore, not be smooth in the best of cases. We must also envisage the possibility, however, that the negotiations will be influenced by possible events affecting sterling. There is reason to believe that the British can work out their problems. Nevertheless it is clear that the British economy has been responding to action so far less rapidly and vigorously than expected. A major change affecting sterling could significantly alter the terms of reference of the impending negotiations.

This is not the place to speculate what form that change might take, in the event that it should occur, or what the United States should do. One thing, however, is clear: the job of containing such a situation would have to be handled by the major countries directly and cannot be solved mainly in the context of whatever improvements in the world's monetary system may be underway. By the same token, failure to consummate such arrangements cannot be blamed for

a crisis, should it occur. The financially strong countries have in the past put up several billion dollars to help sterling and may do so again. But they will want to keep full control over funds of this magnitude. They are unlikely to entrust them to an international organization that conceivably might use them for other purposes. What happens to sterling will be the consequence, ultimately, of Britain's domestic and balance-of-payments policies. It will not depend on success or failure of world monetary reform.

Benefits and burdens of the key currency system

The gold exchange standard is customarily blamed, in the United States, for two defects: (1) it puts our domestic policies under too severe balance-of-payments discipline; and (2) it makes us vulnerable to foreign gold withdrawals even in the absence of a deficit. Both criticisms are misconceptions, the first totally, the second largely so.

An analysis of the American payments deficit and its financing during the last 7 years shows that for the reserve currency country, the gold exchange standard reduces rather than increases balance-of-payments discipline. Had we had to pay gold for the entire deficit instead of paying partly in dollars, we should have been under much greater pressure to balance our accounts. That the gold exchange standard relaxes discipline is the routine textbook commentary on the subject. The special advantages we have thus enjoyed are the principal reason why the French want to deprive the dollar of its key currency role, American public opinion, which believes the gold exchange standard to be a burden, will have a sad awakening if we ever have to operate under a monetary system reflecting the creditors' notions of proper discipline.

The second criticism of the gold exchange standard, which points to the possibility of withdrawals in gold of official balances is correct as far as it goes, but it does not go nearly far enough. If all official balances were withdrawn, or funded, private foreign balances would remain and could pass into official hands. Domestic American funds of far greater magnitude could leave the country and end up in foreign official hands. The potential for gold withdrawals far exceeds the official foreign balances that are the core of the gold exchange standard. We are vulnerable, because the dollar is convertible, and so is every other convertible country. The gold exchange standard enhances this vulnerability to the extent of the foreign official balances, but that is all.

During the last few years we have overused our ability to pay in dollars instead of in gold. For that reason, and because we have not yet proved that new supplies of dollars will be scarce hereafter, there is probably some kind of natural ceiling on the volume of dollars that the European countries are willing to hold. If we demonstrate better control of our balance of payments, and as foreign reserve needs grow, dollars presumably will become acceptable again.

The benefits of the gold exchange standard have in the main been those of greater flexibility in our balance of payments and greater freedom for our domestic policies. For a country like the United States, whose domestic economy is large relative to its balance of payments, such freedom is particularly valuable. The countries of Europe have suffered, in terms of prolonged inflation, the consequences of our freedom to run a large deficit. But this inflation has in part also been of their own making. The rest of the world, along with Europe, has benefited because the United States has been able to continue foreign aid and military expenditures on a scale that would not otherwise have been possible. Certainly the United States has not been a net borrower but, because long-term lending has exceeded short-term borrowing, has remained a net capital exporter, as it ought to be.

As contrasted with a potential world central bank, the gold exchange standard offers one great advantage: it is backed by the self-interest of a large country in keeping its currency sound. No international institution can be stronger than the willingness of its members to cooperate. In the present state of international cooperativeness, it is fairly clear where the greater strength lies.

Adequacy of liquidity

Tests of adequacy of liquidity are hard to devise. At the present time, some countries have less liquidity than they want, others have more, some feel that their liquidity is about right. Unless, however, the countries that are not satisfied with their present liquidity are taking positive action to correct the situation, assertions that they have too little or too much are meaningless—there is no effect in world markets.

Most developing countries, for instance, have low liquidity. But they are making no obvious efforts to increase it. If somehow they were given liquidity, they presumably would quickly use it up. A real demand for liquidity is one for liquid assets to hold, not to spend. They would have little demand for liquid assets if they had to hold them idle except during emergencies, and if they had to rebuild them once the emergency had passed. The developing countries, therefore, have no demand for added liquidity in a meaningful sense.

Some of the European countries have more liquidity than they need. In Germany, for instance, it is widely said that the country could get along with $5 billion of reserves instead of its present $7 billion. France, Italy, Spain, and others also are said to have "excess reserves" of this sort. Few if any of these countries are making deliberate efforts to get rid of their reserves, by domestic expansion, low interest rates, or stepped up foreign lending. It is their domestic situation, in good part, that prevents them from doing so. In this sense their "excess supply" of liquidity is also not very meaningful. If reserves should flow out as a result of events abroad, however, they could be expected not to resist the trend. In this only partially effective sense these countries can be said to have excess liquidity.

Some countries are actively seeking to increase their reserves. Among these are the United Kingdom and to some extent Japan. The United States is trying to balance its accounts, but is not aiming at a major surplus.

From this rough account, the most likely conclusion is that there is no excess demand for liquidity in the world today. Substantial demands on the part of individual countries could be satisfied without creating a general excess demand.

A slightly different way of looking at the same facts is to assess the relative strength of inflationary and deflationary pressures around the world today. Most of the developing countries suffer from inflationary pressures. So do most of the continental countries, although some with interruptions. The United Kingdom is in the same position, the United States and Canada are in reasonable balance, and Japan may be experiencing deflation. The widespread predominance of inflationary pressure does not point to any liquidity shortage of the kind that might threaten to bring on world deflation.

A balance of inflationary and deflationary forces, it is sometimes argued, means a "fair" distribution of the burden of balance-of-payments adjustment. This assumes that some "fair" trade off can be agreed upon between the degree of inflation suffered by the surplus countries and the unemployment suffered by the deficit countries. The two evils are incommensurate, and different judges will consider different doses of them as equivalent. In the last few years, it would seem that as between continental Europe and the United States, each side has suffered the evil it most dreads: inflation in Europe, unemployment in the United States.

Still another test of adequacy of liquidity depends upon the movement of world trade. The deflationary effects of a liquidity shortage are expected to make themselves felt through a shrinkage of world trade. Although liquidity does not serve to finance world trade, as is often incorrectly asserted, but principally to even out temporary trade imbalances, an all-round effort to increase liquidity by reducing imports would certainly shrink world trade. In fact, world trade rose 11 percent during 1964 and 8 percent during 1963. There is no evidence here of liquidity shortage.

A further test of liquidity, which, however, rests on dubious assumptions is to compare the rate of increase in world trade with the increase in official reserves. Official reserves are only a part of total liquidity, which also includes private foreign balances, less liquid foreign investments, and private and official credit facilities. The need for liquidity, moreover, is not measured by foreign trade, but by prospective imbalances therein, plus other international transactions. It is evident that the relation between trade and liquidity needs is slim, beyond the plausible assumption that in the long run both will rise.

Finally, one might undertake to measure adequacy of liquidity by the movement of world prices. This is almost certainly too severe a test. While there is no reason why prices in deficit countries should not fall, if wage gains are held below productivity increases, in practice this has happened in very few countries. The price stability test would almost certainly understate the need for liquidity.

The future role of the dollar

The role of the dollar in future should be, as it has been in the past, to form an important part of world liquidity. That should be the U.S. objective in the forthcoming negotiations. It will also be the result, in all probability, if those negotiations do not take place or lead to no major conclusion. But the negotiated role of the dollar should be somewhat different, and more circumscribed, than it has been in the past.

Since the gold exchange standard has been beneficial to the United States in the past and can be helpful, although on a more moderate scale, in the future, there is no reason for the United States to abandon it. For the Europeans the issue is not quite so simple. They have been hurt by U.S. misuse of the gold exchange standard and will need assurances against repetition. Both sides will require two important improvements in the system:

(1) The rate at which new liquidity is created must be better regulated; and

(2) The system must be better secured against instability.

To achieve better regulated creation of liquidity, a third source will have to be provided, in the form of a new reserve medium that could be increased flexibly. It will be argued below that the new medium should be based on the IMF, but that is not the essence. The new medium, new gold, and dollars combined would make up the sources of new liquidity in the future. Unevenness or inadequacies in the supply of new gold and dollars could be compensated by appropriate management of the new medium.

Some assurance would have to be given against repetition of the hemorrhage of dollars of the last 7 years. The United States, in other words, must make credible that it will control its balance of payments more effectively hereafter. The means of achieving better control are numerous, and have been rehearsed thoroughly in recent years. The means of making credible that adequate action will be taken are harder to come by. Reliance on exchange control, as at present, becomes more distasteful the longer it lasts. Willingness to use short-term interest rates is probably the most convincing demonstration. No special burden for the United States is involved in making a commitment to this end, for if the dollar should cease to be a reserve currency, we would in all probability operate under an even tighter balance-of-payments discipline.

Quite likely some time will have to pass before the world comes to believe that the recently achieved balance in our accounts will last. It is only after such a demonstration period that we can expect moderate increases in dollar holdings once again to be acceptable to European central banks. In other words, after a period of demonstrated stability, the United States could again run moderate deficits in its balance of payments without losing gold. I would estimate the tolerable average level of such deficits to be between $0.5 and $1 billion. Fluctuations would have to be close to this range, as a general rule.

Even small and gradual increases in dollar liabilities, however, will weaken the dollar in relation to its gold base. The latter, under the conditions described, would remain roughly constant. Means must be sought, therefore, to protect the United States against excessive gold withdrawals while giving foreign creditors assurance as regards the gold value of their balances.

Several possibilities suggest themselves.

1. Agreement could be sought by negotiation or implicitly, on a diminishing proportion of gold to be held in central bank reserves. In one form or another this is bound to happen anyway, since gold supplies are not rising fast enough to meet reserve needs. The difference will have to be made up somehow, by a new reserve medium still to be created, and additionally by dollars if they can be made acceptable.

2. Arrangements could be made additionally to reduce gold movements resulting from short-term capital movements. Dollar receipts from short-term capital inflows should not, in other words, lead to conversion into gold. This would leave somewhat greater freedom for these flows and consequently for differential national monetary policies, of which they tend to be a result. There will be statistical and definitional difficulties in implemeting this suggestion, which will mean that it may have to be formulated rather loosely.

3. The United States may consider broadening the guarantees it has so far given against devaluation of its official foreign liabilities. These have consisted of the so-called Roosa bonds which assure the creditor country of the value of the obligation in terms of its own currency. Proposals for far-reaching guarantees are undesirable because they might force the giver's policies into a strait-

jacket, because of their domestic political aspects, and because in the last analysis they may not even be credible. But obligations incurred in connection with the creation of a new reserve medium, inside or outside the IMF, would also have to be guaranteed. U.S. policies during the last 7 years have demonstrated that we are determined to maintain the foreign exchange value of the dollar. Subject to proper safeguards and in limited amounts, therefore, broader guarantees than hitherto may prove feasible.

4. The United States could rely on the new reserve medium to increase its monetary reserves. This increase in the reserve base might be sufficient to maintain or even improve the relation of reserve to liabilities, provided the rise in liabilities is kept sufficiently small.

What would be the alternatives if dollars are not accepted as part of rising world reserves? If the view prevails that the new reserve medium is to supplant rather than supplement the dollar, the United States would have to repay its official foreign liabilities over a period of time. We would have to pay gold, or run a balance-of-payments surplus. If private foreign dollar balances rise, the amount of official balances to be repaid would diminish; if they fall because establishment of the dollar leads to more general distrust of its future, the amount to be repaid would rise. Our share in the proceeds from the new reserve medium presumably could be compensated against the amount to be repaid.

If an alternative view prevails that existing dollar balances are to remain as reserves, perhaps funded in some form, but no increases are to be tolerated, there would be no repayment problem. But the international role of the dollar would nevertheless shrink as the proportion of dollars in rising reserves steadily diminishes. The role of the dollar would come to resemble that of greenbacks in the American currency system—a historical curiosity of little significance.

The distinction between these several alternatives will depend upon technical arrangements, upon the reserve practices of individual countries, and upon the ups and downs of payment balances. All these may have the effect of blurring the differences. Some countries do not now hold dollars and presumably would not under new arrangements. Some countries hold dollars very willingly and perhaps would continue to do so regardless of new arrangements. Flows of reserves between these two groups would affect the volume of dollar reserves outstanding. The technical complications deriving from these circumstances will increase the difficulty of reaching agreement with the major creditor countries.

Creation of reserves

The technique of reserve creation is a relatively unimportant matter once two basic issues have been decided: (1) who is to control the creation of reserves, and (2) who is to get them. Decisions on these two issues will also determine what the relation, if any, is to be between the IMF and any new reserve medium.

Among the considerations that should guide decisions are the following:

1. Some countries insist on the creation of "owned reserves." This rules out the possibility, otherwise plausible, of providing liquidity by a simple continuous increase in IMF quotas.

2. Many developing countries, as pointed out above, have no true demand for additional liquidity. Precisely because they are so hard pressed for real resources, they are likely to spend any increment in liquidity, putting undesirable pressure upon the resources of the surplus countries. The continental countries conclude from this that the developing countries ought to be given no access to newly created liquidity. A fairer solution would be to endow them with more conditional liquidity. This could take the form of larger IMF quotas, usable subject to the rules of the Fund.

3. The perpetuation of a "rich man's club" outside the IMF is undesirable for obvious reasons. At the same time, the continental countries will insist upon maintaining control over the resources they contribute, which they do not have within the IMF, or at a minimum will insist on sharing this control exclusively with countries of a certain financial maturity. These circumstances could be met by creating a special fund within the IMF that would hold contributions from countries considered eligible, would issue liabilities to serve as reserve medium, and would be governed by the contributing group rather than by the entire membership of the IMF.

4. Given the objections of the European countries, it seems undesirable to mix the provision of liquidity with that of long term capital. To compensate developing countries for their failure to benefit, the countries joining in the creation of new liquidity might undertake to increase their developmental financing in some form.

5. In the very long run, one may expect the IMF to gain in stature and perhaps eventually to advance to the point where it can perform the functions of an international central bank. This long run consideration adds strength to proposals that seek to place the mechanics of reserve creation with the IMF.

The complexity of the issues as well as the lack of basic agreement suggest what the stance of the United States should be in the forthcoming negotiations. We should seek to narrow as much as possible the area of negotiation. Agreement will be difficult, implementation perhaps even more so. The less needs to be settled, the better we are likely to come off. If our payments are in balance, natural forces will be working for the dollar under any system. We can afford to accept a partial settlement and to postpone some issues so long as time is working for us.

Representative REUSS. Thank you, Mr. Wallich.

I am going to ask Senator Proxmire to preside and initiate the questions while I make a quorum call.

Senator PROXMIRE (presiding). Mr. Smith, in the course of your remarks you said that you would oppose any policies or any agreement in the conference which would tend to put more pressure on deficit countries to correct with more discipline. And you said all the present bias is deflationary. I am very sympathetic with that view. I think after all if we are going to have an opportunity for developing countries to expand, and if we are going to have a chance for those countries that are industrially developed to grow as we would like them to grow, we certainly should do all we can to encourage growth in every possible way. At the same time the facts just superficially seem to contradict your position in view of the general inflation throughout the world; the very great inflation in many developing countries; the moderate inflation elsewhere, and the very, very limited inflation, if any, in this country.

But that seems to be the rule rather than the exception.

Mr. SMITH. In the first place, I wasn't really, in anything I said, intending to make much reference to the undeveloped part of the world. I was talking about the industrial countries.

I think, as I said, that there are a number of ratchets in the machinery that determines prices in the industrial countries that tend to make prices drift up gradually over time, that we have to face this, and that price stability is not really a viable goal for individual countries for the most part, or for the world economy.

I think that countries have had inflation not because they were forced to have it because of something which happened to the balance of payments, but because they were willing to accept it as the price for achieving the employment levels that they wanted to arrive at. If they didn't want it, they didn't have to accept it.

I think that when you have a balance-of-payments deficit in any system with fixed exchange rates and a limited quantity of reserves, the system tends to put more pressure on deficit countries to contract than it puts on surplus countries to expand. Moreover, the concept of discipline is always applied to the deficit countries. You never hear people talking about applying more discipline to surplus countries.

Now, the world, as I see it, is one in which every country doesn't really have the option of achieving full employment without inflation;

what it has is the option of achieving various combinations of employment levels combined with various associated rates of change in the price level. And in a world like that I don't see any reason why, when a country has a deficit, that country should be forced to accept a reduction in its level of employment and an associated decline in the rate of increase of its prices any more than a surplus country should be expected to accept some movement in the other direction.

Senator PROXMIRE. That is a very refreshing idea. I like it very much. But I am wondering how we can exert this discipline, how we can achieve the adjustment that has to be made by the country suffering the balance-of-payments deficit. All the political pressure is the other way: to reduce taxes and increase expenditures from a fiscal standpoint, and in monetary policy to reduce interest rates. These are the policies that are usually welcomed and happy and easy and popular.

Mr. SMITH. I don't want to leave the impression that I am an unmitigated inflationist, that I want prices to go up 10 percent a year. But I think you have to face reality. And what I have tried to suggest is something which might be done in the way of increasing the flexibility of monetary and fiscal policy in order to give countries freedom, within limits, to seek the goals that they would like to have internally in terms of price-employment combinations and at the same time make some stab at adjusting the balance of payments.

Senator PROXMIRE. I think that is a very helpful understanding that you are giving us, because it is something that has been badly overlooked. And I think that the notion of mutuality is essential, that this is a dual responsibility, not only responsibility on the part of the deficit country to do what it can to adjust, if it is consistent technically with its domestic policies, but, also, responsibility on the part of the surplus country to correct. Just this understanding will exert, it seems to me, some good moral force if nothing else, and in the long run that can be effective.

I am very interested by your table (p. 68) in which you set forth the conditions that would suggest various kinds of policy action—fiscal policy and monetary policy. It is interesting to me that you only have one case out of four in which it is not wise to lower taxes. This should be very appealing to Members of the Congress, and to the taxpayers. We have a situation in your table in which only if you have excessive demand and a surplus in your balance of payments do you raise taxes. In all other cases you lower taxes.

Mr. SMITH. Your copy must be different from mine.

Senator PROXMIRE. I have got a table here that says——

Mr. SMITH. Clearly you would lower taxes only in case where internal demand was below target.

Senator PROXMIRE. You have got "lower taxes" under Nos. 1, 2, 3, and you "raise taxes" under No. 4.

Mr. SMITH. There is a mistake in yours, because it should be "raise taxes" in No. 3. In No. 3, internal demand is above target, it is too high, and, to achieve an adjustment of internal demand, you would either have to tighten money or raise taxes.

Senator PROXMIRE. There is an interesting typographical error, because it says "raise interest or lower taxes."

At any rate, if the internal demand is excessive, even though the balance-of-payments position is in deficit, you would follow a policy of raising taxes?

Mr. SMITH. Or tightening credit.

Senator PROXMIRE. That has got more symmetry, at least.

Let me ask both of you and Dr. Wallich, you came down very hard, I thought, on the side of relying on monetary policy to compensate for expansionary fiscal policy when you have an adverse balance of payments. And I am just wondering once again if you have any documentation to show that this can do much. Both of you were against really high interest rates—Dr. Wallich was very explicit about it. We want to know what we have to do in the conference, if we would have to bow to the French position and get really high interest rates.

I am wondering if a moderate increase in interest rates, moderate enough not to have a deflationary effect on our domestic economy, would have any significant real effect in attracting capital here.

Mr. WALLICH. Senator, you know that this is an older dispute. This committee has had an expert who found that the impact would be small, the Treasury had an expert who found that there would be a substantial impact.

I am reminded of the period before the accord between the Federal Reserve and the Treasury. At that time, too, it used to be said that interest rates are insignificant for domestic purposes, so let's peg them and have the advantages of a fixed interest rate.

Gradually we learned that this wasn't so. We backed away from that position. I have the impression that it is repeating itself in the international sphere.

Meanwhile, the European countries which use interest rates, the successful ones, Germany, France, Italy, used interest rates long before 1951 domestically. Now they are using interest rates, principally internationally, for balance-of-payments control. I expect that we will be following their lead as we followed it domestically.

Senator PROXMIRE. We have this problem. We increase our interest rates. Other countries respond by increasing their interest rates, and we have to increase our interest rates again. As we increase our interest rates to overcome this deficit we have in our international payments, we reduce effective domestic demand. To provide adequate demand for employment we have to overcompensate; we have to compensate by a still more expansive fiscal policy, by spending more and taxing less. And it seems to me that you work your way into a position where, as long as we have this very heavy and important responsibility as the banker for the world, and as long as we have such an impact on the economies of the other countries, we are going to have, No. 1, quite high interest rates, and, No. 2, quite a loose fiscal policy which might have unfortunate effects in the long run.

Now, I can see that at the present time, perhaps, you can argue that the national debt is not really very serious. But servicing it is the second biggest cost of our Government. And if you follow this policy logically, and follow it for a number of years, it seems to me it could work us into some quite serious difficulties.

Mr. WALLICH. The Europeans are not following Mr. Smith's table of instructions. They ought to raise taxes and lower their interest rates, given that they have inflation and a payments surplus. Instead

they meet their inflation by raising interest rates. Now, for what do we have the OECD in which these things supposedly are negotiated and agreed?

I ought to say that Mr. Mundell is the great expert on this mix of policies, and probably could tell us more.

Mr. SMITH. I would like to say something on this.

In the first place, if you follow this line you have to accept the fact that you may have to use interest-rate policies with sufficient vigor so that they in themselves, unless offset, will have some unfavorable effects on the domestic economy. I might just make as a side comment, however, that I think the pendulum has swung perhaps a little too far in the sense that people exaggerate the impact that minor changes in the interest rate have on the domestic economy. I don't think they have as much effect as some people do.

I think they have some effects. But remember, you have to have an agreement so that you don't have this ratcheting of interest rates on the part of everybody. The other people have to follow the rules, too. When they are in a situation that calls for it, they are supposed to lower their interest rates. You have to coordinate policies so that you don't have one fellow raising his interest rate and the next fellow trying to catch up with him, and so on. If you do have coordination, I think the thing would be workable, but it would require that you place more emphasis on fiscal policy for internal stability.

I might add, as I have pointed out in my statement, that since under some circumstances a country might find that with a continuing deficit it had to have high-interest rates for some appreciable period of time, it would be necessary to be flexible about the use of tax incentives for investment. If a country has a balance-of-payments deficit, you don't want it at the same time to suffer from inadequate investment and growth, because that means its productivity is not increasing at a rapid pace, making it even more difficult for that country to get out of the balance-of-payments deficit position. So you have to be flexible in the sense of offsetting higher interest rates not only in terms of the effect on aggregate demand, but through fiscal incentives to stimulate investment.

I am not talking about changing fiscal incentives to stimulate investment very frequently, but if a country has a balance-of-payments deficit for some period of time and has to have high-interest rates for several years, it would make sense for that country to make an adjustment, let's say, along the lines of our tax credit to stimulate investment in order to achieve the necessary level of investment, even at the higher interest rates.

Senator PROXMIRE. My time is up, Mr. Chairman.

But it seems to me that we always have these circumstances, and we have had them for a long time, which persuade some great economists to call for lower taxes and higher interest rates.

I would like to ask one technical question with the sufference of the Chairman, because I think it is important to get it clear.

Mr. Wallich, you said that you would think that once we got our balance of payments into equilibrium that it might be appropriate to have a half a billion to a billion dollars a year deficit. Are you talking about the liquidity definition, the present definition, or are you talking about the Bernstein official settlements definition?

Mr. WALLICH. By leaving a half a billion margin, I tried to straddle that issue.

Senator PROXMIRE. I was afraid of that.

Mr. WALLICH. Senator, I think that there are a great many things to be said for the Commerce definition. But if we want to use the dollar as a reserve currency hereafter, then it makes a lot of sense to make the deficit look as small as we decently can. So I lean toward the Bernstein definition. I would, therefore, lean also toward the lower end of my $½ to $1 billion range, if we use the Bernstein definition.

Senator PROXMIRE. Thank you very much.

Thank you, Mr. Chairman.

Representative REUSS (presiding). Mr. Ellsworth?

Representative ELLSWORTH. Thank you, Mr. Chairman.

Mr. Smith, your very interesting, and, I think, important suggestion about using a mix of monetary and fiscal policies to strengthen the adjustment mechanism—do you think that is something which ought to be included on the agenda of any preparatory negotiations, or the agenda of any conference along the lines of the one Secretary Fowler has said that he is able and available to attend?

Mr. SMITH. That is a hard question to answer. I doubt if the technical details of the thing would be capable of being handled this way. All you can hope to do is perhaps to lay down some kind of ground rules. There have been, I believe, some discussions already on ways in which codes of behavior might be established. I think that perhaps negotiations might involve some discussion of the coordination of policies beyond what is established already, but I doubt if the details of anything like this could be negotiated. It would have to be a flexible arrangement that would involve continual discussions among the countries involved, because the requirements of such a policy may alter from day to day. And, by the way, no rules can be laid down that the money supply has to increase by X percent when you have a surplus; or decrease by Y percent when you have a deficit. It has to be very flexible.

Representative ELLSWORTH. You made the point in your testimony that taking care of any one or two of the problems that you mentioned; that is, systematizing the increasing of reserves, taking care of the official overhang, private speculation, and strengthening the adjustment mechanism, you made the point that we ought to make an effort to make some progress in all of these areas.

Mr. SMITH. I believe we should. And I believe the question of the adjustment mechanism should be considered in connection with the negotiations, and that some effort ought to be made to cope with it and possibly some general notion as to the approach to it might be worth discussing.

Representative ELLSWORTH. Professor Mundell, do you have any comments you want to make on that, since Professor Wallich said you were an expert in this field?

Mr. MUNDELL. Thank you.

Some time ago when I developed a similar scheme [1] I was quite enthusiastic about it. But I applied this later on empirically,[2] to the

[1] "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability," IMF Staff Papers (March 1962).

[2] "On Selecting a Program of Economic Policy With an Application to the United States," Banca Nazionale del Lavoro Quarterly Review (September 1962).

U.S. economy, and I was struck by how aggressive monetary policy would have to be and how large a change in fiscal policy would be needed to get even a little bit of improvement. You needed such a big change in interest rates and such a big change in fiscal policy that I thought complete reliance on the scheme would prove to be unacceptable.

There is another feature of the adjustment mechanism that doesn't receive the prominence it deserves in the scheme. In the Atlantic Community, since 1958, we have had a "classical" situation. The United States has had a deficit and excess unemployment, and Europe has had a surplus and inflationary pressure. Europe has been inflating at a rate on the average of 4 or 5 percent a year.

In this connection I cannot agree with Mr. Smith that there has been too much of a deflationary bias in the world. If you take the two serious deficit countries in the past 2 or 3 years—Britain and Italy—you find that even these countries have had inflation rates of the order of 6 percent. That doesn't seem to imply anything like the kind of discipline that would be required. After all, you could not gear the world economy to keep up with the inflation rates of Britain and Italy.

Now, with respect to the monetary and fiscal mix, the problem is that when a surplus country is inflating, as Europe has been, interest rates automatically rise, especially when this is connected with a rapid rate of growth and a high return to capital. There is inevitably an inflation premium that is put on the return to all bonds, even if it takes time for a community to adjust to. This in itself leads to a capital flow toward Europe because an American investor in a European bond doesn't care about the real rate of interest in Europe, which may be, let us say, only 3 or 4 percent. He cares only about the money rate of interest as long as he feels sure the exchange rate is not going to change.

So there is an automatic shift of capital to Europe when Europe inflates to correct a balance-of-payments surplus. It is quite impossible for Europe to get interest rates down very much. I spent the last 3 months in Switzerland where the authorities have been trying continually to keep interest rates down. Yet the force of a high level of activity on the capital market combined with the inflation premium on bonds means that they probably can't prevent these rates from rising.

That is one main reason why interest rates are much higher in Europe generally than they are here. But it creates an important source of instability in the system, because once there is a change in the expectation, once there is a change in the view that a major source of the inflation, the European balance-of-payments surplus, will continue, then there will be, not just a leveling off of interest rates, but a big drop in interest rates. That causes a shift out of security markets. The reversal of expectations has already played a part, I think, in depressing the stock markets throughout Europe in the past few months.

Representative ELLSWORTH. Professor Wallich, in your prepared statement you said:

The French, who originally seemed to turn down the idea of a conference, now appear to be taking a more constructive attitude.

What do you mean?

Mr. WALLICH. As you recall, Congressman Ellsworth, originally Mr. Giscard d'Estaing said that this didn't seem to be the time for a conference because certain preconditions would have to be met. Recently there have been press notices to the effect that this may have been a short-term rejection, but that it is really a long-term acceptance. This is the basis of my observation. It doesn't necessarily imply that we are going to meet less resistance from France. But by turning down a conference the French would have put us in the position of the country that has tried to help the world, while they had prevented it. By going in to the negotiation they can confront us with their very powerful demands, and since we have nailed our flag to the mast of this negotiation, how are we going to make the negotiation a success except on something approximating their terms?

Representative ELLSWORTH. Professor Wallich, I fully agree with you when you say that every effort has to be made to insure the success of any conference before a conference is ever convened. And I am glad you emphasized that as much as you did in your statement.

Let me just ask two or three questions about the conference and the time between now and whenever the conference may be called.

Now, supposing that a preparatory commission is formed this September as Secretary Fowler suggested, what do you see as the functions of that commission, and what do you see as the membership of that commission?

Mr. WALLICH. I think that is the question that treasuries and the central banks the world over are wracking their brains over right now.

Representative ELLSWORTH. Here is an opportunity for you to supply them with the answers.

Mr. WALLICH. How is this new negotiation going to differ from what the Group of Ten did and what the Ossola group did after them?

I think it will differ in that the economic situation has changed somewhat. The United States is in balance, although perhaps dubiously and precariously so. If we can hold this balance, which remains very much to be seen, then as these negotiations proceed, the growing pressure on liquidity and the growing demonstration of our strength will change the basis of negotiation.

As for what the terms should be, I think we ought to make them as narrow as possible. The displacement of the dollar—I hope we can evade this issue by the mere technical difficulty of the thing. To displace the dollar is a very drastic demand. One can perhaps get the support of other countries in throwing that back. To put a fixed ceiling on the use of dollars might be the next worst thing. This would perhaps happen if we funded the outstanding official dollar balances. It is quite hard to limit official holdings of dollars to a particular amount if some countries, as Mr. Mundell said, find a national interest in holding part of their reserves in dollars. By simply not responding to a demand for either displacing or limiting dollars, and by saying that it is technically very difficult, we can perhaps back away from that proposal.

That leaves us with the method of producing an increase in liquidity. This, I think, ought to be within the IMF, not outside the IMF. I don't think it can be a simple increase in quotas, nor can it be, I think, a simple increase in automaticity of drawing rights.

These techniques would apply to all members. The developing countries, I think, would quickly use up the new reserves. By doing so they would inflate the European countries some more, which they dislike, and we would be back where we started.

I would like to see more conditional liquidity for most of the developing countries, and a CRU type thing for a special group larger than the Group of Ten. Without naming countries now, one can list perhaps 20 or 25 countries that have the financial strength to enter that group.

Representative ELLSWORTH. Thank you very much.

Thank you, Mr. Chairman.

Representative REUSS. Yesterday Professor Chandler made a strong distinction between owned and borrowed reserves. I am going to quote from what he said:

> Nations may feel under deflationary pressure if they can maintain their needed liquidity only by large and continuous borrowing from the IMF or foreign central banks. There can be no assurance that the total supply of liquidity for the world as a whole will behave acceptably if it must depend substantially on the willingness of individual countries, each looking to its own needs and interests to borrow and remain in debt.

Today Mr. Smith said that he saw no essential difference between creating new owned reserves and enlarging automatic drawing rights at the Fund, as I believe he phrased it, in terms of increasing the 25 percent gold tranche.

The choice between these two ways of creating reserves is a crucial one, and I would like to hear the views of all of our witnesses as to whether there are any criteria to choose between owned and borrowed reserves and related to that is the question of whether an increase in automatic drawing right suggested by Mr. Smith, and which has had some kind of impetus now from Mr. Wallich, is a sufficient method of increasing world reserves.

Mr. WALLICH. May I comment?

Automatic drawing rights have the limitation that the Fund must have the currency that is wanted. The drawing right is automatic provided the Fund can respond.

Under the General Borrowing Agreements the Fund probably has the resources, but we can't be sure. If every country exercises its automatic drawing rights against France, for instance, we can be pretty sure that the French tranche can run out.

What could be done to make the automatic drawing rights almost identical with owned reserves would be, first, to make them transferable. In that case they would simply be a deposit of the IMF which circulates like legal tender or like a CRU. And in that case the difference for owned reserves and credit rights, credit reserves, becomes almost nil, because even a CRU must, after all, be a financial instrument that is the liability of some agency, a fund into which individual currencies have been put. It isn't just going to be a piece of paper that circulates by hand.

Representative REUSS. If I may interrupt at that point, the paperization of an automatic drawing right would in some degree at least reassure your Dutch friends who seem to have a predeliction for pieces of paper in the cigarbox.

Mr. WALLICH. That is it. A piece of paper that is an exact extension of gold. And I would think, unless I have overlooked something,

that an automatic drawing right that is completely transferable among all members, and which all members are willing moreover to accept, is exactly like a piece of paper in a cigarbox.

Representative REUSS. I am exploring this, of course, because if there aren't any great bugs in it, it is an extraordinarily easy and graceful way of acquiring a new reserve unit.

Have you expressed yourself fully on that?

Mr. WALLICH. It is a very major step, Mr. Chairman, to make this automatic drawing right transferable, because the way the Fund operates now, as you know, is by giving the drawer a particular currency. A transferable drawing might really be like a note.

Representative REUSS. And it would be by definition, if it is acceptable at all, it would be desirable currency and thus replace the desire of some one user of it for the French francs which in your model are not available because there just aren't enough? Does it meet that point?

Mr. WALLICH. I don't know. It would be a good substitute for any currency that is needed, because the drawer can use it immediately.

Representative REUSS. Couldn't he buy French francs from France with it?

Mr. WALLICH. Yes. By definition the drawing might be acceptable to the French and the French must be willing to take it into their reserves, otherwise the whole thing will not work. It must be automatically transferable by the borrower, say, Argentina, to France, the creditor. But the long-term acceptability of this instrument runs into the problem whether the Fund is stronger than the United States. While in the short run claims on the Fund guaranteed against devaluation, if proper interest is paid, may be very attractive, in the long run the Fund is no stronger than the assets it has and the cooperation that its members will give it. I would be inclined to bet at the present time that in over 20 years the dollar may be a better asset than a claim on the Fund.

Representative REUSS. But you do not exclude the possibility that two kinds of international money, the dollar and this new papered automatic drawing right, could both be legal tender for central bank international transactions?

Mr. WALLICH. I think so. Now we have the dollar and gold. It is to some extent embarrassing for the United States if anybody holds gold, which gets no interest, because the interest is the measure of doubt in the dollar. There will also be doubt in the Fund liability. The interest differential between the dollar and the Fund liability will be the measure of the difference in quality between the two.

Representative REUSS. Let me review with you which of the objections you have met.

One, the Pickwickian and Dutch objection that they want a piece of paper, you have met that, you give them a piece of paper.

Two, the desire of countries for scarce currencies, deutschemarks, francs, whatever isn't in there in sufficient amount, you have with qualifications, it sems to me, met by saying that this new piece of paper with a gold guarantee would be hopefully acceptable.

What do you have to say to a third objection which it seems to me is still floating around? After all, automatic drawing rights are still debt, and they have to be repaid. Getting back to Professor Chandler's point, doesn't this rob them, to a degree, of money status?

Mr. WALLICH. I don't think automatic drawing rights would have to be repaid if the holding country's position in the Fund is a debtor position. If a country, say France, had received from Argentina an automatic drawing right, it goes into surplus in the Fund. The United States was in surplus in the Fund for a long time.

What does Argentina have to do with this situation? If Argentina goes into debit in the Fund, if it hadn't previously accumulated automatic drawing rights, then it may be that Argentina has to repay. This depends partly on how the automatic drawing rights are constituted. If they are constituted within the credit quotas of the Fund, and only given out by drawing against credit quotas, then they have to be repaid, insofar as the Fund rules require repayment, which is somewhat flexible. If some system is created where everybody can use his automatic drawing right freely because he is endowed by the Fund with such a right, outside the credit quota, then that is not the case.

I realize the weight of this distinction.

Representative REUSS. Mr. Wallich has just made a very cogent defense of your proposal, Mr. Smith, against some objections which occur to one. Do you have anything to add to that?

Mr. SMITH. I have several things to say.

First of all, I am not adamantly against a CRU plan except that I would want to be sure that it was set up in such a way that the new CRU's were primarily a supplement to dollar balances rather than a substitute for them. I wouldn't want to see a plan set up in such a way that the dollar as a reserve currency would be destroyed. I am a little worried about that, because what would happen depends on the details of the way in which it was set up.

I do think that even without making automatic drawing rights transferable, the problem of the Fund having resources to meet the drawing rights is capable of being exaggerated. I would think that, if you increased the drawing rights through the first credit tranche, the other thing I would want to do would be to systematize the process of increasing quotas and increase them more frequently. It seems to me that when the quotas were increased the problems of adequacy of the supply of various currencies could be adjusted to the situation in some degree. The reason I like the proposal is that it is simple. You don't have to negotiate a great deal to accomplish it.

Now, with respect to the use of credit as against owned reserves, I don't see any really great difference except that you may have customs and habits that make people hesitate to use credit. This, for example, has been true in the American banking system. The banks don't like to borrow from the central bank. But in the international monetary field with the IMF, we don't have a tradition that goes back for 100 years. The IMF has been in existence only a relatively short period of time, and it should be possible to get countries to accept the idea of using their automatic drawing rights at the Fund as a regular thing as a means of dealing with a portion of their deficits. With respect to repayment, it is my understanding that while technically you have to repay drawings within 3 to 5 years that are made under the present gold tranche, you can in fact simply renew the drawings at the end of that period so that in fact they don't have to be repaid. And I would propose to extend that principle to, say, the first credit tranche, or whatever you did to extend automatic drawing rights.

Representative REUSS. Mr. Mundell?

Mr. MUNDELL. Let me say first that I strongly support the idea that if any new reserve unit is created it should be done through the IMF. There are two distinctions that have to be drawn between IMF drawing rights and a country's owned reserves. One is that access to Fund resources is "conditional," whereas the use of one's owned reserves is, of course, unconditional; the other is the distinction between owned reserves and borrowed reserves.

If a country gets into debt in the Fund, that is, if its currency is bought by the Fund, the country eventually has to buy it back; there are repurchase provisions for this. Interest rates rise on any indebtedness of a country to the Fund in proportion to the time the country is indebted to the Fund.

Now, if, say, the United States makes a large drawing beyond its gold tranche, the U.S. authorities would probably feel that the indebtedness to the Fund has to be repaid. The United States doesn't count its drawing rights as part of its reserves. It doesn't think of these drawing rights really as part of its reserves. They look upon drawings from the Fund as borrowings of last resort.

The key distinction, I think, between the facilities provided by the Fund and those provided by a bank is that all countries in the Fund cannot draw—borrow—at the same time. Only half of its resources at the maximum can be drawn at the same time, because a country, using the Fund resources, has to show that it needs these for current payments. Only if a country has a deficit can it draw currencies needed for current payments.

Representative REUSS. Excuse me. Does that apply to the gold tranche?

Mr. MUNDELL. The overwhelming benefit of the doubt is given to a country when it draws in the gold tranche; every country is supposed to have the overwhelming benefit of the doubt. In the credit tranche, though, it is another matter. The gold tranche is close to unconditional liquidity; the credit tranches constitute conditional liquidity.

The key thing that the Fund cannot do that a world central bank could do, is to permit all countries simultaneously to draw. The best analogy to the Fund is the swap system. Suppose the British and the United States engage in a swap of $1 billion, and they each get a claim on each other's assets which they can use if they need to. If you did that through the Fund, the United States would draw a billion dollars worth of British pounds from the Fund, and simultaneously the British would draw a billion dollars worth of U.S. dollars. The U.S. currency would go up in the Fund when they draw pounds, while British currency would go down; and the British currency would go up when they draw the U.S. dollars while U.S. currency would go down. Fund currency holdings would then be unchanged but gross reserves of the United States and United Kingdom would have risen. In effect the mutual drawing is a swap agreement.

But you can't work a system like that between a deficit and a surplus country in the Fund at the present time because only the deficit countries are supposed to draw. If you got a system under which all countries simultaneously could draw a certain amount every year from the

52-324—65—pt. 1——7

Fund, quite apart from their balance-of-payments position, then you would have in fact a multilateral gold-guaranteed swap arrangement.

In that case countries may begin to treat their access to the Fund resources as owned reserves rather than borrowed reserves, simply because all countries are doing the same thing. If all countries are in debt to their own institution the onus of repayment doesn't exist.

Representative REUSS. Would there be anything catastrophic or even wrong with a situation where they did regard them as owned reserves?

Mr. MUNDELL. No. I think this would be an excellent mechanism. But it would require a change in the Articles of Agreement.

Representative REUSS. I am going to permit myself one additional question, because there is an objection floating around that we haven't quite answered yet. That was the one put by Mr. Wallich a while ago when he said that one trouble with elevating expanded gold tranche borrowings to the status of something like owned reserves is that the less developed countries would then have a means of immediate payments, and would use them, and this might cause inflation in the developed countries, and so on. This needs consideration.

Does somebody want to answer that?

Mr. Smith?

Mr. SMITH. One of the useful things about this way of increasing reserves, it seems to me, is that it does automatically exclude any country from getting any additional automatic drawing rights if it has already drawn more than 125 percent of its quota, because it is already beyond the first credit tranche. Thus, it automatically excludes the countries making heavy use of the Fund's resources. But it does leave them in the position where by repaying in the course of time they can gain something from the plan.

Representative REUSS. But a country that was loaned up to its present 125 percent——

Mr. SMITH. Would not gain anything in the way of automatic drawing rights.

Representative REUSS. But you want to increase it to what—150 percent or something like that?

Mr. SMITH. There are various levels you could increase it to. I spoke of increasing automatic drawing rights through the first credit tranche. That would mean that a country could draw automatically up to the point where the Fund's holdings of its currency were 125 percent of its quota, because it has to pay its own currency into the Fund when it draws. And I am saying that if a country has already made extensive use of the Fund's resources so that the Fund's holdings of its currency are already in excess of 125 percent of its quota, it would not get any additional automatic drawing rights until such time as it repaid the Fund, so that the Fund's holdings of currency fell below 125 of its quota. So some countries that had been using the Fund extensively would automatically be excluded immediately when the things went into effect.

It might be desirable if this were done, by the way, to raise the upper limit on the amount a country can borrow from 200 percent of its quota to 225 percent of its quota to reconstitute the conditional drawing rights which are so important to the underdeveloped countries. That is, at the same time that the unconditional drawing

rights were raised to 125 percent, raise the total upper limit to 225 percent. This would mean that if you are going to maintain the same balance between drawing rights and resources available to the Fund, you would have to have some commitment on the part of countries involved to supply additional resources for the Fund if needed, if a country were to push beyond 200 percent of its quota.

Representative REUSS. Mr. Hanna?

Representative HANNA. Thank you, Mr. Chairman.

I want to explore first some of the things that we might do outside of the Fund.

As I gather it, there is a short-term and a long-term haul in those things.

And as you have pointed out, Mr. Wallich, maybe some of the things like creating some new unit for convertibility may be a longer haul than some things we might investigate at the present time.

Now, in the face of that I have been very interested in the suggestions that were just made about taking what has been developed outside the Fund, such as the swaps.

Now, that was done outside the Fund, and still is, is that not right?

Mr. WALLICH. Yes.

Representative HANNA. It would appear, however, that it has demonstrated itself and has received some degree of acceptability. I gather that some have suggested that perhaps having demonstrated its ability, and having received acceptability, it might now be incorporated in the operation of the Fund.

Do you agree that this might be a normal step?

Mr. WALLICH. The central bankers all seem to think that swaps are a very short-term thing. They talk of 90 days, maybe extendable another 90 days. But if the credit gets to be longer than that, it has to be paid off either genuinely out of reserves, or by funding with Roosa bonds, or some other way. The central bankers feel that longer credits have political aspects. They don't have any particular economic disadvantages, but they involve the central banks in a kind of operation which isn't proper for them. They prefer to let the Treasury then take over.

Hence, I view these central bank credits more as defenses against a sudden crisis, of the kind that may strike us now. I would be happy if they were larger.

But for the IMF type of credit, which after all runs for 3 to 5 years, I don't think they are a substitute.

Representative HANNA. In other words, even though it is taken into the IMF operation it would still maintain its characteristic of being a short time crisis type of operation?

Mr. WALLICH. Yes.

Representative HANNA. You mentioned the Roosa bond. And here, too, I am very interested in this. As I understand the Roosa bond, this is a new vehicle developed that has some medium range credit possibilities, and that seems also to have been developed outside the IMF. Its use, however, is not as broad as the swap up to this time, right?

Mr. WALLICH. The Roosa bond is good only for countries that think that their currency is better than ours, because it is an obligation denominated in francs, marks, and so forth. Whatever country thinks

that it is going to devalue more often or more than the United States is better advised to hold a bond in dollars than in its own currency.

This limits the foreign currency bond very sharply.

And to the extent that the European countries now think—and nobody can read their minds—that if there were a move in sterling, that they would move along, who knows what the dollar will do?

Roosa bonds lose considerable attractiveness under these conditions.

That is why I said we ought to consider broadening the range of guarantees. One thing would be a composite unit that in case of devaluation goes down no more than the associated currencies which devalue least. This has been used in Europe for certain bonds.

Another, and one rather boggles at this, is a gold guarantee. If we guaranteed some of our liabilities in gold, one difficulty in obtaining acceptability is the precedent in abrogating the gold clause in the United States in 1934.

Representative HANNA. In other words, this has been referred to as a kind of illusory guarantee in some sense, and on the basis of history, particularly what the English did back in 1931, there might be some merit in that position.

Mr. WALLICH. Of course, today U.S. liabilities to the IMF are guaranteed in gold. Just what would happen if the price of gold—to take a completely theoretical example—were doubled, whether we would all agree to double our contribution to the IMF, and whether the U.S. budget would be burdened by $5-odd billion as a result I hesitate to guess.

Representative HANNA. Now, pursuing further your idea of making broader terms for the guarantees behind the Roosa bonds, what would be their possible utilization, then, after we have reached a balance of payments equilibrium?

Is it possible through this and with broader guarantees that we might have a different reserve created here?

Mr. WALLICH. I should think so. We could give countries a choice, bonds in their own currency, bonds in our currency, and bonds in the strongest of some group of currencies. The interest rate presumably would make some difference. The dangers of moving to a full gold guarantee give one pause in suggesting it.

But I think somewhere in this range of possibilities—there is one interesting suggestion that really doesn't bear on what currency to guarantee in, but on protection against another misuse. It is to put money that arises from the making good of a guarantee into the IMF to be used only if and when the beneficiary country reaches a point where it needs it. Otherwise we would run the risk that today—to take again a completely hypothetical case—the United States devalues, we make good on all sorts of guarantees, the other countries pocket the money, and the day after they devalue.

Representatice HANNA. In other words, this would be kind of a trust operation within the IMF?

Mr. WALLICH. Yes.

Representative HANNA. It would seem to me, Mr. Chairman, that in terms of making guidelines it wouldn't be amiss to include the possibility of studying some of these things outside of the IMF as well as what can be done through the IMF.

Representative REUSS. I think it is in the subcommittee's mind that we will take a broad view.

Representative HANNA. Thank you, Mr. Chairman.

Mr. SMITH. Could I make a comment on this?

Representative HANNA. Yes.

Mr. SMITH. I don't really understand Mr. Wallich's reservations about a gold value guarantee. It seems to me that logically a gold value guarantee is the thing that needs to be considered here, because the alternatives that countries are considering and that we might be trying to change are the alternatives of holding dollars or of holding gold. So it is a guarantee against the impact of a change in the price of gold that they are really concerned about. And I don't see what bearing the gold clause cases back in the 1930's have on this sort of thing. We are not talking, of course, about a gold guarantee in the sense that we would pay directly in gold, but rather a gold value guarantee in the sense that we would reimburse holders, if they cashed their bonds, in proportionately more dollars in case there was a change in the price of gold. The dollars would, it is true, be convertible into gold if holders should wish to convert them. Protection needs to be provided against the possibilities that people worry about, one of which is a general increase in the price of gold for all countries without any change in relative exchange rates.

Mr. WALLICH. And we might get caught in a movement like that, unless the guarantee excluded that—unless the guarantee were specifically limited in amounts, so that private balances couldn't get into official hands and enjoy the guarantee there.

This is one of the things that worry one about a deposit in the IMF that could be increased indefinitely by the action of the countries that make the deposit.

And finally, I visualize what would happen in the unlikely case the dollar were devalued. It would then be said that we were robbing widows and orphans of their savings but that we were protecting international bankers. I think we ought to be very careful about what we commit ourselves to here. Money is not just paper.

Mr. SMITH. But there is another point. And that is, if we should be forced to devalue, we might at the present time be in the position of being accused of victimizing those countries that had cooperated with us by holding their reserves in dollars rather than in gold.

Mr. WALLICH. The one good reason, Mr. Chairman, why we even consider the subject of guarantees is that I feel much more confident now that we won't devalue. I think 7 years of agony have proved to us that whatever we might do in the case of a sterling crisis, we will at least not devalue against the European currencies. And so we can afford to give this guarantee with a little easier mind.

Representative REUSS. I had promised the witnesses that we would try to conclude at 12:15, but I want to give Mr. Ottinger a chance to ask any questions he has.

Representative OTTINGER. I have no questions.

Representative REUSS. Mr. Ellsworth?

Representative ELLSWORTH. I pass.

Representative REUSS. Our witnesses have been most helpful and I notice if we have any additional questions we can put them to you.

Thank you very much, gentlemen.

We will stand adjourned until 2:30 this afternoon in this place to hear a statement by Senators Hartke and McCarthy.

(Whereupon, at 12:15 p.m., the subcommittee adjourned, to reconvene at 2:30 p.m., the same day.)

AFTERNOON SESSION

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

This is a continuation of our hearings this week exploring the international monetary situation in an attempt to evolve guidelines for improvement. We are honored this afternoon to receive a statement by two distinguished Senators, the Senator from Indiana, Mr. Hartke, and the Senator from Minnesota, Mr. McCarthy.

I understand that Mr. McCarthy is unfortunately ill this afternoon, but it is a joint statement and it will be so received.

We should be very happy, Senator Hartke, if you could proceed to either read it or extemporize, any way you like. I note the presence with you of Mr. Eliot Janeway and his son, both of whom are old friends of mine, and I am delighted to have them here this afternoon.

STATEMENT OF HON. VANCE HARTKE, A U.S. SENATOR FROM THE STATE OF INDIANA; AND HON. EUGENE McCARTHY, A U.S. SENATOR FROM THE STATE OF MINNESOTA; ACCOMPANIED BY ELIOT JANEWAY

Senator HARTKE. It is a real pleasure for me to be here with the distinguished chairman whose reputation is known far and wide and who is a close personal friend of mine, and Mr. Ellsworth and other members of the committee.

I would like to say Senator McCarthy does regret very much he could not be here with us due to his illness this afternoon, but he does join in this statement, and has joined with me in release of it.

Of course, the time of the day and the time of which we are speaking is immediately following that in which the President has made his announcement concerning the situation in southeast Asia, especially in relation to Vietnam. I think to some extent that in the field of economics at least, and business, the statement was reassuring.

In the first place we are not going onto a wartime footing. There will not be controls, rent controls, business controls. I think that many look upon full wartime footing as a period in which there is helter-skelter in the business community, but that cannot be anticipated now because this is not of that nature. I think it was a statement which pointed in two directions.

One of them is resolution in the military problem, and the other one is aimed directly toward the problem of international negotiations and international relationships.

I think upon this ground we all have a common interest in business going on as usual. I think probably the stock market itself, in its activities recently, has been somewhat responsive to the uncertainty in the international situation. But with the statement of the President clarifying that, I think we can all go about the regular business

here at home and internationally. Since the real big problem which the President pointed out was the question of international negotiation, I think we are on common ground because one of the big problems we hear so far as the United States is concerned lies in the field of international negotiation on problems of finance and commerce.

Mr. Janeway is with me here and he will be available for any comment or answer to any question and I, too, of course, also will be available.

Like any domestic economy, the world economy runs on liquidity. In the case of the world economy, liquidity consists of gold, currencies linked to gold, and credit based upon those "hard currencies."

This system is known as the gold exchange standard, but, without undue chauvinism, it might well be termed the dollar exchange standard. For, during the past 20 years, the principal vehicle for the movement of goods from economy to economy has been the U.S. dollar. The relative abundance of dollars, and the relative confidence in their stability, have largely determined the efficiency with which the international monetary system has performed its fundamental task—facilitating the international transfer of goods.

Today the world economy and many of its national components are threatened with a lack of liquidity, or at least with a controversy about liquidity requirements, with a shortage of the one most flexible and acceptable vehicle for the international transfer of goods—the U.S. dollar. It is significant that the subject of these hearings is not the liquidity crisis which now confronts the world per se, but is instead the system which that crisis has called into question.

The problem of time is already becoming critical, and I think this is the same type of critical time problem we have in the field of international politics, international peace. The various proposals for fundamental reform—from the Triffin plan for a world central bank to the Rueff plan for a return to the gold standard on the basis of a general devaluation—all will require deep study and careful consideration and long argument. It is hardly likely that any proposal for fundamental reform will become operative in less than 2 years. But it is also certain that the current international money squeeze produced by the end of the dollar payments deficit will grow and continue to grow with potentially disastrous effect for every participant in the world economy.

In other words, the clock is running out on the postwar era of prosperity. We appear before this committee in a spirit of urgency to propose a simple measure to buy time for the boom to stabilize itself.

The immediate need is for measures which will buy time for the world, during which time the fundamental questions and answers can be granted all the attention which they so critically demand. The immediate need, therefore, is for measures which can swiftly counter the shortfall in international liquidity produced by the end of the dollar deficit and can thereby prevent any faltering in the international transfer of goods, upon which the present prosperity of the world is based.

It is the firm belief of the present witnesses, Senator McCarthy and myself, confirmed by our discussions with our distinguished visitor whom we have asked and talked with about these matters, Mr. Eliot Janeway, of New York, who is here today, that the first need is for the

continued maintenance of balance-of-payments equilibrium on the part of the United States.

The word "equilibrium," of course, covers a range of specific positions; its proper determination is dependent upon many, constantly changing conditions. Thus, the Federal Reserve Board described a net deficit bank reserve position of $200 million for the week ended July 21, 1965, as an "equilibrium" position.

Similarly, given the present needs of the world economy, a modest controlled balance-of-payments deficit in the neighborhood of $1 billion would fulfill the conditions of "equilibrium" in the international accounts of the United States. It is our point judgment that the massive U.S. balance of trade surplus, and the jobs, income, and tax revenue which it creates, is worth preserving at the cost of a nominal payments deficit.

Such a balance-of-payments posture by the United States would fill some of the need for internationally acceptable currency and credit which the maintenance of world prosperity requires. But the danger of either too big or too small a U.S. deficit renders this solution only an interim, though necessary, expedient. Some further means of expanding internationally accepted credit is vitally needed, and needed soon.

The means are readily available for a swift and sound expansion of international credit in order to keep the goods moving. These means include the International Monetary Fund, the world's supply of monetary gold, and the great fund of experience in the commercial financing of trade. Simply put, our proposal is to mobilize some part of the world's supply of monetary gold, through the medium of the International Monetary Fund, for the purpose of facilitating the international transfer of goods.

Any supply of money, domestic or international, acts both as a store of value and as a medium of exchange. The gold component of the present international money supply serves primarily as a store of value—only the barter-oriented nations of the Communist world actually purchase goods for gold. The dollar, the mainstay of today's system, serves as both a store of value—as a reserve currency—and as the prime medium of exchange for the world's trade; to a lesser degree, the pound sterling performs this dual function, as well.

Our proposal would make no change in the current arrangements, insofar as the status of the dollar is concerned. What it would change is the present sterile status of gold. The thrust of our proposal is to activate gold as the basis for trade, which is its classic function. Today, when gold enters international transactions—above all, when dollars or pounds are used to purchase gold—the net effect is a reduction in the world money supply. The gold is moved from one nation's reserves to another's and in the meantime some part of the outstanding supply of working money, dollars and pounds, is withdrawn from the world economy. This is true for French purchases of gold from the United States; it is true, also, for Red China's recent purchases of gold from Great Britain. In fact, to the degree that the recent liquidity crisis produces a crisis of confidence and a movement away from the dollar and pound and into gold, international liquidity will be all the more reduced and international trade all the more threatened.

Today the dollar and the pound are alone available to do the primary job of moving goods from one nation to another. They are the world's working currencies for international clearing purposes. Our proposal would establish a new working medium to supplement the dollar and the pound as vehicles for trade—that is, mediums of exchange—not to supplant them as international reserves—that is, stores of value. It would create a supplement, rather than a substitute.

The process would work as follows. All nations adhering to the proposal would make a voluntary subscription of gold to the IMF, in the same proportions as under the present quota arrangements. Thus, the United States, whose IMF quota is now 26 percent of the total, would put up $260 million out of every $1 billion subscribed. We have little doubt that other member nations would find such a subscription of gold in their interest. It is further worth noting that all nations which have recently been cashing dollars for gold, with the exception of France, but including even Switzerland, are or hope to become beneficiaries of U.S. aid, Export-Import Bank loans, or trade concessions. The IMF would then be empowered to issue trade credits against the actual shipment of goods in international trade up to an amount equal to two, three, or four times the absolute amount of gold subscription. Both the amount of the gold subscription and the size of the multiple are properly subjects for administrative decision and international negotiation.

It is well worth noting how far a little gold could go. It would be possible, in fact, for us to extend the life expectancy of the current world boom indefinitely by investing in the IMF no more than 1 or 2 month's gold loss, taken at the present rate.

The trade credits, a form of international bankers' acceptances, would, in effect, constitute the first step in the direction of an international currency; they could well be denominated as composite reserve units. But the scope of this proposal has been deliberately limited. Under this proposal, no question arises as to who is to manage an international currency according to what criteria. For the amount of IMF credits made available is determined, first, by the agreed-upon multiple of the agreed-upon gold subscription, and, second, by the actual needs of international trade. No sovereignty is surrendered, no danger of an artificially produced, international inflation or deflation is run. Yet the ground would be broken for the development of a truly international banking and monetary system, at the same time as the immediate liquidity crisis is simply and effectively countered. Furthermore, gold, which today has become the worldwide symbol of deflation, would be mobilized to aid in doing the world's work.

For the first 20 years of its existence, the IMF has been limited to dealing with currency disturbances and to preventing monetary disasters. We propose to add to this negative, though necessary, function a further, positive function—productive, activity supporting banking. As the Journal of Commerce, wisely and conservatively dedicated to the maintenance of world trade, editorialized on July 20:

> If the Gold Exchange Standard is to survive, the IMF will have to make it work. To do so, it may have to take on some banking characteristics it does not now have.

Implementation of this proposal to empower the IMF to act as an international acceptance house will take a number of steps. As

an essential aspect of the process of implementation, it is our intent to introduce in the U.S. Senate appropriate authorizing legislation for a further subscription of gold to the IMF, under the terms of this proposal. It is our earnest hope that this proposal will become the basis for an urgent call to action on the part of the U.S. Government. The September meeting of the IMF Executive Board will provide the proper forum for such a call.

We understand that this proposal may not encompass all the reforms of the present international monetary system which may be deemed necessary or desirable. This proposal in no way forecloses more fundamental, longer term reform. For its purpose at this time is to meet the overriding problem of today—a shortage of internationally accepted means of transferring goods within the world economy. The continued search for a more perfect international monetary system must and will continue. But it would be tragic if international prosperity were to collapse even as international negotions to defend that prosperity were underway. This is the danger which the proposal presented today is aimed to avert.

This concludes the statement, Mr. Chairman.

Representative REUSS. Thank you, Senator Hartke, for a very stimulating contribution, and I can assure you that it will receive careful thought and consideration from this subcommittee.

I have a number of questions suggested by your provocative presentation.

Senator HARTKE. I thought possibly Mr. Janeway might like to add a statement if you would care to hear him.

Representative REUSS. Yes. Mr. Janeway?

Senator HARTKE. We asked him, we have consulted with him, we consider him to be of excellent mind.

Representative REUSS. You have been identified by the witness, Mr. Janeway. We will be delighted to have you say what you wish.

Mr. JANEWAY. Mr. Chairman, I may say, after three decades of friendship with you, that when Senator Hartke and Senator McCarthy suggested to me that this leadership forum that this subcommittee has developed, be the occasion of their presenting this proposal, I deemed it a memorable privilege for me to be associated with them in this advisory capacity.

Why, when the Senators talked to me about the problem in connection with earlier testimony publicized as having been presented to this committee, and after I myself had studied and discussed the proceedings of the committee, the testimony of my friend, Mr. Chittendon of Morgan Guaranty, which you will recall, in which he commented so provocatively on the Bernstein proposals, my answer to the Senators was that it seems to me that we could run through this boom and run into a depression or in any event be thrown upon the mercy of the tides before we can get general agreement as to what the balance of payments is.

It seems to me that "time is awasting," and various dangers are rising while we may get distracted into procedural and accounting problems, semantic problems, problems of definition, problems of uniform accounting between one country and another. So this proposal is designed to buy time instead of allowing time to run out, and it is addressed specifically to, I would say, the kind of pragmatism that Presi-

dent Johnson has always been associated with, an effort to cut through to the middle ground between various theoretical extremes and find something that we can do about it.

Now, I am not aware of a nickel's worth of gold that has gone into the IMF that has actually been dedicated or activated for working purposes, for trade purposes.

Representative REUSS. On that question, Mr. Janeway, I have a question which I would like to put to either you or Senator Hartke or perhaps both of you.

Mr. JANEWAY. Yes?

Representative REUSS. As I understand the proposal, it would be for an additional subscription of gold by IMF members to the IMF, and based upon that gold subscriptions IMF credits could be issued in an amount, two, three or four times the gold subscription.

Mr. JANEWAY. Some conservative multiplier.

Representative REUSS. The Congress, of course, has just authorized an additional quota increase in the IMF which involves as you know, a gold deposit.

Mr. JANEWAY. $385 million.

Representative REUSS. And that gold deposit in turn, in accordance with IMF procedures leads to credits of up to five times that amount subject to certain conditions as you get into the higher brackets in relation to quotas.

The House, in passing that IMF bill, incidentally, was somewhat critical of the amount and the techniques of it, but that is another story.

How does your proposal differ from an additional IMF quota increase? Not that there is anything wrong with such a proposal. I just want to get the mechanics straight.

Senator HARTKE. I think the purpose of the subscriptions heretofore, and generally speaking, of the whole activity of the International Monetary Fund has been one of preserving economies and preserving countries in financial distress. It has been very useful, been very helpful.

I think everyone who has watched it operate could not disagree. But it has not been used in the field of trade, and this new subscription of gold would be specifically taken into the field of commerce and trade.

Representative REUSS. I see.

Mr. JANEWAY. In other words, Mr. Chairman, the IMF has not been what in the techniques or standard practice of world trade could be called a draft issuing agency against invoices. In world trade the problem is how to get liquidity out against invoices.

The Senators, in their statement, quote this very interesting comment of the Journal of Commerce in its lead editorial, which I think is seeking for a consensus among all these views. When Senator McCarthy and I saw M. Rueff here in March, he seemed much more tolerant in his stance than some of his statements may have sounded. He said to the Senator——

Representative REUSS. Rueff or McCarthy?

Mr. JANEWAY. Rueff.

To my surprise, he said there are entire families of solutions. Well, it might take generations to run through them. But this editorial

cites Professor Triffin, it cites Professor Wallich, and then I think it makes this contribution to which the Senators' proposal has been responsive, and which I know Senator McCarthy addressed himself to with particular force to add this dimension of activity to the function of the IMF, to get it into the field of acceptance banking.

Now, of course, if that were done, a considerable load would be displaced from on top of the dollar. The dollar would no longer be needed for such work. So that we would be—we would tend to get free from this standard dilemma that we are now involved in, namely, either have a dollar payment deficit or risk a world depression or a world slum. It is clear, and the actions of the British Government just announced emphasize it, that the pound has been disqualified from this function.

Now that the dollar is in surplus, the dollar cannot take over functions from which the pound has had to be withdrawn. Some new trade vehicle which American opinion and apparently world opinion wants not to be the dollar, must be improvised, and there appears to be a growing consensus of opinion with which professionally speaking I certainly associate myself, that the IMF is the obvious agency. It exists; there need be no argument or delay. There is confidence——

Representative REUSS. I think you will find a very substantial amount of agreement on this subcommittee on both sides.

Mr. JANEWAY. That is right.

Representative REUSS. That the IMF must play a key role in whatever is going to be done.

Could I pinpoint my other question based upon what you have just said?

Mr. JANEWAY. Yes.

Representative REUSS. And what Senator Hartke answered: having been told that the major thrust of your proposal is in the direction of trade and acceptances.

Mr. JANEWAY. Drafts against documents, hard physical activity.

Representative REUSS. I would ask this question: Our international payments position is not due to a trade deficit; we have been running a very healthy trade surplus. Our troubles have been due to a deficit on capital transactions and my question would be: Why do you restrict these new credits to the financing of trade?

Isn't it equally important to finance deficits from whatever cause, including capital flows?

Senator HARTKE. The problem at the moment is that when we came home to straighten up what was a political worry here, at least for some people, and what was an international political worry in view of what De Gaulle had said about putting our house in order and indicating we couldn't do so, and then we did correct them with the President's voluntary program of restraints—whether you want to say they were right, wrong, or indifferent, the truth of it is now they are corrected.

The difficulty of that has been that while the net result may be good politically here at home, and while it may be that we have shown De Gaulle that we could put our house in order, what is happening to the trade in the meantime?

The truth of it is that your credit overseas for trade is drying up, and these figures are out from the Commerce Department, for whatever reason you want to say, whatever the cause of it is, we are down

over $2 billion on an annual basis on our trade surplus of what we were last year.

What is causing this can be argued all day long but the truth of it is they have conceded, and this is not new, at the present time, there is a lack of international credit availability and that is what we are interested in. We are trying to get back into this field. This is the heart of the problem. We are not saying our proposal is a cure-all. It is not a panacea for all the problems, and possibly you may want to extend it to some other field—but trade is the No. 1 item upon which at the present time our prosperity is based.

The question is, how do you go about keeping international trade high? We had a call from the Secretary of the Treasury for an international monetary conference, which I applauded him for. I hope he moves rapidly, I hope he doesn't hesitate, but no matter how fast he moves I think that you and I could agree if you could get it done in 2 years, a successful one, or even have one, we would be very fortunate.

What are you going to do in the interim? I hate to call this a stopgap measure. I think it will be more than that.

Representative REUSS. Let me say in that connection that we welcomed at this hearing the notion that there isn't any one single thing that one can do that will cure all problems of international exchange and payments. It takes a whole arsenal of measures and that is why we are so glad to have this suggestion which, as you say, is beamed particularly at the trade problem. Not that trade is the sole problem.

Senator HARTKE. Not only the trade problem; but the trade problem is going to be the central focal point of new difficulties which maybe you haven't had heretofore in a different fashion. I mean heretofore we have had availability of credit. We have been able to move. But I think they will tell you that their credit is not there at the present time, that it is drying up.

Mr. JANEWAY. The administration has recognized this, I believe, by moderating the voluntary program as regards export bank loans, bank loans for exports. So there is a considerable worry on the executive side of Government about this.

Mr. Chairman——

Representative REUSS. We have had testimony from other witnesses at the hearing to this effect.

Mr. JANEWAY. Mr. Chairman, if I may bring the discussion back to this one theme that in the area of the balance of payments question it seems so difficult to get agreement as to theory and agreement as to even accounting. Whereas by contrast, if time is a problem in the balance of trade areas there is really nothing to argue about. Either the goods move or the goods don't. It is a hard area rather than an area of words. It is an area of activity, and I think that the thrust of this proposal is aimed toward moving forward in the activity area with all due respect to the appropriateness of discussion and controversy in the area of words. The payments controversy is a relatively new controversy. Even in the great depression of the 1930's, the literature, the deliberations of world conferences, the deliberations of governments were not diverted or held back, whatever else may have been lacking, by large philosophical and procedural and semantic difficulties over what is a balance-of-payments deficit and whether a balance-of-payments deficit is a good or bad thing or whether periodically we must

go through the exercise of one or another country going into surplus and passing the difficulty to another country which will be deemed in deficit. This is a very contemporary intellectual and policy difficulty that we are in. No one respects debate, discussion, analysis, I am sure, more than Senator Hartke, Senator McCarthy, you, and I hope myself. But this should not be permitted to interrupt the boom that we have, which is stabilized and powered by world trade, and there is a danger, I think.

Senator HARTKE. As to evidence of that——

Representative REUSS. Senator Hartke.

Senator HARTKE. I think the figures are in for the first 5 months of this year, that our imports are up 11 percent. Our exports are down 1 percent, that is what I meant to say.

Mr. JANEWAY. Mr. Chairman——

Senator HARTKE. Pardon me, just a moment. We have to have an exchange of goods not alone here between Indiana and Illinois and Wisconsin and Minnesota and Michigan. That is all very good. But we don't want to live in an island politically, and this is the problem that the President was addressing himself to on Vietnam. We are just no longer that type of nation and we are just not going to live that way economically, and if you are going to go home with these nice little statements and phrases and talk about an equilibrium of balance of payments that means zero, that is what you are going to mean, you are going to talk about the same thing on your reserves and people having differences of opinion as to what is going to happen, but as Mr. Janeway said, when you finally come down to it what you are doing is you are talking about pencils, glasses, microphones, radio sets, tractors, equipment, and grain and food and if these things are not going to be moved, and if there is no method available, if there is not sufficient available credit to move them, I don't think anyone would doubt what will happen.

Representative REUSS. Your colleague, Senator McCarthy, who unfortunately can't be with you this afternoon, once had a very appealing figure of speech on this point of phony balance in which he described the ship of state sinking not by the stern, but settling all at once perfectly balanced.

Mr. JANEWAY. Perfectly balanced.

Representative REUSS. It is a good point that you raise.

Senator HARTKE. This is exactly right. This is exactly what we are talking about. But when you come down to the final fact, we do have, I think we have, a problem which now has been pretty generally recognized and which I think these hearings in and of themselves recognizes.

I think the very fact that you are here conducting these hearings recognizes the problem, but we do need some action as well as some words, with all due respect to the fine words that you put out.

Representative REUSS. Well, we hope that the hearings and the report which we will issue will have an effect in stimulating action.

We are very grateful to you, Senator Hartke, and to you, Mr. Janeway, for coming before us with a constructive proposal which certainly is going to get concerted attention from this committee.

Senator HARTKE. Let me congratulate you again upon conducting these hearings.

Representative REUSS. Thank you so much.

We will stand adjourned until 10 o'clock tomorrow morning in this place, at which time we will hear from Prof. Richard N. Cooper of Yale, Prof. James Ingram of the University of North Carolina, and Dr. Lawrence B. Krause of the Brookings Institution.

(Whereupon, at 3:10 p.m., the committee adjourned, to reconvene at 10 a.m., Thursday, July 29, 1965.)

GUIDELINES FOR INTERNATIONAL MONETARY REFORM

THURSDAY, JULY 29, 1965

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

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

Present: Representatives Reuss and Ellsworth; and Senator Proxmire, of the subcommittee.

Guest attending: Representative Hanna.

Also present: Gerald A. Pollack, economist; James W. Knowles, executive director; John R. Stark, deputy director; and Hamilton D. Gewehr, administrative clerk.

Representative REUSS (presiding). Good morning. The session of the Subcommittee on International Exchange and Payments will be in order.

We have been pursuing this week our inquiries to develop guidelines for improving the international monetary system.

For this morning's session we are grateful for the presence of Prof. Richard Cooper of Yale University, Prof. James Ingram of the University of North Carolina, and Dr. Lawrence Krause of the Brookings Institution.

We are grateful for the three prepared papers you gentlemen have submitted and without objection, in accordance with our practice, they will be included in the record.

Now, I would like to ask each of you to proceed either to read your paper, summarize it, extemporize it, go beyond it, or to handle it in any way you think best.

Mr. Cooper, would you start out, please.

STATEMENT OF RICHARD N. COOPER, ASSOCIATE PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. COOPER. Yes, thank you, Mr. Chairman.

I have submitted a rather lengthy paper. With your permission, I will just read portions of it this morning.

It is customary these days to consider the weaknesses of the international monetary system under three broad headings: defects in the mechanism of international payments adjustment, inadequate means for generating international liquidity, and vulnerability of the composition of international liquidity to crises in confidence. Although

52-324—65—pt. 1——8

every discussion of the need for international monetary reform refers to one or more of these weaknesses, the weights which different observers attach to each vary greatly, and so as a result do the proposed reforms. I will say something general about these weaknesses and then as requested by the subcommittee offer specific guidelines to reform.

International liquidity is needed primarily to finance temporary imbalances in payments and to obviate precipitate action to correct a balance-of-payments deficit. Ample liquidity provides time for more acceptable corrective measures to be taken. Liquidity requirements therefore depend both on the size of disturbances to international payments and on the speed with which imbalances are corrected.

To clarify the relationship between liquidity and adjustment I find it useful to classify the methods for coping with a prospective (ex ante) balance-of-payments deficit under fixed exchange rates—flexible rates have been ruled out by the terms of reference of the subcommittee. Two of these categories involve measures of adjustment, one internal, the other external; one involves financing the deficit, that is, international liquidity.

First, a country confronted with a prospective deficit can use internal economic policies to reduce the deficit. Typically this will involve deflationary policies in the domestic economy; a tighter budget or higher interest rates. Such internal policies influence international payments by lowering the level of domestic activity or raising the yield on assets in the domestic economy.

Second, a country might use external measures to switch expenditures away from imports of foreign goods, securities, and other transactions which involve payments to foreigners. Thus, these selective measures operate directly on international transactions. To help reduce a deficit such actions might include imposing import quotas, raising tariffs, or prohibiting capital outflow.

To the extent that measures within these two broad categories were not taken, the country would experience an actual (observed) deficit which would then have to be financed in some way. Such financing often takes the form of drawing down gold and foreign exchange reserves, but it can also involve compensatory official capital movements from abroad, special borrowing through private markets or commercial banks, or even compensatory sales of goods and services—all motivated by the imbalance in international payments.

The choice among these three methods for coping with prospective imbalances touches on matters of high national importance. We are thus far from indifferent about which types of measure are used.

Most observers want to avoid extreme forms of all of these three categories of action. Many bankers, for example, speak of the need for the "discipline" of the balance of payments; they wish to restrict the means to finance deficits. Liberal economists and people favoring international integration are offended by trade quotas and exchange controls and generally dislike autarkic measures which interfere with trade and payments. Other observers emphasize the need to preserve domestic autonomy in economic policymaking and in particular the ability to maintain full employment or stability in the level of domestic prices.

Economists love diagrams, so true to my profession I have included one. I will not burden you with a description of it—that can be found in my written submission—but I introduce it to illustrate two points:

First, to indicate we cannot generally forswear extensive use of external measures, internal measures, and liberal financing simultaneously. Prospective balance-of-payments deficits must be handled in some combination of these three ways, and if we set our standards too high, one or more of them will have to give. (That is what fig. 1 is all about.)

Second, to illustrate the alternatives which we face.

The postwar evolution of the international payments system can be characterized (as shown in fig. 2) as a steady movement away from reliance on selective or external measures such as import quotas and exchange controls to greater reliance on international financing of deficits (as with the Marshall Plan grants after 1948) and on internal adjustment. The question we now face is where to go from here. A given scope for freedom of trade and capital movements will result over time in greatly increased transactions—and imbalances—among countries. Therefore more frequent and more extensive use must be made of internal policies, or liquidity must increase sufficiently to accommodate the larger imbalances. Alternatively, freedom of trade and capital movements will have to be restricted.

This brings me finally to the question of how urgent is the need for international monetary reform. I will make a conditional forecast which is in two parts. First, unless we improve the means for generating international liquidity and distributing it adequately, we will experience national balance-of-payments "crises" in industrial countries with greater frequency; countries will increasingly find themselves facing balance-of-payments deficits and a weakening of confidence in their currencies, and they will be compelled to adjust domestic policies and/or their barriers to trade and capital movements.

To be sure, in each case it always looks as though the country in question is at fault; its domestic policies may have gotten "out of line" or the public may not be saving enough or something else. But this observation is not sufficient to pass the entire burden of responsibility, or even the major portion of it, to the country in question. At any point in time the positions of some countries will be weaker than others, and any deficiency in the international payments system will show up at their doorsteps first. They are vulnerable, the "marginal" cases. As with general unemployment, it always hits someone, and also like unemployment, there is the danger of confusing the particular case with the general phenomenon.

The second part of the conditional forecast is that we will observe a reversal of the trend toward liberalization of trade and payments and will see greater reliance on selective external measures for eliminating payments deficits. This is not a very daring prediction; we have already seen several moves in that direction: the import surcharges of Canada in 1962 and of Britain in 1964, and the interest equalization tax followed by the program of "voluntary controls" in this country. Countries balk at having to rely too heavily on internal measures to correct imbalances unless such measures also happen

to be consistent with domestic objectives of policy, as they were to some extent for Italy last year. This reluctance to use internal measures is as true for surplus countries as it is for deficit countries. Germany has resisted strongly the domestic inflation which is the logical implication of its balance-of-payments surplus under fixed exchange rates; it has relied instead on special devices to induce private short-term investment abroad and on special arrangements with Britain and the United States for purchasing military equipment. But the dilemma is always more acute for the deficit countries.

When the countries in trouble do move to correct their positions, they, of course, worsen the positions of other countries. Unfortunately it is as likely to be countries with weak positions as those with strong ones. When Japan cut back sharply its imports in 1961, it hit primarily the United States, which was struggling with a large deficit. Canada's devaluation and import surcharges in 1962 hit first its two largest suppliers, the United States and Britain. And measures taken by the United States to curb capital outflow aggravated the problem of Britain. Again an analogy can be made with unemployment: retraining and special placement programs can always succeed in reemploying particular individuals. But if total demand is not adequately large to absorb the potential output of the economy, such reemployment will simply displace someone else.

The degree of urgency which we attach to the need for international monetary reform depends then on the accuracy of this forecast and on how strongly we object to the outcome. Assume the forecast is correct. Then how costly would be the reversion to use of direct or indirect controls over international trade and capital movements? Or, to put it another way, how valuable are relatively liberal trade and capital movements?

I do not have a decisive answer to this question. It has plagued economic theorists and policymakers a good many years. However, I think three observations can safely be made:

First, the economic costs of a reversion to restrictions on international payments would be much higher for "small" nations than for "large" ones. Countries such as the Netherlands and Switzerland depend vitally for a high standard of living on foreign trade. The same is not so true for a country such as the United States or for the European Economic Community taken as a unit. Extensive and liberal trade is no doubt beneficial to them, but it is not vital.

Second, a reversion to restrictions would mark a sharp reversal in European and American foreign economic policy since the Second World War. Whether such a reversal could be effectively isolated from our overall foreign policy, and in particular from our political and military commitments to Europe, is an open question. At the very least, it would require extremely refined judgment and delicate skill to create an effective separation between economic and other relationships.

Third, a reversion to restrictions unless delicately handled would in some respects increase the vulnerability of the payments system, even while it provided instruments for maintaining international balance. Our bulwarks against vulnerability to crises in confidence rest on the extensive arrangements for close cooperation among national monetary authorities which have been built up in recent years. This

cooperation would surely be threatened by a reversion to unilateral national use of restrictions, for precisely one of the major motivations for close cooperation is to preserve liberal trade relatively free from restrictions.

These then are the crucial questions: How badly do we want liberal trade and capital movements? And how much autonomy in setting and pursuing domestic objectives of economic policy are we willing to sacrifice in order to get them?

My forecast suggests that countries will be highly unwilling to give up much domestic autonomy. To the extent we want to avoid restrictions over international payments, therefore, adequate financing will be necessary to cover periodic balance-of-payments deficits. In the time remaining, I would like to make several comments on the form which improvements in international liquidity and its mode of generation should take. These unfortunately have the ring of obiter dicta, as there is not sufficient time to justify them in detail.

1. From the viewpoint of the user, international liquidity can be divided into reserves and lines of credit. Reserves are something, such as gold or dollars, which a country "owns" and can dispose of at its own initiative. Credit, on the other hand, must usually be arranged and requires accommodation of the creditor. Future increases in international liquidity should include both components. Owned reserves (or fully automatic line of credit) are necessary because creditors cannot always forbear imposing conditions on the borrower. Foreign creditors insisted that Britain cut its unemployment compensation in 1931. The United States has a full postwar history as a generous but exacting creditor, starting with the Anglo-American loan in 1946 which we used to dictate British financial policy, and illustrated by our insistence on strict financial policies as a condition of the loans to France in early 1958. Sometimes the creditor's advice will be sound, but sometimes it will not be; and always it will rankle with the debtor.

On the other hand, owned reserves are not always adequate either. In periods of uncertainty a decline in owned reserves is perversely taken as a sign of weakness, an occasion to flee the currency. In early 1964, for instance, Italy, a country enormously well supplied with reserves, preferred to acquire large credits from the United States and other sources in order to support the lire. (And it borrowed first from the United States rather than from its Common Market partners apparently out of fear of the more exacting conditions which would be imposed by the latter.) If countries become reluctant to use owned reserves because such use merely signals distress, owned reserves cease to serve their only function. International credit, preferably unknown to the public in amount, then becomes necessary to finance deficits.

2. If owned reserves are to be increased, what form should they take? In particular, should the dollar continue to play its present role as a reserve currency?

The dollar's role in international finance is a vital one. It is extremely useful to have an international currency of exchange to act as intermediary between other moneys. Without it, most exchange markets would be extremely "thin," and matching buyers and sellers at reasonably firm prices would be difficult. Just as we avoid com-

modity barter domestically by using money as an intermediary, we avoid bartering money internationally by using just a few currencies, principally dollars and sterling, as intermediaries between the others.

Similarly, so long as monetary authorities preserve stability in exchange rates by intervening in currency markets, they must intervene in something, and it is natural to use the currency of exchange, which provides an active and well-developed market vis-a-vis other currencies. Thus most central banks support their currencies by buying and selling dollars.

But this vital function of the dollar, a currency of exchange and by virtue of that a currency of intervention, is quite separable from its function as a reserve currency. Reserves are stores of value, and they can be held in anything so long as they are readily convertible into international means of payment. Corporations and banks do not hold all of their liquid assets in currency and demand deposits; on the contrary, they typically hold amounts in excess of working balances in Treasury bills or other earning assets, confident that they can convert these assets into cash on short notice and with little or no loss. Gold is a useful form in which to hold international reserves because it is readily convertible into external sterling in London or dollars at the U.S. Treasury. By the same token, the role of the dollar as a reserve currency is not nearly so essential as its role as a currency of exchange; what is important is the ready convertibility of any form of owned reserves into dollars and other "key" currencies of exchange.

For this reason I do not think it should be an objective of U.S. international financial policy to preserve the reserve currency status of the dollar. In the face of growing reluctance by foreign monetary authorities to hold even the stock of dollars already in foreign hands, I would think we should welcome alternative forms of reserve assets which relieve this source of concern.

3. If not the dollar, what then? I would prefer some internationalization of liquidity creation, partly in the form of owned reserves or automatic credits, partly in the form of discretionary credits such as the credit tranches of a country's drawing rights at the International Monetary Fund. These sources should be generous, but beyond them countries should be expected, as a rule, to reduce their payments deficits. It would be the responsibility of those governing the use of discretionary credits to distinguish between those cases where extension of large credits would be globally beneficial and those cases where refusal to provide credits except under certain conditions would actually benefit the deficit country.

From a technical economic point of view it really does not much matter where such liquidity creation takes place; I confess a preference for the International Monetary Fund, partly because it is an existing institution with high expertise, partly because it is a global organization where every viewpoint can at least get a hearing.

The IMF as it stands at present, however, is not well suited for taking on the job of managing world money. Its Executive Board is heavily occupied with the day-to-day tasks of lending to its 102 members, the vast majority of which are less developed countries. The Executive Directors are not intimately involved in the process of economic policymaking in the countries whose economic activity sets the pace for world production and trade. As a practical matter, monetary officials

of the major industrial countries are not likely to delegate to Executive Directors of the IMF the job of creating international reserves on a systematic basis. Moreover, the less-developed countries are well represented on the Executive Board, and while they have a strong and legitimate interest in the mechanism for generating international liquidity, there is perhaps some merit in the European fear that they are not so likely to balance the disadvantages of an overabundance of international liquidity against the disadvantages of a shortage of liquidity. But this is no reason to go to the other extreme and neglect their views and interests entirely.

It would be desirable, therefore, to bring together under the auspices of the IMF the key monetary officials of the countries most important to the world economy, possibly four times a year and more often if needed, to assess the world economic situation with the help of the Fund's staff and to decide what implications it has for international liquidity. This group of officials should include a few representatives from the nonindustrial countries. Such a group could decide on necessary increases in owned reserves and could set general guidelines for extensions of credit in the near future.

It should consider the overall economic situation, not simply the rate of change in prices. For this reason national representation should involve the top economic policymakers of governments, those who must face the actual choice among competing policies. Price stability may on occasion have to be weighed against other economic objectives, and this is no less true at the international level than at the national one.

Action by such a group could not, of course, be by unanimous vote; that would make it quite unworkable. Any country which objects strongly enough to the group's decisions can exert its ultimate sovereign right of withdrawing from the entire system of collaboration.

4. Once the appropriate level of international liquidity and discretionary lending has been decided, economic adjustment among countries under fixed exchange rates will necessarily require moderate inflation in some regions of the world, moderate deflation in others. To avoid this, some nations will be tempted to resort to selective, external measures to cope with imbalances in their international payments. As the history of the thirties suggests, such measures can too easily degenerate through aggressive retaliation or mere self-defense into a self-defeating spiral of rising barriers to trade and payments. It would therefore be desirable in any consideration of international monetary reform to review the rules we now have governing the use of external measures for balance-of-payments reasons and to establish some new guidelines to govern violation of the rules.

(Mr. Cooper's prepared statement in full follows:)

PREPARED STATEMENT OF RICHARD N. COOPER, ASSOCIATE PROFESSOR OF ECONOMICS, YALE UNIVERSITY

It is customary these days to consider the weaknesses of the international monetary system under three broad headings: defects in the mechanism of international adjustment, inadequate means for generating international liquidity, and vulnerability of the composition of international liquidity to crises in confidence. Although every discussion of the need for international monetary reform refers to one or more of these weaknesses the weights which different observers attach to each vary greatly, and so as a result do the proposed reforms.

I will say something general about each of these weaknesses and then as requested by the subcommittee offer specific guidelines to reform.

Liquidity and adjustment

International liquidity is needed primarily to finance temporary imbalances in payments and to obviate precipitate action to correct a balance of payments deficit. Ample liquidity provides time for more acceptable measures to be taken. Liquidity requirements therefore depend both on the size of disturbances to international payments and on the speed with which imbalances are corrected.

To clarify the relationship between liquidity and adjustment I find it useful to classify into three broad categories the methods for coping with a prospective (ex ante) balance-of-payments deficit under fixed exchange rates—flexible rates have been ruled out by the terms of reference of the subcommittee. Two of these categories involves measures of adjustment (one internal, the other external), one involves financing the deficit (that is, international liquidity).

First, a country confronted with a prospective deficit can use general (or internal) economic policies to reduce the deficit. Typically this will involve deflationary policies in the domestic economy: a tighter budget or higher interest rates. Such internal policies influence international payments by lowering the level of domestic activity or raising the yield on assets in the domestic economy.

Second, a country might use selective (or external) measures to switch expenditures away from imports of foreign goods, securities, and other transactions which involve payments to foreigners. Such actions might include imposing import quotas, raising tariffs, or prohibiting capital outflow. Thus, these selective measures operate directly on international transactions to help reduce a deficit.

To the extent that measures within these two broad categories were not taken, the country would experience an actual (observed) deficit which would then have to be financed in some way. Such financing often takes the form of drawing down gold and foreign exchange reserves, but it can also involve compensatory official capital movements from abroad, special borrowing through private markets or commercial banks, or even compensatory sales of goods and services—all motivated by the imbalance in international payments.

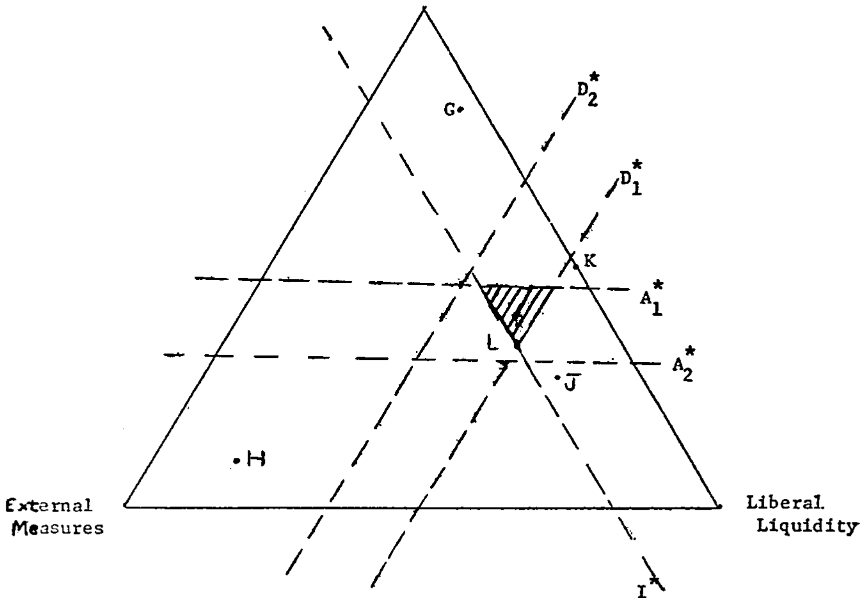
As used here, the term "international balance" follows closely Ragnar Nurkse's definition of international equilibrium: balance in international payments, excluding gold and other compensatory transactions, over a certain period of time wth full employment and without restrictions on trade and long-term capital movements imposed for balance of payments reasons.[1]

The observed deficit in international payments may thus be only an imperfect measure of the ex ante disequilibrium, for a country may have been compelled by limited financing to take measures to reduce the deficit. Surplus countries are rarely constrained to adopt really repugnant measures, although on occasion they may be pressured by the deficit countries into doing so. Sometimes, of course, measures to reduce imbalances—as distinguished from financing them—may themselves be desirable on other grounds, as when a surplus country with unemployment adopts an expansionary program. But happy coincidences such as this usually must turn into policy conflicts before both internal and external equilibrium are restored.

The three broad categories for coping with imbalances—internal measures, external measures, and financing—can be illustrated diagrammatically on a triangle such as figure 1. Each point in the triangle represents some combination of the three types of measure for handling a given ex ante imbalance in the international payments of any country or region under fixed exchange rates during a specified period of time. The three vertices of the triangle represent exclusive use of measures in each of the three categories, and the closer a point is to a vertex, the greater the reliance on measures of that type. Thus point G in figure 1 represents the textbook gold standard, in which domestic deflation is primarily relied on to reduce a payments deficit and domestic expansion to reduce a payments surplus. Temporary financing for deficit countries was often arranged by borrowing, and modest exchange rate flexibility within the gold points could be regarded as a minor external measure. But principal reliance was on adjustments in the domestic economy. By contrast, point H represents

[1] Ragnar Nurkse, "Conditions of International Monetary Equilibrium," Princeton Essays in International Finance, 1945; reprinted in Howard S. Ellis and Lloyd A. Metzler (ed.), "Readings in the Theory of International Trade," Philadelphia, the Blakiston Co., 1950, pp. 3–34.

FIGURE 1



heavy reliance on external measures such as exchange control and changes in import quotas. Point J represents a country which has ample ability to finance deficits. Many Europeans claim that the United States is in this position by virtue of its role as a reserve currency country, since foreign countries simply accumulate the excess dollars arising from U.S. deficits. Point K might represent a State within the United States. External measures are totally ruled out—no State can impede interstate commerce or impair contracts made by its residents in U.S. dollars. On the other hand, it acquires liberal financing through many cushioning features of a federal system. A drop in income and employment as a result of a fall in exports reduces tax payments to "foreigners" and increases receipts from "foreigners" in the form of unemployment compensation—both through the Federal fiscal system. Moreover, a State can, up to a point, sell financial claims in the national capital market and it can draw down its stock of cash.

This characterization is extremely rough; there are many variants of each type of measure, and in some instances the differences between various types of external measure may be far greater than between certain external measures and certain internal measures or financing measures. Moreover, the time dimension is important. Virtually all regions have ample sources of finance to cover a short-lived deficit. But if the deficit persists it must arrange extraordinary financing or resort to other measures. Thus it will be most useful to consider the position of regions with reference to some considerable length of time, say 2 to 4 years. Finally, as already noted, the pressures on a surplus country are considerably less than those on a deficit country. A surplus country can if necessary finance its surpluses indefinitely—or, if it is taking gold or other international reserves, at least until the deficit countries exhaust their reserves and must adopt other measures. Thus it is most instructive to consider the position of a country with respect to payments deficits.

The choice among these three methods for coping with prospective imbalances touches on matters of high national importance. We are thus far from indifferent about which types of measure are used.

Figure 1 can be used to illustrate the relationship among different objectives for the international payments system, and to indicate the relationship between balance-of-payments adjustment and international liquidity. Most observers want to avoid extreme forms of all of these three categories of action. Many bankers, for example, speak of the need for the "discipline" of the balance of payments; they wish to restrict the means to finance deficits. Liberal economists and people favoring international integration are offended by trade quotas and exchange controls and generally dislike autarkic measures which interfere with trade and payments. Other observers emphasize the need to preserve domestic autonomy in economic policymaking and in particular the ability to maintain full employment or stability in the level of domestic prices.

These three objectives can be represented on figure 1 by boundaries beyond which various observers do not want to venture. Thus the line D^*_1 may represent the limits of financing which those in favor of maintaining balance-of-payments discipline are willing to permit. They do not want to see the country closer than that to the vertex representing liberal liquidity. Similarly, the line I^* represents the greatest reliance on external measures which integrationists are willing to countenance. Finally, the line A^*_1 can represent the greatest intrusion on domestic policies which still others are willing to permit. With these three constraints, potential imbalances can be handled only by combinations of measures in the shaded area. Point L, for example, marks the maximum permissible degree of domestic autonomy in economic policymaking.

The diagram makes clear, what is not always clear in public discussion, that we cannot generally forswear extensive use of external measures, internal measures, and liberal financing simultaneously. Prospective balance-of-payments deficits must be handled in some combination of these three ways, and if we set our standards too high, one or more of them will have to give.

As we have described the constraints above, they permit some flexibility. But if those urging discipline insist on no greater financing than that permitted by line D^*_2, for instance, or if those wanting to preserve domestic autonomy in economic policy set a limit of line A^*_2. the country or region would have conflicting objectives and one or more of them would have to yield. No point can satisfy the limits set by the lines I^*, D^*_1, and A^*_2. Given the degree of international agreement to avoid external measures and the degree of balance-of-payments discipline desired, our ability to pursue domestic economic objectives without regard to the balance of payments is sharply limited; and similarly for other combinations.

At considerable risk of oversimplification, those who argue that the mechanism of adjustment is defective—under the constraint of fixed exchange rates—argue in effect that we do not have enough balance-of-payments discipline under the present international payments system. (It is precisely to escape this implication that several economists urge flexible exchange rates as a preferable system.) Those who think that more liquidity is needed feel that the discipline is too severe, that domestic economic policies are already too threatened by balance-of-payments considerations, and that the adjustment which does take place is apt to involve ad hoc and for the most part undesirable restrictions over international payments.

Vulnerability

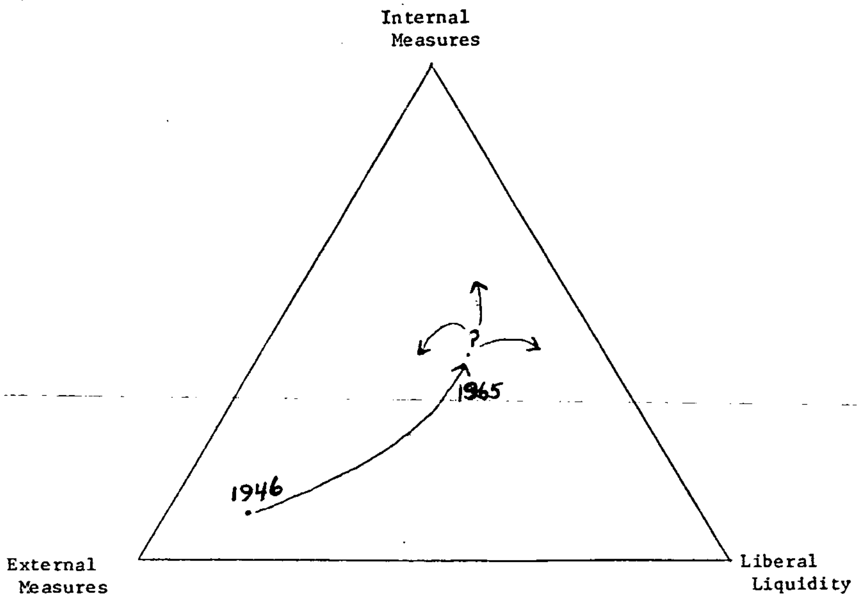
The third problem identified earlier—the vulnerability of the payments system, or its ability to withstand "shocks" of various types—usually focuses on the form of international liquidity rather than its amount; but it is obviously related to the method by which liquidity is generated. Many economists claim that the reserve currency system is inherently unstable in the long run: it relies for additions to international reserves on deficits by the reserve currency countries, but these deficits and the resulting rise in liquid claims on those countries itself undermines confidence in the reserve currencies.

The 32 academic economists who held several meetings on international monetary reform at Princeton and Bellagio, Italy, in 1964 regarded protection against the vulnerability of the reserve currency system as deserving "a high order of priority." In contrast, studies by the staff of the International Monetary Fund and by the deputies of the Group of Ten, both released last summer, not surprisingly downgraded this defect to the point of not mentioning it. Officials are not likely to reveal concern for the vulnerability to crises in confidence of the system they must manage, even if they have any such concern.

It is true, moreover, that international cooperation among national monetary authorities has increased enormously over the past 6 years, and the methods for coping with large speculative flows of funds have been vastly improved. Monetary authorities may feel, therefore, that they have this potential difficulty well under control. They certainly deserve much credit for the improvements of the recent past, but these improvements do not solve all the problem; they do not, in particular, eliminate entirely the possibility of a confidence crisis among officials. Panic of the type found in the early 1930's is unlikely; rather, the difficulty could arise over disagreements in distinguishing between a temporary speculative flow of funds from a country, which warrants extensive official support, and a more basic maladjustment in a country's position. Often, in fact, the two are found together. Officials will differ legitimately in judgment about the support to be given; some may indeed feel that the basic adjustments required will take place only under extreme pressure on the deficit country. But such pressure precisely casts in doubt the ability or the willingness of the deficit country to maintain its exchange rate and it raises questions about which countries would follow in devaluing their own currencies. Under these circumstances monetary officials may themselves develop a *sauve qui peut* psychology.

To return to the relationship between liquidity and adjustment: the postwar evolution of the international payments system—at least as it affects the typical industrial country—can be characterized (as shown in fig. 2) as a steady movement away from reliance on selective measures such as import quotas and exchange controls to greater reliance on international financing of deficits (as with the Marshall plan grants after 1948) and on internal adjustment. The question we now face is where to go from here. A given scope for freedom of trade and capital movements will result over time in greatly increased transactions—and imbalances—among countries. Therefore more frequent and more extensive use must be made of internal policies, or liquidity must increase sufficiently to accommodate the larger imbalances. Alternatively, freedom of trade and capital movements will have to be restricted.

FIGURE 2



The need for reform: A conditional forecast

This brings me finally to the question of how urgent is the need for international monetary reform. I will make a conditional forecast which is in two parts. First, unless we improve the means for generating international liquidity and distributing it adequately, we will experience national balance-

of-payments "crises" in industrial countries with greater frequency; countries will increasingly find themselves facing balance-of-payments deficits and a weakening of confidence in their currencies, and they will be compelled to adjust domestic policies and/or their barriers to trade and capital movements.

To be sure, in each case it always looks as though the country in question is at fault; its domestic policies may have gotten "out of line" or the public may not be saving enough or something else. But this observation is not sufficient to pass the entire burden of responsibility, or even the major portion of it, to the country in question. At any point in time the positions of some countries will be weaker than others, and any deficiency in the international payments system will show up at their doorsteps first. They are vulnerable, the "marginal" cases. As with general unemployment, it always hits someone; and also like unemployment, there is the danger of confusing the particular case with the general phenomenon.

The second part of the conditional forecast is that we will observe a reversal of the trend toward liberalization of trade and payments and will see greater reliance on selective external measures for eliminating payments deficits. This is not a very daring prediction; we have already seen several moves in that direction: the import surcharges of Canada in 1962 and of Britain in 1964, and the interest equalization tax, followed by the program of "voluntary controls" in this country. Countries balk at having to rely too heavily on general, internal measures to correct imbalances unless such measures also happen to be consistent with domestic objectives of policy, as they were to some extent for Italy last year. This reluctance to use internal measures is as true for surplus countries as it is for deficit countries. Germany has resisted strongly the domestic inflation which is the logical implication of its balance-of-payments surplus under fixed exchange rates; it has relied instead on special devices to induce private short-term investment abroad and on special arrangements with Britain and the United States for purchasing military equipment. But the dilemma is always more acute for the deficit countries.

When the countries in trouble do move to correct their positions, they, of course, worsen the positions of other countries. Unfortunately, it is as likely to be countries with weak positions as those with strong ones. When Japan cut back sharply its imports in 1961, it hit primarily the United States, which was itself struggling with a large deficit. Canada's devaluation and import surcharges in 1962 hit first its two largest suppliers, the United States and Britain. And measures taken by the United States to curb capital outflow aggravated the problem of Britain. Again an analogy can be made with unemployment: retraining and special placement programs can always succeed in reemploying particular individuals. But if total demand is not adequately large to absorb the potential output of the economy, such reemployment will simply displace someone else.

Let me be clear on one point: I do not forecast another period like 1929–36. At that time rising barriers to trade and competitive devaluations interacted with sharp declines in internal demand. In the future, countries will be quicker, I think, to impose barriers to imports and other payments to foreigners and will be willing to hold up domestic demand even in the face of balance-of-payments difficulties. They will also be more willing to engage in discriminatory trade practices. Thus, world trade, not domestic output and employment, will be the principal victim.

The degree of urgency which we attach to the need for international monetary reform depends then on the accuracy of this forecast and on how strongly we object to the outcome. Assume the forecast is correct. Then how costly would be the reversion to use of direct or indirect controls over international trade and capital movements? Or, to put it another way, how valuable are relatively liberal trade and capital movements?

I do not have a decisive answer to this question. It has plagued economic theorists and policymakers for many years. However, I think three observations can safely be made:

First, the economic costs of a reversion to restrictions on international payments would be much higher for "small" nations than for "large" ones. Countries such as the Netherlands and Switzerland depend vitally for a high standard of living on foreign trade. Widespread use of barriers to international transactions would be a serious blow to them. The same is not so true for a country such as the United States or for the European Economic Community taken as a unit. Extensive and liberal trade is no doubt beneficial to them, but it is not vital.

Second, a reversion to restrictions would mark a sharp reversal in European and American foreign economic policy since the Second World War, with the United States pushing rather harder for freedom of capital movements than most European nations. Whether such a reversal could be effectively isolated from our overall foreign policy, and in particular from our political and military commitments to Europe, is an open question. Would all our postwar efforts at international cooperation unwind? At the very least, it would require extremely refined judgment and delicate skill to create an effective separation between economic and other relationships.

Third, a reversion to restrictions unless delicately handled would in some respects increase the vulnerability of the payments system, even while it provided instruments for maintaining international balance. Our bulwarks against vulnerability to crises in confidence rest on the extensive arrangements for close cooperation among national monetary authorities which have been built up in recent years. This cooperation would surely be threatened by a reversion to unilateral national use of restrictions, for precisely one of the major motivations for close cooperation is to preserve liberal trade relatively free from restrictions.

A further point may be mentioned. In the present state of excitement about the vulnerability of the international payments system, reflected even today by skittish and irrational concern in many financial circles about possible devaluation of the dollar, the failure to reform the international monetary system might itself enhance the uncertainty and hence the vulnerability of the present system.

Some general guidelines to reform

These then are the crucial questions: How badly do we want liberal trade and capital movements? And how much autonomy in setting and pursuing domestic objectives of economic policy are we willing to sacrifice in order to get them?

My forecast suggests that countries will be highly unwilling to give up much domestic autonomy. To the extent we do want to avoid restrictions over international payments therefore, adequate financing will be necessary to cover periodic balance-of-payments deficits. In the space remaining, I would like to make several comments on the form which improvements in international liquidity and its mode of generation should take. These unfortunately have the ring of *obiter dicta*, as there is not sufficient time to justify them in detail.

1. From the viewpoint of the user, international liquidity can be divided into reserves and lines of credit. Reserves are something, such as gold or dollars, which a country "owns" and can dispose of at its own initiative. Credit, on the other hand, must usually be arranged and requires accommodation of the creditor. Future increases in international liquidity should include both components. Owned reserves (or fully automatic lines of credit) are necessary because creditors cannot always forebear imposing conditions on the borrower. Foreign creditors insisted that Britain cut its unemployment compensation in 1931. The United States has a full postwar history as a generous but exacting creditor, starting with the Anglo-American loan in 1946 which we used to dictate British financial policy, and illustrated by our insistence on strict financial policies as a condition of the loans to France in early 1958. Sometimes the creditor's advice will be sound, but sometimes it will not be; and always it will rankle with the debtor, who will be the more reluctant to borrow and the more eager to seek alternatives such as restrictions on trade.

On the other hand, owned reserves are not always adequate either. In periods of uncertainty a decline in owned reserves is perversely taken as a sign of weakness, an occasion to flee the currency. In early 1964, for instance, Italy, a country enormously well supplied with reserves, preferred to acquire large credits from the United States and other sources in order to support the lire. (And it borrowed first from the United States rather than from its Common Market partners apparently out of fear of the more exacting conditions which would be imposed by the latter.) If countries become reluctant to use owned reserves because such use merely signals distress, owned reserves cease to serve their only function. International credit, preferably unknown to the public in amount, then becomes necessary to finance deficits.

2. If owned reserves are to be increased, what form should they take? In particular, should the dollar continue to play its present role as a reserve currency?

The dollar's role in international finance is a vital one. It is extremely useful to have an international currency of exchange to act as intermediary between other moneys. Without it, most exchange markets would be extremely "thin,"

and matching buyers and sellers at reasonably firm prices would be difficult. There are currently about 110 distinct currencies in the world. Without a currency of exchange, there would have to be nearly 12,000 different bilateral currency markets, and the number of transactions going through most of them would inevitably be small and sporadic. Trade would be discouraged. Just as we avoid commodity barter domestically by using money as an intermediary, we avoid bartering money internationally by using just a few currencies, principally dollars and sterling, as intermediaries between the others.

Similarly, so long as monetary authorities preserve stability in exchange rates by intervening in currency markets, they must intervene in something, and it is natural to use the currency of exchange, which provides an active and well-developed market vis-a-vis other currencies. Thus most central banks support their currencies by buying and selling dollars.

But this vital function of the dollar, a currency of exchange and by virtue of that a currency of intervention, is quite separable from its function as a reserve currency. Reserves are stores of value, and they can be held in anything so long as they are readily convertible into international means of payment. Corporations and banks do not hold all of their liquid assets in currency and demand deposits; on the contrary, they typically hold amounts in excess of working balances in Treasury bills or other earning assets, confident that they can convert these assets into cash on short notice and with little or no loss. Gold is a useful form in which to hold international reserves because it is readily convertible into external sterling in London, or dollars at the U.S. Treasury. By the same token, the role of the dollar as a reserve currency is not nearly so essential as its role as a currency of exchange; what is important is the ready convertibility of any form of owned reserves into dollars and other "key" currencies of exchange.

For this reason I do not think it should be an objective of U.S. international financial policy to preserve the reserve currency status of the dollar. Those who think it should be preserved must specify how in the future maintaining the reserve-currency status of the dollar will enhance our other, more basic objectives: higher living standards, wide employment opportunities, national security, and so on. In the face of growing reluctance by foreign monetary authorities to hold even the stock of dollars already in foreign hands, I would think we should welcome alternative forms of reserve assets which relieve this source of concern.

3. If not the dollar, what then? I would prefer some internationalization of liquidity creation, partly in the form of owned reserves or automatic credits, partly in the form of discretionary credits such as the credit tranches of a country's drawing rights at the International Monetary Fund. These sources should be generous, but beyond them countries should be expected, as a rule, to reduce their payments deficits. It would be the responsibility of those governing the use of discretionary credits to distinguish between those cases where extension of large credits would be globally beneficial and those cases where refusal to provide credits except under certain conditions would actually benefit the deficit country.

From a technical economic point of view it really does not much matter where such liquidity creation takes place; I confess a preference for the International Monetary Fund, partly because it is an existing institution with high expertise, partly because it is a global organization where every viewpoint can at least get a hearing.

The IMF as it stands at present, however, is not well suited for taking on the job of managing world money. Its executive board is heavily occupied with the day-to-day tasks of lending to its 102 members, the vast majority of which are less developed countries. The executive directors are not intimately involved in the process of economic policymaking in the countries whose economic activity sets the pace for world production and trade.

As a practical matter, monetary officials of the major industrial countries are not likely to delegate to executive directors of the IMF the job of creating international reserves on a systematic basis. Moreover, the less developed countries are well represented on the executive board, and while they have a strong and legitimate interest in the mechanism for generating international liquidity, there is perhaps some merit in the European fear that (because of their pressing demand for capital) they are not so likely to balance the disadvantages of an overabundance of international liquidity against the disadvantages of a shortage of liquidity. But this is no reason to go to the other extreme and neglect their views and interests entirely.

It would be desirable, therefore, to bring together under the auspices of the IMF the key monetary officials of the countries most important to the world economy, possibly four times a year and more often if needed, to assess the world economic situation with the help of the Fund's staff and to decide what implications it has for international liquidity. This group of officials should include a few representatives from the nonindustrial countries. Such a group could decide on necessary increases in owned reserves and could set general guidelines for extensions of credit in the near future.

The group should consider the overall economic situation, not simply the rate of change in prices. For this reason national representation should involve the top economic policymakers of governments, those who must face the actual choice among competing policies, and not only representatives of central banks.

Price stability may on occasion have to be weighed against other economic objectives, and this is no less true at the international level than at the national one.

Action by such a group could not of course be by unanimous vote; that would make it quite unworkable. Any country which objects strongly enough to the group's decisions can exert its ultimate sovereign right of withdrawing from the entire system of collaboration.

4. Once the appropriate level of international liquidity and discretionary lending has been decided, economic adjustment among countries under fixed exchange rates will necessarily require moderate inflation in some regions of the world, moderate deflation in others, just as it does for regions within the United States. Unlike regions within the United States, however, nations set national economic objectives and the required inflation or deflation for international adjustment may conflict with those objectives. To avoid this they will be tempted to resort to selective, external measures to cope with imbalances in their international payments. As the history of the thirties suggests, such measures can too easily degenerate through aggressive retaliation or mere self-defense into a self-defeating spiral of rising barriers to trade and payments (or rising subsidies to exports). It would therefore be desirable in any consideration of international monetary reform to review the rules we now have governing the use of external measures for balance-of-payments reasons and to establish some new guidelines to govern violation of the rules.

Representative Reuss. Thank you, Mr. Cooper. Our next witness is Professor Ingram. Mr. Ingram, will you proceed, please?

STATEMENT OF JAMES C. INGRAM, PROFESSOR OF ECONOMICS, UNIVERSITY OF NORTH CAROLINA

Mr. Ingram. Thank you, Mr. Chairman.

I think the focus of this hearing is exactly right, given the present state of the discussion of international monetary reform. We have been treated to such an enormous volume of discussion of the technical issues and the theory underlying the problems of international monetary adjustment that what we now need, it seems to me, is precisely what you have asked us for: a discussion of practical steps that can be taken and what it is that can be negotiated among nations.

Unfortunately, however, I don't think economists, at least university economists, are in the best position to know what can be negotiated among nations. At least speaking for myself, I am uninformed about the extent to which agreement can be reached in international discussions. We don't have access to the proceedings of these bodies. We don't have access to the minutes, for example, of Working Party 3. We don't know what these governments are saying to each other, or the representatives of them.

Now, it may be that as an outsider I exaggerate this handicap. And I note that the Economist recently remarked that British and American officials were finding a wide area of agreement in discus-

sions with French officials, yet Mr. Giscard d'Estaing said on July 19 that differences were so profound that an international conference could serve no useful purpose.

If there is that kind of disagreement by those who should know what is going on inside these conferences, perhaps the handicap of being outside is not so great.

In any case, I thought I would focus most of my remarks this morning on the things that the United States can do on its own initiative, things it can do unilaterally. That is, I am making the assumption that we will not be able to reach any very substantial area of international agreement, and that, therefore, we ought to consider what it is we can do on own own initiative.

In my prepared statement I have listed some objectives of an international monetary system. I think they are standard ones—that it should promote trade, allow growth in income, stable prices, and provide financing for deficits where needed, but also provide some kind of adjustment mechanism which seems to be the chief missing element at present.

The main point I want to argue is that the United States should move to protect its own interests, provided we are unable to reach an international agreement that is acceptable to us.

I recognize that this is a second-best proposal, in the sense that the first choice would certainly be to work out an international agreement that was satisfactory to us and to other countries. But if I start with the assumption that we cannot do that now, then I say we should move to protect our interests, to free ourselves from some of the handicaps the present system imposes on us.

I think our balance-of-payments deficits have been misinterpreted and exaggerated, and that the United States has adopted undesirable policies in response to world opinion based on this misinterpretation.

The problems of definition and accounting have been exhaustively discussed and I won't comment on those, except to say I generally agree with Professor Kindleberger in his recent statement to the Senate Committee on Banking and Currency.

It seems to me that the present system, at least as it has operated since 1945, is essentially a dollar exchange standard, that it is not a gold standard, or was not intended to be one, that the United States has satisfactorily met its responsibilities as a key currency country, and that the gold tie is now being misused to place us in a defensive, apologetic position. I think we should break out of that position, unilaterally if necessary.

We could do so by forcing the world to decide whether or not it wants a dollar standard, a straight dollar standard. We can force that choice simply by ceasing to buy gold at any price.

If we seriously consider this move, and discuss it publicly, it might even improve the negotiating climate for other types of monetary reform. But even if we cannot reach an agreement, I think this step has a number of practical advantages in its favor.

So I will talk about some implications of that step, and then end with a few brief remarks about the first best choice, a true international agreement.

As I have mentioned, the world has been on a dollar standard for the past 20 years, but the link to gold through the U.S. dollar created

the appearance of a gold exchange standard. When a few countries began to accumulate dollars in greater amounts than they wished to hold, their conversion of the excess dollars into gold exposed the weakness of the system. The dollar standard could be clarified and strengthened by one simple action by the United States. The Treasury could simply announce that it will not buy gold, but will continue to sell it at the present price. This proposal has been frequently heard.[1] There is nothing original about it. But I think it deserves more careful consideration than it has received. I am afraid it has been put into the same category as flexible exchange rates, or doubling the price of gold. As such, it may lie outside the scope of this hearing, which is supposed to deal with practical steps, not far out proposals.

I will argue, however, that this proposal has a number of advantages, that it is a practical possibility, and that it could liberate the dollar standard to perform its functions.

Under the dollar exchange standard, other nations link their currencies to the dollar, and they have the responsibility for supporting those exchange rates. The appropriate responsibility of the United States under the dollar exchange standard is to maintain the value of the dollar, not in terms of gold, but in terms of purchasing power relative to other currencies, and to prevent a scarcity of dollars from hampering the orderly growth of world trade and output. We have discharged this responsibility quite well since 1945. Except for price rises in the immediate postwar period, and during the Korean war, we have had a good record of price stability, and we did develop mechanisms for alleviating the dollar shortage.

The dollar has served well as a medium of exchange and a store of value, as a key currency.

I agree with Professor Mundell in his remarks yesterday about the probable future importance of the dollar in international trade and finance. I don't think it can easily be displaced or replaced as a unit of account in the foreseeable future.

I think the gold link, which appears to convert the dollar exchange standard into a gold exchange standard, is unnecessary to its proper functioning, that it was originally incorporated as a form of window dressing, and that a literal insistence upon it is what really threatens the present system. Because of it a dollar exchange standard that is working as well or better than we had any right to expect is now threatened by an eventuality that scarcely anyone foresaw when the Bretton Woods agreements were made, an insufficiency of U.S. gold reserves.

Even so cautious an economist as Professor Machlup wrote in 1940 that "there is little chance * * * that we shall use substantial parts of the gold for payments abroad," and that "we seem to be justified as regarding as unlikely that the gold which we now have will ever again leave our country."

I think that was the prevailing view in 1944 and 1945 as well, and that there was little real consideration of this end of the problem.

However, because of the loss of gold, we have been under constant attack since 1958, and we have had to adopt a number of undesirable policies to mollify critics, including even partial exchange controls

[1] EDITOR'S NOTE.—For additional materials on the advantages and disadvantages of changing U.S. gold buying policy, see the submissions by Senator Javits, printed in "Part 2—Supplement," the second volume of these hearings.

52-324—65—pt. 1——9

and selective depreciation of the dollar. These measures would be unnecessary in a straight dollar standard. Indeed, they are unnecessary even now, as far as most of the world is concerned.

I am impressed by the simple figures on the distribution of gold and the varying preferences among central banks for gold. It is impressive to me that in the 6 years, from the end of 1958 to the end of 1964, five countries increased their gold stock by $7 billion, and the entire rest of the world, not counting the United States and the United Kingdom, increased gold holdings by only $1.5 billion. These five countries are the countries that seem to be putting the stress on the gold exchange aspects of the present system—the others seem content with the dollar standard, as they have increased their reserves quite a lot, but have taken the increases in the form of dollars.

These five countries do not now have a very large dollar holding, despite the attention given to their concern about such holdings. At least according to the figures I have, these five countries increased their dollars by only $1.5 billion in this 6-year period, from 1958 to 1964, and their so-called overhang dollars seem not to be growing as rapidly as the publicity it receives might indicate.

I think by ceasing to buy gold, the United States could put the issue squarely to the world, and especially to the OECD nations, as to whether they want a dollar standard or not. If they do, then they can continue to link their currencies to the dollar, as they have been doing, and support the fixed parities. If they do not, then they can convert their dollars into gold, as we would continue to sell, and set their exchange rates in some other manner.

In my opinion, most nations have a strong preference for stable exchange rates, and I believe most of them would continue to operate in about the same way as in the recent past.

Indeed, as long as the key currency country maintains relative price stability, I can see no reason why other countries would wish to alter their relationship to the dollar just because the United States stops buying gold. I think there is a high degree of artificiality about the present crisis, and the alleged dollar glut, and I think it is caused in large part by the bizarre arrangement through which the dollar tie to gold gives value to that metal, while at the same time the declining U.S. gold stock threatens the stability of the dollar.

Since the present climate of opinion does not seem to permit agreement on fundamental reform, I think we should move unilaterally to extricate ourselves from the present predicament, and stop apologizing for our balance-of-payments position.

In Professor Mundell's phrase, I think we should remove the "gold herring."

The shift to a full-fledged dollar standard need not make much difference to the operation of the system. Whether it would do so depends upon the responses of the various nations. As I have mentioned, I think the world wants stable exchange rates, and that most nations would continue to link currencies to the dollar.

If other countries do supply their currencies—and if we have a deficit—they accumulate dollars. In that event, there are actions they can take to cause these dollars to pass into the hands of the private sector, either to be held or to be used for the purpose of goods, services, or assets. Dollars need not accumulate in the central bank or

Treasury, although some governments may prefer to hold the dollars themselves, rather than to take the actions that would cause them to be firmly held in the private sector.

I think there is much inconsistency in complaints by some Europeans that U.S. deficits were the cause of inflationary pressures in their economies—though I would not deny that this has been a contributing influence.

These very same governments that complain about excess liquidity take numerous actions to prevent funds from moving out of the country on private account, and they limit foreign borrowing in their capital markets. I should say parenthetically that I recognize that some governments have also taken a good many measures to encourage the movement of funds into foreign assets, particularly by the banking sector.

The French reaction to the campaign of California savings and loan associations to attract savings from France is an instructive case in point. The French Government evidently did not want private individuals to hold dollar funds abroad. Excessive domestic liquidity in Europe, and price inflation, could also be effectively combatted by liberalizing imports, but they don't seem eager to choose that way out.

I think some nations are using the U.S. deficits as a club to achieve other objectives they desire, such as the reduction of U.S. direct investment. While I can understand the concern that, say, France has about the volume of U.S. direct investment, I should think if that is the focus of their concern, direct action on that particular element would be more appropriate than a generalized assault on the entire structure of the international monetary system as a means of bringing direct investment under control.

Now, it must be admitted that a dollar exchange standard of this kind does involve some asymmetry in the world economy. It gives the United States a dominant role in certain respects. The United States becomes the chief pricemaker in world capital markets, and U.S. actions largely determine the rate of increase in world reserves and money stock.

At the present time, acceptance by European countries of the U.S. role as pricemaker, in interest rate structure particularly, would require a general reduction in European interest rates. Europeans resist such a reduction, because of its inflationary influence. But they could probably contain inflation as well with a 5-percent long-term interest rate as with 7 percent, if they were willing to use a different combination of policy actions. Basically, however, they do not accept U.S. leadership in setting these levels. Of course the United States can move part of the way, too, and we have done so in short term interest rates.

From the political standpoint, the present conflict about international monetary matters may be interpreted as a challenge to U.S. primacy in these matters.

So we seem to have three choices. The rate of increase in reserves and money supply in the world at large and the general structure of interest rates can be determined or influenced in three ways: First, arbitrarily by a rigid link to gold, as France seems to prefer; second, by some system of international management through the IMF; or, third, largely at U.S. initiative, through the dollar exchange standard.

Most people reject the rule of gold, and international agreement seems unattainable—at least that is my working assumption. So we are left with the dollar exchange standard. The chief problems with it is that the United States itself is not placed under any explicit discipline when the gold tie is cut. Other countries fear we may not act responsibly. They are understandably reluctant to allow the United States to determine matters so vital to their own economic interest.

Perhaps we should seek ways to limit the power of the key currency countries, ways that make more sense than the discipline of gold.

I next list a few specific advantages that I think going to a straight dollar standard would offer us at the present time.

First, open public discussion of this action would not start a run on the dollar—I don't think it would, at any rate.

Second, in itself the action does not greatly alter the present system, wouldn't change exchange rates, or institutional arrangements.

Third, the United States does not break its moral commitment to supply gold in exchange for official dollar holdings.

Fourth, this is an action we can take on our own initiative.

Fifth, gold hoarders are not rewarded.

Sixth, this action does not bar the way to more fundamental reforms. Indeed public consideration of it might act as the spur to international negotiations.

And, seven, existing perimeter defenses of the dollar could continue.

If we did stop buying gold, what would happen to its price? On this matter, every man must be his own psychologist. When Mr. Jacques Rueff was asked that question by Mr. Fred Hirsch early this year, his answer was: "The price of gold would fall to a very low level and nothing would make it possible to maintain it. Unless, of course, there were great speculation which convinced people that gold was still a refuge." I think most economists would agree that the first impact would be a sharp fall in the price of gold on the London market. However, if present restrictions on private ownership of gold were removed in the United States and other countries, I think it is possible that the price of gold would soon recover.

In any case, this would not mean a great diminution in the value of gold reserves held by a number of countries.

I would like to turn briefly now to some alternatives, things that might be done if we can in fact obtain some kind of international agreement.

I would favor building on the IMF, perhaps by permitting it to accept deposits. If we are merely concerned about the overhang of dollars, we could reduce the severity of that problem by allowing nations to transfer the excess holdings of national currencies to the IMF in exchange for deposits. These deposits would have to be denominated in some unit of value, and I suggest that the unit of account device now being used in some European bond issues, and used earlier in EPU, might be the best alternative. These assets would, of course, be covered by an exchange guarantee by the debtor country.

That might take care of the overhang problem.

It is more difficult to design acceptable rules to govern further expansion of IMF deposits. I don't think an automatic formula would work—2 or 3 percent a year. Some discretionary power would have to be delegated to the Fund.

As for the technique of expansion, I favor letting the IMF buy World Bank bonds. When the funds are lent by the Bank to underdeveloped country borrowers, real resources become available to them.

This has been objected to on the grounds that the IMF then holds illiquid assets. But I personally don't think that is a serious disadvantage since the whole system rests on confidence, anyway, and if nations agree to accept IMF deposits denominated in some unit of account as owned reserves, then I don't think the composition of IMF assets is a vital matter.

Here, too, the overriding issues are political. Who is to have the power to decide how much of any currency the IMF can hold or how much it can expand deposits? How much influence over a nation's economic policy can the IMF exert by virtue of the fact that it holds financial assets denominated in that nation's currency?

Without a wide measure of agreement on these essential questions, without some willingness to delegate real power to an international organization, I don't think much can be done in this direction.

Perhaps central bank cooperation will be a more feasible alternative. Certainly such cooperation in the recent years is one of the most important developments in the international monetary system.

Most observers deplore the ad hoc and unsystematic character of this coordination, and would like to replace these ad hoc measures with some kind of formal organization. However, since nations probably won't agree on that, either, it is possible that continued use of informal cooperation is the best course of action. If some nations don't wish to participate, the others can still work out useful defensive mechanisms. In a sense, this kind of central bank coordination serves as a check on U.S. action, thus offsetting U.S. dominance over policy, a problem I mentioned earlier.

Foreign central banks can attach conditions to their cooperation. It is possible that techniques could be developed through which central bank coordination could provide the needed check on U.S. policy under a full-fledged dollar exchange standard. Other countries would have the power to change exchange rates, and they could also demand higher interest rates on dollar holdings, and thus increase the cost to us of further increases in world dollar reserves. We would then be under some inducement to correct any excessive creation of dollars.

Finally, I would like to say a few words about capital movements.

No matter what specific structural reforms are finally adopted, I think the adjustment process, under a fixed exchange rate system, would be greatly facilitated if barriers to capital movements could be removed or at least greatly reduced in major industrial countries. If we do want continued movement toward economic integration, stable exchange rates, low tariffs, and if we have long swings in national balances of payments, I think these swings might be financed largely by private capital movements. In such a world, little scope would remain for independent monetary policy, and interest rates would become similar in the major countries.

I think the United States should make a vigorous effort to negotiate the removal of the many barriers to capital movements that exist in Europe. If Europeans had been really free in recent years to place funds in the United States and acquire U.S. assets, I doubt that official dollar holdings would have risen very much.

It is unfortunate, in my opinion, that the Fowler committee report was followed, not by a campaign to reduce European barriers to capital movements, but by the erection of some of our own, and I would hope that the one practical step in negotiations would be in that direction, to remove and reduce exchange controls in Europe on capital movements.

Thank you, Mr. Chairman.

Senator PROXMIRE. Thank you, Mr. Ingram.

(The prepared statement referred to follows:)

PREPARED STATEMENT OF JAMES C. INGRAM, PROFESSOR OF ECONOMICS, UNIVERSITY OF NORTH CAROLINA

STRENGTHENING THE DOLLAR-EXCHANGE STANDARD

The international monetary system has been discussed at such length in recent years, and proposals for its reform have been so plentiful, that novelty now seems hardly possible. Considerable agreement exists about the nature of the deficiencies in the present system and about the range of alternatives available. The real problem seems to lie in the area of negotiation, in the process of reaching a consensus satisfactory to the several nations. Thus I think the focus of this hearing is exactly right. I am less certain, however, that outside economists are in a position to know what is negotiable in the present climate of international politics. In contrast to the open discussions that have taken place about the international monetary system and its problems, the proceedings of official bodies have been unavailable to the public, except for noncomittal reports from time to time. It is difficult for an outsider to know the extent of agreement, or exactly what the limits are, or to form a judgment about what is practicable. Perhaps I exaggerate this handicap. It is interesting to note that the Economist (July 10, 1965) remarked that British and American officials were finding a wide area of agreement in discussions with French officials, yet Mr. Giscard d'Estaing said on July 19, 1965, that differences were so profound that an international conference could serve no useful purpose.

Subject always to the limitations of an outsider, my own view is that the nations of the Atlantic Community have not yet decided what degree of economic integration they want, and that genuine monetary reform must await that decision. For a time, in the late 1950's and early 1960's, it appeared that these nations wanted a world of convertible currencies at fixed exchange rates, low tariffs, and substantially free capital movements—all of which imply a considerable degree of economic integration. Since 1962, the tide has receded. The split in Europe hardened with the failure of Britain's bid to join the European Economic Community, tariff reduction is stalled, the U.S. dollar has moved away from convertibility (at least for residents), and capital movements are increasingly limited by discretionary government control.

In these circumstances, it seems idle to speak of fundamental reforms of the international monetary system, reforms that require close cooperation of governments, a common set of objectives, and perhaps what Myrdal called "human solidarity" among nations. As the EEC is learning, monetary matters are among the most sensitive to national differences; they touch the nerve of national sovereignty.

Consequently, I do not believe that any complex scheme of monetary reform, requiring for its negotiation and operation a wide agreement among member nations of the IMF, is likely to be attainable at this time. However, this judgment is largely a political one, and I must emphasize again that I have no personal, practical knowledge of what can or cannot be done in intergovernmental negotiations.

The objectives of an international monetary system are similar to those of a national monetary system. In neither case can these objectives be fully attained by monetary actions, institutions, or policies alone. My list of objectives includes the following:

(1) To permit, at least not hamper, growth in income and trade;

(2) To promote stable prices;

(3) To provide deficit countries with access to funds to finance deficits during long swings in the balance of payments;

(4) To impose some check on a country that is "out of line," thus inducing use of some kind of adjustment process;

(5) To provide some machinery for determination of the interest-rate structure and the desired rates of increase in world reserves and money supply;

(6) To provide an environment in which nations can achieve currency convertibility and in which individuals and firms may exercise free choice in the purchase of goods and assets;

(7) To provide a mechanism for decision that takes account of the national interests of the several nations and yields an equitable outcome.

These objectives might be achieved in a number of different ways. Ideally, reforms in the present system should be based on an international agreement, perhaps a revision of the IMF charter. However, since I am doubtful that agreement can be reached on a sufficiently broad basis to remove the deficiencies of the present system, I think the United States should move to protect its own interests, to free itself from some of the handicaps the present system imposes. I think our deficits have been misinterpreted and exaggerated, and that the United States has adopted undesirable policies in response to world opinion based on this misinterpretation. The problems of definition and accounting have been exhaustively discussed, and I will not comment on these, except to say that I am in general agreement with Professor Kindleberger in his statement to the Senate Committee on Banking and Currency in March of this year.

The main point I want to argue is that the present system is a dollar-exchange standard, not a gold standard, that the United States has satisfactorily met its responsibilities as a key-currency country, and that the gold tie is now being misused to place us in a defensive, apologetic position. I think we should break out of that position, unilaterally if necessary. We could do so by forcing the world to decide whether or not it wants a dollar-exchange standard. We can force that choice simply by ceasing to buy gold at any price. Serious consideration of such a move by the United States might also improve the negotiating climate for other types of monetary reform, but if agreement cannot be reached, this step has a number of practical advantages in its favor.

In the remainder of this paper I will concentrate on what the United States can do unilaterally, namely (1) cessation of U.S. gold purchases in order to offer the world a true dollar-exchange standard, and then comment briefly on (2) revision of the IMF to enable it to hold the exchange reserves of member nations, and (3) extension of central bank coordination.

THE DOLLAR-EXCHANGE STANDARD

The world has been on a dollar-exchange standard for the past 20 years, but the link to gold through the U.S. dollar created the appearance of a gold-exchange standard. When a few countries began to accumulate dollars in greater amounts than they wished to hold, their conversion of the excess dollars into gold exposed the weakness of the system. The dollar-exchange standard could be clarified and (I think) strengthened by one simple action by the United States: We could announce that the U.S. Treasury would no longer buy gold, but would continue to sell it at $35 per ounce. This proposal has been frequently heard in recent years, and probably in previous hearings of this committee. There is nothing original about it, but I think it deserves more careful consideration than it has yet received. I'm afraid it has been put into the same category as flexible exchange rates or doubling the price of gold. As such, it may appear to lie outside the scope of this hearing, which is supposed to deal with practical steps, not far-out proposals. I will argue, however, that this proposal has a number of advantages, that it is a practical possibility, and that it could liberate the dollar-exchange standard to perform its functions in a more effective manner. It might also be useful as a bargaining counter.

Under a dollar-exchange standard, other nations link their currencies to the U.S. dollar, and they have the responsibility for supporting exchange rates at the levels they have chosen. Their support operations have effects on domestic money supply and other economic variables. The appropriate functional responsibility of the United States, under a dollar-exchange standard, is to maintain the value of the dollar, not in terms of gold but in terms of purchasing power relative to other currencies, and to prevent a scarcity of dollars from hampering the orderly growth of world trade and output. We have discharged this responsibility quite well since 1945. Except for price rises in the immediate postwar period and during the Korean war, we have had a good record of price stabilty

(especally relative to other countries), and we did develop mechanisms for alleviating the dollar shortage when it existed. The dollar has served well as a key currency—a medium of exchange and a store of value.

I think the gold link, which appears to convert the dollar-exchange standard into a gold-exchange standard, is unnecessary to its proper functioning qua dollar-exchange standard, that it was originally incorporated as a form of window dressing, and that a literal insistence upon it is what really threatens the present system. Because of it, a dollar-exchange standard that is working as well or better than we had any right to expect is now threatened by an eventuality that scarcely anyone foresaw when the Bretton Woods agreements were made—an insufficiency of U.S. gold reserves. Even so cautious an economist as Professor Machlup wrote in 1940 that "there is little chance * * * that we shall use substantial parts of the (U.S.) gold (stock) for payments abroad" and that "we seem to be justified in regarding as unlikely that the gold which we now have will ever again leave our country." [1]

Because of this gold loss we have been under constant attack since 1958 for our balance-of-payments deficits, and we have had to adopt a number of undesirable measures to mollify critics, including even partial exchange controls and selective depreciation of the dollar. These measures would be unnecessary in a straight dollar-exchange standard; indeed they are unnecessary even now as far as most of the world is concerned.[2]

By ceasing to buy gold, the United States could put the issue squarely up to the OECD nations: Do you want a dollar-exchange standard or not? If you do, then continue to link your currencies to the dollar and support the fixed parities. If you do not, then convert your dollars into gold or sell them in the market and set your exchange rates as you wish. In my opinion, most nations (especially OECD nations) have a strong preference for stable exchange rates, and I believe most if not all nations would continue to operate in substantially the same way as in the recent past, linking their currencies to the dollar at fixed parities. Indeed, as long as the key-currency country maintains relative price stability, I can see no reason why other countries would wish to alter their relationship to the dollar just because the United States stops buying gold. I think there is a high degree of artificiality about the present crisis and the alleged "dollar glut," and I think it is caused in large part by the bizarre arrangement by which the dollar tie to gold gives value to that metal, while at the same time the declining U.S. gold stock threatens the stability of the dollar.

Since the present climate of opinion does not seem to permit agreement on fundamental reform of the international monetary system, I think the United States should move unilaterally to extricate itself from its present predicament, should stop apologizing for its balance-of-payments position, and should reject the preachments of the central bankers. In Professor Mundell's phrase, I think we should remove the "gold herring."

The shift to a full-fledged dollar-exchange standard need not make much difference for the operation of the international monetary system. Whether it would do so depends on the responses of the various nations. As I have said, I think the world wants stable exchange rates, and that most nations would continue to link currencies to the dollar. If there is an excess demand for their currencies at the fixed parities, they can supply it or not. If not, they can let their currencies appreciate. (President de Gaulle can cause the dollar to depreciate vis-a-vis the franc at any time.) If other countries do supply their currencies, they accumulate dollars. In that event there are actions they can take to cause these dollars to pass into the hands of the private sector, either to be held or to be used for the purchase of goods, services, or assets. Dollars need not accumulate in the central bank or treasury, although some governments may prefer to hold the dollars themselves rather than to take the actions that would result in their being firmly held by the private sector.

---

[1] Fritz Machlup, "International Payments, Debts, and Gold" (New York, 1964), p. 238. Professor Machlup did qualify this forecast, of course, and the assumptions he made in 1940 have since changed a great deal.

[2] A list of countries which do not consider the dollar to be in dangerously excess supply would probably include Canada, Japan, the United Kingdom, virtually all underdeveloped countries in Asia, Africa, and Latin America, and most of Western Europe. Indeed, only France, Germany, Switzerland, and perhaps the Netherlands seem really concerned about a dollar glut. Even in these countries, the concern seems limited to central bankers and government officials; the private sectors show no unwillingness to hold or acquire dollars.

I think there is much inconsistency and even doubletalk in complaints by some Europeans that U.S. deficits are the cause of inflationary pressures in their economies, and that they must have some relief from this excess liquidity. The very same governments take numerous actions to prevent funds from moving out of the country on private account, and they limit foreign borrowing in their capital markets. The French reaction to the campaign of California savings and loan associations to attract savings is an instructive case in point; the French Government simply did not want private individuals to hold dollar funds abroad. Excessive domestic liquidity and price inflation could also be effectively combated by liberalizing imports, but this alternative is not received enthusiastically. I think some nations are using the U.S. deficits as a club to achieve other objectives they desire, such as the reduction of U.S. direct investment.

Under a full-fledged dollar-exchange standard, when dollars are in excess supply, other nations will accumulate dollar assets, whether held officially or privately. That is their role in the system, and in return they earn income on these assets. The U.S. responsibility is to preserve the purchasing power of the dollar relative to other currencies. If we do not fulfill that responsibility, other countries can cause the dollar to depreciate. That puts some restraint on us.

It must be admitted that a dollar-exchange standard of this kind does involve some asymmetry in the world economy. It gives the United States a dominant role in certain respects. The United States becomes the chief pricemaker in world capital markets, and U.S. actions largely determine the rate of increase in world reserves and money stock. At the present time, acceptance by European countries of the U.S. role of pricemaker in interest-rate structure would require a general reduction in European interest rates. Europeans resist such a reduction because of its inflationary influence, but they could probably contain inflation as well with 5-percent long-term rates as with 7 percent, if they were willing to use a different combination of policy actions. Basically, however, they do not accept U.S. leadership in setting these levels. (Of course the United States can move part of the way, too, and we have done so with respect to short-term interest rates.) From a political standpoint, the present conflict about the international monetary system may be interpreted as a challenge to U.S. primacy in these matters. If it were possible to reach an agreement specifying ways to regulate them through international action, that might be preferable. But such agreement seems impractical, and the attempt to force the United States to alter its position through the discipline of gold has little to commend it, in my opinion.

We seem to have three choices. The rate of increase in reserves and money supply, and the general structure of interest rates, can be determined (or at least influenced) in three ways: (1) arbitrarily by a rigid link to gold, as France seems to prefer, (2) by some system of international management through the IMF or another institution, or (3) largely at U.S. initiative through the dollar exchange standard. Most people reject the rule of gold, and international agreement seems unattainable, so we are left with the dollar-exchange standard. The chief problem with it is that the United States itself is not placed under any explicit discipline when the gold tie is cut. Other countries fear that we may not act responsibly. They are understandably reluctant to allow the United States to determine matters so vital to their own economic interests. Perhaps we should seek ways to limit the power of the key-currency country that make more sense than the discipline of gold.

U.S. action to offer the world a dollar-exchange standard through ceasing to buy gold has a number of advantages.

1. Open public discussion of this action would not start a run on the dollar. Indeed, many central banks might sell some of their stocks of gold before the window closed.

2. In itself the action does not greatly alter the present system, and it would probably not disturb existing exchange rates and institutional arrangements. The International Monetary Fund structure and mechanism could be preserved.

3. The United States does not break its moral commitment to supply gold in exchange for official dollar holdings of other countries. Although it is unlikely that we would sell much gold at $35 per ounce, our gold stock is large enough to enable us to pay all official holders of dollars if the demand were made.

4. This action is one the United States can take unilaterally.

5. Gold hoarders are not rewarded.

6. This action does not bar the way to more fundamental reforms of the international monetary system. Indeed, public consideration of it might act as a spur to international negotiation.

7. Existing "perimeter defenses" of the dollar could continue, though they would be less necessary than at present, and efforts to increase reserves in other forms would not necessarily be hindered.

If we did stop buying gold, what would happen to its price? On this matter, every man must be his own psychologist. When Mr. Jacques Rueff was asked that question by Mr. Fred Hirsch early this year, his answer was: "The price of gold would fall to a very low level and nothing would make it possible to maintain it. Unless, of course, there were great speculation which convinced people that gold was still a refuge."[3] I think most economists would agree that the first impact would be a sharp fall in the price of gold on the London market. However, if present restrictions on private ownership of gold were removed in the United States and other countries, I think it is possible that the price of gold would soon recover. It is conceivable that it might even rise above the present price of $35 per ounce in a few years. As world population and wealth increases, private individuals might well wish to hold as much as 2 billion ounces of gold—which is roughly the size of the present stock of gold. The question is highly conjectural, however.

PERMIT THE IMF TO ACCEPT DEPOSITS

If, contrary to my assumption, international agreement does seem feasible, I would favor building on the IMF, perhaps by permitting it to accept deposits. For a start, member countries could simply transfer their excess dollars and pounds to the IMF in exchange for deposits with the IMF. These deposits would have to be denominated in some unit of value. Many alternative arrangements have been suggested; my own inclination is to use the "unit of account" formula now being used in some European bond issues. Although I have not studied the intricacies of the composite currency schemes, my impression is that they are unwieldy and probably unnecessary. The assets held by the Fund should of course be covered by an exchange guarantee by the debtor country.

That would take care of the problem caused by existing official holdings of national currencies, but the more difficult problem is to design acceptable rules to govern further expansion of IMF deposits. I do not think an automatic formula would work; some discretionary power would have to be delegated to the Fund. As for the technique of expansion, I favor letting the IMF buy World Bank bonds. When the funds are lent by the Bank to underdeveloped country borrowers, real reserves become available to them. I do not think the illiquid nature of IMF assets is a serious disadvantage. If IMF deposits are not accepted readily the scheme won't work in any case.

A great many technical questions arise in connection with this proposal and its many variants. Other witnesses are much more familiar with these matters than I am. It seems to me that here, too, the overriding issues are political. Who is to have the power to decide how much of any currency the IMF can hold, or how much it can expand deposits? How much influence over a nation's economic policy can the IMF exert by virtue of the fact that it holds financial assets denominated in that nation's currency? Without a wide measure of agreement on these essential questions, and without a willingness to delegate some real power of decision to an international organization, I do not think much can be done in this direction. Quota increases and enlarged supplementary borrowing arrangements are useful, but they do not come to grips with the main problem.

CENTRAL BANK COOPERATION

The most important development in the functioning of the international monetary system in the past 6 or 7 years is the increase in ad hoc cooperation among central banks and treasuries, aided of course by the IMF. These arrangements have taken the brunt of recent crises. Most observers deplore their ad hoc, unsystematic character, and want to replace them with some kind of formal organization. However, since nations will probably not agree on this matter neither, it is possible that continued use of informal cooperation is the best course of action. If one or two nations do not wish to participate, the others can still

[3] Jacques Rueff and Fred Hirsch, The Role and the Rule of Gold: "An Argument" Essays in International Finance No. 47, Princeton University, June 1965.

work out useful defensive mechanisms. I think it likely that, despite the clamor for basic reform, the decision will still be in favor of a policy of "muddling through," just as Professor Machlup predicted in 1962.[4]

In a sense, this kind of central bank coordination serves as a check on U.S. action, thus offsetting U.S. dominance over policy; foreign central banks can attach conditions to their cooperation. It is possible that techniques could be developed through which central bank coordination could provide the needed check on U.S. policy under a full-fledged dollar exchange standard. Other countries would have the power to change exchange rates. They could also demand higher interest rates on dollar holdings, and thus increase the cost to us of further increases in world dollar reserves.

CAPITAL MOVEMENTS

No matter what specific structural reforms are finally adopted, I think the adjustment process would be greatly facilitated if barriers to capital movements could be removed in the major industrial countries. If economic integration does continue, I think we will move toward a world of stable exchange rates and relatively low tariffs, with long swings in national balances of payments financed largely by private capital movements. Little scope would remain for independent monetary policy in such a world, and interest rates would be broadly similar in all major countries.

I think the United States should make a vigorous effort to negotiate the removal of the many barriers to capital movements that exist in Europe. If Europeans had been really free in recent years to place funds in the United States and acquire U.S. assets, I doubt that official dollar holdings would have risen very much. It is unfortunate, in my opinion, that the Fowler Committee report was followed, not by a campaign to reduce European barriers to capital movements, but by the erection of some of our own.

Representative Reuss. Our next witness is Mr. Lawrence B. Krause. Will you proceed, please?

STATEMENT OF LAWRENCE B. KRAUSE, BROOKINGS INSTITUTION[1]

Mr. Krause. Mr. Chairman, it is indeed a pleasure for me to appear before this committee. This is not the first time that you have given me an opportunity to express my views on international monetary problems. Because we concluded that there was no state of the balance of payments which would remove the constraints imposed on the United States in its efforts to attain more basic objectives of policy, my colleagues and I, in the Brookings balance-of-payments study, presented to this committee our belief that the international monetary system needed reform.[2]

In looking for criteria by which changes in the system should be viewed, it is well to keep in mind the goal for which a well-working international monetary system is sought. Most important of all, we seek an international monetary system that will permit the United States and other countries to pursue proper economic policies to achieve the basic economic objectives of our society. We desire our international system to have three specific characteristics. The first is that of fixed exchange rates. I believe that fixed exchange rates are a virtue and add to the well-being of all countries able to partake in such

[4] Fritz Machlup, "Plans for Reform of the International Monetary System, Special Paper No. 3", Princeton University, August 1962.

[1] The interpretations and conclusions in this statement are those of the author and do not purport to represent the views of the other staff members, officers, or trustees of the Brookings Institution.

[2] "The United States Balance of Payments in 1968," by Walter S. Salant and Emile Despres, Lawrence B. Krause, Alice M. Rivlin, William A. Salant, and Lorie Tarshis (Washington: The Brookings Institution), 1963.

a system. But it must be remembered that fixed exchange rates require sacrifices and obligations of countries maintaining these rates. Some countries are neither in the economic position to accept these sacrifices, nor are they in a position to obtain most of the benefits of fixed exchange rates; therefore, they should neither be expected to, nor attempt to, keep their rates firmly fixed. This may well apply to most underdeveloped countries today.

The second characteristic of the system is a maximum degree of freedom of movement of goods and services across international borders. Fortunately, we have been moving closer to this end despite the fact that some countries in specific periods of time have had to resort to restrictions. While the slow pace of the Kennedy round may cause one to reconsider, it still appears to me as if liberalization of trade is the desire of all countries in GATT.

The third characteristic is that of a maximum degree of freedom of private international capital movements. I view the value of freedom in this area as great as that obtained by the free movement of goods and services. Unfortunately, however, capital movements are less free today than they have been in the recent past. Indeed, we may well question whether some countries even desire it to be otherwise. No doubt the unequal commitment to freedom of capital movement has been a source of disturbance in the past and will continue to be unless remedied.

There has been sufficient discussion of the fixed exchange rate system as we know it today so that economists have agreed to classify the problems that have arisen into three parts: the balance-of-payments adjustment problem, the liquidity problem, and the confidence problem. We can question whether all of these problems should be attacked through reform of the international monetary system. The confidence problem can certainly be handled through international monetary reform. Since the technical side of the confidence problem arises from shifts in central bank portfolio, this is a rather traditional kind of banking problem for which a number of remedies are possible. The liquidity problem can also be approached through reform in that any change we are likely to make in the international monetary system will provide for the growth of reserve over time. However, the third problem, the adjustment problem, is unlikely to be eased through reform of the monetary system itself and it may well be exacerbated. This raises the question of whether we need something beyond mere reform of the international monetary system in order to establish a stable world economy.

It is possible to set up some general economic criteria by which reform of the international monetary system should be judged. After reform, the system should operate in such a way as to provide the amount of reserves and the growth of reserves that are needed to finance deficit countries while they are bringing their balance of payments back into equilibrium. The system should also prevent the unwanted contractions of reserves caused by the shifts in the form in which reserves are held which occurs today when countries convert currency into gold. Furthermore, the system should generate confidence in the fixity of exchange rates. Confidence in fixed exchange rates is furthered by providing assured sources of liquidity for currencies in difficulty. A fixed exchange rate system which constantly

threatens the cessation of support for weak currencies will remain basically unstable. Finally, the system developed for creating and holding international reserves should not interfere with the choice by private traders of which currency they wish to use in their international transactions. Private traders, therefore, should not be prevented from accumulating reserves of foreign currenices needed for working balances by overzealous balance-of-payments discipline. Also, governments should not be prevented from holding working balances of foreign currencies for stabilization purposes even if rigid ratios of foreign currencies in international reserves are decided upon. If need be, central banks could set up separate accounts: a reserve account and a trading account, with restrictions applying only to the former.

In the process of reforming the international monetary system, changes should be avoided that would themselves be so disruptive of existing institutions as to undermine the goals for which reform is sought. It must be recognized that international reserves are made up roughly two-thirds in gold and one-third in foreign currency—mainly dollars. Proposals for reform which involve eliminating all of one or the other form of reserves require too great an adaptive process and therefore should be avoided if possible.

These criteria are sufficiently general so that not one, but many possible plans for reform could be devised and indeed have been devised to meet them. The choices are not so open-ended, however, because in addition to the economic criteria just discussed there are certain political criteria which also must be met. The political criteria that I refer to stem from the recognition that international finance, just as domestic money creation, touches on a basic area of national sovereignty. In fact, it is one of the extremely guarded areas of sovereignty in that the creation of international finance can be a mechanism of redistributing claims to real goods and services and capital assets among different countries. Because of this sensitivity, proposals for reform which involve giving sovereignty to an international authority over which national control is lacking are bound to be rejected. National sovereignty is, of course, not absolute; every international agreement limits the freedom of action of nation-states. Therefore, the political criterion implied is that the economic plan for reform should be advocated which minimizes the divestiture of national sovereignty.

International monetary arrangements have always been between nation-states. In the past the system has worked best when a single country has been in a dominant economic position. This was true during the pre-1914 period when the United Kingdom was dominant and immediately after World War II when the United States was clearly dominant. Dominance comes from the existence of economic power, however, not from a formal mechanism nor from institutions. A system which requires dominance that does not exist will not work well. The countries being dominated will become restive for they can easily see the advantages that come to the dominant country but are unlikely to appreciate the responsibilities that go with that position. More importantly, if economic dominance does not exist, other countries will have weapons with which to influence the country in the dominant position. As long as the United States was in a position to

provide dollars or take them away from other countries at our will, a system based solely on the dollar worked tolerably well. But when other countries reached the position in which they could accumulate dollars despite the U.S. desire to the contrary, then they had weapons to disrupt the system if they saw it in their interests to do so. Despite our great economic strength, we must recognize that the world economy is not dominated today by the United States, and the international monetary system must reflect this.

The point was made very forcefully by General de Gaulle in his press conference of February 4, 1965, when he said that the system of international exchanges must be established on a monetary basis which does not bear the mark of any individual country. His solution of a resurrected gold standard properly deserves to be discarded. However, the criterion which he set for the international monetary system is a real one and must be respected. Therefore, a second political criterion requires that the reformed international monetary system should be one which recognizes existing economic power and which matches the privileges and the responsibilities of that power. The system should be one that includes all countries, even those with very little power. Given modern international relations, it is not sufficient for a monetary system to be established under the exclusive control of the rich countries even if intended for the benefit of all. The system must have room for the economic power of even the smallest country to be represented, no matter how slight a weight may be attached to it.

So far I have been speaking in generalities, but now I wish to turn to some rather specific issues. I believe an international monetary system can be formed which bears all of the economic and political characteristics decribed. I think it can evolve from our existing institution, the International Monetary Fund. The International Monetary Fund has many attributes to recommend it as the building stone for a better international monetary system. It has a broadly representative base. It has an expert staff and is experienced in this field. Through past actions, it has gained the respect of many governments all over the world. But its greatest asset is that it already exists and can begin immediately to undertake an expanded role.

The objections some have raised to evolving a new international monetary system based on the International Monetary Fund have been based on the fact that the Fund, as now constituted, is dominated by the United States and the United Kingdom. This criticism needs to be met, and as stated previously, cannot be avoided regardless of the approach to reform. Making the control of the IMF conform to the existing distribution of economic power among countries requires a substantial readjustment of the target quotas of the Fund for some countries. Target quotas might be made relative to the size of countries, based on the amount of their international transactions. The term "target quota" was chosen advisedly, for the change required of some countries to bring up their quota to properly reflect their economic position might be so great as to cause difficulties in the short run. A transitional system might be worked out in which voting power preceded the adjustment of quotas according to an agreed upon schedule.

The role of the International Monetary Fund for countries committed to a fixed exchange rate would be much different than at present. Currently advanced industrial countries use the IMF as a third line of reserves. In general, countries use the resources in their own reserves for their immediate needs, then use bilateral swap arrangements as a second line of defense and only call upon the resources of the IMF to reconstitute bilateral positions and to provide further resources if needed. A transformed Fund could become a first line of reserves for countries. The automatic drawing rights of the Fund could be used before the reserves of countries were employed. Countries would immediately and continually replenish their currency reserves when used to maintain fixed exchange rates in currency markets, or they could deputize the Fund to operate as their agent in the market itself. With the IMF being used as a first line of defense of the fixed exchange rate system it would be possible to determine the needs for future liquidity after some experience has been gained. Furthermore, the operations of the International Monetary Fund could be brought closer to exchange markets and would enable a narrowing of the existing range of exchange rate fluctuations.

For those countries that are not able to meet the obligations of a fixed exchange rate system, the role of the IMF could remain much the same as it is today. The IMF would be a discretionary lender and could, also, on its own volition, counter cyclical swings in foreign exchange earnings of these countries for the purpose of preventing unwanted fluctuations in exchange rates. I personally do not think that the Fund should be used to provide real long-term resources for developing countries. There are other agencies available for this purpose and I believe that the Fund would be better able to perform its own specialized function if it was not given an additional task.

In order to provide the first line of reserves for the fixed exchange rate countries, the mode of operation of the Fund would have to change substantially. The automatic drawing rights of the fixed exchange rate countries of unrestricted funds would have to be appreciably expanded. When a country would call upon the Fund for reserves, the Fund would provide convertible currencies of its own choice. In this way, the Fund could make sure that the responsibilities of expanding international liquidity were shared in proper proportion among countries. The Fund should also have the right to negotiate special drawings of a limited duration for countries in the midst of currency flights. Indeed, a prearranged agreement to unconditionally provide such funds should be negotiated.

Over time the expansion of the resources of the Fund would come through quota increases. Since it is very difficult to predict the needed expansion of reserves in the short run, I would think that it would be desirable to constantly have a 5-year horizon for the target expansion of reserves. One-fifth of the 5-year growth target, however, should be implemented every year. The amount of growth over the 5-year horizon would presumably be investigated by the staff of the IMF and approved by the members at the annual meeting. While there is virtue in looking 5 years ahead in determining needed reserves, there is no virtue in waiting 5 years to see whether the projection was correct. Therefore, I think that every year a 5-year projection should be made and the annual growth rate reviewed on the basis of it. When

increases in quotas are deemed necessary—as I believe they would be every year—they need not be made proportional to existing quotas. They should reflect the changing position of countries as measured by their share of international transactions.

This still leaves open the question of what criteria one should use to determine how much growth is needed in reserves. The concept of reserve adequacy is clearly one of subjective determination not easily reduced to a formula. For this reason, I would favor annual negotiations. As a guide to these negotiations one might say that reserve growth would be adequate if countries were not forced to follow domestic economic policies inappropriate for their own needs. One European central banker recently expressed the opinion that monetary policy in his country was limited by the fact that foreign reserves had declined relative to internal liquidity. By using this logic, the needed growth of international reserves would be equal to the growth of the domestic money supply.[3] I think that such a rate of growth might well be excessive. One might start, however, by having as a goal the growth of international reserves equal to the growth of international transactions and then adjust as experience warranted. Clearly there would be no need or desire to tie the increases in reserves to the availability of gold in the system. Therefore, there should no longer be a requirement that part of the increase in IMF quotas be paid in gold. While the system should not rest on gold, I see no reason to take gold out of the system. It provides a means whereby countries can accumulate owned reserves if that is their desire.

Most of the changes in the International Monetary Fund that I have described would be directed toward providing a means for growth of reserves. At the same time, however, I believe that the conversion of dollars into gold would cease to be a problem. I believe the United States has adequate reserves of gold to meet all immediate calls for conversion and with the use of our rights within the IMF, future demands can easily be met. If, however, others feel that the existing overhang of dollars is excessive and might undermine the changes in the system that are currently being sought, the United States could issue a new security that would stand between gold and existing U.S. Government obligations. This would be a gold-guaranteed bond which would carry only a nominal rate of interest. Foreigners who do not wish to take the risk of holding unguaranteed dollar bonds could obtain a gold-guaranteed bond for which they would have to pay a premium in the form of a lower rate of interest. My own feeling is that there would be very few takers for this new issue.

Criticisms of schemes to increase the automaticity of reserve creation generally concentrate on the fact that such a system lacks discipline. A system with automatic provisions for increases in reserves might keep countries from following the policies needed for balance-of-payments adjustment. Since the system forces surplus countries to give up real resources through the creation of additional reserves without disciplining deficit countries in the use of these resources, the whole system may turn out to be extremely inflationary. The present system certainly does provide this kind of discipline on non-key cur-

---

[3] Speech by the governor of the Bank of Italy, Dr. Guido Carli, on May 31, 1965, as reported in the July 2 issue of the International Financial News Survey.

rency countries and to a growing extent also on the United States and the United Kingdom. But this discipline is indiscriminate. It works on a country following a proper policy for solving its balance-of-payments deficit if a long time is needed for adjustment as well as on a country taking no corrective action. Furthermore, the discipline, even when appropriate, is applied much too late and in a form that questions the stability of the fixed exchange rate system. I think discipline is required in the system and that even the present arrangement is insufficient, but I do not believe this goal is well served through the cutting off of liquidity which is needed to maintain fixed exchange rates.

As conventionally viewed, discipline is needed to prevent the importing of inflation. However, I believe that discipline is needed more importantly because of the mutual interdependence of countries encouraged by a fixed exchange system with freedom of movement of goods and capital. If countries specialize in production, they become dependent on foreign markets for their continued prosperity and therefore have an interest in seeing that neither inflation nor deflation occurs in the world. A system which favors mutual dependence must also demand mutual responsibility. This can only come by having discipline applied at an early stage of a disturbance and only when needed. Waiting until a liquidity crisis occurs is much too late for an effective use of discipline. I believe that effective discipline should require two things: first, that countries follow stabilization policies appropriate to their domestic needs—avoiding both inflation and deflation; and second, that the mix of policies chosen to achieve these stabilization objectives be consistent with a fixed exchange rate system with free movement of capital. This requires that domestic stabilization needs be furthered primarily through fiscal policy while monetary policy at least in part be reserved for the needs of international balance. To achieve the discipline of the system, an altered form will be required. Without limiting access to liquidity, the price at which liquidity is provided should be made dependent upon a country following proper policies. If a country pursues improper policies leading to an inflationary situation, then the liquidity made available to it should be at increasing interest charges. But this discipline should be symmetric, unlike the present system in which countries following too deflationary policies bear little responsibility. Interest returns to surplus countries following too deflationary policies should be reduced in a similar manner. Countries accumulating credit balances in the IMF would be paid successively lower interest rates if those countries were following too deflationary policies. Furthermore, unless countries are willing to limit their use of monetary policy for domestic purposes it must be recognized that fixed exchange rates and freedom of capital movements are basically inconsistent. I would suggest that countries refusing to gear their monetary policy sufficiently to the needs of the balance of payments should be denied access to the international capital market as their own behavior reflects a desire not to have it operate.

One may still question whether having to pay higher interest rates is a sufficient penalty for a country following inflationary policies. It could be argued that this may not dissuade countries from absorbing real resources from other countries. There remains the ultimate

weapon of discipline for use on an erring country—expulsion from the group of fixed exchange rate countries. If a country is unwilling to take the responsibilities and the obligations that go with the fixed rate system, then it should be denied the benefits that go with the system.

One of the major advantages of approaching the reform of the international monetary system through the evolution of the International Monetary Fund is that the first step in such a reform, as well as the ultimate goal, can be specified. Much can be done to change the International Monetary Fund without requiring unanimous agreement by all member countries. The United States acting unilaterally could expand its own use of the Fund and thereby transform it from a third-line to a first-line source of reserves. The United States could also urge more frequent revision of quotas through normal consultations at Fund meetings. The Fund's own lending criteria can be altered within the existing articles, as already indicated by spokesmen for the IMF, in such a way as to expand it automatically in lending.

Clearly some of the more basic changes in the Fund will require a change in the articles of agreement. This suggests that a conference will be necesary at which substantially unanimous agreement must be reached; however, this is a requirement for all plans of basic reform of the international monetary system. I believe that revising the International Monetary Fund is the logical way to approach a reform of the international monetary system. If, however, other countries refuse to take steps toward improving the system, then the United States must explore alternative solutions open to us. At that time, it would be clear that all of our major domestic and international goals cannot be met. We would then have to question whether domestic stabilization, fixed exchange rates, freedom of capital movements, or freedom of goods should be maintained. I would regret having to face such decisions, but we should not close our minds to the possibility that this basically distasteful situation might be forced upon us.

Representative Reuss. Thank you, Mr. Krause.

Mr. Ellsworth.

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

Well, I think all three statements this morning were exceptionally clear and helpful. I just have a few questions.

Of course, we are hearing testimony this morning against the background of Secretary Fowler's announcement that the United States stands prepared to attend a conference to consider reform in the international system. I thought it was interesting that you, Mr. Ingram, suggested the possibility of the United States taking unilateral action by way of refusing to buy any more gold, which would presumably strengthen our position at a conference, or possibly if a conference does not develop for some time would in any case help the situation.

Mr. Krause, you also suggested unilateral action we might take to turn the IMF into a first line of reserves rather than a third line of reserves.

I think that both of those suggestions were very timely, and I hope they will be given consideration.

Mr. Cooper, I understand that in August you are going to take office as Deputy Assistant Secretary of State for Monetary Affairs. Of course you are taking that office at a particularly crucial

time for monetary affairs in the international scene. And so your statement is particularly, I think, significant this morning—even though you have not taken office yet.

Mr. Cooper, last year the UNCTAD had a meeting, a conference, and passed a resolution, among other resolutions, providing for a study of international monetary problems by a group of experts. I understand that that study is to get underway sometime this October. What effect does that group's interest in this problem have on the proposed conference that Secretary Fowler has suggested and on the composition and agenda of any preparatory committee that may be formed in September?

Mr. Cooper. Let me open just by saying that I sit here this morning as an employee of Yale University and not of any Government agency. This is my last fling as a professor of economics for awhile. There is, of course, a risk attached to too many international conferences in this area as in others. But countries outside the Group of Ten—and they amount to most of the countries in the world—a number of them have been very restive about what they regard as matters intimately affecting their own interests being discussed by a very limited and self-selected group of countries. The UNCTAD resolutions in the area of international monetary reform—in a sense to one side of their main agenda—were a reflection of this concern.

I would think that a carefully conceived study by representatives of the less-developed countries and the developed countries together, under the auspices of the new Trade and Development Board which grew out of UNCTAD, could be very helpful in guiding anything that a more limited group of countries does, whether through Working Party 3 of the OECD or through the Group of Ten.

This meeting of experts for the U.N. Trade and Development Board in October would not serve the same role as a preparatory conference for a major international conference. But I would think that any preparatory committee should pay a lot of attention to the product of such an effort.

Representative Ellsworth. Whom do you see being on the preparatory committee or commission? In other words, how is that group going to differ, for example, from the group that was responsible for the Ossola report?

Mr. Cooper. I confess I have not thought much about the membership of a preparatory committee for an international monetary conference. I am inclined to think before holding a full-fledged international monetary conference, most of the positions would have to be worked out well ahead of time by a much smaller group of countries and the remaining questions very clearly defined. The natural group for such preparation. I suppose, is the Group of Ten—if not under those auspices, at least those countries, or substantially the same membership as the Group of Ten. But as I have indicated, the risk there is that the interests of other countries, over 90 percent of all countries, might get neglected. It is in that capacity that the UNCTAD effort can serve a very useful function. It provides a sounding board and a megaphone, if you like, for the reactions and views of those countries to the whole area of international monetary reform.

If the preparatory group were to become much larger, then it would become as unworkable for the early stages of any major reform as the conference itself would be.

Representative ELLSWORTH. Do I understand you, then, that you do not visualize the preparatory group as being any different from the Group of Ten or 11; is that correct?

Mr. COOPER. I would say there would have to be considerable overlap in membership. I would not want to say there should be no difference.

Representative ELLSWORTH. Do you see any merit or virtue——

Mr. COOPER. Excuse me. It might be even smaller, for example. There is something to be said for having only four or five countries.

Representative ELLSWORTH. Do you see any virtue or merit in having groups or organizations such as the OECD, the IMF, UNCTAD, what have you, either instead of or in addition to nations represented on the preparatory group?

Mr. COOPER. Representing international organizations rather than nations?

Representative ELLSWORTH. As such.

Mr. COOPER. The U.N. Trade and Development Board is brand new. I would think that this group that they have called together to gather in October, which is really a group of national experts but independent of governments and presumably selected representatively from the entire membership, might serve a most useful function, but not as a preparatory committee. I do not at the moment see any special advantage in having representatives of international organizations as such participate in the preparatory work except insofar as they can provide expertise regarding the various possibilities—the IMF could play a very useful role in that respect.

I think—and this was explicit in Professor Ingram's statement—this is a matter that touches very importantly on national policy, and nations are very jealous about what they conceive to be their prerogatives in this area. When you get down to it, successful monetary reform of any type is going to require agreement among the major nations—or possibly—and I don't think this should be ruled out—an agreement among some substantial subgroup of the major nations. It would need their cooperation for success. To the extent that they can draw on the advice, the expertise, of international organizations and get a reflection of the interest of all the other countries, so much the better.

Representative ELLSWORTH. Thank you very much.

Mr. Ingram, you emphasized the importance of reducing the barriers to international capital movement in your statement and pointed out that one of the effects of reducing barriers to international capital movement would be to reduce the freedom of nations to use monetary policies in attaining domestic goals.

Of course, nations for various reasons connected with the international balance-of-payments situation have already experienced substantial intrusion into their autonomy, in fiscal policy and in other areas, too. I would like to ask both Mr. Cooper and Mr. Krause to give their views on this—on the value of increased freedom of international capital movements as an important objective for national policy

of the United States in moving into any of these international conferences.

Mr. KRAUSE. As I said in my statement, I view free movement of capital as an important objective—as important as free movement of goods—because I think the welfare benefits are of the same order of magnitude.

But the free movement of capital does require that at least part of monetary policy be devoted to international balance.

I think that this is only possible when you have instituted flexible enough fiscal policy so that you will not sacrifice important domestic stabilization objectives. I think you can move on both of these fronts simultaneously. As a matter of fact, the United States has been more advanced in this area than European countries. Possibly we have been forced to be more flexible, since we have been the deficit rather than the surplus country. But I think it can be done. Both goals are simultaneously obtainable.

If you have flexible fiscal policy, I see no great loss in not having flexible monetary policy for domestic needs.

Mr. ELLSWORTH. Mr. Cooper.

Mr. COOPER. Yes. Let me say first that just as a statement of preference I attach more importance to freedom of trade than I do to freedom of capital movements.

I think in principle the contribution of international capital movements to world welfare can be very large. In practice such movements are likely to be distorted by differences in national policy among countries—much more so than is true of trade. I am not persuaded, for example, that when a hundred million dollars moves from the United States to country X, that this automatically increases world output and benefits the world. It depends very much on what kind of special tax and other inducements country X has offered as compared with taxes and other factors in the investing country. It is just not clear to me that the benefits of nearly free capital movements in the real world are as high as they are for nearly free trade, although to be sure trade can be distorted also.

I would like to underline very strongly, though, the second of Dr. Krause's remarks, that until we improve our other instrument of economic policy, we should be most reluctant to give up monetary policy as an instrument for domestic stabilization purposes. I think it is possible to reach a state in which monetary policy's principal role would be to influence the balance of payments and that we would rely on fiscal policy—the position of the Government's surplus or deficit—and tax structure and other such things to influence the course of domestic activity, to stabilize the domestic economy and to achieve whatever rate of growth we want. But we are very far from that state and I think most European countries, with a few exceptions such as Sweden, are even further than the United States is.

I recall that 4 years ago the Congress turned down a proposal by President Kennedy to give the President very modest powers to change tax rates countercyclically.

I think it is most interesting to note that while the United States has had nearly 4 years now of prodding by the European countries to raise interest rates, and to restore full employment by relying on fiscal policy instead of monetary policy, that when they themselves begin to

run into domestic difficulty, the principal instrument on which they rely is not fiscal policy but monetary policy—despite the implications for the balance of payments.

When Germany begins to worry about inflation, it raises interest rates—it does not raise the government surplus.

Fiscal policy just is not that flexible. And until it becomes flexible and recognized as an important year-to-year tool of economic policy, I would be most reluctant to give up monetary policy, which is perhaps not so powerful but which nonetheless has some impact on domestic activity.

Representative ELLSWORTH. Thank you very much. My time is up.

Senator PROXMIRE. Mr. Cooper, you talk of adjustment, it seemed to me, in the earlier part of your paper, primarily on the part of the deficit countries. And this is the kind of an adjustment that most of us think of, and certainly the classical adjustment. The surplus country relaxes, does what comes naturally, and the sinfulness of our nature—spending more, taxing less, borrowing more—theoretically helps bring equilibrium.

Yesterday one of the witnesses emphasized—and Mr. Krause said in his paper today, too, to some extent—how important it is to achieve a conscious, deliberate adjustment on the part of the surplus countries.

Do you think this is a realistic expectation? Did you have that in mind when you used that French phrase, which I cannot pronounce—sauve qui peut—he who knows can do it—something like that. What does it mean?

Mr. COOPER. That phrase was used in a different context. Central banks, if they see the system of international cooperation crumbling, will retreat into their own interests very narrowly determined. They will "save what they can."

But on your other point, I deliberately couched my suggestion in terms of a prospective deficit country, because I think that is where the hard choices have to be made.

The surplus country always has the option, if it chooses to do so, of simply accumulating reserves. So that hard choices have to be made by the deficit country.

Now, if one were to ask how should the system work, I would certainly agree with Dr. Krause that there should be much more symmetry in it. It would be desirable for the surplus countries to do some of the adjusting.

In fact, most discussions about the need for symmetry, I think, are misleading to this extent. It depends very much on the source of imbalance. There may be occasions in which the surplus country should do most of the adjusting. There may also be occasions in which the deficit countries should do most of the adjusting.

I interpret Dr. Krause's scheme to introduce this kind of discretion and guidance through the International Monetary Fund, possibly indicating where the principal burden of adjustment should lie.

Some arrangement of that type would be desirable. But it is much more difficult to compel adjustment from the surplus countries than it is from the deficit countries.

Senator PROXMIRE. I ask that because deficit countries adjust, in terms of internal policy, according to Mr. Krause's suggestion—and

it is a consistent and common suggestion of expert economists—that they use monetary policy, which means that they hike interest rates. It seems that that is the thrust, that is the tendency. And you get a pressure on interest rates—I mean a tendency to rely excessively, it seems to me, on interest rates, when you do that.

Furthermore, Mr. Mundell raised the point, in disagreement with this position yesterday—and I would like you to comment on this, Mr. Krause—he argued, after I asked the question, that there is some question now in this country, for example, whether an increase in interest rates might have an adverse effect on our economy, that if the increase were mild enough not to have an adverse effect on our economy it might not have any significant effect on our balance of payments. This is all on the assumption our balance of payments continues to be adverse, and that the President's program is only going to be temporary.

Mr. Krause. The degree to which interest rate policy is used for balance-of-payments purposes is related to the ratio of rates rather than the absolute level. If the United States raised its rates but European countries follow by raising their own rates as they have done previously, then I would agree with Dr. Mundell.

Senator Proxmire. And that does seem to happen, you know.

Mr. Krause. That is right. While I have referred to using monetary policy for balance-of-payments purposes, I would not want this to imply that as of this moment I favor higher interest rates because of the balance of payments. Higher interest rates may not lead to any good at all, right now.

Senator Proxmire. Dr. Cooper, you talk about the tremendous urgency of international monetary reform, and you talk about it in terms of the consequences if we do not have monetary reform, and the crises that may develop, the restrictions on trade that may follow.

With this kind of diagnosis, and it may well be accurate, doesn't this tend to weaken our bargaining position—if we go into a conference recognizing this, feeling this strongly, and France is not so concerned?

Mr. Cooper. No. On the contrary——

Senator Proxmire. Aren't we pretty much under pressure to reach an agreement that will do something about this quickly?

Mr. Cooper. I did not mean to convey the impression of urgency in reform. Only that the degree of urgency which we attach to reform depends on how costly we regard this conditional forecast which I made.

As I indicate, I think in a certain real sense the costs to a country, such as the United States, of flexible use of trade controls and controls over capital movements are just a lot less than they are to other countries. From a narrow national point of view it seems to me we can take—and ignoring now the problem of vulnerability of the payments system—we can take a more relaxed attitude than other countries. It seems to me only insofar as we begin to take a global view—and in this I agree completely with Professor Ingram—I think the United States has behaved very responsibly over the last two decades—it is only insofar as we take a really global view that the United States should attach a high urgency to this. Countries such as Japan, possibly Canada—Canada is in good shape now but it may not be—countries of that size that I think have the serious, more serious costs of these balance-of-payments crises.

Senator PROXMIRE. I got the impression, Professor Ingram, that you felt our position was not strong at the present time, that one of the remedies you suggest is that we cease buying gold. You thought this would strengthen our position dramatically, and that we should continue to sell gold. This is a very intriguing suggestion. It is a welcome, new suggestion.

Does not Professor Machlup also espouse this position?

Mr. INGRAM. He had a somewhat different proposal that we attempt to reduce the price of gold steadily over time, in some automatic fashion.

Senator PROXMIRE. It seems to me when he brought this up before our Banking Committee, it was criticized by a whole series of economists—it was hard for them to grasp the notion that if we sold gold and didn't buy it we could maintain adequate reserves. If our gold reserve did diminish, there would develop a lack of confidence. And, as you say, Machlup did couple his "no gold buying" with the notion that we sell gold at less than $35 occasionally.

Mr. INGRAM. The proposal I remember from Professor Machlup was to engineer a reduction in the price of gold, and that presumably would make it less attractive as a speculation holding.

I don't myself believe that that is a feasible proposal at the present time. I am not certain we could bring it off, even if it were desirable.

In response to your initial statement, I would say that I did not intend to leave the impression that I think the United States is now in a weak position. Quite the contrary, I think our position is strong and has been strong, and the general impression throughout the world that we are in a weak position has been exaggerated and has caused us in responding to that to do a lot of things——

Senator PROXMIRE. This is something that has happened since February?

Mr. INGRAM. No, I mean within the last 6 years.

Senator PROXMIRE. Well, I am talking about the coming conference. Has our bargaining power improved since we have temporarily, at least, mastered our balance-of-payments deficits, or are you talking about the fact that our economy is strong, and we are——

Mr. INGRAM. Yes, I am talking about the latter, the basic strength in the U.S. economy.

Senator PROXMIRE. You did give me the impression that you felt that timing may not be happy for us to press our position now.

Mr. INGRAM. Yes.

Senator PROXMIRE. Is that right?

Mr. INGRAM. I said that because I have this sort of uninformed skepticism about the prospects for getting real agreement of a fundamental nature to reform the international monetary system.

And if we cannot get such an agreement, then I suggest that we ought to take some actions which would bring into prominence the underlying strength of the U.S. position, which I think is indeed very strong.

Senator PROXMIRE. But you say that your suggestion that we stop buying gold is not practical at the moment?

Mr. INGRAM. I think that is something we could do unilaterally.

Senator PROXMIRE. And you think it would have a significant strengthening effect on our position at the conference?

Mr. INGRAM. Yes; I think it might be a useful bargaining ploy. If other countries want a dollar standard, and they like stable exchange rates, and want to link currencies to this key currency of the dollar, then they can do so. Also, I think the suggestion that we might consider this second step might be an inducement to them to be more amenable to the fundamental kinds of reforms that might be our first choice, too.

Senator PROXMIRE. I think you do a real service in airing this publicly, because I think it might have an interesting effect. It is a real alternative.

Your dollar exchange standard, wouldn't that give us a very heavy burden to regulate our economy, to help maintain an expansive and constructive international monetary situation? If the world standard is not a gold exchange standard but a dollar exchange standard, that seems to me to really put us in a terribly responsible position, which maybe we have to assume—but it limits our freedom in regulating our domestic economy.

Mr. INGRAM. Well, I would take the opposite view of that, too, I am afraid. It seems to me it would free us. Of course it depends on the reaction of the rest of the world. I say that I believe they would be willing to accumulate dollars, if the alternative were to give up stable exchange rates and find some different method of arranging matters. But I think it would free us to do things we think are desirable domestically, and if this generates an excess supply of dollars in the exchange markets, then other countries would be accumulating these. If they then want to take actions to cause their private sectors to accumulate dollar assets—and this comes down to freeing capital movements—I don't think there would be any very large increase in official dollar holdings as a result of that policy.

Senator PROXMIRE. That is an interesting idea. Then France would lose its threatening position that it has as long as we are on a gold exchange standard, being able to use its accumulation of dollars as a threat through the vehicle of gold.

Mr. INGRAM. I believe it would reduce that threat. France might still have a strong preference for gold and, if so, she could go 100 percent into gold without crippling anything in the present arrangements. I don't believe most countries would wish to go 100 percent into gold. It is a pretty costly alternative from their standpoint.

Senator PROXMIRE. As we move away from gold, are you concerned about the possible inflationary effect, since there is a perfectly understandable, and to some extent constructive, inflationary bias? After all, developing countries have suffered inflation, severe inflation. If you don't have this anchor which helps somewhat to stabilize currencies, are you not somewhat concerned that we might be under a constant pressure to inflate more and more?

Mr. INGRAM. Other countries would be under the same restraints they are under now—the developing countries in particular. They are limited by the amount of their reserves.

Senator PROXMIRE. Restraints are not working on those countries now, are they?

Mr. INGRAM. Yes. I would not think this proposal would alter their situation.

Whether the system would be inflationary in character or not would depend really on whether we continue to act responsibly or not. If we do, our policies basically will determine how many dollars come into the hands of the rest of the world—it leaves us, as I say, in a rather dominant position in the determination of the rate of increase of this major component of world reserves, dollar holdings.

Senator PROXMIRE. Dr. Krause, apropos of that dominance, you raised a fresh notion, too. You seem to imply that we may be losing our capacity to dominate the free world financially. Britain had it for years up to 1914. We had it from 1945 to very recently. Do you have any statistical evidence to indicate that our economy is losing its relative position, or is this just an impression?

Mr. KRAUSE. I don't have the statistics with me. But in the areas where this is important, in the size of international transactions, some changes have taken place. We know, for instance, that the Common Market countries together now control about twice the amount of trade that the United States does.

While the United States has more capital movements, they are not large enough to offset this. This means the total transactions of the European Community are greater than those of the United States.

The United States is still the largest single country. If the Common Market survives its current crisis and moves closer together, one can well question whether any single country, even the largest, can offset its unified policy.

Senator PROXMIRE. That certainly is hypothetical, because the Common Market, at the moment at least, seems to be farther apart than it was 3 or 4 years ago.

Mr. KRAUSE. But even if you don't rely on absolute comparisons of this type, other countries have increased their international transactions faster than the United States over the last 7 or 8 years. So our position has certainly been weakened.

Whether our ability to dominate the world economy has been undermined significantly is a question which is hard to answer. We have witnessed, however, the ability of countries to accumulate dollars, and to use those dollars in a political way. I think that this is a sign that we are vulnerable.

Senator PROXMIRE. Well, we are correcting that now, we hope. I see your point. Your point is that we have had the adverse balance of payments—the evidence of it—over the past few years. And you have emphasized that other economies are growing rapidly—more rapidly than ours is growing.

Mr. KRAUSE. Senator, I wish I could say we are correcting the situation. The correction involves not letting dollars get into the hands of those countries that want to use them in the way that I have suggested: in a political way. But all we have done is to restrict the outflow of dollars. The restrictions most of all affect the weaker countries. This does not mean that, for instance, France will accumulate less dollars.

Senator PROXMIRE. Yes. But you could also say, by the same token, that the reason that we have the adverse balance of payments is because of political decisions made by the Congress, because of our foreign aid program, our military program primarily, and if you just had the private sector, the economy of our country would have a favorable balance of payments. Isn't that correct?

Mr. KRAUSE. As you can recall from the balance-of-payments study that Brookings did, I am much more relaxed about the balance of payments than many economists.

I interpret 1964 as being one of the strongest years for our balance of payments that we have had in 7 or 8 years. And, therefore, we do have a strong position. But we don't have a dominant position.

Senator PROXMIRE. You seem to rely—you feel that the International Monetary Fund is a good basis for an international monetary control mechanism. How about Mr. Cooper's objection to reliance on it, which I understood to be based in part on the notion that it was too broadly based?

Professor Cooper, you raised objections which few, if any, other economists have raised before the committee.

Mr. COOPER. Yes. My feeling is that the Fund as it exists today is not the right institution for undertaking the kind of activity which I think would be desirable to have undertaken. But I expressed a strong preference for building on the Fund, modifying it as required, to serve that function; not to scrap it or to set up some alternative kind of arrangement outside of the Fund.

Senator PROXMIRE. Would you accept that, Dr. Krause?

Mr. KRAUSE. I think the Fund is in a very difficult position to be a discretionary lender to developed countries. And I would agree that to perform the kind of function that I see, it cannot be a discretionary lender but must be an automatic lender.

Senator PROXMIRE. Just one final question.

You talked about relating the growth of international reserves to the growth of international transactions. I just don't know enough about it to know whether or not you should also consider the growth of economies, separate and distinct from that—perhaps not—if you are talking about just strictly international reserves.

At any rate, how could a system of automatically expanding reserves be inflationary if the expansion kept pace with the growth of transactions?

You seemed to indicate that this was inflationary.

Mr. KRAUSE. I think it could be inflationary. Some economists believe that what is limiting some countries from being more expansionary is a shortage of international reserves, and this is a restraint I would lift from them. I would not ever allow a liquidity crisis to develop. The restraints I would impose on erring countries would come from the cost of obtaining reserves, but I would never question the ability of countries to obtain reserves.

Putting ourselves in the position of an erring country, we must weigh the cost of stopping the inflation against the cost of higher interest charges that they would have to pay. Today we have a sort of absolute discipline in which the alternative to stopping inflation is giving up the fixed exchange rate. Putting ourselves in a new institutional context, I thought that one would have to face the possibility that the choice of continuing inflation is too easy.

Senator PROXMIRE. Not as long, it seems to me, as your increase in reserves is keyed to your increase in trade and other transactions. If it exceeded that, I can see it. And it might be inflationary in some areas. But you would still have an aggregative effect that would be stabilizing, I should think, provided reserve increases precisely

keep pace with trade increases. It may be that the dollar deficit has expanded more rapidly than the transactions. I have not seen a study that would show that. So, reserves may have increased in the last few years more rapidly than transactions. And we may have gone through an international inflationary situation.

Mr. KRAUSE. The reason I have used the term "transactions" rather than "trade" is because I think reserves are needed when capital moves, also. But if you geared it to transactions, and there was a shift in composition away from capital toward trade, then we could still have inflationary pressure on real goods and services at one point in time. I think it would have to be used rather flexibly.

Senator PROXMIRE. But this is a good way to try and have a stable rather than an inflationary or deflationary change in reserves, to try and relate it to transactions in terms of real volume.

Mr. KRAUSE. This would be my idea, yes.

Senator PROXMIRE. All right.

Thank you, Mr. Chairman. I appreciate your giving me the time.

Representative REUSS. Mr. Ingram, I would like to get back to your "why don't we cease buying gold" proposal.

Incidentally, a proposal like that was recommended by the Republican minority members of this committee 3 or 4 years ago, and immediately drew a great outcry from certain people. I guess it has not been heard about since, but I am glad to hear about it now.[1] And I never quite understood the outcry.

Would you list the advantages of such a change in our policy?

One advantage, of course, as a straight economy we wouldn't spend any more real resources of the Nation on gold and, also, I should think, to the extent that we held our reserves in something other than gold, we could earn interest on that, which we can't on gold. How much this might amount to, I don't know, but it could, I suppose, save several billions of dollars over the next few years.

These are two advantages.

However, I am under the impression that you attribute other advantages to it of a monetary character.

Mr. INGRAM. Yes. We haven't been troubled with that particular advantage in recent years, anyway—excessive allocation of our resources into gold.

I list a series of advantages of a practical bargaining nature somewhere in my paper.

It seems to me it has the effect of putting it up to the rest of the world whether they want a dollar standard or not. And it removes this arbitrary discipline which is being exerted by the tie to gold in the present system.

I think that, as I have said—fundamentally this is a dollar standard we are on, and have been on for some time, and that it has been working extremely well.

Representative REUSS. You still would, of course, have the tie to gold, at least until your present $14 billion of gold was gone. And that would take some time.

---

[1] EDITOR'S NOTE.—For an elaboration of the advantage and disadvantage of a change in U.S. gold buying policy, see the materials submitted for the record by Senator Javits, printed in "Part 2—Supplement," the second volume of these hearings.

Mr. INGRAM. Yes; there would be a tie to gold in that sense. And I would anticipate that a ceiling on the price of gold would remain for a very long time, in that even public discussion of a proposal like this might cause some central banks to begin selling to us before the window closed. So our gold stock might rise temporarily while the matter was being debated.

But, after that, it would depend, I suppose, on whether the price of gold did indeed fall in the free market. If it did drop somewhat under $35, then we would retain our present holding for as long as it remained down there.

Representative REUSS. I cannot quite get through my mind the way in which this would make things easier for us monetarily speaking.

Mr. INGRAM. Well, as the key currency country——

Representative REUSS. Let's assume we did it tomorrow—we announce no more purchases of gold.

Incidentally, can we do that under our international Bretton Woods agreement and other obligations? I don't know why we can't. We simply agreed to sell gold.

Mr. INGRAM. I believe the IMF agreement does contain both sides—that we do agree to purchase.

Representative REUSS. Then it would take an amendment to the IMF agreement. But let's assume we get that. And so now we are operating under a sell but do not buy arrangement.

Mr. INGRAM. Then as a key currency country, we would still have the responsibility implicitly of maintaining reasonable stability in the price level in the United States, and making the dollar an attractive medium of exchange and store of value. If we discharged that responsibility, then we could go ahead with any other domestic policies we think advisable. In the foreign exchange markets, if an excess supply of dollars appeared, the rest of the world would be responsible for maintaining fixed exchange rates, namely they would be buying up the excess supply of dollars, and their own reserves of dollars would rise.

Now, whether they would be willing to accumulate further dollars or not is a question. But at least it would be up to them. If they don't, they could begin to take action to create a larger demand for dollars—and I think freeing up capital movements would cause a lot of those dollars to be used as their citizens begin to acquire U.S. assets.

But I think the world wants a fixed exchange rate system, and would be willing—at least most countries—a hundred countries out of 105, anyway, would probably be willing to continue to accumulate dollars. I don't see any great universal disinclination to hold dollars at the present time.

Representative REUSS. Presumably France, Germany, Switzerland, and the Netherlands which show gold-grabbing propensities would satisfy their urge, which would take $2 or $3 billion worth of gold, I guess.

Mr. INGRAM. Yes. If they wanted to do that, fine. I would think it would be a desirable thing for them to move 100 percent into gold.

Representative REUSS. You would have to amend our gold cover law, to take the cover off of notes as well as deposit liabilities.

Mr. INGRAM. Yes; the cover would have to be eliminated completely, or should be.

Representative REUSS. Well, then, really what you would do, after some interim period in which the gold remained around, would be to go, despite yourself, to flexible exchange rates. They would be flexible, because unless the other countries were willing to maintain the relationships of their currencies to the dollar, they would fluctuate.

Mr. INGRAM. Yes; they have that option now. You don't change the options available to them.

Representative REUSS. But under the IMF rules they have got to support the present relationships, haven't they?

Mr. INGRAM. Yes; with some provision for them to change it at their initiative, and with IMF concurrence.

Representative REUSS. So in essence, ending our obligation to buy gold, with whatever changes in the IMF charter are necessary to do this, is really a way of going to flexible exchange rates, is it not? I don't say that that is bad. I am just trying to understand it.

Mr. INGRAM. I don't think it is, unless that is what these other countries want.

Representative REUSS. You can go to flexible exchange rates tomorrow, but if countries don't want them, they can still preserve the existing exchange rates. It is still an option.

Mr. INGRAM. Yes; they can operate the stabilization fund, and keep their currencies pegged to the dollar if they wish to.

I simply think they would wish to, and that that is the essence of the dollar standard.

Representative REUSS. Why would they wish to any more than if one went to flexible exchange rates outright tomorrow? I should think they would still wish, many of them, to maintain current relationships.

Mr. INGRAM. Yes.

Representative REUSS. I would welcome the comments of Mr. Cooper first and then Mr. Krause, on the question of ceasing to buy gold at a fixed price.

I have always been attracted to it because it would save the Treasury and the taxpayers several billions of dollars.

I was mentioning, Mr. Ellsworth, while you were out of the room, that the Republican minority on the Joint Economic Committee very specifically made this recommendation 2 or 3 years ago. And I added that I never saw too much wrong with it.

Representative ELLSWORTH. I am sure it has a lot of merit.

Mr. COOPER. I agree with Professor Ingram that most countries would probably choose to continue just as they have done in the past. It would require no change in their behavior if we ceased to buy gold at a fixed price. They would continue to maintain their parities between their currencies and the dollar. And the same would be true if we went to a system of flexible rates. They would continue to intervene in the exchange markets, just as they do now, buying and selling their own currencies for dollars, and gold is always in the background, but does not play an active role in the process of fixing exchange rates among currencies.

The reason other countries would continue to support the exchange rates is that they would certainly not welcome a depreciation of the dollar against their own currencies. The trade surplus of the United States is enormous. It was nearly $7 billion last year. It will be

smaller this year, but still very large by any reasonable standard. And I think that the other industrial countries of the world just would not tolerate new measures to increase further U.S. exports as a way to eliminate the U.S. payments deficit. And in particular, they would not tolerate depreciation of the dollar—no matter how it was brought about. So they would continue to support their currencies at present parities in the exchange market.

I think one principal value which Professor Ingram did not mention in response to your question about ceasing to buy gold is that it would put private holders of gold on notice that they can no longer count on a floor to the price of a commodity in which they are speculating.

Representative REUSS. Yes, this is the point which I now recall was made by the minority several years ago—by removing the floor under speculation, it makes it less of a sure thing than it is now.

Mr. COOPER. This is especially important in the case of gold, because of the very small margins on which gold can be purchased. So that even a relatively small fall in the price of gold can give a speculator an enormous beating. This possibility, I think, would give gold hoarders great pause.

On the other hand, I am less pessimistic than Professor Ingram is about the possibilities for truly international cooperation and the necessity of unilateral action, and I think that this move might disturb the atmosphere of international cooperation, so to speak, even more than it is already disturbed. This is apart from its intrinsic merits as a proposal, but in my view outweighs the merits at the present time.

Representative REUSS. But outside of its atmosphere-disturbing character, you see some good and not much harm in it?

Mr. COOPER. A lot to be said for it.

Representative REUSS. As you say, this is your last gasp for dear old Yale. I bet when you become a State Department official in a month you will be up here saying this would be most injudicious, it would cause a great international crisis.

Mr. COOPER. That is right. I will have to change my tune.

Representative REUSS. Mr. Krause, would you like to comment?

Mr. KRAUSE. Let me put myself in the position of Mr. Cooper 1 month hence, because I am not overly excited about this idea. A similar kind of proposal has been circulated by Professor Despres and worked out in some detail. I think that it is the kind of proposal that one would consider after it was clear that you could not get a cooperative solution, because I think it is quite irreversible.

The basic problem with this idea is that two-thirds of the reserves of the world are today in gold. If you are going to do away with gold as a reserve, you are either going to have deflationary pressures from having to operate on a smaller margin, or you must have some way to replace those reserves very quickly. This implies quite a disruptive movement of the system.

The supposed attraction of the system of only selling gold is that it forces foreign countries into the option of either accepting a dollar standard, and thereby taking the responsibility of maintaining fixed exchange rates—and that would be fine from our point of view; or they would be forced to go to flexible exchange rates—and that

would also be fine from our point of view. But I think other countries have a third option, and that is to maintain a fixed exchange rate system without going on the dollar standard. The way they could do that is by enforcing bilateral balancing. If the United States won't accept gold in settlement of accounts and France won't accept dollars, France and other countries linked to her could put on exchange controls to insure that transactions are always bilaterally cleared. We would have regressed back to the immediate postwar period and have lost free movement of goods and capital.

I tried to point out in my statement that it will be a very basic policy objective that will be given up once you recognize that cooperation is not possible. You might have to give up domestic stabilization, which I think would be wrong. You could give up fixed exchange rates, free movement of capital or free movement of goods. But unless you get cooperation, one of those things or maybe even more than one are going to be given up. I think through this scheme you give up two of them—free movement of goods and free movement of capital. I think we should only go that route after the others have been clearly investigated.

Representative REUSS. I have one additional question which I would like to ask all three of you gentlemen. I have already circulated to you a typed copy of it. It has to do with the distinction between owned reserves and automatic lines of credit.

Professor Chandler on Tuesday of this week suggested there was an important distinction and suggested that the rise in the world demands for liquidity ought to be met by increases in owned reserves rather than by borrowing facilities. My question to you is this: Can we resolve this issue by focusing on the distinction between borrowing to get liquidity and borrowing to use liquidity? A country can have automatic drawing rights at the Fund without any borrowing on its part. On the other hand, as soon as the country draws on its automatic line of credit, it assumes an obligation to repay, usually within 3 to 5 years. Owned reserves, if used, may also have to be replenished, but this is discretionary as to amount and timing.

Is this difference material?

Mr. COOPER. I think there is some difficulty here in the use of the word "automatic." If taken literally, an automatic line of credit is also an indefinite line of credit. There may in fact be a contractual obligation to repay after 90 days or 3 years, but if it is truly automatic, the country can simply renew its line of credit without any trouble, no questions asked.

Now, under those circumstances, I would say there is not a meaningful distinction between owned reserves and automatic lines of credit.

In my statement I tried to indicate that I think there is quite an important difference between conditional lines of credit and owned reserves. Conditional lines of credit inevitably tempt the creditor to impose conditions on the borrower. Sometimes these are desirable, but sometimes they are not. But if the lines of credit are automatic, not only in the sense that they can be activated at the borrower's initiative, but that they can at any point in time be so activated and in particular that they can be repaid and reactivated simultaneously, then the important distinction to be made, I think, is between owned reserves

and automatic lines of credit on the one hand, and discretionary or conditional lines of credit on the other hand.

This is in a smoothly functioning international payments system. I suppose that if nations really fell apart, they would attach a much higher value to owned reserves than on anything which depended on the willing cooperation of an international institution or other countries.

But assuming a background of international cooperation, I would think that automatic lines of credit would be much closer to owned reserves than to discretionary lines of credit.

It is worth noting that one of the early British proposals for the IMF involved fully automatic lines of credit within specified limits. Indeed, one can interpret the Fund's Articles of Agreement as meaning that drawing rights should be used in parallel with owned reserves as we normally use them. Thus they would have to be automatic, with a limit of 25 percent of each country's quota per year. The repurchase requirements assure that the Fund would reacquire a part of any member country's increase in reserves.

Now, in fact the Fund, until very recently, has never treated drawing rights as automatic. But I think that intention can be found in the original discussions regarding the IMF. A fixed repayment period is not mentioned in the Articles of Agreement that were introduced later. In their original sense, IMF drawing rights are much closer to owned reserves, and they don't involve a repayment period.

Representative REUSS. Mr. Ingram?

Mr. INGRAM. Yes, I agree entirely with what Mr. Cooper has said, so I can be quite brief.

It does depend largely on precisely what is meant by automatic in this question.

It strikes me that Professor Chandler may be reflecting an American view of the banking process. I would think that a British firm that has an overdraft facility at its bank may think it has a current ratio that is satisfactory to it, comparable to one that a U.S. corporation might have if it had borrowed from a bank on a 3-year note, and had the funds on deposit. This distinction between owned reserves and automatic lines of credit seems comparable to the distinction between the form in which borrowing processes take place in different banking systems. And if this is really a fully usable nondiscretionary overdraft facility, or line of credit, then I don't see much real difference between that and owned reserves. Though I guess this depends on the psychology of the central bankers concerned.

Representative REUSS. Mr. Krause?

Mr. KRAUSE. I think the question has been handled very well. In an ideal system, I think that the only reserve that a country would want would be gold. They would have trading accounts of currency. But everything else would be handled through the IMF, and through automatic drawing rights.

Representative REUSS. Mr. Ellsworth?

Mr. ELLSWORTH. Thank you very much.

I just have one brief question for Mr. Cooper.

Mr. Cooper, you said this morning—and you have said this before in expanded ways, in other settings—that foreign nations will not tolerate any further U.S. exports or something to that effect. At the

same time, one of the policies of the President, instituted by President Kennedy at a rally for the purpose of promoting exports, is to promote our exports, in order to assist with our balance-of-payments problem.

Being from the Great Plains area myself, I am very interested in exporting wheat in commercial markets all over the world.

Congress has adopted various tax devices to help stimulate exports. And so in lots of ways our Government seems to have strong export promotional policies and pressures of all kinds.

So I have two questions. First of all, why won't foreign countries tolerate any further U.S. exports, and what can we do about it?

And, second, what will they do to express their intolerance of further U.S. exports?

Mr. COOPER. Let me try to distinguish between two things, if I may, because I think the distinction is quite important.

I did not mean to say that the foreign countries will not tolerate any further increase in the U.S. exports surplus. I think their tolerance will be severely tested by measures taken by the U.S. Government to increase exports—not by an increase in exports per se. That may come in the course of events, due to European growth, possibly even an increase in the trade surplus.

It is new measures which would invite retaliation. In particular, devaluation of the dollar would have the effect of stimulating exports and retarding imports. And that type of measure, I think, would not be acceptable to European governments.

When you ask why this is so, I am rather hard put to answer that question—particularly since many European countries, until this year, have been complaining about inflation. One would think that they would welcome some deterioration of their own trade position—a reduction in demand for their exports is anti-inflationary.

But the fact seems to be that one important measure which countries use of their international strength is their trade position. Even countries enjoying very large accruals to reserves worry a lot when they see their trade position deteriorating. Somehow they are not satisfied to be running a trade deficit and offsetting that, or even more than offsetting that, by inflows of capital.

Canada, particularly in the late 1950's and early 1960's, was very much worried about its large current account deficit. Japan was, too, even when neither country was losing reserves. Switzerland is very much concerned about its basic economic position, its weak trade position, even though its reserves continue to grow intermittently.

Over and above the strength of the international position, I think there is still in many countries a strong mercantilist sentiment in the business community. Larger imports and smaller orders for exports mean tougher competition for business, and the business community, of course, does not welcome this increased competition—especially if it results from deliberate action by governments.

Now, when it comes to how foreign countries manifest their lack of tolerance for U.S. measures to promote exports, that, I think, depends very much on what measures the United States takes. I suggested that if we were to devalue the dollar, or to adopt a system which had that effect, other countries would continue to support their currencies in the exchange markets at the present parities, which

would mean they would essentially maintain present exchange rates, despite any attempt we might make to let the dollar float or its equivalent.

We haven't done that, and don't intend to.

We have, however, taken a number of other measures to promote exports, involving export credits, insurance for exports, guarantees of various types. And there we can see a response which was perfectly predictable—other countries have adopted similar measures.

Britain just again this week has extended its export guarantee program. I would conjecture that if one were to travel around to hear the Parliamentary debates in these countries, and to probe the reasons for their measures, they would all cite their neighbors: "Somebody next door just did it, and we have to do it to keep up." I think this is a competitive process we can see at work.

Countries tend to compete in their policies just as they compete in the marketplace—only it is government measures that are involved. And the more drastic the measures for export promotion, the more drastic the response. For example, there is talk from time to time about tax subsidies to exports. I think within a matter of months, certainly within a year, we would find any such move substantially offset by similar measures in other countries, even countries in balance-of-payments surplus, in what they regard as self-defense.

Representative ELLSWORTH. Thank you very much.

Thank you, Mr. Chairman.

Representative REUSS. Gentlemen, we are very grateful to you indeed for helping us with our discussions.

Without objection, I would like to have included in the record a number of currently pertinent papers.

One, a June 2, 1965, address by Pierre-Paul Schweitzer, Managing Director of the IMF. Two, an address by Under Secretary of the Treasury, Frederick L. Deming, of April 29, 1965. Three, excerpts from an address by Assistant Secretary of the Treasury, Merlyn N. Trued, on June 16, 1965. Four, excerpts from a speech by Under Secretary Deming, on June 22, 1965. Five, "The Future of the Dollar as International Money," by Prof. James Tobin, a lecture delivered on March 23, 1965. Six, four articles by Edward M. Bernstein. Seven, excerpts from "International Liquidity: Toward a Home Repair Manual," an article by Richard E. Caves. Eight, an article by Robert Triffin, and excerpts from his study, "The Evolution of the International Monetary System: Historical Reappraisal and Future Perspectives." Nine, excerpts from "International Monetary Arrangements: The Problem of Choice—Report on the Deliberations of an International Study Group of 32 Economists," 1964. Ten, "The International Monetary System: Conflict and Reform," a report by Robert A. Mundell, July 1965. Eleven, "The 'Band' Proposal: The Limits of Permissible Exchange Rate Variations," a study by George N. Halm. And 12, excerpts from a discussion by Franco Modigliani in the 1964 Annual Report of the Federal Reserve Bank of Boston.

In addition, Senator Javits has asked unanimous consent to have included in the record various materials bearing on the advantages and disadvantages of changing the U.S. gold-buying policy.

(The documents referred to by the chairman are reproduced in vol. 2, supplement of these hearings. They are the following:)

"The International Monetary System and International Liquidity," address by the Managing Director of the IMF, Pierre-Paul Schweitzer, June 2, 1965.

"International Liquidity," address by Frederick L. Deming, Under Secretary of the Treasury for Monetary Affairs, April 29, 1965.

Excerpts from speech of Merlyn N. Trued, Assistant Secretary of the Treasury for International Affairs, June 16, 1965.

Excerpts from "International Banking in Relation to the Balance of Payments and to International Liquidity," an address by Frederick L. Deming, Under Secretary of the Treasury for Monetary Affairs, June 22, 1965.

"The Future of the Dollar as International Money," Carl Snyder Memorial Lecture by Prof. James Tobin at the University of California, Santa Barbara, March 23, 1965.

"The U.S. Balance of Payments and International Liquidity," by Edward M. Bernstein, June 18, 1965.

"Changes in the International Monetary System," by Edward M. Bernstein, October 27, 1964.

"Two Reports on International Liquidity," by Edward M. Bernstein, August 19, 1964.

"The Underdeveloped Countries and Monetary Reserves," by Edward M. Bernstein, March 24, 1965.

Excerpts from "International Liquidity: Toward a Home Repair Manual," by Richard E. Caves, in the Review of Economics and Statistics, May 1964.

Excerpts from "International Monetary Arrangements: The Problem of Choice—Report on the Deliberations of an International Study Group of 32 Economists," International Finance Section, Princeton University, 1964.

"The International Monetary System," by Robert Triffin, in Moorgate and Wall Street, special supplement, July 1965.

Excerpt from "The Evolution of the International Monetary System: Historical Reappraisal and Future Perspectives" by Robert Triffin, Princeton Studies in International Finance No. 12, Princeton University, 1964.

"The International Monetary System: Conflict and Reform" by Robert A. Mundell, Canadian Trade Committee, Private Planning Association of Canada, July 1965.

"The 'Band' Proposal: The Limits of Permissible Exchange Rate Variations," by George N. Halm, Special Papers in International Economics No. 6, Princeton University, 1965.

Excerpts from "Discussion 2" by Franco Modigliani in the 1964 Annual Report of the Federal Reserve Bank of Boston, entitled "A Critique of Central Banking in the United States."

"Part 2—Supplement" of these hearings also contains the materials submitted by Senator Javits.

Representative Reuss. Thank you again, gentlemen.

The subcommittee now stands adjourned.

(Whereupon, at 12:20 p.m., the subcommittee recessed, subject to the call of the Chair.)

APPENDIX

ADDITIONAL STATEMENTS

STATEMENT BY WALTER S. SALANT OF THE BROOKINGS INSTITUTION

THE BROOKINGS INSTITUTION,
Washington, D.C., July 19, 1965.

Hon. HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments,
Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR CONGRESSMAN REUSS: As things have developed, I have much less time than I expected to answer your letter of July 1. Moreover, it was accompanied by a list of guiding questions which was so admirably full, as well as highly sophisticated, that it is very forbidding and calls for a major opus. Since only a few days remain before I go abroad, I shall have to answer your letter less fully than it deserves, stating only what I think is essential and operationally useful in defining the direction of desirable changes.

First, let me say that I interpret your request to exclude discussion of changes in the price of gold as not excluding consideration of the plan advanced by Prof. Emile Despres. His plan would not change the monetary value of an ounce of gold, although it would limit the willingness of the United States to buy gold and, therefore, presumably would affect the free market price. I do not discuss it in this letter, however, because I have discussed that proposal fully in a letter to Senator Javits. I am sure he will be glad to provide you with a copy of the letter if you want it.[1]

My first choice in improving the monetary system is to seek the cooperation of other countries in modifying the existing system so that it will meet some basic requirements outlined below, and to persuade them that its operation should be governed by some principles that differ from the conventional official wisdom about international payments.

The major provisions of any satisfactory system must include at least the following:

1. The effects on total monetary reserves of large shifts in the composition of total reserves should be eliminated, whether these shifts result from the action of a single country or from transfers of reserves between countries which hold their reserves in different forms. An approach to this requires, as a minimum, an agreement among major holders of reserves to keep within a relatively narrow range both the proportion of gold held in official reserves and the proportion used in making settlements. I suggest that something around 60 or 65 percent might be an appropriate maximum. Whatever the maximum figure, it could be reached in stages over a few years.

If the number of national currencies used as reserves is increased, avoidance of adverse effects of such shifts requires agreement either among the major industrial countries to hold them in fixed proportions or agreement among the reserve-currency countries that, in the event of shifts of reserves among reserve currencies, the countries to which reserves are shifted will act to offset the effects of the shifts on the currencies from which they are shifted.

2. Provision must be made for secular expansion of official liquidity (i.e., owned reserves and readily available credit facilities). Provision should be made for either the creation of new reserve assets or increases in quotas in the International Monetary Fund at more frequent intervals than 5 years, or both. Quota increases should cease to require gold payments. Changes in quotas can be made more frequently without changing the articles of agreement, either by examining the need for changes more frequently than every 5 years, as the

[1] EDITOR'S NOTE.—The letter to Senator Javits referred to is printed as part of the submission by Senator Javits in "Part 2—Supplement," the second volume of these hearings.

articles now permit, or by continuing to examine the situation every 5 years, as at present, but making the quota increases effective in stages within the 5-year period.

So far as the credit component of officially available liquidity is concerned, the first credit tranche of IMF drawing rights should be made available to members of the Fund as automatically as drawings under the gold tranche are now.

3. Provision should be made for long-term financing of deficits in agreed cases to tide countries over a period of adjustment when that adjustment calls for reallocation of labor and capital. The financing should be made available for between 5 and 10 years, but at rates of interest that would provide the deficit country with the incentive to face the problem.

These are the absolute minimum requirements that occur to me now.

In addition, the foregoing should be accompanied by a sustained educational effort to obtain general recognition among monetary authorities of the following points, which are essential to operation of the system:

1. In some cases, long swings between surpluses and deficits in a country's balance of payments are to be expected and should be tolerated. The prevailing general view among monetary officials that deficits should always be eliminated quickly—not much is said about prompt elimination of surpluses—has no rational basis. As I have noted elsewhere, the reasoning begins with the fact that countries generally do not have enough liquidity to reduce their deficits slowly, deduces that therefore they must do so quickly, and concludes that consequently they should do so quickly. This reasoning clearly takes the existing amount of liquidity as given, but is often used to deduce that it should not be increased. In effect, it says that liquidity should not be sufficient to finance deficits over a long period because it is not sufficient to do so. I know no other argument for speedy adjustment.

What the opponents of slow adjustment really mean to resist is the temptation, which large reserves may indeed provide, to postpone necessary adjustments indefinitely. This is an entirely different problem from the speed of adjustment. Ways should be found to press countries to begin eliminating imbalance promptly without forcing them to complete the process quickly, if doing so would frustrate important objectives. One way to induce a prompt beginning might be to require deficit countries to use the facilities of the Fund concomitantly with use of owned reserves and at the same time to increase the costs of using those facilities.

In this connection, it should also be more clearly recognized that private credit is a substitute for reserves and for credit from official institutions for a country that is regarded as creditworthy, and that there is no hard and fast line, as is often supposed, between eliminating a deficit and financing one.

I call to your attention the fact that some fundamental issues underlying the questions of speed of adjustment and financing of deficits, and basic reasons for disagreement about them, are discussed in pages 43–53 of the small volume "International Monetary Arrangements: The Problem of Choice," edited by Machlup and Malkiel (Princeton University, 1964).[1]

2. An important part of the process of education is to correct false notions of what constitutes equilibrium for a financial center in a growing world economy. The prevailing idea that a decrease in the net liquid assets of a financial center represents disequilibrium is quite incorrect and would not be entertained for a moment in judging the behavior of the domestic banking system. Yet monetary authorities appear to be dominated by incorrect views about what constitutes equilibrium, as well as about the way it is restored. (In this connection, I may cite the often-quoted statement of Keynes that, "Practical men who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist," and observe that all the economists who enslave the practical men are not defunct.) Much of what we have been calling U.S. deficits has been a trading of long-term European securities for short-term U.S. securities. This trade in financial assets has performed the function of providing other advanced countries—mainly European countries—with liquidity which their own financial industry has not provided for them. We have called the import of these securities payments, but have refused to call the sales of any of our liquid liabilities receipts. Until it is generally recognized that the United States has been performing a financial service which other countries want and which, through its superior system of financial intermediaries, the United States is well able to provide, we will go on thinking it necesary to make adjustments

[1] EDITOR'S NOTE.—The pages referred to and other parts of the Princeton publication are printed in "Part 2—Supplement," the second volume of these hearings.

where none would be required, except for the runs on the United States in its role as a bank which the defects of the international monetary system itself make possible or induce.

In the performance of this financial intermediary service, the United States has contributed to European and world economic growth. Largely for this reason, I think that proposals which reduce the international financial role of the United States and of Britain—the major present suppliers of international liquidity—solve the problem of confidence in these currencies in a way that is not satisfactory. They would withdraw essential financing facilities which are now taken for granted and have not adequately been appreciated—at least until the past few months. A loss of these facilities probably would have more serious adverse effects upon some countries, including continental Europe and Japan, than upon us. The economic role of financial intermediation in general and its effects upon the rate of investment are set forth, largely for a closed economy, in the pioneering work by Gurley and Shaw, "Money in a Theory of Finance," but are only now beginning to be recognized in the international sphere. (See the recent work of Prof. James Ingram and Prof. Charles Kindleberger.) It is this role which makes it desirable to maintain fixed exchange rates, to have the United States continue to serve the world as its major banking center, and to achieve greater integration of money and capital markets.

Since full recognition of the importance of financial intermediation is something new in economics and still newer in its international aspects, I think it would be premature to be defeatist about the possibilities of making it clear and thereby modifying the monetary system so as to eliminate the irrational features forcing resort to otherwise unnecessary interference with capital movements. Once it becomes clear, it may be possible to obtain agreement to a system involving elimination of instability in the composition of official reserve assets and to obtain recognition that equilibrium calls for reserve-currency countries' having some "deficit" (on the Department of Commerce definition).

I conclude, therefore, that the United States should first try to obtain such changes, insisting that the improvements in the present monetary system include at least the points in the first set of numbered paragraphs above and treating them as nonnegotiable. There will be plenty of other things to negotiate about. If these conditions are not met, however, it would probably be better for the world as a whole, as well as for the United States, to adopt the Despres plan. We should be ready to do so, if necessary, and to make that fact clear in the course of discussions.

I am sorry that pressure of time prevents me from dealing more fully with the many other questions accompanying your letter. I hope this answer will be a useful contribution to the subcommittee's record.

With best wishes for successful hearings and kindest personal regards, I am,

Sincerely,

WALTER S. SALANT.

STATEMENT BY ROBERT TRIFFIN, YALE UNIVERSITY

GUIDELINES FOR INTERNATIONAL MONETARY REFORM[1]

I. THE URGENCY OF ACTION

A. GENERAL CONSIDERATIONS

The case for a fundamental reform of the international monetary system was unanimously recognized and strongly affirmed, more than a year ago, both in the annual report of the IMF and in the report of the Group of Ten, and need not be rehashed here.

This unanimity concealed, however, some significant differences of, at least, emphasis on several aspects of the problem:

1. Deficit countries—particularly the United States and the United Kingdom—stressed the danger of a future liquidity shortage, bound indeed to develop rapidly once the United States succeeded in eliminating the balance-of-payments deficits which have, over the last 7 years (1958–64), fed about three-fourths of other countries' reserve increases. They accented, therefore, the need for additional means to meet legitimate requirements for reserve growth in an expanding world economy.

2. Creditor countries, on the other hand, particularly France, were primarily concerned with the immediate inflationary dangers of the system and with the haphazardness imparted to actual reserve creation by its dependence on such unstable sources of supply as the whims of speculators, the gold sales of the Kremlin, gold purchases of China, and, most of all, the United States and the United Kingdom deficits. The annual growth of world reserves had indeed fluctuated wildly from a mere $0.4 billion in 1962 to a whooping $3.4 billion in 1963, as estimated U.S.S.R. sales rose from $200 to $550 million, and foreign exchange accumulation by central banks from $395 to $2,260 million.

They also denounced the asymmetry and inequity of a system which permitted the United States alone to finance too easily its balance-of-payments deficits through foreign central banks' accumulation of dollar I O U's as international reserves and to foster thereby inflationary pressures upon other countries. They stressed, therefore, the need for multilateral surveillance on all forms of liquidity creation and deficit financing.

3. The urgency of action on both of the above counts is dramatically demonstrated by the sudden reversal of liquidity trends in the first part of this year. Estimates for the first quarter (January–March

[1] This paper is written at the request of the Honorable Henry S. Reuss, chairman of the Subcommittee on International Exchange and Payments, and attempts to give specific answers to the crucial questions raised by the subcommittee. For further details, see the author's paper on "The International Monetary System," published in "Part 2—Supplement" of these hearings.

1965) projected at an annual rate reveal for the first time in nearly 35 years an absolute decline in world monetary gold stocks (minus $1 billion, as against plus $0.7 billion last year), in central banks' foreign exchange holdings (minus $2.1 billion, compared to plus $1.6 billion last year) and a total decline in world reserves, including gold tranches in the IMF, of nearly $2.9 billion in lieu of a $2.5 billion increase in 1964.

B. THE U.S. INTEREST

The excess of the gross monetary reserves of the United States—gold, IMF gold tranche, and foreign exchange holdings—over its indebtedness to the IMF and foreign monetary authorities has fallen precipitously from about $15.9 billion at the end of 1957 to about $3 billion at the end of March of this year. This continued deterioration—even though far more than compensated by the steady growth of our direct investments and other long-term assets abroad—has prompted, ever since 1960, increasing uneasiness about the future stability of the present gold and exchange rate structure. Short-term capital—including privately held dollar balances abroad and "errors and omissions"—used to flow to the United States at an annual rate of about $5 billion a year in the early 1950's, and more than $1 billion a year in the late 1950's, as can normally be expected by a major world financial center. These inflows reached a peak of $1.8 billion in 1959—that is, well after the restoration of confidence in European currencies—but were abruptly replaced by large, persistent, and abnormal outflows of $2.5 billion in 1960, $1.8 billion in 1961 and again in 1962, and $1.4 billion in 1964, while private gold purchases in London about doubled, beginning also in 1960, and total inflows of private capital in the EEC countries reached $1 to $2 billion year after year.

Our net losses of short-term capital declined to less than $4 billion in 1963, when large U.S.S.R. gold sales and indications of agreement by the Group of Ten against gold revaluation temporarily deterred speculation about a proximate increase in the price of gold.

There can be little doubt, in my opinion, that these speculative movements—linked to the vulnerability of the present monetary system, and particularly of its so-called key currencies—account for most, if not all, of our net reserve losses of recent years. This impression is confirmed by the results of a recent econometric study of Jerome L. Stein, estimating at about $2.5 billion the annual impact of the reversal of speculative capital movements on our balance of payments.[2] An international monetary reform eliminating the present Damocles sword of sudden and massive gold conversion of oustanding dollar balances, accumulated over many years past, could hardly fail to restore equilibrium and even substantial surpluses, in our balance of payments.

C. THE DANGERS OF PROCRASTINATION

This makes it all the more ludicrous to find that one of the few points on which we agree with the Europeans is that concrete reforms should be postponed until sufficient evidence develops to demonstrate that we—and the British?—have succeeded in restoring a dura-

[2] Jerome L. Stein, "International Short-Term Capital Movements," American Economic Review, March 1965.

ble equilibrium in our balance of payments. The Europeans regard this as a necessary safeguard against the channeling of such reforms—and the new reserve assets to be created—into continued financing of United States and United Kingdom deficits. We, on the other hand, wish to be able "to negotiate from a position of strength," and fail to see that postponement of needed reforms perpetuates the major, or only, source of weakness in our present situation. We also forget that "overall" balance—or even surplus—is a mere accountant's concept, perfectly compatible with huge gold losses incurred to repay previously accumulated indebtedness to central banks and other dollar holders. Our "overall" position is reported to have improved enormously in the first 6 months of this year, but our gold losses over these 6 months are about 10 times those incurred over the previous 12 months. While such losses should not be expected to continue at the same rate, the methods presently used to correct our "overall" deficit are bound to have unfavorable repercussions on the attractiveness of the dollar, both as a key currency for private traders and investors, and even as reserve asset for highly cautious central bankers.

These dangers may be brought to a head in the forthcoming months by the spreading conviction of speculators that a devaluation of the pound sterling will, sooner or later, prove inescapable. I have shown elsewhere[3] that successive increases and declines of British net international reserves—calculated *à la* Bernstein—have, for years, been determined primarily by parallel inflows and outflows of private capital, rather than by fluctuations in the current account balance or official capital movements. Whatever the other weaknesses of the British situation, the enormous short-term indebtedness of Britain and the traditionally low level of its gross reserve assets make the pound exceedingly vulnerable to speculative capital outflows.

The need for close international monetary cooperation remains stronger than ever to ward off an unrequited devaluation of the pound, whose consequences would be incalculable for other currencies and for the dollar itself. This cooperation, however, has recently been strained closer and closer to the breaking point by the slow progress of the negotiations of the Group of Ten, the impact of resulting speculative uncertainties upon the United States and the United Kingdom capital account and balance of payments, the hardening of unnegotiable national positions by France and the United States, and the bitterness engendered on both side by the politicization of the debate in "summit clashes" between ministers and heads of state.

Yet, such politicization has now to be recognized as a fact of life. Foreign central banks have now been pressed for years to accumulate unrequited dollar balances, and refrain from converting them into gold, for the express purpose of keeping within manageable bounds the gold losses that our balance-of-payments deficits would otherwise entail. We can hardly be surprised if their political masters now begin to question such financing, whenever they disagree with some features of our own policies on which such deficits can partly be blamed, be it our efforts to avoid untimely rises in our interest rates, or the dramatic expansion of U.S. direct investments in foreign markets, or even the escalation of the war in Vietnam.

[3] See, e.g., the accompanying paper on "The International Monetary System."

The old gold-exchange standard under which central banks accumulated dollar assets, in preference to gold, by their own choice, has been killed already by the very success of our efforts to induce them to do so, on a larger scale, for the sake of international cooperation. They reasonably claim today a voice in the decisions regarding the amounts of such "credit reserves" that they should be called upon to absorb, and the distribution and purposes of the credits thus made available so far to two countries only, and overwhelmingly to the United States alone.

We may regret the good old days when such credits were extended to us without question—and even against our own wishes—but it is not in our power to resurrect the past. The only realistic choice open to us is to join with others in adjusting the world monetary structure to present-day needs and realities.

II. Broad Goals and Criteria

Abstracting for the moment from national considerations, two broad goals of international monetary reform should be agreed by all, and were indeed unanimously endorsed, in principle, in last year's reports of the Group of Ten and of the IMF.

A. OVERALL PACE OF RESERVE CREATION

The first is that the overall pace of reserve creation should be oriented, by concerted action and decisions, in such a way as to adjust to the noninflationary requirements of economic growth in world trade and production. The concrete implementation of such a principle is no more susceptible of precise advance formulation than is the exact pace of desirable monetary and credit expansion in a national economy. All that can be said is that the pace of reserve creation should be stepped up at times of pervasive deflationary pressures in the world economy, and that it should be slowed down—or even reversed—in the opposite case of pervasive inflationary trends. International monetary deliberations are unlikely to gage such needs with unfailing wisdom and to enforce them with unmitigated skill and determination. The difficulties of the task, however, are no conclusive argument for shirking it, and for entrusting it blindly instead to the gold speculators, the Russian or Chinese leaders, the fluctuations in a single country's balance of payments, and the uncoordinated and precarious choices of scores of central bankers between gold and dollar assets.

Joint decisions could at least be relied upon to protect us against the dangers of a sudden and massive contraction in international liquidity, such as is now entailed in the legal right of any country to convert overnight into gold metal foreign exchange assets accumulated over many years past. This in itself would eliminate the major source of vulnerability and crises to which our international monetary system now exposes us.

To insure an appropriate rate of growth will undoubtedly be more difficult, and our groping toward ideal solutions will remain a trial-and-error process internationally, as it has long been and still is in national monetary management. Excessive conservatism is, however,

a more likely pitfall than excessive expansionism, in the decisions of an international body, as amply demonstrated by the experience of the International Monetary Fund over 18 years of operation. It should not be difficult, moreover, to erect strong safeguards against inflationary abuses of the IMF lending power. The maximum lending potential of the institution will in any case remain circumscribed by the total size of the commitments accepted by the participating countries, and its actual use can be further limited by requiring qualified majorities (two-thirds, three-fourths, et cetera, of the total voting power) for any Fund decisions expanding world reserves by more than some presumptive annual ceiling (3 to 5 percent a year) related to the average rate of growth of world trade and production.

B. IMPROVING THE ADJUSTMENT PROCESS

Barring a substantial increase in the price of gold,[4] the maintenance—over the long run—of an appropriate average growth rate of world reserves will undoubtedly require large and continuous increases in "credit reserves." Over the last 6 years, for instances, these have increased on the average by about $1.6 billion a year. These increases have overwhelmingly been used to finance the U.S. deficits, but have benefited indirectly other countries through the enormous size of U.S. foreign aid and long-term investments abroad which they made possible. The United States was borrowing short from Europe, and lending long—or giving away—to other countries and to Europe itself.

For the reasons mentioned above, this process cannot continue indefinitely. Other countries will have to share with the United States the responsibilities and decisions inherent in the necessary growth of world reserves in an expanding world economy. They will have to decide jointly the way in which such lending potentional will be distributed among prospective borrowers and the maturity and other conditions to be attached to such lending operations.

The undoubted difficulties of reaching international agreement on such complex and delicate matters make it highly tempting to seek to evade them through automatic formulas such as proposed in the French—or Bernstein—CRU plan. In the last version available to me here, Dr. Bernstein proposes to allot, by treaty, 80 percent of any future increases in CRU reserves to the major reserve holders of the Group of Ten and 20 percent to the IMF for redistribution to other countries. The 80 percent assigned to the Group of Ten would itself be distributed among them in accordance with some highly arbitrary formula, such as their proportionate IMF quotas. (If this latter method of calculation were adopted, the United States would automatically receive about 40 percent of the future CRU allotments; the United Kingdom, 20 percent; France, 8 percent; et cetera.)

Personally, I doubt whether such blind commitments for years to come would prove easier to negotiate—and less repellent to the defenders of national sovereignty—than the far more modest commit-

[4] Following the chairman's suggestion, I refrain from discussing here proposals for such an increase as well as for flexible exchange rates. I also reject both for the reasons presented in the accompanying paper and in my study on "The Evolution of the International Monetary System: Historical Reappraisal and Future Perspectives" (Princeton, 1964).

ments involved in periodic negotiations and decisions. Most of all, however, they would entail the abandonment of the principle repeatedly, and rightly, affirmed by the Group of Ten in August of last year; that is, that "the process of adjustment and the need for international liquidity are closely interrelated;" that "the need being to supply sufficient liquidity to finance temporary payments imbalances without frustrating the required processes of international adjustment in individual countries, it is desirable to bring under multilateral review and appraisal the various means of financing surpluses or deficits;" and again that there should be established a "multilateral surveillance of the various elements of liquidity creation, with a view to avoiding excesses or shortages in the means of financing existing or anticipated surpluses and deficits in the balance of payments, and to discussing measures appropriate for each country in accordance with the general economic outlook." [5]

These wise and agreed conclusions would hardly be compatible with a system under which arbitrarily assigned portions of future liquidity creation would automatically be earmarked, years in advance, for distribution among selected countries, irrespective of their needs and of the wisdom or folly of the policies pursued by them at the time. The lending potential derived, as a byproduct, from needed increases in liquidity creation would undoubtedly be far better used to promote and support national adjustment policies, jointly agreed by members, and such policies only. It is, anyway, difficult to view as realistic and viable a system committing its members in advance to extend indefinite credits in support of policies deemed irresponsible or obnoxious by a majority of the participants.

III. Major Stumbling Blocks to Agreement

Two major stumbling blocks have paralyzed for a full year by now the remarkable agreement of principle reached last August by the Group of Ten. The first relates to the problem of voting power, and the second to the future status of the present reserve currencies, particularly the dollar.

A. VOTING POWER

The International Monetary Fund is obviously the natural framework for negotiations and decisions relating to the world reserve system. This position, strongly supported now by the United States, the United Kingdom, and the developing countries, is nevertheless deemed totally unacceptable by some of the major creditor countries of continental Europe, particularly France.

The reasons are not far to seek. The distribution of voting power in the Fund is determined primarily by the relative size of each country's quota. The practical significance of quotas, however, is totally different for the creditor countries and for the debtor countries. They measure indifferently the lending commitments of the first and the borrowing rights of the latter. It is not difficult to understand, therefore, the objections of current and prospective creditors

[5] "Ministerial Statement of the Group of Ten and Annex Prepared by Deputies," August 1964, pp. 4, 9, and 11.

to a system which rewards equally with voting power presumptive calls on their resources and the presumptive rights of others to borrow. This is particularly true at a time when the camp of the presumptive borrowers includes not only several scores of less developed countries, but also the United States and the United Kingdom, which alone command more than twice as many votes in the Fund, for instance, as the six countries of the European Economic Community. Taken together, the latter hold today not far from two-thirds of the net claims that finance the lending operations of the IMF, but they wield only 15 percent of the voting power in the decisions of the Fund's Executive Board.

I have long recommended two parallel solutions to this worldly problem. The first is to encourage a substantial decentralization in the Fund's operations and responsibilties, through positive encouragement to regional monetary cooperation and integration, such as is being rapidly developed today in EEC and in Central America. This would offer the added advantage of helping to couch readjustment advice to individual countries in more realistic terms, taking account of regional differences in a vastly heterogeneous world and to avoid excessive criticism of the Fund by countries which now bear little or no real responsibilities for such advice and financing.

Article 108 of the Rome Treaty provides a most realistic model for such decentralization. Any disequilibria among the EEC countries themselves should be dealt with primarily by the EEC itself, and financed through a joint European Reserve Fund, as long advocated by Jean Monnet's Action Committee for the United States of Europe.[6] This would reduce to a more manageable size the contributions which these countries should be called to make to the IMF itself to cover disequilibria between the EEC area as a whole and the rest of the world.

A further, and not unreasonable, compromise would be to observe the voting procedures of the Articles of Agreement for normal quota drawings, but to establish a special open market committee to manage the investments financed from voluntary "deposits" additional to the quota subscriptions of the Agreement, and to give adequate recognition to the relative size of these deposits—and contingent commitments—in determining the relative voting power of the depositors.[7]

B. THE FUTURE ROLE OF THE DOLLAR AS A KEY CURRENCY AND AS A RESERVE CURRENCY

The other major stumbling block relates to the future position of the present reserve currencies—particularly the dollar—in a reformed system of truly international monetary reserves. The United States is understandably reluctant to abandon the supposedly privileged position traditionally enjoyed in this respect by the U.S. dollar—and in previous days by the pound sterling—while some other countries—particularly the French—strenuously object to the perpetuation and legalization of such unequal status, now that the dollar holdings of central banks—and the credits thus implicitly extended to the United

[6] See also my study on "Intégration Économique Européenne et Politique Monétaire," in "La Restauration des Monnaies Européennes," Sirey, Paris, 1960.

[7] The case for such "investment" operations alongside traditional drawings is discussed below and in the accompanying paper.

States—have become a matter for international negotiations and decisions instead of being left, as in the past, to the free choice of each central bank.

1. The dollar as a key currency in private trade and finance

A widespread misapprehension of the U.S. banking community should be cleared up first; that is, the mistaken view that the key currency role of the dollar in world trade and finance is dependent on its continued use as a reserve currency by foreign central banks. The relationship runs, in fact, in the opposite direction: the reserve currency role of the dollar is the byproduct of its key currency role, and not the other way around. The dollar became a key currency long before it began to be used as a reserve currency, and would remain a key currency even if it were totally displaced as a reserve currency, by IMF or CRU deposits, for instance. Any new type of reserve asset that might be established would be available to the monetary authorities only, but not to private traders or bankers. The latter would continue to depend on national currencies of wide use and acceptability for the maintenance of working balances appropriate to their operations.

The size of private dollar holdings is closely related to the size of foreign countries' total imports, from other countries as well as from the United States. Over the last 7 years, for instance, the ratio of the first to the latter has fluctuated very narrowly indeed between 7.3 and 7.9 percent, except for a brief spurt to 8.6 percent in the year following the restoration of convertibility in the major European countries. While other currencies may gradually assume a larger role in this respect, there is no reason to expect any sudden shift away from the dollar because of the substitution of an international reserve asset—but not of any national currency—for the dollar in the reserve holdings of central banks.

The main threat to the key currency role of the dollar in private trade and finance lies, on the contrary, in the type of measures recently adopted to preserve its reserve currency status, that is our ability to convert at all times and upon demand into gold metal the enormous short-term claims accumulated on the United States, under such a system, by foreign central banks. The "voluntary" restraints now imposed upon capital outflows, and particularly U.S. banks' foreign loans, may induce substantial shifts from the dollar into other currencies by present holders afraid of future extensions of "creeping" exchange controls. Interest rates abroad may be pushed upward as a result of the present scramble of U.S. firms to obtain financing abroad for planned investments which they are barred from financing from U.S. sources. This may induce further shifts of floating funds from the United States to more remunerative investments in Europe. Foreign customers of U.S. banks may also shift their accounts abroad, when advised that U.S. banks can no longer accommodate their requests for credit.

A long-term maintenance of even the mild forms of exchange controls introduced this year would be bound to damage severely the attractiveness of the dollar to private traders and investors as well as to central banks, as the main medium for the working balances needed for daily operations. The removal of these controls should remain a prime, and urgent, objective of U.S. policy.

2. The role of the dollar in central banks' working balances

The role of the dollar as the main medium for central banks' operations in the exchange markets is an ineluctable and durable byproduct of its continued use as the major key currency in private trade and finance, and would in no way be endangered by the creation of a new type of reserve asset available to central banks only, but not to private traders and banks.

No precise figure can be advanced as a measure of this incompressible use of the dollar by central banks, but it is certainly well below the bloated holdings accumulated by them since the last war, and particularly since 1957. If pressed upon to venture a rough "guesstimate" of the minimum central banks' dollar holdings needed as working balances, I would hazard a figure of about $5 billion, corresponding to about 2 weeks of imports, and 10 percent of the global monetary reserves of countries other than the United States. This would leave a residue of about $10 billion of official dollar holdings in excess of such working balances.

3. The role of the dollar as reserve currency

Much of the current controversy—and of the deadlock reached in the Group of Ten negotiations—relates to this use of the dollar as a reserve currency, beyond normal needs for working balances.

We have long affirmed ourselves—beginning with President Kennedy's first message to Congress on the balance of payments and gold—that continued increases in dollar and sterling I O U's could not be relied upon indefinitely to supplement gold in short supply, as a safe method to meet legitimate requirements for reserve growth in an expanding world economy. This viewpoint was unanimously endorsed, by the Group of Ten and the IMF, and the conclusion drawn that a new type of reserve asset would have to be established for this purpose in a not too distant future.

The British and ourselves, however, tend to view the new reserve asset as a mere supplement to the untrammeled use of dollar and sterling balances, while other countries—particularly the French—advocate at least a partial and gradual substitution of dollar and sterling reserves by the new type of reserve asset to be jointly created and managed.

I am deeply convinced that the official position adopted so far constitutes a foredoomed rearguard fight against the undoubted and overdue progress of world monetary organization and—paradoxical as it may seem—against our own national interests in the matter.

First of all, it certainly is not in our interest, no more than in the interest of the world, to preserve a system under which the world reserve level and our own gold stock are forever exposed to sudden and massive deflation through whimsical or deliberate conversions into gold metal of dollar—or sterling—balances accumulated over many years past. I have stressed above the disastrous impact of such a Damocles sword over world confidence in the future of sterling and the dollar, over short-term capital movements, over our balance of payments deficits of recent years, and—as a consequence—over our freedom of national monetary management. It does not take much imagination to perceive also the political bargaining—or blackmailing—power conferred thereby on our major short-term creditors.

I had, long ago, envisaged that international monetary negotiations would assign the highest priority to the elimination of this unnecessary source of vulnerability of the world monetary system, and of the position of the dollar and the pound sterling. Outstanding reserve balances should be converted into fully transferable reserve certificates or IMF deposits, with appropriate convertibility and exchange-value guarantees making them as fully acceptable, liquid and usable as gold in all balance of payments settlements, but protecting the United States and the United Kingdom against sudden raids on their gold reserves by nervous or politically motivated creditors.

The exchange-value guarantees entailed by any such arrangement were denounced by some of our officials as unacceptable, even though they would remain totally costless and indeed beneficial,[8] if they helped remove one of the major threats to the stability of the dollar. Foreigners could hardly fail to notice the contradiction between our strenuous objections to the contingent cost of exchange-value guarantees in the event of devaluation and our repeated assurances that such guarantees were unnecessary since the dollar would never be devalued anyway.

The protection of outstanding dollar balances against gold conversion, however, would inevitably raise as a second question the problem of future dollar accretions by central banks. The consolidation of unrequited balances acquired in the past would hardly be negotiable if it were felt that the same problem could be recreated tomorrow through renewed U.S. deficits and piling up a precariously held dollar balances by foreign central banks. Our proposal for an additional type of new reserve asset could then be easily misinterpreted as designed to bail us out, in such an event, by enabling the IMF to repurchase—against the new reserve asset—and mop up periodically the unwanted excess dollars palmed off on central banks by our deficits.

If the international monetary problem is to be solved by an international monetary agreement rather than through the chaos of a new crisis *à la* 1931, we shall have to accept the two basic principles which underlie the Group of Ten and IMF reports, that is:

(*a*) That the creation of international reserves—in whatever form—is a matter for joint decisions, aiming at adjusting their overall level to the noninflationary requirements of feasible world economic growth;

(*b*) That the process of adjustment and the need for liquidity creation are closely interrelated and that, therefore—

> all forms of liquidity creation should be brought under multilateral review and appraisal with a view to avoiding excesses or shortages in the means of financing existing or anticipated surpluses or deficits in the balance of payments, and to discussing measures appropriate for each country in accordance with the general economic outlook.[9]

The traditional role of the dollar—and sterling—as reserve currencies, whose accumulation or liquidation are left at all times to the free and uncoordinated decisions of scores of central banks would, of

[8] The lowering of interest rates on such guaranteed balances would indeed save us, in all likelihood, several hundred million dollars a year in interest payments.

[9] "Ministerial Statement of the Group of Ten and Annex Prepared by Deputies," pp. 4 and 11.

course, be totally contrary to both of these basic principles. It could be reconciled with the first only if central banks agreed:

(*a*) To avoid expansionary abuses by placing some annual ceiling on their combined purchase of dollar and sterling balances; and

(*b*) To combat deflationary pressures by agreeing also to a minimum rate of accumulation of dollar, sterling, and the proposed new type of reserve asset, to the extent necessary to supplement gold in short supply. Actual recourse to the new type of reserve asset would then be determined either by the unavailability of sufficient dollar and sterling supplies—when the United States and United Kingdom were in balance-of-payments surplus—or by the lack of confidence in dollar and sterling, and the inclination of central banks to refrain from further additions to their holdings or even to liquidate balances accumulated in the past.

Such a system would, of course, fit admirably the United States and United Kingdom interests, since it would give them an assured source of financing for any future deficits, up to very substantial amounts indeed. It would, however, constitute a complete denial of the adjustment objective embodied in the second principle enounced above. Can anyone seriously believe that it could provide a realistic basis for negotiation, and that all countries, or even simply the Group of Ten countries, could be induced to reverse themselves on this issue, and earmark for the sole benefit of the richest—the United States—and one of the richest—the United Kingdom—countries in the world all or most of the lending potential deriving from the need to assure an adequate expansion of world liquidity?

The French CRU plan would enlarge the number of beneficiaries to 10—or 11, if Switzerland is included—countries, and probably a few others in the course of time. The revised Bernstein CRU plan would leave a few crumbs—20 percent of total CRU creation—to the some hundred other members of the IMF, provided they satisfied the Fund's conditions for borrowing. Under both plans, however, the privileged members of the club would be assured a steady inflow of CRU resources, according to some predetermined formula, irrespective of their needs and policies. The CRU proposals are, in this respect, only slightly less arbitrary than the Anglo-American insistence on a privileged status for the dollar and the pound alone; and they are just as incompatible with the adjustment objective so rightly emphasized in the Group of Ten report.

C. THE U.S. INTEREST AND NEGOTIABLE COMPRISES

Our primary interest, for the reasons summarized in the first part of this paper, is to reach agreement in time on a sensible and long overdue reform of the present crisis-prone system of international reserve creation. We and the British have even more to gain, and nothing to lose, in protecting the world reserve system against sudden and massive liquidation into gold metal of the outstanding dollar and sterling components accumulated over many years past.

Some of us might, it is true, regret the old days in which the willingness of foreign countries to absorb our national currency as interna-

tional reserves could postpone, for protracted periods, the normal balance-of-payments pressures and disciplines to which other countries were, and remain, subjected. Others, however, would regard this feature of the old gold exchange standard as a disguised curse rather than a blessing, since it merely postponed, but also aggravated, the day of reckoning, by exposing us at the most inconvenient time to sudden and massive pressures through crises, in lieu of more modest and gradual ones. Whatever view is taken on this matter, these good old days are now irretrievably gone for us, as they have been for many years already for our British friends.

Our chances of palming off any substantial amounts of dollars on foreign central banks are becoming steadily dimmer in comparison with the risks of being called upon to redeem in gold some of the excessive short-term claims accumulated by them on us over the past. Additional purchases, or even retention, of dollars by them have already become a matter for political negotiations which are now embittering our relations with old friends and allies. Most, or all, of our large gold losses this year have been due to repayments of past debts to central banks rather than to any overall deficit in our current transactions, and are a clear evidence that our policies of the last few years have now reached, or exceeded, the foreseeable limits of their usefulness and ultimate viability.

The major threat to the stability of the dollar, and of the world monetary system itself, lies in the $15 billion of short-term debts now owed by us to foreign central banks, and roughly equal to the total gold reserves available to us to repay them at the option of our creditors. The elimination of this threat would leave us with ample gross reserves, equal to about 75 percent of our annual imports; i.e. a far larger ratio than that of nearly any other country. These reserves could be further supplemented, in case of need, by our large IMF quota and by our participation on a fair basis in the benefits of the new system of reserve creation that should be established tomorrow.

Of all the countries in the world, we should be the least interested in claiming, or preserving at the costs outlined above a privileged, but increasingly precarious access to direct financing of our deficits by foreign central banks. It is high time for us to accept a lesson which history has long taught to Britain, and to convince our own "Colonel Blimps" that the prestige of the U.S. flag is not to be confused with the precarious floating of our short-term I O U's in the overflowing coffers of European central banks.

The U.S. dollar would, in any case, retain, as discussed above, its traditional role as a key currency in private trade and finance, and as the major component of central banks' working balances. Furthermore, even the toughest negotiators of the Group of Ten, the French, have long agreed that the dollar and the pound sterling could continue to be used as monetary reserves by the countries of the so-called dollar and sterling areas. This would apply to all or most of the $6 billion now held as reserves outside Western Europe itself, and is likely to raise little objection by most of the countries concerned, which would probably prize the larger interest earnings available on direct dollar holdings more than the guarantees attached to IMF deposits against a devaluation of the dollar, particularly if the major danger

of such a devaluation were to be removed by the agreements reached among the major reserve holders of the Group of Ten.

Such a compromise might be difficult to defend against the full logic of the multilateral surveillance principle, but would be unlikely to endanger seriously the stability of the system as a whole, in view of the unlikelihood of substantial variations, upward or downward, in the traditionally low share of most of these countries in the world reserve pool.

IV. The IMF Proposal

Of all the various proposals officially discussed so far, the IMF proposal for a deposit-investment reserve system [10] is the only one which would fully implement both of the basic, and unanimous conclusions reached a year ago in the Group of Ten negotiations. I have tried to spell out, in the accompanying paper,[11] the ways in which such a proposal could operate in practice, and be made acceptable to the major reserve holders of continental Europe as well as to the major reserve debtors of the present system, the United States and the United Kingdom, and to the other countries, also vitally interested in the stability and adequacy of the international monetary system, including the countries of the so-called Third World.

In brief, the traditional lending operations of the IMF would continue to be financed from present quotas and from any quota increases that might be regarded as necessary for this purpose, in accordance with the present Articles of Agreement of the Fund. Additional needs for world reserves would be met, or reduced in part, by the encouragement of regional monetary cooperation and integration, such as are now in existence or in prospect in various parts of the world,[12] and in part by the new technique proposed in the Fund's last report, i.e., by—

> investment operations * * * undertaken on the initiative of the Fund, with a main purpose of creating liquidity, and not necessarily in response to a particular blance-of-payments need.

The financing of these investments would be assured by the commitment of members to hold an agreed proportion of their overall reserves in the form of deposits with the Fund. The management of these operations would be entrusted to a special investment committee in which voting power would be determined, at least in part, by the relative size of members' deposits and commitments.

This is by no means a revolutionary proposal, nor one that would imply vast surrenders of national sovereignty by members. It would merely multilateralize the broker responsibilities between ultimate reserve holders and ultimate borrowers, traditionally discharged by reserve centers, i.e. the United States and the United Kingdom, but which exposed them to unnecessary risks which were bound to become increasingly irksome and eventually unsustainable by them. It would spread between all, or at least all major, reserve holders the added

---

[11] "The International Monetary System," pp. 12–29.

[10] IMF Annual Report, 1964, pp. 38–39.

[12] See, e.g., the paper mentioned above on "Intégration Économique européenne et politique monétaire"; "International Monetary Arrangements, Capital Markets, and Economic Integration in Latin America," Journal of Common Market Studies, Oxford, 1965; and "Report on the Possibilities of Establishing a Clearing and Payments Union in Africa," United Nations Economic and Social Council, Feb. 4, 1965.

burdens of foreign lending imposed upon the United States by the unrequited short-term loans thrust upon them by other countries' central banks which preferred to hold a portion of their reserves in the form of short-term claims on us than to channel them, as we did and still do, into longer term loans and investments abroad.

The main advantage of the proposal would be to eliminate the vulnerability, and ultimate unviability, of this indispensable brokerage function. No individual country could commit itself in advance never to withdraw the liquid balances held in the United States, since it might need them at any time for balance-of-payments settlements, or might feel it necessary to protect them, through gold conversion, against the risk of a dollar devaluation. On the other hand, such withdrawals could result in heavy drains on our gold reserves, even in the absence of any U.S. deficits, if not offset by new deposits of other countries. We could thus be in so-called overall balance in our payments, whether in the Lederer or in the Bernstein sense of the word, and yet lose large amounts of gold either because of foreign countries' fears of a dollar devaluation, or even merely because some of the many countries accustomed to hold a large portion of their reserves in the form of dollar balances happened to be in deficit toward the few countries which traditionally hold most of their reserves in the form of gold. Both of these factors are in evidence at the moment and explain the steep increase in our gold losses this year in the face of an unprecedented improvement in our so-called overall balance.

No such danger would face the IMF as long as its investment portfolio did not exceed the global amount of reserve deposits held with it by members. This condition could be satisfied in either of two ways:

(*a*) By a commitment of all members to hold in deposit with the Fund a uniform porportion of their global reserves. Balance-of-payments fluctuations would then merely reshuffle among members the deposit liabilities of the Fund, without changing in anyway the global deposits financing its investments.[13]

(*b*) By leaving each country free to decide which portion of its total reserves it wishes to retain in Fund deposits, but with the proviso that countries with the lowest ratio of deposits to reserves will increase this ratio if, and to the extent, necessary to finance the investments jointly agreed as necessary to assure an appropriate growth of the world reserve pool. This alternative method might facilitate the transition from the present system to a more orderly one, and minimize greatly the element of compulsion involved in such a change. Central banks' preferences between gold and earning assets vary greatly today from one country to another. Some countries would certainly maintain, by their own choice, a larger proportion of their reserves in Fund deposits than any that might jointly be agreed to as the minimum necessary to finance the desired level of Fund investments. In the longer run, the attraction of guaranteed earning deposits with the Fund, perfectly usable and liquid for all balance-of-payments settlements, should induce a growing preference for this type of asset—

[13] The total of agreed deposits would indeed increase over time with the rise of world reserves consequent upon new gold accretions and upon the rise in the IMF investments themselves.

as against sterile gold holdings—on the part of all, or most, Fund members.[14]

Immediate agreement among all Fund members would not be necessary to initiate the proposed system. Voluntary membership in it would suffice in practice, as long as most of the major reserve holders agreed to participate. This might indeed be preferable, in order to keep the administrative and consultative machinery as light as possible in the difficult formative period of the new organization. Participation by the present Group of Ten countries should certainly be highly desirable at the start, but should obviously not be arbitrarily and indefinitely limited to them.

Among the numerous questions necessarily left unanswered by this brief outline, two might still be mentioned in closing:

(1) How should deposits with the Fund be acquired?
(2) How should they be invested?

1. For the foreseeable future anyway, gold would of course be accepted by the Fund in exchange for reserve deposits. The Fund would also accept, for the same purpose, transfers of convertible currencies, i.e., of currencies which the issuing country agrees to redeem from the Fund at any time in other currencies needed for Fund operations or in gold. Finally—and in sharp contrast with normal Fund drawings—any exchange of a country's own currency for a deposit with the Fund could be undertaken only at the initiative of the Fund itself, and in order to cover an actual or impending shortage of such currency in the Fund's operations.

2. As to the nature and purposes of the Fund's investment operations, they would be determined by the special investment committee mentioned above, subject only to the broad guidelines and specific limitations that the negotiators might wish to impose upon it in the agreement establishing this new procedure. A presumptive ceiling on the yearly expansion of the Fund's investment portfolio—adjusting it to a "normal" growth rate of world reserves—might, for instance, be agreed upon, and qualified majorities—or even unanimity—required to exceed it in case of need.

Two uncontroversial kinds of investment operations, however, should be foreseen from the start. The first would be designed to mop up the excessive short-run indebtedness of reserve centers—the United States and the United Kingdom—to foreign central banks, incurred as a result of long years of operation of the gold-exchange standard. Thus outstanding dollar and sterling balances exchanged for IMF deposits at the initiation of the new system would not be retained in New York and London, subject only to moderate annual instalments at most and/or extraordinary amortization required to cover later United States or United Kingdom surpluses.

Secondly, reshufflings in the Fund's investment portfolio among the major currencies held by it would substitute for, and serve the same purposes as, the present "general arrangements to borrow."

It may be more difficult to reach agreement on the nature and conditions of the new investments that will have to be undertaken in future years to sustain a pace of reserve growth consonant with desirable and feasible rates of expansion in world trade and production.

---

[14] For the guarantees that could be offered against default and even war risks, see the attached paper on "The International Monetary System."

This will require a persistent rise, over time, in the Fund's investment portfolio, and can therefore properly be channeled—directly or indirectly—to help meet the crying needs of many countries for long-term development finance. This is indeed the very mechanism through which the gold-exchange standard of yesteryears transformed into long-term lending by the United Kingdom and the United States the short-term loans extended to these countries through the accumulation of sterling and dollar balances by others as part and parcel of their international reserves.

The insertion of the Fund into this circuit has become necessary to remedy the fatal flow which doomed it in the long run; i.e.; the growing short-term indebtedness which it entailed for the two reserve center countries and which has now undermined the previously unquestioned acceptability of the dollar as a reserve currency, just as it did for the pound sterling many years ago already. What is proposed here is to substitute exchange-guaranteed reserve deposits with the Fund for unguaranteed sterling and dollar balances. The Fund itself would not engage directly in long-term lending for development purposes, but would invest in the major financial markets and international institutions specialized in such operations, in such a way as to minimize the reserve risks that they inevitably entail. While these Fund's investments would retain a highly liquid character, they need not expose the recipients to sudden withdrawals and reserve losses. As different from the United States—or Britain—the Fund would never have to face a liquidity crisis arising from a global contraction of the deposits maintained with it by reserve holders. Deposit withdrawals by the countries in deficit would be matched by deposit increases from the surplus countries. Nor would the Fund have any reason to modify the pattern of its investments, except for stabilization purposes—such as envisaged in the GAB—protecting individual members' reserve position against temporary reversals in their balance of payments, particularly those associated with the volatility of international capital flows under conditions of currency convertibility and of unevenly paced cyclical—and, therefore, desirable interest-rate—movements between major countries and financial centers.

Let us note, in passing, that the similarities between the new type of reserve asset here proposed and the alternative CRU assets of the French and Bernstein plans are as striking as their differences. The pace of new reserve creation would, in both cases, be guided by general considerations of recognized worldwide needs for liquidity rather than by any particular country's request to finance its balance-of-payments deficits. The new reserve units to be created would also be acquired, initially at least, by a limited number of countries. The reserves distributed in the form of new CRU assets would be no more "earned" nor "owned" than those arising from IMF investments, since they would—again initially—entail corresponding liabilities to the CRU fund [15] or to the IMF. Either system would leave the world reserve pool unchanged if it were considered proper to deduct such liabilities from gross reserves to calculate reserves on a net basis. The crucial point, common to both proposals, is the protection of these

[15] Unless, of course, the CRU proposals are merely designed to conceal, or anticipate, a disguised revaluation of gold itself.

liabilities against ill-timed repayment obligations, of a destabilizing character, such as those to which present reserve centers are constantly exposed.

The two major differences remaining between the two systems are the automatic and unconditional character of the proposed distribution of CRU units among a limited group of countries, in accordance with some arbitrary and predetermined formula, irrespective of their policies both with respect to balance-of-payments adjustments and to the use—or lack of use—to which the consequent reserve increases would be put. I strongly suspect that these differences would have to be considerably toned down, anyway, in the process of negotiation, before agreement could be reached on a proposal so devoid of any incentives to desirable readjustment policies and so heavily biased in favor of what has been devastatingly described as a "rich man's club."

V. Conclusion

Finally, I feel that an apology is in order to the members of the committee for the inordinate length of these inadequate answers to its most searching and comprehensive questionnaire. I am also keenly conscious of the fact that I do not have all the answers and that some of those offered here must still be regarded as highly tentative and subject to considerable modification—and, let us hope, improvement—in the difficult process of international negotiation indispensable to concrete and successful action.

There is an old French saying: "Le mieux est l'ennemi du bien." I sincerely hope that it will be taken to heart by all those who participate in this intellectual debate, and even more by those who bear the awesome responsibility of having to sacrifice some of their countries' points of view and—true or fancied—interests for the sake of reaching in time an indispensable agreement. The major blunder and disservice to our country as well as to the world community would be to let the trees of individual or national preferences obscure the forest of our common interest in consolidating the international monetary system against the insane gamble which might at any time bring about its collapse, as it did a third of a century ago, on September 21, 1931, around the exhausted and luckless participants in the defunct League of Nation's Gold Delegation Committee.

Sources of gross reserve increases, 1958–64

	In billions of U.S. dollars	In percent of totals I and III
I. World	13.6	100
A. Monetary gold	4.3	31
1. From Western sources	2.2	16
(a) Production	8.6	64
(b) Private absorption (−)	−6.4	−48
2. U.S.S.R. sales	2.1	16
B. International organizations	1.1	8
1. Reserve claims on IMF	1.8	14
2. Gold sales	−.7	−5
C. National currencies (excluding EPU balances)	8.2	60
1. Dollars	6.9	51
2. Sterling	.7	5
3. Other and discrepancies	.6	4
II. Reserves centers	−8.2	------------
III. Other countries	21.8	100
A. Net reserve losses of reserve centers	16.6	76
1. United States	15.6	72
2. United Kingdom	1.0	5
B. International organizations	.3	2
1. World impact (I–B above)	1.1	5
2. Minus lending to reserve centers	−.8	−4
(a) United States	−.6	−3
(b) United Kingdom	−.2	−1
C. Increases in world monetary gold (I–A above)	4.3	20
D. Other currencies, and discrepancies (I–C3 above)	.6	3

NOTE.—World reserve estimates are calculated from the revised series of the May 1965 International Financial Statistics.

United States and United Kingdom monetary reserves and international investment position, 1957–64

[In billions of U.S. dollars]

End of year	United States			United Kingdom		
	1957	1962	1964	1957	1962	1964
I. Net monetary reserves	15.9	3.5	0.3	−4.2	−2.8	−5.1
A. Gross assets	24.8	17.2	16.7	2.4	3.3	2.3
1. Gold	22.9	16.1	15.5	1.6	2.6	2.1
2. IMF reserve position	2.0	1.1	.8		.5	
3. Foreign exchange		.1	.4	.8	.2	.2
B. Liabilities (−) to	−8.9	−13.7	−16.4	−6.5	−6.1	−7.4
1. IMF	−.2	−.8	−.8	−.3		−.5
2. Foreign monetary authorities	−8.7	−12.9	−15.6	−6.2	−6.1	−6.9
II. Other international assets and liabilities (net)	28.9	46.6			7.4	
A. Short term	−4.7	−1.9			−2.6	
B. Long term	33.6	48.6			9.9	
1. Official	13.6	16.0			−4.4	
2. Private	20.0	32.5			14.3	
(a) Portfolio	.3	2.9			6.3	
(b) Direct investment	19.7	29.6			8.0	
III. Total	44.8	50.1			4.6	

Sources: This table attempts to present in comparable form estimates derived from the following sources:
1. The Survey of Current Business estimates of the U.S. balance of payments and international investment position.
2. The incomplete estimates of the United Kingdom international investment position published in the March 1964 issue of the Bank of England Quarterly Bulletin, from officially reported gross monetary assets, and from rough estimates of the evolution and breakdown of short-term liabilities pieced together from various tables of the Bank of England Quarterly Bulletin, particularly in an article on "The Balance of Payments: Methods of Presentation" (December 1964 issue, pp. 276–286).

Balances of payments of the United States, the European Economic Community, and the United Kingdom: 1958–64

[In billions of U.S. dollars]

	1958	1959	1960	1961	1962	1963	1964
I. Current account and official capital	2.4	−0.6	1.6	3.0	1.7	0.7	2.6
United States	−.8	−2.5	.8	2.6	2.1	1.5	4.0
European Economic Community	2.4	1.8	1.8	.6	−.5	−.8	
United Kingdom	.8	.1	−1.0	−.2			−1.4
A. Current account and private transfers	5.5	3.8	6.1	8.6	7.0	6.5	8.4
United States	1.5	−.7	3.2	4.9	4.3	4.9	7.4
European Economic Community	2.8	3.8	3.4	3.4	2.0	1.0	1.5
United Kingdom	1.2	.7	−.4	.3	.7	.7	−.5
B. Official transfers and capital	−3.1	−4.4	−4.6	−5.6	−5.3	−5.8	−5.8
United States	−2.3	−1.8	−2.4	−2.3	−2.2	−3.4	−3.4
European Economic Community	−.4	−2.0	−1.6	−2.8	−2.6	−1.8	−1.5
United Kingdom	−.3	−.6	−.6	−.5	−.6	−.7	−.9
II. Private capital	−1.7	−.1	−1.2	−3.6	−2.5	−1.9	−3.9
United States	−2.2	.2	−4.4	−3.9	−4.4	−3.5	−5.2
European Economic Community	.2		1.4	1.2	1.2	2.1	1.8
United Kingdom	.3	−.3	1.8	−1.0	.7	−.5	−.5
A. Long term	−2.5	−1.4	−1.5	−.9	−1.4	−2.4	−3.5
United States	−2.6	−1.6	−2.1	−2.2	−2.6	−3.2	−4.1
European Economic Community	.5	.6	.9	1.0	1.3	1.0	1.3
United Kingdom	−.4	−.4	−.2	.3		−.2	−.7
B. Short term	.8	1.3	.3	−2.7	−1.1	.6	−.4
United States	.3	1.8	−2.3	−1.7	−1.8	−.3	−1.1
European Economic Community	−.2	−.6	.5	.2	−.1	−1.1	.5
United Kingdom	.7	.1	2.1	−1.2	.7	−.3	.2
III. Net monetary reserves (=I+II)	0.8	−0.7	0.4	−0.6	−0.8	−1.2	−1.2
United States	−3.0	−2.3	−3.6	−1.3	−2.2	−2.0	−1.2
European Economic Community	2.6	1.8	3.2	1.9	.7	1.3	1.8
United Kingdom	1.1	−.2	.8	−1.1	.8	−.5	−1.9
A. Reported reserve assets	1.2	−1.2	2.4	1.2	−1.1	.9	1.0
United States	−2.3	−1.0	−2.1	−.6	−1.5	−.4	−.2
European Economic Community	2.8	.1	3.6	2.2	.4	1.5	2.0
United Kingdom	.7	−.3	.9	−.4		−.2	−.8
1. Gold	.5	−.2	.1			.3	.4
United States	−2.3	−1.1	−1.7	−.9	−.9	−.5	−.1
European Economic Community	1.6	1.1	1.5	1.4	.6	.9	.9
United Kingdom	1.3	−.3	.3	−.5	.3	−.1	−.3
2. Convertible currencies	.5	−1.3	2.1	.6	−.8	.6	.7
United States				.1		.1	.2
European Economic Community	1.0	−1.2	1.9	−.2		.5	.5
United Kingdom	−.5	−.1	.2	.6	−.8	−.1	
3. IMF reserve position	.2	.3	.2	.6	−.3		−.2
United States			−.4	.1	−.6		−.3
European Economic Community	.2	.2	.2	.9	−.2	.1	.6
United Kingdom		.1	.4	−.5	.5		−.5

Balances of payments of the United States, the European Economic Community, and the United Kingdom: 1958–64—Continued

[In billions of U.S. dollars]

	1958	1959	1960	1961	1962	1963	1964
III. Net Monetary reserves—Con.							
B. Liabilities to IMF	−0.1	0.3	−0.3	−0.6	0.6	--------	−0.5
United States	--------	−.3	−.3	--------	--------	--------	--------
European Economic Community	−.1	.3	--------	--------	--------	--------	--------
United Kingdom	--------	.3	--------	−.6	.6	--------	−.5
C. Other assets and liabilities (net)	−.4	.2	−1.6	−1.2	−.2	−2.1	−1.7
United States	−.7	−.9	−1.1	−.7	..7	−1.6	−1.0
European Economic Community	--------	1.4	−.4	−.3	.2	−.2	−.1
United Kingdom	.4	.2	−.1	−.2	.2	−.3	−.5

Sources: These estimates have been pieced together, in as comparable a form as possible, from the more detailed estimates published in International Financial Statistics, the current IMF Balance of Payments Yearbook, the Survey of Current Business, the Bank of England Quarterly Bulletin, the Monthly Report of the Deutsche Bundesbank, and other official publications.

The following letter was sent by Chairman Reuss to a number of organizations:

JULY 14, 1965.

DEAR SIRS: The Subcommittee on International Exchange and Payments plans to hold hearings on July 27, 28, and 29 on the international monetary system. We hope to point the way to needed changes by developing detailed guidelines that are operationally useful and clearly define the direction in which we should move.

This session of Congress has been so busy that it was impossible to schedule appearances for all of the witnesses and organizations who can contribute to our project. We therefore take this opportunity to invite you to submit a written statement for consideration in the preparation of our report. If you find it possible to prepare such a statement, as we hope you will, could you have it in our hands by August 9? Of course, your statement will be printed in the record of our hearings.

I feel that we can make our greatest contribution by addressing ourselves directly to those changes in the international monetary system which are in the realm of the possible, and avoiding those changes which, however desirable in concept, are so much opposed both in the United States and abroad that they stand no reasonable chance of adoption. I am therefore asking all of our respondents to refrain from discussing flexible exchange rates and changes in the price of gold. Our main focus should be on strengthening existing institutions, perhaps supplementing them in new ways, providing them with new features, or changing the relative importance or "mix" of the various elements that make up today's international monetary system.

Your contribution would be especially valuable if you made the identification of major guideposts the central organizational theme of your prepared statement. Your statement should also make explicit the objectives which you believe the international monetary system should serve, but the development of guidelines rather than a discussion of objectives is our principal goal in these hearings.

We have prepared a paper listing major questions, grouped in broad subject areas, which may be useful in this task. Any guidelines we may favor will necessarily imply answers to a number of these questions. I do not suggest, however, that your statement should primarily focus on these or other questions and attempt to answer most of them. We conceive of them only as building blocks in our basic objective of spelling out the characteristics of an improved international monetary system.

The timeliness and importance of our project was underscored by the speech of Treasury Secretary Henry H. Fowler on July 10 in which he announced that the United States "now stands prepared to attend and participate in an international monetary conference * * *." We hope that you will find it possible to give us the benefit of your views.

Sincerely,

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

Statements were received from the AFL–CIO; the Foreign Investment Committee of the Investment Bankers Association; and the U.S. Council of the International Chamber of Commerce. These statements follow.

STATEMENT SUBMITTED BY AFL–CIO

AMERICAN FEDERATION OF LABOR
AND CONGRESS OF INDUSTRIAL ORGANIZATIONS,
Washington, D.C., August 19, 1965.

Hon. HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments, Joint Economic Committee, House Office Building, Washington, D.C.

DEAR CONGRESSMAN REUSS: I am sorry to be so late in responding to your letter of July 14, requesting the AFL–CIO views on the international monetary system.

The AFL–CIO has supported every administration measure to improve the international financial mechanism. This support included the initial authorization to extend the borrowing authority of the International Monetary Fund in 1961, the implementation of that agreement at the end of last year and again earlier this year, and most recently the 25-percent general increase in IMF quotas. "Workable reform" of the monetary system as Secretary Fowler cited the objective of the U.S. decision to pursue international monetary system changes, has always been the AFL–CIO's basic suggestion for meeting the balance-of-payments necessities of world finance.

Two years ago, on August 13, 1963, the AFL–CIO Executive Council adopted a statement on "The Balance of Payments" which declared:

"The long-run solution to the U.S. payments difficulty requires two series of measures.

"First, America must adopt expansionary policies to attain a growing, full-employment economy at home. Confidence in the American economy is a key to long-run strength at home and abroad. In addition, a prosperous domestic economy will provide increased opportunities for profitable investments. It will attract more foreign investments to the United States and reduce the attractiveness of investments in foreign countries to American investors.

"Second, America must take the lead in working for the development of a new international monetary mechanism, with ability to expand credit—to ease world pressures on the dollar and to enable free world trade to grow. The establishment of such a new international banking arrangement will take time and American action in this direction is long overdue.

"Meanwhile, however, short-term difficulties continue. For this purpose, America should adopt measures to remedy the specific difficulties that have arisen."

Our thinking in connection with the U.S. balance-of-payments difficulty is based on the premise that economic health at home is our first and foremost bulwark, because America's productive ability and actual levels of output and productivity are its ultimate strength.

As a result we do not believe that tight money and high interest rate policies—or other policies to restrict domestic demand through restraints on Federal expenditures and/or personal consumption—are appropriate objectives of national policy until full employment is reached and as long as there are no general shortages of goods, productive capacity, and manpower. Indeed, it is our view that pursuit of such policies can be a dangerous adventure, with the potential result of a loss of confidence in the dollar as well as rising unemployment and economic stagnation or recession.

We have seen no evidence that higher U.S. interest rates have solved or can solve America's balance-of-payments difficulty. Continued small-scale increases of interest rates are a gamble with the health of our domestic economy, while they are insufficient to bring any meaningful reduction of balance-of-payments pressures. On the other hand, a sharp rise of interest rates would result in dangerous deflation at home and possibly abroad as well.

The dollar, as I see it, has not been in jeopardy since 1960–61, when "hot money" flowed out of the recession-bound American economy in search of attractive investments elsewhere—such as in the German stock market. The technical international monetary steps taken by the U.S. Government since then—accompanied by measures to strengthen the domestic economy—have improved the dollar's standing.

Last year's outflow was, as Hal Lary of the National Bureau of Economic Research put it, "a flight of the dollar" in expectation of Government restrictions on private capital outflows, rather than a "flight from the dollar." The experience with the administration's voluntary capital control program this year has proved that the outflow of private capital can be curbed effectively. Supervision of private capital outflows is an essential mechanism to curb balance-of-payments pressures without inflicting dangerous deflationary pressures on the domestic economy.

The improvement of the international monetary system is needed as rapidly as workable reform can be achieved. This is needed to provide sufficient international liquidity to enable world trade to grow. It is needed to prevent—or at least to curtail—the possibility of harmful financial and monetary conflicts among the free nations of the world. It is also needed to decrease world dependence on the dollar in international financial transactions, which can generate world pressures on the dollar.

At least until an effective and workable reform of the international monetary mechanism is achieved, it will be necessary to continue to pursue specific measures to handle specific aspects of the balance of payments difficulty. In any case, such specific mechanisms, including supervision of private capital outflows, should be available to the U.S. Government, for use whenever necessary. But above all, we must persist and improve our efforts to sustain expansionary full-employment policies at home because the health of the American economy is the bulwark of the free world, as well as our own society.

Sincerely,

NAT GOLDFINGER,
Director, Department of Research.

STATEMENT BY THE FOREIGN INVESTMENT COMMITTEE OF THE INVESTMENT BANKERS ASSOCIATION OF AMERICA, AUGUST 13, 1965

INVESTMENT BANKERS ASSOCIATION OF AMERICA,
Washington, D.C., August 13, 1965.

Hon. HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR CONGRESSMAN REUSS: In response to your letter of July 14, addressed to our association, Mr. Nathaniel Samuels of Kuhn, Loeb & Co., New York, who is the chairman of our foreign investment committee, has asked me to transmit to you the enclosed statement with respect to the international monetary system. He has also asked me to advise you that although the statement reflects the views of the overwhelming majority of the committee, a few members had reservations with respect to parts of the statement.

Sincerely yours,

MURRAY HANSON.

No currency achieves the status of a reserve currency for central banks or of a key currency for private transactions by more fiat, but only as a result of a general consensus. This general consensus rests on the economic and political importance of the countries whose currencies are so employed, and on widespread confidence and usage. The present and future roles of the dollar depend, therefore, not on any arbitrary act or desire of Washington or Paris or London or Bonn or Zurich, or of any other national capital or private money market, but on the strength and vitality of the United States as an economic and political unit, on the wisdom of our economic, fiscal, and monetary policies, and on the skill and determination with which these are implemented. Fundamentally, the health of the dollar or any other currency does not depend on a monetary system, but on the nature and the timeliness of continuing economic adjustments among nations to meet ever-changing circumstances. It is useful to bear these truisms in mind when reexamining the international monetary system and the role of the dollar in it.

In formulating guidelines for possible modification of the international monetary system, we suggest that U.S. policy incorporate the following considerations:

1. Revision of the international monetary system is a matter of urgency for three reasons: (*a*) there is an accelerating anxiety in the private sector in many countries which is induced by the fear that one or another balance-of-payments crisis will lead to a serious international financial crisis; (*b*) the trend toward economic nationalism will be intensified by monetary uncertainty and, therefore, the main hope for arresting the new economic nationalism now gaining ground in the world is to eliminate governmental and private anxieties about the adequacy of the monetary system; (*c*) a system is not tolerable in which improvement in the balance of payments in one major country results almost automatically in a payments strain in another major country. The measures which the U.S. Government has taken over the past 2 years, regardless of their merits or demerits, have served to convince the world that we shall and can do whatever may appear necessary to bring our accounts into balance. It is not necessary to wait further to bring this fact home; meanwhile we risk serious damage to the whole international system by allowing private anxieties to rise and economic nationalism to grow. Better 10 minutes early than 1 minute late.

2. The use of gold as the basic and primary means of settling international accounts is virtually certain to decline in relative importance in the years ahead if world trade increases substantially faster than the production of newly mined gold, and if capital movements are to be free despite their increasing magnitude and velocity. This is the situation which prevails at present and has prevailed throughout most of the postwar years. It certainly must be our aim to facilitate the growth of world trade as broadly and as rapidly as possible, and to maintain and enhance the freedom of capital movements. It seems clear, therefore, that even if gold remains as the centerpiece of the international monetary system for some years ahead, a method of supplementing it as a monetary reserve is likely to be required and in all probability will assume a relatively more important role in the system as the years go on.

3. The use of dollars and, to an important degree, sterling has provided this supplement in the postwar years in the form of the gold exchange standard. The maintenance of the postwar growth in world trade and the broadening freedom, until recently, of capital movements, have been possible because the United States and the United Kingdom, in particular the former, have been pursuing internal and external policies which have resulted in massive and persistent net outflows of their respective currencies. The consequence has been large accumulations, particularly of dollars, by central banks, mainly European, and by private entities in various parts of the world. If the foreign central banks of the major industrialized countries were prepared to hold dollars in unlimited amounts, regardless of what percentages these might bear to their gold holdings, there would be no need to consider the future role of gold or the need for supplements to gold. In this case, the United States could, if it wished, continue internal and foreign policies which result in the large net outflows of official and of private capital. The simple fact is, however, that while most countries would surely prefer to hold dollars as reserves rather than some artificially created reserve unit, a number of the important industrialized countries are not willing to hold dollars in unlimited quantities.

4. Such proposals as might be adopted to improve the adequacy of the international monetary system should enable world trade to continue its upward surge, should sustain vigorous economic development and should assure free capital movements, while involving only limited risks to the existing monetary structure. Two classes of proposals, probably in combination, would seem to offer sufficient scope within which to meet these criteria. One such class of proposals involves an expansion of the resources of the International Monetary Fund and enlargement of the scope of drawing rights, while a second class of proposals involves the creation of a reserve unit by the major industrialized countries which would be used to supplement gold and dollars. Increasing the magnitude and extending the operational scope of the IMF would be highly desirable, but the granting of powers of credit creation and contraction does not appear to be necessary, in the immediate future in any case, nor does such action appear politically feasible. As for the creation of a reserve unit it should, in the first stages, be limited and experimental, and the component national currencies to be used and the extent to which each component is to be used, should be those which central banks and private entities are genuinely willing to accept as having reserve status. The formula for constituting the reserve unit, therefore, should conform to the merits of the components as reserves, and not be governed by arbitrary political considerations.

5. The mechanism for creating and operating the reserve unit should be grafted on to the IMF, so that the requirements of the Group of Ten, for example, are safeguarded, while the integrity of the international monetary system as embraced within the IMF is kept intact.

6. While the dollar will, under all foreseeable circumstances, continue as the essential key currency for transactions, a limited sharing of the dollar's reserve currency task may afford the United States somewhat greater freedom in economic and monetary policy. This might be desirable in view of the foreign economic aid and military assistance burden carried by us, provided we do not seek greater freedom in these matters as a means of escape from the imperatives of monetary discipline. If we keep the U.S. economy as a part of a world system, and not seek to isolate it through fiscal and monetary policy, we should not suffer any adverse consequences from a limited sharing of the reserve currency task, and be able to maintain our international banking position.

7. The international monetary system has shown itself to be deficient more on the side of sustaining free movements of capital than of sustaining the growth of world trade. The magnitude and the rapidity of capital movements have

had serious impact on the balance of payments of one country or another, and this has induced certain governments, including unhappily that of the United States, to interfere, directly and indirectly, with the free movement of capital. This is resulting in the fragmentation of capital markets. If this new trend toward economic nationalism continues, it is likely to have a seriously adverse effect on economc development. At the present time the United States is following a policy of virtually barring the major developed countries from our capital market, while urging Americans to withdraw dollars from Europe and at the same time to borrow money they need for foreign purposes in the limited European markets. The result has been further sharp upward pressure on interest rates in Europe, disorganized capital markets abroad and thus the intensification of anti-American attitudes on the part of European industrial and political circles. It is an illusion for us to believe that it is possible, for any extended period of time, to regard developed countries and less developed ones, as in different categories for capital flow purposes, since the growth of the less developed world is intimately tied to, and to a large degree dependent on, the freedom of capital movement and economic growth of the more developed world.

8. Reexamination of the international monetary system should also involve reexamination of the conceptual problems, primarily so that a uniform method can be adopted within which to ascertain the true balance-of-payments position of any one country in relation to that of other countries. The present methods may contain certain conceptual deficiencies and certainly are not uniform in application for all countries.

NATHANIEL SAMUELS, *Chairman.*

STATEMENT SUBMITTED BY THE U.S. COUNCIL OF THE INTERNATIONAL CHAMBER OF COMMERCE

FIRST NATIONAL CITY BANK,
New York, N.Y., July 30, 1965.

Hon. HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR CONGRESSMAN REUSS: As chairman of its committee on international monetary relations, I want to respond to your kind invitation to the U.S. Council of the International Chamber of Commerce to prepare a written statement for consideration in the preparation of your report.

The U.S. council has had proposals for international monetary reform under continuing study. In view of the rapid actions to deal with our balance of payments, and uncertainties respecting consequences, statements we have prepared in the past have gone out of date. Because of vacation absences, and the IMF meetings in September, our committee may not be meeting again until October and, thus, will not have opportunity to develop a considered new statement in the allotted time.

Nevertheless, I am glad to offer some lines of thinking which have developed in our own committee discussions.

Your quest for guidelines is a constructive approach. We believe the problem merits a close and objective study of the entire range of ideas advanced. We must be openminded and willing and eager to exchange ideas. My personal view, in the background of criticisms of the dollar and sensitivities to dollar diplomacy, is that we ought to concentrate on listening. We may find ourselves in a role of arbitrating differences, and seeking consensus among conflicting proposals of others. Above all, we must promote a conciliatory spirit and discourage unilateral actions. If we do not hang together we will hang separately. The thought of a breakdown of international cooperation is too appalling to contemplate.

Some guidelines are already agreed to: no change in gold price; no floating rates. Our committee would further agree that there is no reform of the international financial system that can spare nations the consequences of financial follies. Creditor countries and institutions like the IMF must be prepared to refuse credits and ask reforms as a consideration for credit lines. Without limits on credit lines worldwide inflation looms, and with it destruction and distortion of savings habits. We need specifically to guard against trying to make up shortage of capital for constructive long-term investment by creating more domestic and international liquidity. Shortage of capital is a graver problem than shortage of international liquidity and one much more difficult to remedy.

We were glad to see your Joint Economic Committee, in its thoughtful and penetrating review of the balance-of-payments question, under date of March 17 (Report on the January 1965 Economic Report), remind us of our long-term objective of freedom for capital movements. Many members of the inetrnational business community are disturbed by evidences of retrogression, rather than progress, in this direction. It would be helpful, in this context, to enact the legislation proposed by the President to increase incentives for foreigners to invest in U.S. corporate securities. It would be even more helpful to find our way out of the balance-of-payments problem by means that avoid restrictions on capital outflow.

Each country has its own responsibility for formulation of wise monetary, fiscal, and wage policies. The responsibility is heaviest for us because the world is more on a dollar standard than a gold standard. As Secretary Fowler has suggested, we need to get rid of the image, in Europe and elsewhere, of the United States as "a monetary paper tiger." A sound, trusted dollar is needed by the world as much as by ourselves. There is nothing to take its place. A composite reserve unit could be adopted as a unit of account, for use in bookkeeping among central banks. But to be respected, a CRU would necessarily

have an equivalence to the dollar and the backing of our economic and financial strength. Let's not sell the dollar short.

We believe the base of the international financial system does need to be broadened, most desirably through the institutional framework of the IMF. Yet we should not entertain the thought of getting rid of the key currency role for the dollar and, as it were, liquidating the world's largest bank and for no better reason than that it has become somewhat overextended. Foreign commitments must be limited to what our export surplus and overseas investments can produce, plus the foreign private capital we can attract. And that is a good deal.

In regard to expanding international credit facilities, your outline raises significant questions. We would rely first of all on private credit facilities which do, in fact, finance the bulk of world trade. Shortages of official reserves among developing countries ideally should be compensated by attracting private capital; capital is the real need. Beyond this, any member country, under appropriate conditions, can seek help from the IMF. The IMF has great power to create international liquidity, as the Managing Director, Mr. Pierre-Paul Schweitzer, brought out in a recent speech. Our committee feels that new international arrangements should be centered on and operated through the established IMF. The Fund itself could develop its image as a bank and promote better public understanding of its activities if its transactions were reported more in banking rather than foreign exchange trading language. It should be possible, at some point, to supersede the necessity for bilateral arrangements.

The hard truth of our balance-of-payments problem is that we have been trying to do more abroad than our European creditors have been willing to finance. The efforts through 1965 were helpful but insufficient. The efforts this year are sufficient but raise questions, in the minds of thoughtful persons abroad as well as at home, that we may, while restoring trust in the minds of creditors, be giving impulse to broadening restrictions on trade, travel, and capital movements. As I know you will appreciate, this is a tide that must be resisted. For prosperity is indivisible. Our goal, after all, is promotion of freedom and competitive international intercourse to mutual benefit.

Sincerely yours,

NORRIS O. JOHNSON.