NEW APPROACH TO UNITED STATES INTERNATIONAL ECONOMIC POLICY

339

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NEW APPROACH TO U.S. INTERNATIONAL ECONOMIC POLICY

FRIDAY, SEPTEMBER 9, 1966

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

The joint subcommittee met, pursuant to notice, at 10:05 a.m., in room S-407, the Capitol, Representative Henry S. Reuss (chairman) presiding.

Present: Representatives Reuss and Ellsworth; Senators Proxmire and Javits.

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

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

We welcome here this morning our panelists, Professors Roy Blough of Columbia University, Emile Despres of Stanford, and Robert A. Mundell of the University of Chicago, and Dr. Walter S. Salant of The Brookings Institution.

This hearing has been called to ask the general question: Where does the free world go from here in its problems of international balance of payments and monetary reform in particular, and its international economic problems in general? On international payments the unilateral effort of the United States to put its own payments in order without damage to the international economy has shown little real progress, and as a result there has been a continuing increase in the supply of dollars in foreign hands, accompanied by a persistent conversion into gold by at least one of the powers, France.

On international monetary reform, the heads of the national treasuries and the central banks have been talking about reform for at least 5 years, but today we still live on hope rather than on accomplished agreement. We have reached agreement on some brilliant exegeses of the alternatives, but no agreement at all on which one can be the basis for policy, and our best hope is that if all goes well, everyone but France will be in agreement a year from now as to what we might start to do if the world ever ran into serious financial trouble. But this is small consolation because real trouble will not necessarily give us notice of a year or two in order to enable us to put new machinery in place. The world, therefore, faces a very real risk that if a financial crisis comes, it will be with so little warning that we had better have the machinery in existence and functioning, not merely

agreed upon in vague principle. That kind of agreement is far from an immediate prospect.

One can't discuss payments and money without being aware of the problems in other fields. In trade the Kennedy Round is unhappily bogging down, and there is no agreement, indeed precious little discussion, of what the world is supposed to do after June 1967 when the Kennedy Round authorization runs out.

In AID, the decade of development is more than half over now. This was supposed to be the decade in which 1 percent of the gross national product of the developed world would be placed at the disposal of the developing nations. Nothing like this has happened, and in general the poor are very little better off than they were at the start of the decade.

In our domestic economies, in the 20-odd leading industrial countries of the world—the United States, Canada, Europe, Japan, et cetera—everywhere you find the same story: a good deal of prosperity and something like full employment; but all of the countries flutter in confusion as to how to manage such a prosperous economy without inflation.

The reason for the fact that the free world now finds itself largely on dead center in its international economics seems to the chairman of this subcommittee to be caused by several factors. These technical discussions on trade or aid or monetary problems are usually attended by technical officials, and while they are multilateral in character, the technician's level at which they are conducted has contributed to preventing any great morale-building forward drive.

Equally, when heads of government do get together, they tend to get together on a purely bilateral basis and for too short a time and there just isn't the opportunity to explore in depth and multilaterally and at the highest level how the free world can get moving forward once again.

The questions that are in the minds of the subcommittee, and on which we want the help of the panelists are, first, whether we now don't have technical solutions in sight to most of the technical problems of international economics that are presented, and whether the problem now is not very largely political, and one involving the will of the leaders of the free world to do something about these technical problems.

If our conclusion is that a new political will is necessary, we would like the panel to think specifically about the desirability of a high-level, heads-of-government conference of the 20 or so leading countries of the free industrialized world, to see if it isn't possible to recapture some of the international cooperation and dynamism that characterized the world 20 years ago, when we were evolving an International Monetary Fund, a World Bank, and in 1947 the Marshall Plan, whose 20th anniversary will come next June 5—the 20th anniversary of General Marshall's speech calling for a new and intensified level of international cooperation, and asking that countries other than the United States take some of the initiative.

Finally then, we ask of the panel, where do we go from here, what can be done at the IMF meeting later this month, at OECD upcoming meetings, and by the heads of government generally of the free world, to see if there cannot be evolved, 20 years after the first great example and monument of international cooperation, a second round of international economic cooperation on a grand scale.

(The following statement, prepared by the staff and approved by the subcommittee, had been circulated earlier among the members of the panel for their comments:)

[Released Aug. 28, 1966]

PROPOSED POLICY STATEMENT BY THE UNITED STATES

1. The United States, for some years, has been attempting—

A. To balance its payments, consistent with maintaining its international responsibilities, and;

B. To bring about an international monetary reform which will relieve the dollar (and sterling) from key currency pressures.

Despite the recent Hague decision to continue discussions in the International Monetary Fund, no agreement is in sight, at least for several years to come. The main cited reason for disagreement is the U.S. failure to balance its payments. The present situation—no monetary reform, plus a universally deplored U.S. payments deficit—is dangerous in that it can lead either to insufficient international liquidity if our payments deficit diminishes, or a run on the dollar if it does not.

2. One reason for the unsatisfactory state of free world economic arrangements is that the monetary negotiations are entrusted solely to finance ministers and central bankers. The discussion needs to be elevated to the level of heads of government.

3. Accordingly, the IMF, at its September 26–30 Washington meeting, could well invite the 21 leading free world industrialized nations of the OECD promptly to prepare governmental positions on the following:

A. In the absence of international monetary reform, how much U.S. payments deficit, if any, would be necessary for the next few years, in order to create sufficient liquidity?

B. What action would they recommend in order to enable the United States to meet this target? If our deficit is below the target, should there be an issue of credits by the United States? If our deficit threatens to exceed the target, should there be—

(i) Action by continental countries to restrict U.S. private investment;

(ii) Reduction of U.S. untied foreign aid, by such means as refusal to contribute to the replenishment of IDA funds, as requested by World Bank President Woods;

(iii) Accelerated removal of trade barriers, under the Kennedy Round and later programs;

(iv) Greater use by continental countries of fiscal rather than monetary measures in their domestic economies;

(v) Programs to broaden the non-U.S. capital markets;

(vi) Efforts to encourage foreign travel to the United States and to discourage U.S. travel abroad;

(vii) Reduction of United States and British military dispositions around the world, and particularly in France and Germany;

(viii) Reduction of U.S. commodity imports by tariff or quota barriers;

(ix) Further reduction of U.S. private capital outflows by the United States;

(x) Increased monetary stringency by the United States;

(xi) Any other actions?

4. The IMF and the OECD would then act as cohosts at an international conference of heads of government of the 21 nations to be held as promptly as possible.

5. The United States promises to give serious and sympathetic consideration to the proposals of other nations designed to promote the economic health of the free world, without imposing a domestic recession upon the United States.

Chairman REUSS. My colleague and friend, Mr. Ellsworth, who has done so much for this subcommittee, has an introductory statement.

Representative ELLSWORTH. Thank you very much, Mr. Chairman. Certainly your opening statement was an inspiring one and gives guidance to all of us.

These hearings on U.S. international economic policy take place in a setting of rapid action and great stress.

Possible devaluation of the British pound is very much in the air.

Gold hoarding all over the world is so widespread that only $250 million of the $2 billion in new gold produced last year went into official reserves. Because of heavy gold conversions, the U.S. balance-of-payments deficit last year made almost no contribution to world liquidity.

High interest rates all over the industrial world reflect an inadequate supply of capital to meet the needs of our industrial civilization, while the capital shortfall for the less developed world is estimated at $5 to $20 billion a year.

The annual meeting of the full International Monetary Fund and World Bank will convene here in Washington the end of this month, and the overriding subject will be the timing of an international monetary reform plan designed to provide additions to world liquidity.

In the face of these conditions, our hearings today take on more than the usual academic interest.

1. In their report of August 25, the Deputies of the Group of Ten repeatedly emphasized the reliance of the whole industrialized world on the U.S. dollar. The report explicitly stressed this point at least 10 times. Devaluation of the British pound, if it comes, must not be allowed to affect the strength and prestige of the U.S. dollar.

For political as well as economic reasons, the British pound is in serious trouble. The monetary system can take devaluation in stride if it does not set off a wave of devaluations by other countries and if it does not trigger a flight from the dollar into gold. It is vital for the administration to begin now to make clear that devaluation of the pound would not have the slightest effect on the basic strength of the American economy and of the U.S. dollar.

2. In that same report, the Deputies stressed on at least eight separate occasions that the international monetary system cannot continue to rely on new gold production alone for legitimate increases to world liquidity. It is now clear that the need for a new and better system for creating periodic additions to world liquidity is immediate and not remote. Failure to move promptly to provide a new reserve asset for this purpose will have a deflationary impact on the world economy. In fact, nations have already begun to compensate for the lack of such additions to liquidity by the use of restrictive monetary and trade policies.

3. Domestic inflation in the United States has for months clearly indicated a need for fiscal action including elimination of low-priority Government spending. The administration's almost exclusive reliance on monetary policy has undercut our lectures to other nations about the importance of using fiscal policy in the adjustment process. It has also contributed to the worldwide upsurge in interest rates.

I hope all the witnesses will address themselves to these issues as well as to full development of their own views and programs.

Chairman Reuss. Thank you, Mr. Ellsworth. Senator Proxmire?

Senator Proxmire. I have no opening statement.

Chairman Reuss. When the witnesses were invited, they were told that they could, if they wished, present an opening prepared statement. I believe Mr. Mundell does have a prepared statement which he has been kind enough to hand me, and without objection that statement in full will be placed in the record. I would like Mr. Mundell to proceed, if he will, to summarize, or otherwise give us the

essence of his prepared statement. After Mr. Mundell's presentation, I think the most useful way to proceed would be for any and all members of the panel to be heard from on the general, "Where do we go from here," subject matter.

Mr. Mundell, will you begin, please?

(The prepared statement of Mr. Mundell follows:)

PREPARED STATEMENT OF PROFESSOR ROBERT A. MUNDELL, THE UNIVERSITY OF CHICAGO

Mr. Chairman, the successful operation of the gold exchange standard requires a specific set of monetary and fiscal policy "rules of the game" in both the key currency ("inner") country and the non-reserve ("outer") countries. At the heart of the system lies the role of the size and composition of the deficit of the inner country.

The outer countries peg their currencies (directly or indirectly) to the inner country's currency (the dollar) and thus act as residual purchasers or sellers of dollars, while the inner country (the U.S.) pegs the dollar to the ultimate asset (gold), and thus acts as the residual buyer or seller of *gold*. This means that the *size* of the U.S. deficit determines the increase in reserves of the rest of the world, while its *composition* determines the change in reserves of the U.S., given the rate of increase of monetary gold holdings in the world.

When U.S. monetary policy is very expansive the outer countries have to buy up large amounts of dollars and this has direct and indirect *inflationary* consequences for the outer countries; similarly, when U.S. monetary policy is restrictive there is a scarcity of dollars and this has deflationary consequences for the rest of the world.

The outer countries' protection against an excessive or deficient flow of dollars is to alter the *composition* of the U.S. deficit and thus affect the reserve position of the U.S. When U.S. monetary policy is excessively expansive the outer countries can convert dollars into gold; this leaves the aggregate level of their own reserves unchanged, but it destroys world reserves because it reduces U.S. reserves. And similarly, when U.S. policy is unduly restrictive, the outer countries can convert gold into dollars, leaving their own reserves unchanged, but *improving* the reserve position of the U.S. The *composition* of the U.S. deficit, which is under the control of the outer countries, is the mechanism by which the outer countries, in their role as governors of the gold exchange standard system, cast their votes with respect to the appropriateness or inappropriateness of the aggregate size of the U.S. deficit.

The *vigor* with which the votes are cast, however, is circumscribed by the attachment of the inner and outer countries alike to the existing system. The outer countries can *warn* the U.S. by gold conversions, but they cannot lower the U.S. gold stock below the point at which it no longer pays the U.S. to continue running it; overly aggressive conversions would reinforce the go-it-alone forces in the U.S. represented by Professors Despres, Kindleberger and Salant. On the other hand, the U.S. freedom of action is also circumscribed in the sense that U.S. monetary policy must not be so inimical to the interests of the rest of the world that the outer countries decide, in their own protection, to opt out of the system by abandoning the dollar for gold.

This is the system as it is supposed to operate. But within these constraints monetary and fiscal policies have to be carefully coordinated as both the U.S. and the outer countries try to preserve internal balance (full employment without inflation) and external equilibrium (reserves increasing at the rate countries desire them to increase). The correct set of policies to achieve these goals, under fixed exchange rates, is for the authorities to run a budget surplus when there is inflation and a budget deficit when there is unemployment; and to have easy money when there is an "excessive" balance of payments surplus and tight money when there is an "excessive" balance of payments deficit.

There are definite criteria that can be applied to determine whether the deficit is "excessive". When the U.S. and Europe both have high unemployment the U.S. deficit should be large to encourage fiscal and monetary expansion in Europe as well as the U.S., while the Europeans should be willing to part with gold to free the U.S. from concern over its gold constraint. On the other hand, when the U.S. and Europe both experience inflationary pressures, the U.S. deficit should be small to encourage contraction in Europe as well as in the U.S., while Europe

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should take gold out of the U.S. to bring pressure on the authorities here to contract.

The U.S. followed these principles between 1962 and 1964 when taxes were cut and interest rates were allowed to rise. But she departed from them after 1965 when unplanned defense spending and an excessive rate of monetary expansion created inflationary pressure in the U.S. The correct policy last winter and spring was to raise taxes, restrain monetary expansion, or both. Sufficient monetary restraint would have corrected the balance of payments; sufficient fiscal restraint would have prevented inflation.

Meanwhile, Europe in 1960–4 had been running an excessive balance of payments surplus and inflating; they incorrectly failed to raise taxes and instead allowed interest rates to rise. By 1965 their failure to raise taxes in the midst of a boom aggravated the pressure on credit and bond markets broke sharply, while their current account balances worsened because of their inflation, and their reserve position improved because of tight money conditions which continued to attract U.S. capital.

The basic mistakes in world policy in 1965–6 have now come home to roost. Monetary restraint was needed in the U.S. in 1965 and fiscal restraint was needed in Europe; our misfortune is that we got the opposite. The crash in the bond market in Europe is a symptom that monetary policy was used to do the job that should have been reserved for fiscal policy; while the fall of U.S. stock market prices—or should I say the rise in yields—reflects the recent about turn of monetary policy in the U.S., which finally—too late—stepped into the vacuum that should have been filled by fiscal policy.

Sudden reversals of policy, such as those we have recently experienced, combine with complicated dynamic factors to create a policy-induced uncertainty, and grave doubt about the future. World economy is now in serious trouble. We may already have passed that critical point beyond which it is impossible to stop inflation without creating a depression on a world-wide scale.

It is in this milieu that the managers of the system—the central bankers and the finance ministers—have reached an impasse on the issue of monetary reform. Yet the stability of the system depends entirely on their ability to agree. It follows that, unless we are prepared to attribute to them the most incredible folly, they have at least agreed to preserve the present system.

The weak link in that system is the stability of the price of gold, and that is the most urgent problem to which attention should be directed. The minimum cooperation that could therefore be asked of our monetary statesmen is that the groups of eleven, ten or nine, or any other relevant collection of countries, settle between them on the need to preserve the present dollar price of gold, and agree to commit their gold resources—more than $25 billion—to this end by a drastic enlargement of the stand-by resources of the gold pool. Given the failure to agree on a new system, we have to make do with the one we have.

To this end there is an inevitable balance of responsibility. Europe must be willing to alter the composition of her reserves to the extent necessary to preserve the present dollar price of gold. America, on her part, must be willing and able to preserve the stability of her economy to make Europe's commitment worth while.

TESTIMONY OF PROF. ROBERT A. MUNDELL, UNIVERSITY OF CHICAGO; PROF. ROY BLOUGH, COLUMBIA UNIVERSITY; PROF. EMILE DESPRES, STANFORD UNIVERSITY; AND DR. WALTER S. SALANT, THE BROOKINGS INSTITUTION

Mr. MUNDELL. Thank you, Mr. Chairman. The substance of my report, which I will try to summarize, is that we now have a system, the gold exchange standard, that has certain equilibrating features in it, and the absence of agreement on a new system implies that we have to improve the operation of the system we now have, at least in the interim before any new, radical, or substantial plans can be adopted.

By now, a set of rules have evolved with respect to the operation of this gold standard system—rules based on the appropriate use of monetary and fiscal policies, to achieve the goals of domestic stability in this country and in the rest of the world.

In certain cases, policy in this country—which is of special importance for the rest of the world—has to operate in a direction that is not in the interests of the rest of the world. If the rest of the world is undergoing considerable inflationary pressure, and the United States is in a state of depression, then the United States will have to expand its financial policies, especially its fiscal policy, in order to improve employment, while using some restraint on the use of monetary policy because of the disequilibrium in the balance of payments.

But one case is very clear cut, where the appropriate U.S. policy is completely in harmony with the interests of the rest of the world. That is the case when the United States has inflationary pressure and when the rest of the world is also experiencing inflationary pressure. In those circumstances, no matter what the deficit in the U.S. balance of payments is, tighter monetary and fiscal policies need to be followed in the United States.

In 1965 we could fault the Europeans for their failure to use fiscal policy, but we certainly have to fault the U.S. monetary policy for an excessively rapid expansion which greatly exacerbated the burdens of financial adjustment on European countries. For the past 5 years they have been allowing a rate of inflation that is not in their own interests, but they have acceded to that policy, allowed that policy to continue, partly because they could not do much about it, and partly in the interests of international adjustment. To make the adjustment effective European prices have to rise relative to American prices.

Well, now we have got into a box. The box is that U.S. policy has been too expansionary, and this has harmed European policy as well; clearly a reversal of policy was in order. Now, that reversal of policy was undertaken abruptly about 2 months ago, when the Federal Reserve System sharply restrained its open-market purchase policy. It reduced the rate of expansion of reserves to the banking system, and caused a tight money squeeze on the economy with consequential effects on the stock market and the bond market.

Sudden reversals of policy are extremely dangerous. It would have been better to have been more restrained in the previous year while following a tighter fiscal policy. But all that is water over the dam. The problem now is that the reversal of policy that is taking place in the United States is inevitably going to have effects on world credit markets, and especially on the weak reserve currency, the pound sterling.

In the event of a devaluation of sterling, an increase in gold hoarding or a run on the dollar, begun either in the private markets or through the central banks, is a serious likelihood. There are perhaps three consequences of such a catastrophic event.

One is that the United States has to suspend operations in gold, which will force the countries in the rest of the world to adopt a dollar standard, continuing to buy up whatever dollars are necessary, as Messrs. Despres, Salant, and Kindleberger have argued.

A second possibility, which is also likely if there is disorganization, is a rise in the price of gold which could come about sporadically with sequential devaluations in various countries. Of course, a third alternative, a dramatic coordinated monetary policy on the part of all the central banks to stabilize the price of gold would be the best.

I would say that the correct policy—by far the best for the free world in the interim, before officials can agree upon a plan for international monetary reform—is to tackle the gold problem, give that problem the highest priority, to take care of the price of gold in the event that there is some kind of serious financial disturbance.

The only way in which that can be done is by an agreement between the United States and the other members of the group of 11, 9, or 10 to use their full resources, gold resources, to stabilize the London price of gold, in the event of a disturbance. With $25 billion among them there is no reason why the price of gold has to go up. But in the event of a sterling devaluation combined with other devaluations of a competitive nature in other countries—that is a serious likelihood.

Thank you.

Chairman REUSS. You say in your statement, Mr. Mundell:

> Europe must be willing to alter the composition of her reserves to the extent necessary to preserve the present dollar price of gold.

By this, do you mean an interim agreement pending the adoption of a new international monetary mechanism under which countries would agree to maintain only a certain proportion of their reserves in gold?

Mr. MUNDELL. Yes. Suppose there is a dramatic, speculative increase in gold hoarding of $2 or $3 or $4 billion. That $2 or $3 or $4 billion is going to have to come out of the reserves of either U.S. or European central banks, unless the price of gold in London is going to rise; and in order to stabilize the price, there has to be an agreement.

There is no reason at all, with $25 billion between them, that the price of gold in London has to rise, but it would take some agreement on the part of the monetary authorities to feed gold into the market whenever it is necessary. They can do this through an enlargement of the gold pool, but not a gold pool with half a billion dollars in it, but a gold pool with $5, $10, or $15 billion, whatever is necessary.

In the long run they are not going to have any less gold, because if the private speculators are faced with the enormous weight of $25 billion of gold committed to support the dollar, there is no reason why a speculator would want to hold on to a non-interest-bearing asset. His only chance of getting money, of gaining, is if the price goes up, and it can't possibly go up if the central banks in the Group of Ten cooperate.

Chairman REUSS. Another provocative statement in your paper, Mr. Mundell, is that in which you say:

> It is in this milieu that the managers of the system—the central bankers and the finance ministers—have reached an impasse on the issue of monetary reform. Yet the stability of the system depends entirely on their ability to agree.

Taking that statement as a jumping-off point, would you agree, yourself, to the larger question presented here this morning, as to whether free worldwide discussions of matters like monetary reform, and, for that matter, balance of payments, trade, aid, and some of the other subjects, should not be elevated to a heads-of-government level on a multilateral basis, where the technical level of discussions which have gone on for the last many years is rarely adequate to the gravity of the problem.

Mr. MUNDELL. I have mixed feelings about that. On the longrun issue of monetary reform, I think the technical expertise of the indi-

vidual treasuries and central banks is necessary, and while they should be prodded in this direction, they can't be commanded to come up with an idea that is politically acceptable to the group when the political framework in which reform is to take place isn't really established.

Where I would agree with that statement, however, is the absolute necessity of an agreement among officials, perhaps as high as heads of government, on this immediate issue—coordination of policies in the event of a crisis. This is an issue on which the most general directive can be given or the most general meeting can agree that they will either at this stage raise the price of gold or not raise the price of gold, and if they are not going to raise the price of gold, then take whatever steps are necessary to insure that the price of gold isn't chaotically forced up.

Chairman REUSS. Thank you. I think it would be useful if I now invite members of the panel to comment generally on the subject matter we are discussing, or on any specific part of it, and I will just recognize members, starting with Mr. Blough.

Mr. Blough, incidentally, has a commitment back in New York, and must leave at 11:30, no later than 11:30, so I would hope that we could ask him whatever questions we have before then.

Mr. BLOUGH. Mr. Chairman, at this time I would like to speak only on one point raised by Mr. Mundell; namely, the possibility of a rise in the price of gold. I think this is a risk, at any rate, that cannot be excluded as a possibility in the present state of the world's monetary system. France now has about $5 billion of gold which is much larger than is necessary in relation to her international trade, her liabilities, and her other responsibilities.

The French head of state has made some statements which indicated a strong belief in close ties to gold. One of his economic advisers is reported as strongly supporting a substantial increase in the price of gold.

There are a number of people in Europe today who are actively working toward a substantial increase in the price of gold.

Suppose the French decided that getting back to gold was the real answer, that economic international financial cooperation was no longer something that they were willing to go along with, and that they wanted to get back to the old gold standard. Obviously, that cannot be done on a worldwide basis at the present price of gold.

I think my question would be, if this admittedly highly speculative supposition were actually to come true, so that we had strong pressures to increase the price of gold, and in case there was a failure of the pound sterling—which we certainly hope will not occur—would France be able in effect to force a substantial increase in the price of gold as the substitute for the use of international cooperation, using appropriate international machinery?

I share the belief of the Joint Economic Committee, and, I believe, of most students in the field, that some type of international pool of credit, using one of the methods or other that have been mentioned, is much superior to increasing the price of gold.

So in summary, I would not at this point lightly dismiss the possibility that we may be pushed, by some combination of factors, into consideration of an increase in the price of gold. I hope not; it would be a very inferior approach to the problem.

Chairman REUSS. Thank you. Mr. Despres?

Mr. DESPRES. I would like to make some general comments about where we stand today and what it seems to me that the problems are. I would describe the whole period since 1959 as a period of contained international monetary crisis, and this is ironical in many ways.

(A formal statement, subsequently submitted by Professor Despres, appears on p. 39.)

Mr. DESPRES. The franc was devalued and stabilized in 1958, and at the end of 1958 the advanced countries of the free world achieved general current account convertibility. This was a kind of a culmination of one of the long-term objectives of American foreign economic policy, to establish a world in which you would have liberalized multilateral trade without restriction on international payments, so that it didn't matter whether people wanted to spend their vacations at home or abroad, and whether you were using foreign exchange or domestic currency. It was supposed to be a world free from intense balance-of-payments preoccupations.

The ironical part of it is that this kind of culmination resulted in what amounts to a quasi-mercantilist world, in which countries are taking measures for balance-of-payments reasons, to get a "favorable balance of payments," to restrain out-payments in one way or another, to encourage in-payments, and so on.

The reason I say "quasi-mercantilist" is that we have sought to adhere to, we have sought, despite payments difficulties, to push forward with some of the commercial policy objectives of long standing, such as the Kennedy Round. At the same time, we have taken a lot of measures of a mercantilist variety for the sake of husbanding foreign exchange, such as tying aid and the Government's substitution of domestic for foreign military procurement.

The situation has been one of contained crisis. I do not share the fears of some of my colleagues at the table about a forced devaluation of the dollar. Until General de Gaulle's statement—was it in the latter part of 1964, I think it was—I think one can say that there was a general consensus among the advanced industrial countries that the crisis would be contained; that whenever a panic run developed, some emergency devices would be brought into play to prevent things from getting utterly out of hand, to prevent a blowup. And although France is no longer a member of this consensus, and has made it very clear that they do not desire to forestall a blowup—nevertheless, the consensus remains very strong, I think, among the other countries concerned, and when the spokesmen of the Federal Reserve Bank of New York and former Under Secretary of the Treasury Robert Roosa talk about the highly sophisticated techniques that have been developed for intervening in the exchange market and for mutual support and so on, and laud themselves and their colleagues abroad on the efficient methods of cooperation that have been developed, there is this much truth to it.

For the purpose of forestalling an undesired breakdown of the system, the methods, although in part informal, are I think very good, very reliable, and I would say that the lack of French cooperation alone is not potent enough to eliminate this consensus, to weaken the system decisively. So that I don't fear a breakdown or a forced devaluation.

What I think is wrong about the present situation is that it not only provides a pretty good guarantee against things coming to a head, it also provides a very good guarantee that a situation of chronic, low-grade, contained crisis will be sustained indefinitely into the future.

Now one thing that might be asked, although we never do, is what is wrong with this permanent state of stress and strain? After all, the world has got along since the end of 1958 in this state of semicrisis or contained crisis. I think that what is wrong with it is that it contains two important longrun dangers:

1. The longrun danger which hasn't become starkly evident as yet, is of a serious retardation of Western World economic growth.
2. I describe the situation as quasi-mercantilist. I think the longrun tendency is for it to become more and more mercantilist, that it is incompatible with liberalized trading arrangements.

If there is to be aid to underdeveloped countries, it is going to be on a reduced scale, and there will be a strong tendency—our own tied aid is an example—for a kind of a partitioning of the free world into economic, or economic-political blocs, with financial and economic intercourse fairly open within the blocs, but with serious barriers between blocs. And I think this kind of a world is bad, not only economically, but in terms of our political objectives.

Now, how do we get out of the trap? I would like to think that our slow progress is due to the fact that these matters have been left to negotiation among technicians, and that the negotiations among heads of government might be more effective.

But, I don't think that this gets at the root of the problem. The root of the problem, it seems to me, is intellectual, and there is an oft-quoted passage toward the end of Keynes' "General Theory" which now I can't quote. The ideas of economists, both when they are right and when they are wrong, have a far greater effect on the way the world is run than is commonly appreciated. Practical men who believe themselves to be quite exempt from intellectual influence are usually the slaves of some academic scribblers of a few years back.

I think we are in that kind of a situation here. The essential doctrine which is accepted by central banks, ministries of finance, and governments, comes, of course, from economists, and I think that the doctrine is out of tune with the realities of the economic world in which we live, and that until this gets fixed up, there is not much chance of progress.

Moreover, I would say this: That the ideas that I think are wrong are held at least as strongly in the United States as anywhere else. All that would be required to put things right would be for the American Government, for American experts, to change their view of the problem.

The problem is, in other words, to a large extent of the self-fulfilling-prophecy variety. It exists in our minds, and it would go away if we thought more realistically about how the international economy actually works and must work.

Now that thesis requires some elaboration, and maybe I ought to stop and let some other people talk.

Chairman REUSS. Unless there is objection from some quarter, I would say do tell what are these intellectual devices which are preventing the new Jerusalem.

Mr. DESPRES. The main point I would say is this. The view of balance-of-payments matters, which you will find in almost any official document or in much of the economic writing that you pick up, is a view that derives from David Hume, the Scotch philosopher of the 18th century, who assumed a world in which everybody used the metallic currency, and in which there was no international lending or borrowing, and in which, therefore, all countries were equal in the sense that each faced the same kind of balance-of-payments problem. There was symmetry in international economic relationships in this sense.

We do not have that kind of a world. We have a world in which the United States exercises a predominant economic and financial role. On the economic side we are, and have been for several years, the only substantial net provider of real resources. I mean by this, current account surplus to the rest of the world.

France provides, in relation to her economic size, a sizable amount to the French community abroad, but it is still true that we are the only country with a large export surplus in goods and services, and this is the measure of the real resource contribution. We are, moreover, the world's financial center. The dollar is not just a domestic currency. It is a world currency, and for deep-seated reasons having to do with the advantages which are provided by size, the structure of finance, whether domestic or international, is hierarchical in organization, and the United States is at the apex. American lending and investment abroad performs two purposes.

It performs the purpose of transferring real resources, which the conventional wisdom acknowledges, and it performs the second purpose of providing financial assets to the rest of the world of types which other countries desire, and taking financial claims of types which other countries desire us to take—this process of financial mediation being an essential part of the flow of saving into investment, not only internationally, but let us say within foreign countries.

The needed expansion of German oil refinery capacity, for example, is facilitated by the acquisition of German refinery companies by Texaco, because Germans are willing to take Texaco stock and are not as willing to take the securities of a German oil refining company. This kind of trade in financial claims occurs quite generally and pervasively.

With a properly functioning international capital market the countries other than the financial center that have good credit standing have no need for additional reserves. Subject only to credit standing, the international ebb and flow of capital frees them of any balance-of-payments problem, as conventionally defined. Their only problem would be to stay within the comfortably wide limits imposed by credit standing. The attempt of all schemes for improving international liquidity to find some universal formula based on the principle of symmetry are beside the point. There is no inadequacy of liquidity so far as other countries with good credit standing are concerned.

Contrast with this the position of the financial center. I would like to call attention to the fact that just a few years ago the U.S. Treasury had great difficulty in borrowing abroad, with the special issues of Roosa bonds, amounts less than we were simultaneously providing to India and Pakistan by way of AID. Now the unwillingness of foreign governments and central banks to buy themselves or to author-

ize the marketing in their countries of U.S. Treasury obligations was not due to the fact that they thought these were poor securities or that American credit worthiness was inadequate. It was due to the fact that they thought there was something deep-seatedly wrong in sparing us the necessity of losing gold.

Now this is where I say a bad doctrine is the cause of the difficulty. It is widely thought that the shift into gold—incidentally, this isn't a French monopoly, the Germans, I think, have converted more dollars into gold than the French have. They have simply done it in a more discreet fashion. This desire for gold rather than dollars is not due first and foremost to fears on the part of foreign central banks that the dollar will be devalued. It is due first and foremost to the fact that the economics that they have been taught says that to relieve us of the pressures which gold loss would entail would be somehow wrong. It is the attitude of the central banks which accounts in turn, for the private speculative demand for gold, and it is our own very great timidity and fear about losing gold, the intensity of our preoccupation with this problem, which has also bolstered and strengthened this attitude.

Now what I am really saying is this: Things will not be changed essentially by international negotiations. There may be some token accomplishments in the way of international liquidity arrangements of little practical importance, but things will not be changed essentially and the present, contained crisis won't be ended until the reserve asset preferences of foreign central banks are radically altered.

The United States has this problem entirely within its control. It is not a matter of international negotiations. The United States doesn't even have to do any of the things that I proposed in the spring of 1965. It merely has to change its mind by recognizing the fact that in the present-day world, gold derives value from the fact that it is convertible into dollars. It must lose its intense anxiety about losing gold. It would be highly useful, incidentally, if, instead of merely abolishing the reserve requirement against member bank reserves, we abolished the gold reserve requirement against Federal Reserve notes also, as a token of our willingness to lose gold.

If our obvious pain in undergoing gold loss disappeared, the whole situation, I think, would be utterly transformed. We could have a functioning international capital market, and without a functioning international capital market, the chances in the long run of maintaining anything approaching liberalized trade are almost nil.

I would say also that with the exception of a few economists like Dr. Mundell, the whole approach to this balance-of-payments problem is to treat it as a problem of the adjustment of the current account, of the trade account. In a world functioning with open international capital markets, a large part of the adjustment consists of international capital movements accommodating to changes in trade balances, so that most countries other than the reserve center are not under what is conventionally thought of as balance-of-payments constraint. They are under another kind of constraint, the constraint only of credit standing.

They do not encounter balance-of-payments difficulties until their ability to import capital from abroad is impaired. The U.S. position is truly unique, since we are the banker. We are the only country which cannot borrow on the basis of credit standing, and I would say

that the reason we can't is because economists, central bankers, governments, are under the spell of this David Hume myth. I admire Hume but I am just opposed to applying 18th-century economics to the 20th century.

Chairman REUSS. Passing Dr. Mundell for the moment, unless you wish to——

Mr. MUNDELL. I had some comments on Professor Despres' statement, but I could leave them until after Dr. Salant.

Chairman REUSS. All right, let's do it that way. I will call on Mr. Salant.

Mr. BLOUGH. I have a few more comments that I would like to make before I leave, so I hope I can break in at some time.

Chairman REUSS. Yes; and I will bear in mind Dr. Blough's travel requirements. I will call on Mr. Salant, then Mr. Blough, and then Mr. Mundell, in that order, if you don't mind. We will all have full opportunity.

Mr. SALANT. I don't have much to add to what Mr. Despres has said, because I am in accord with it. I would like, I think, only to point out a couple of things that I think reinforce it, or cite one or two facts as supporting evidence of the view that the tightness of the situation resulting from the attempt by other countries, some other countries, to impose on the United States the discipline which they think is necessary for the working of the system is chiefly responsible for some of the supposed weaknesses in the dollar or for the belief that it is weak.

In the first place, evidence that private foreign holders do not regard the dollar as weak seems pretty clear from the increases in private holdings of liquid dollar assets, which nobody is compelling them to hold, but their holdings, nevertheless, increase.

I would also like to point out some interesting statements in the annual report of the International Monetary Fund, which was just released the other day. In a discussion of the international market for new security issues, this report points out that the market for these issues tended to become more internationalized in 1964.

As late as 1963 the international securities market, it says, was dominated by issues denominated in the currency of the market in which they were floated. By 1965, two-fifths of the total issues were denominated in a currency other than that of the market in which bonds were sold, and frequently this currency was also different from that of the borrower.

The market has now become dominated by U.S. dollar issues, frequently handled by institutions based in New York. In some respects, the U.S. dollar has become an international capital currency as well as a reserve currency.

A very large and increasing proportion of security issues in which the borrower was a national of one country and which were marketed in a second country, were denominated in the currency of neither of those two countries, but in dollars. This does not suggest any lack of confidence in the dollar, if one is looking for weakness. This tends to support the proposition that difficulties, especially those connected with conversion, resulting in conversion of dollars into gold arise from the attitudes of which Professor Despres spoke

Now I think I share his doubts and the mixed feelings that Professor Mundell also expressed about whether things would be much better if all these matters were left to heads of governments. The

trouble is they get their ideas from the technical experts, and it seems to me that only in the event that they would be prepared to disregard those which are wrong would anything much be accomplished in that way. It seems necessary, therefore, to press on with what we might call the educational problem about how a system with a dominant financial center has to work.

Thank you.

Chairman REUSS. Mr. Blough?

Mr. BLOUGH. Thank you for this special courtesy.

I would like to indicate very substantial agreement with much that Mr. Despres said, but I don't come up with quite the same conclusion. A conclusion with which I agree in part is that the state of affairs will not be changed materially until attitudes of foreign governments toward reserve assets are radically altered; the conclusion with which I disagree is that all that is necessary to bring this about is for the United States to change its mind.

The attitude of foreign governments toward reserve assets is only part of the problem. Their attitude toward the speed with which adjustments ought to be made by countries that run into balance-of-payments deficits is a related but distinct matter. Differences in views as to whether a country should be obliged to deflate internally almost instantly in order to restore balance-of-payments equilibrium is at the bottom of much of the present difficulty. The British, on the one hand, believe that there should be a good deal of leeway to accumulate deficits as a result of rapid growth, or while they are restructuring their economy. The continental approach generally is a much more rigid one, that countries ought to deflate to achieve adjustment promptly when they get into deficit position. I think this attitude presents a problem as well as their attitude toward reserves.

On the point about a conference of heads of governments, I am inclined to agree with Mr. Salant's position. I doubt that it would help very much; the heads of government are not going to get together on this until negotiations have been pretty well agreed to at a lower level. I would certainly welcome a meeting of heads of government, because that would be a signal that they were ready to come to some agreement.

Coming to the suggestion that all that is necessary is for the United States to change its mind, this seems a much too optimistic position. The idea that we can take the risk of everything turning out all right worries me.

We underwent something of this sort internally in the 1930's, when we discovered that gold was not important for domestic money, but a rather serious internal financial crisis was the price of this discovery. Could we accomplish this kind of change of attitude toward gold and reserves for international money without passing through an intermediate stage of international financial crisis? This may not be rational behavior, but since when has rationality dominated international behavior? I do not like to see us take great risks ourselves to attempt to change world opinion on a subject where perhaps most central bankers abroad do not agree with the views toward gold that have been expressed here. The fact that we think they are wrong doesn't mean that we can readily persuade them they are wrong.

A crisis, if it developed, would undoubtedly convince them that they are wrong, but can we afford to risk the crisis to achieve that result?

With regard to financial intermediation as a factor in our deficit, the idea is a very useful addition to the discussion of this subject. But it is not the whole story, and if it were our liquidity problems as world banker would not cease to be important.

As a final remark, I would like to point out that, in a sense, it is not U.S. foreign investment that is necessary to get the confidence of the foreigner. What he has confidence in is American entrepreneurship. Perhaps our efforts in this period should be directed to encourage the export of entrepreneurship, while being obliged to discourage the export of capital.

Senator PROXMIRE. Would it be possible, Mr. Chairman, for me to ask questions now, before Mr. Mundell comments on Mr. Despres' comments?

Chairman REUSS. Yes. I think Mr. Blough can only stay 15 more minutes. Perhaps it would be well for all the members to do this.

Senator PROXMIRE. Did you and other members of the panel receive this very excellent, and what I think is one of the finest, brief and concise summaries that I have seen a member of the committee issue? Chairman Reuss sent out this release dated Sunday, August 28, 1966. (See p. 3.)

Mr. BLOUGH. Yes; I have that.

Senator PROXMIRE. The third item in subsection B asks:

"What action would they recommend in order to enable the United States to meet this (deficit) target?" Now it seems as if our deficit is going to exceed the target for some time. The imports, as you know, are substantially up, and exports didn't change very much in the second quarter, and this seems to be one of the most significant developments.

Let me ask first, Mr. Blough, referring to subsections (i) through (x), do you see any particular actions there which you believe would be most sensible or any which you would be particularly oppoesd to?

Mr. BLOUGH. Yes. No. (i), "action by continental countries to restrict U.S. private investment". I would hope they wouldn't; but I wish they would stop complaining about our private investment when they don't, because they are certainly in a position to restrict our investment if they really desire to do so.

Senator PROXMIRE. You would hope that they would not, however, on No. (i)?

Mr. BLOUGH. I would rather they would not.

Senator PROXMIRE. Even though our deficit does exceed the target.

Mr. BLOUGH. I am afraid that in restricting our private investment, they may restrict the wrong things so far as both they and we are concerned. If they would restrict the right things, perhaps that would be all right. I think on our side we might be in a better position to judge this from the point of view of its effect on us.

Senator PROXMIRE. Right.

Mr. BLOUGH. But I certainly think that, rather than complain about excessive private investment, they have open to them this type of action.

On (ii); I think we probably have tied about all the foreign aid we can, and I consider the amounts involved there relatively small.

Sentor PROXMIRE. The question, then, isn't tying more aid but reducing the aid that is untied.

Mr. Blough. Yes; by reducing what we do through the international agencies. I think the amount of foreign aid ought to be doubled from the United States, and a substantial part of that increase ought to go through international organizations. And I think in view of the fact that it goes to the less developed countries—that while we do lose some of it that is not spent on our goods—in many countries the major part would be spent on our exports, even if the aid was not tied.

Senator Proxmire. So far on these two important measures, you favor making the deficit even deeper.

Mr. Blough. On No. (ii), I would favor making the deficit even deeper, that is correct.

Now on (iii), the accelerated removal of trade barriers, under the Kennedy Round and later programs, I am all in favor of that, but I don't think it is going to do our balance of payments much good. We have a trade surplus. The European countries in particular do not wish to increase our surplus at their expense. For that reason I do not believe that in their negotiations under the Kennedy Round they will agree to arrangements that will benefit our balance of payments. I hope I am wrong about that.

On No. (iv), yes; I think Mr. Mundell in his paper has pointed out that the European countries should have made more use of fiscal policy.

Senator Proxmire. Again, you don't expect much reaction on this. We can't do anything about it?

Mr. Blough. There is nothing we can do about it except to advise and help them.

On No. (v), "programs to broaden non-U.S. capital markets"; I think that is a very useful solution for the future, if you could get the major European capital markets integrated into a continental system with the type of securities and exchange commission laws we have in this country, accounting controls, financial statements that mean something, and the publication of information such as we require. If you could get those kinds of reform in European capital markets, I think it would make a good deal of difference.

Again, we can advise, we can urge, but we can't force them.

No. (vi). Efforts to encourage foreign travel to the United States, and also to discourage U.S. travel abroad, are, I think desirable; although I suppose that it may be politically impossible. But tourist travel is pretty much a dead load. It presents an opportunity for further action.

Senator Proxmire. But again, you wouldn't anticipate that this would be a significant—or a very big—part of the solution.

Mr. Blough. The British limited travel abroad and especially tourist travel after World War II. Other countries have done the same thing. We could do it too.

Senator Proxmire. I misunderstood. You say we should discourage our travel abroad?

Mr. Blough. Yes, to the extent we politically are willing to do it. Economically, I think it would be a desirable thing to do, rather than some of the other things that we have been doing. And perhaps we could, through domestic currency expenditures, encourage enough foreign travel here to make a substantial impact on the balance of

payments. It would be a form of subsidized export—the export of tourism.

Senator PROXMIRE. How about (vii)? That is a big item in the Senate today.

Mr. BLOUGH. Well, I would not care to comment on what is basically a matter of military policy. It is outside of my competence. From the economic point of view, of course, the benefits would be substantial, since military expenditures are the nub of the balance-of-payments problem.

Senator JAVITS. Would the Senator yield at that point?

You say from the economic point of view it is the nub of the problem, but it doesn't involve any more money than the imbalance in tourist expenditure.

Mr. BLOUGH. Well, there is, of course, no one nub of the balance-of-payments problem. I misspoke.

Senator JAVITS. In other words, it is a couple of billion dollars a year either way; isn't that true?

Mr. BLOUGH. That is right, and neither of these necessarily gives rise to any substantial offsetting action. Virtually all other payments abroad give rise to some offsetting movement of real resources, for example, capital investment abroad, and foreign aid. But military expenditures and tourist travel are two things that do not give rise to some offsetting benefits.

Senator PROXMIRE. I want to make sure that this is your conclusion. Let me be explicit. If we should withdraw 4 divisions from Europe, bring back about 700,000 people, the effect would be a couple of billion dollars?

Mr. BLOUGH. I do not recall the figures.

Senator JAVITS. I think that is true, Senator. It is $3 billion in toto, and if you pulled back roughly two-thirds, it would be a couple of billion dollars.

Senator PROXMIRE. Mr. Despres shook his head. Do you have another estimate?

Mr. DESPRES. I don't have a good figure, so I shouldn't have shaken my head. It sounded a little high to me because I think that, as a contra-item, the arrangements with the Germans under which they make their purchases from the Defense Department would be altered, and so on.

Senator PROXMIRE. I don't want to get into that detail, but I think there is an argument against it, too.

Mr. BLOUGH. A recent figure which I saw was $2 billion plus $500 million for Vietnam, but that is not my figure. But as I say, this is a policy problem.

Senator PROXMIRE. I understand.

Mr. BLOUGH. As far as reducing U.S. commodity imports by reducing tariff or quota barriers, (viii) I think the time is going to come when we will have to consider not only in the United States, but in other countries the use of across-the-board tariff changes as a method of international adjustment, such as the British used. We are not now in a position to do this. In the international agreements which we have under the GATT, there is no foundation laid for this sort of thing.

We are limited by the fact that we have an export surplus. For us to use tariff and quota barriers would bring about, under the

GATT agreements, countervailing action on their part against us. Also, we are in the middle of the Kennedy Round, trying to get trade barriers down so that total trade can be increased. It is hard to think of a time to take such action.

But when we look ahead 5, 10, 15, 20 years, considering ways by which countries can make balance-of-payments adjustments, I don't think we can exclude consideration of what are in effect partial devaluations hidden in the form of uniform tariff increases across the board. But we are not now in a position even to consider such methods.

As for further reduction of U.S. private capital outflows by the United States, (ix); this is a very difficult, intricate question. I would say that I am not enthusiastic about the methods we are using, but I don't have anything better to suggest. There is a qualitative problem here as well as a quantitative problem, and we have tackled only the quantitative problem.

As for No. (x), increased monetary stringency by the United States—it is pretty stringent now. I would not recommend that.

Senator PROXMIRE. Let me add just one other here, because I think there might be an eleventh point. How about increased fiscal restraint by the United States—the kind the President suggested yesterday?

Mr. BLOUGH. I think, looking back, that effective action was very much overdue. But anti-inflationary measures have their risks. For example, the Council of Economic Advisers and the President in 1949 were proposing an anti-inflation program to Congress, when later statistics showed that the economy had already started into recession.

Now my guess is many economists have been hesitant about recommending tax increases because they weren't sure how long the inflationary pressures would last. Often there are lags in the impact of tax measures. So that while action ought to have been taken quite a while back, including further increases in taxes in the early part of this year, I am not going to criticize. That is water over the dam.

Senator PROXMIRE. In that connection, I have one more question and I apologize for having taken so long.

The President yesterday proposed as his most spectacular anti-inflation proposal, suspension of the investment tax credit. Secretary Fowler appeared before this committee in February and firmly and flatly opposed such a suspension and documented it very well. After his appearance he sent me a memorandum with a series of reasons for his opposition. One is that it would have an adverse effect on our balance of payments. In this connection he said:

> The investment credit helps the balance of payments in two direct ways. One, it makes investment here in the United States more attractive, and, two, it encourages modernization and cost cutting to strengthen our export position.

Then he went on to point out that there is a lag, which he documented, in the effect of suspending the credit so its prime impact won't be felt for a year.

Just 2 days ago the papers reported the National Industrial Conference Board survey, which showed that beginning in the third and fourth quarters of 1967, business now plans to cut back their invest-

ment. Under these circumstances, doesn't this seem to be an ill-advised proposal by the President, this particular part of his package?

Mr. BLOUGH. I believe that the President's tax proposals regarding the investment credit and depreciation are desirable. We have developed some tools for fiscal policy. We have applied them to stimulate business. The President and the Secretary of the Treasury recommended to the Congress, and it made, tax reductions even in the face of a deficit.

We had some beneficial results which were attributed to this action. I think to a considerable extent they were properly attributed to it.

Now we have the other side of the coin. We have the problem of what do you do as the economy becomes overheated. I don't know whether this particular measure is better than some other measure. I do say that we must experiment with our fiscal tools to find out how they work. A time when the economy is pretty well overheated, which I think it is, is a good time to experiment with these tools.

Now if the economy begins to show signs of downward movement, of too much effect, it is not very difficult to reverse that type of action.

Senator PROXMIRE. There is a lag of a year. If this should provoke a recession it might be pretty hard to reverse it. In the 1930's it took 10 years and World War II.

Now either the Secretary of the Treasury is right or he is wrong. He did document this very well. He didn't make a general statement. He supplied a memorandum which went into great detail as to why there is this lag. He went into one kind of equipment after another and the amount of equipment involved, and so forth.

Mr. BLOUGH. Well, it seems to me that concentrating only on the time of producing the equipment leaves out some important points. For one thing, there is the financing of these orders. For another, there is a psychological impact which can be immediate. In 1950 the anticipation of war orders and of other purchases brought about a tremendous anticipatory boom in the economy, which was not at all justified by what was actually being spent or even ordered by the Government.

An analysis of production would indicate a long lag in the effect of orders but instead there was a flareup of inflationary pressure in the fall of 1950, in anticipation.

Then there is the problem of financing these proposed capital appropriations, usually arranged in advance. The company which doesn't make a capital appropriation isn't going to have to look around for the money to finance it.

In the second place, a manufacturer of machinery and equipment, when he sees his order books are getting smaller, does not need to buy for inventory or expand his own plant. He doesn't need to be in as great a hurry to get his orders out. So that while obviously there are some effects which involve a very substantial lag, there are others that should be felt promptly.

Of course, one of the great difficulties in administering monetary and fiscal policy is the difficulty of anticipating lags.

Senator JAVITS. Would the Senator yield for a question?

Senator PROXMIRE. Yes; I have taken too much time. I yield the floor.

Senator JAVITS. I didn't mean to intrude, but I was going to ask you this question because I think it is central to it. The amount involved

is not enough, that is the real rub of the President's palliative. It is only $2 billion at best. That is all that the 7-percent credit amounts to, and that isn't going to make any real impact on this situation, where one of your members says the world is already going to be in a depression, no matter what you do, if you try to stop this inflation, because it has already run away. Therefore, I ask you this question.

Though you may try to make a case for it, and that is all right, and I suppose we will vote it as a matter of fact, if it is the best we can do, isn't it a fact that the only way to meet this is with a tax increase across the board or in some other way that will produce some real money in terms of somewhere between $5 and $10 billion?

Mr. BLOUGH. There can be no question, Senator, that $10 billion makes more impact on the economy than $2 billion makes. However, I believe there is considerably more incentive involved in $2 billion of investment credit than in $2 billion of increase or decrease in taxes.

Senator JAVITS. And isn't it a fact that this is a critically important incentive money, because what is happening to you is that you need to increase productivity? It may be that you can leapfrog this whole situation, if you had some unbelievable burst in activity.

For example, it is analogous in my mind to what might happen to Britain, which is in terrible trouble, if this North Sea gas find should really be the tremendous asset which it might turn out to be. So that really it has two difficulties. It is too small, it is too late—and it may be very well counterproductive, going completely down the wrong road under present circumstances.

Mr. BLOUGH. May I respond, Senator. I think that the counterproductiveness is almost altogether based on the question of timing, and whether we have hit the wrong time for it. But, certainly, the big increases in capacity——

Senator PROXMIRE. I just can't resist asking if you will yield? That was the reason I expressed the National Industrial Conference Board finding and the lag which the best expert we could get at that time said was involved in this thing. It takes a year, and in a year industry may be cutting back anyway.

Mr. BLOUGH. If you decrease somebody's burden and then try to put it back on him again, you have troubles, but if you put a burden on him and find that it is too much, it is not difficult to take it away quickly.

The Congress has never been willing to give this kind of option to the President, but if the Congress is not willing to give this kind of discretionary action to the President, then the Congress should put itself in a position to take quick action itself.

It seems to me that if the proposed action turns out not to be needed, or if it seems to be heading us into more of a downswing than is desired, that it should not take the President and the Congress very long to reverse the action.

On the general point that unless one believes that more and still more investment is always a good thing for a country, there must be some time when more investment isn't a good thing for a country. I think that this is such a time, since the country's resources are under substantial pressure in this area.

I do not think this is a world-shaking development and probably it should have come sooner. If we are unwilling to use the fiscal tools

we have, then we will never know how they work, and we won't get people into the habit of seeing shifts in action to promote an overall policy under changing conditions.

One problem in this country, and in most countries, is that the public sees the administration apparently shifting gears all the time, up and down, and thinks this means inconsistency. We have to get the public to understand that this is the way policy should be applied. Now, this is getting fairly far away from this balance of payments, but I do believe that a solving or a reduction of inflationary pressure in the United States would be helpful to our balance of payments at this point.

Chairman REUSS. I may say on whether or not we are getting far afield, this session was advertised as taking into account economic life in all its fullness, so I think that what we have been discussing is relevant.

We would love to have you stay, Mr. Blough. I think you can still make your plane.

Mr. SALANT. Could I ask Mr. Blough one question which might clear up the record?

Chairman RUESS. All right. He may have to answer it as he walks down the hall.

Mr. SALANT. When you were answering Senator Proxmire's questions about this list, were you answering them in the context of what you think should or shouldn't be done now, or in the context in which they are placed by their introductory remarks, which is "If our deficit threatens to exceed the target" should these things be done?

Mr. BLOUGH. Since I think it does exceed the target, I went on from there.

Mr. SALANT. But the target that is referred to is the target not of zero deficit but that deficit necessary to create sufficient liquidity. So, if you don't think that the deficit exceeds that target now, then the questions are hypothetical rather than in relationship to the present situation, and I wondered whether Professor Blough was answering them in the context of the present situation or in the context of the hypothetical situation in which they are posed, or whether he thinks that situation is also the present situation.

Mr. BLOUGH. The hypothetical situation is one which we cannot answer, because it says that this would be based on what the 21 leading countries would recommend, and we don't have that recommendation, so I had to base it on my own impression as to whether the deficit is excessive or not, which I think it is.

Chairman REUSS. Thank you.

Mr. BLOUGH. Thank you for inviting me. I am sorry to have to break away and I appreciate your letting me speak somewhat out of turn.

Chairman REUSS. We appreciate your coming.

Let me throw out, if I may, a question based upon Senator Proxmire's leading Mr. Blough through the various points set out in the paper which we gave you some weeks ago, and also direct your attention to a proposed broader approach, a broader political approach which is inherent in this paper and in our discussion.

What the subcommittee was saying to you gentlemen in its draft-position paper was in essence, look at the situation as it is. Our leading partners around the world quite universally deplore the dollar deficit. That is their official line. They are aghast at it.

Secondly, though they have been given 5 years to get off their dime on international monetary reform, they have not done so. We don't have international monetary reform, and it isn't going to happen very soon.

Thirdly, we get a very wide variety of advice from them. Their military people throw up their hands in horror at any suggestion of the lessening of American military presence in Europe, for example. Their central bankers are always giving us their age-old prescription: raise interest rates in America. It will be interesting to see whether they continue that this September.

Their trade officials spend a lot of time building up protective tariff walls around the Common Market, for example, which makes it more difficult for us to get into what used to be and should be our best export market.

The subcommittee, in essence, was wondering whether a somewhat broader approach is not necessary, an approach marked, I think, by two characteristics. One, should we not say to our 20 leading partners for a change, "Look, gentlemen, you tell us whether we ought to run a deficit, what kind of a deficit, and if you think the deficit we are likely to run is greater or smaller than you think we ought to have, how do we adjust matters?"

And secondly, that this should be done on a governmental level, that the time is long past when it is really serviceable for technicians each to preach their parochial lesson to us. This is, in essence, the politically oriented question which we put, and we would welcome some reaction to that.

Let's proceed from left to right. Mr. Despres.

Mr. DESPRES. Well, the first thing I would like to say about the question is this. The way you have formulated the problem—and I think this is the way the problem is viewed generally—is exactly an example of what I called the mercantilist approach; that international payments have to be planned in relation to some target figure for net balances for each country.

We do not have a planned target for the payments deficit of the State of New York, or the payments surplus of the State of Massachusetts. In fact, nobody knows what it is, or cares, and we are not going to have a liberal economic world until we have established arrangements where things stop being approached in this way.

I don't think the deficit—I don't think the U.S. deficit today is a sign of disequilibrium. Indeed, I think the concept is a bad concept, and I think that this is the heart of the problem. You can say this isn't being very constructive, but on all these proposals—take the U.S. military dispositions as an example—a liberal economic world is one which is, as it were, "currency blind", that is, it doesn't make any difference whether an expenditure is in domestic currency or foreign currency. On the military dispositions, it seems to me that this should be decided strictly on the military and strategic and political merits, not balance-of-payments considerations at all. And I would say the same thing for aid, for travel, for commercial policy, and so on.

Chairman REUSS. May I interrupt to say, don't pin the label of David Hume on me.

Mr. DESPRES. Excuse me.

Chairman REUSS. Because these questions and points were not submitted as things that ought to be done.

Mr. DESPRES. Yes.

Chairman REUSS. Indeed, many of them appeal to many members of this subcommittee as very bad things which ought not to be done. But is it not time that the governments of the free world's industrialized nations address themselves to this problem? Maybe if they can, they would contribute to public education and their own education, and come up with the realization that the tail should not wag the dog, and that short-term and advantageous fluctuations in balance-of-payments deficits are nothing particularly to worry about.

Mr. DESPRES. They might.

Chairman REUSS. How are you ever going to do that unless you take the problem from the professional "Humeists" and worriers and the technicians in these fields?

Mr. DESPRES. Hume, I might add, was not a worrier. He said the balance of payments would take care of itself and one ought not worry about it, but it is only that this particular model doesn't fit the present-day world.

I agree with you that the positions of other governments and of this Government are full of internal inconsistencies. I saw a New York Times report, on the latest annual report of the IMF, and I haven't seen the document itself, but the Times report contained hilarious inconsistencies. On the one hand, according to their story, the IMF annual report said that tight money in the United States and the controls we had imposed on capital outflow were having most deleterious effects, and they deplored them.

On the other hand, the balance-of-payments deficit, as is the standard line in these matters, was deplored, too. We must, therefore, liberalize capital outflow, lower interest rates, and also eliminate our balance-of-payments deficit.

It would be a great step forward if people didn't ride off in all directions simultaneously, but I see no prospect that any international conference, any gathering, is going to stop this bad habit.

Chairman REUSS. If I may interrupt there, you are familiar with these gatherings. An IMF gathering is like a Japanese nogaku play. Everybody has his gestures memorized beforehand, and nothing much happens there because they all get instructions from their governments. What our subcommittee is wondering about is whether the whole drama should not be carried on at one level higher, whether this wouldn't be more productive in terms of public education, if not in actual results.

Mr. DESPRES. On the matter of the use of fiscal policy, it does seem to me that the excessive reliance on monetary policy and insufficient reliance on taxation to curb excess demand in the United States has been a main factor in the deterioration of the U.S. current account surplus. On this matter of investment incentives in particular, I think one can say today that the major deterrent to business expenditure on equipment is not on the incentive side. On the contrary, it is on the supply side. And although the National Industrial Conference Board figures show a reduction in planned appropriations in the remote future, the last part of 1967, I think if you look at these figures for the past, you will find they have always shown a reduction for the remote future for the very good reason that business firms' capital budgets are not fully formulated for a period as far ahead as the latter part of 1967.

Senator PROXMIRE. You say they have not been. Do you say they have been uniformly inaccurate and that they have uniformly understated the actual result?

Mr. DESPRES. The actual result for the remote future.

Senator PROXMIRE. Is that your assertion?

Mr. DESPRES. I gathered that was——

Senator PROXMIRE. No, no; it is your assertion that they have been consistently inaccurate and they have consistently understated the actual result as it turns out.

Mr. DESPRES. Not that they have been inaccurate. I don't know whether they have been inaccurate or not, but that what they purport to tell is investment appropriations, investment decisions already made at the reporting date, and it is necessarily true for most corporations that they haven't made up their minds. They haven't made many of the appropriations yet for the latter part of 1967.

Therefore, whenever these surveys come out, they show a decline for the more remote dates to which the surveys refer, and the figures do not purport to be a forecast of what capital expenditures will actually be at these remote dates.

But looking at the trade balance, what one finds is that a considerable part of the increase in imports is in this machinery and equipment category, precisely because of the long delivery delays on many machinery and equipment lines, if you ordered them from domestic manufacturers, so that the only point, the only real point I wanted to make here was that the limitation was on the supply side, not on the incentive side as of today.

Senator PROXMIRE. You make a further point that from the balance-of-payments standpoint, if what you say is correct, the investment credit suspension might have the effect, the beneficial effect of making it easier to secure machinery and equipment domestically, and, therefore, diminish imports of machinery, and, therefore, benefit our balance of payments, reduce our deficit, increase our trade surplus.

Mr. DESPRES. Benefit our current account, let's say. One has to remember that our current account moved from a very, very small surplus in 1959–60 to a surplus of around $8 billion in 1964, with no corresponding change in the so-called net deficit. There are feedback effects, so that very often when our current account "improves," our capital outflow tends to increase. When our current account "deteriorates," our capital outflow tends to be reduced. And this item-by-item approach to balance-of-payments improvement always overlooks that.

In other words, it cannot be said that if our trade balance improved this will improve our balance of payments. It might and it might not. Indeed, I think that the circumstances of European domestic boom under which our trade balance improved from 1960 to 1964 worsened our balance of payments.

In Western Europe, domestic investment took the place of the former export surplus, and the financing of their domestic investment because of our lender-of-last-resort role automatically caused capital outflow from the United States to increase.

Now I can't say that the reverse will happen now because things are so messed up on capital movements, that they might. Retardation

of growth in Western Europe and tight money cum inflation here might curtail capital outflow more than it reduces our export surplus.

Chairman REUSS. Mr. Mundell?

Mr. MUNDELL. Well, there are many issues running around.

Chairman REUSS. Pick those that attract you the most.

Mr. MUNDELL. I can just grab three of them. One concerns the way in which the system is supposed to work. I want to pick up the point that Professor Despres made. I think he greatly underestimates the gravity of the current situation, and he underestimates the threat to the price of gold in it.

If the U.S. dollar were the sole international reserve asset, then there would be no gold problem, of course. The United States could follow its own monetary policy and other countries would keep their exchange rates pegged to the dollar. They would have to inflate when we do, have a depression when we have one, and so on. So that if there were no gold question, monetary policy of the world would be completely determined by the Federal Reserve System, the central bank of the United States.

Now, if we decided to inflate at, say, 5 percent a year, the world would inflate at a rate of more or less 5 percent a year also, and so on. The key element in the present system is that the gold tie represents a protection that Europeans have against excessively bad policies on the part of the United States. If the United States is depressed, and the authorities respond by expanding, the Europeans have to exercise great caution in converting dollars into gold, because they have to recognize that the stability of the U.S. economy is vital for the stability of the world.

But if the U.S. policy is excessively inflationary even in U.S. interests, as well as their own, Europeans have every right to warn the United States that the policy that the United States is following gives them grave difficulties then. Accordingly, they convert dollars into gold.

Now if they convert dollars into gold at an excessive rate, this will bring about a collapse of the system. What Professors Despres and Kindleberger and Salant have urged is that if they detonate a collapse of the system in this way we will just have to go along, continue with a policy for domestic stability, and let the rest of the world adjust.

Up until 1964 the United States had a very good case, and a very good reason to be angry at France and the European countries. Since that period they have not had a good reason to be angry. Other countries are simply taking more of their surpluses out in the form of gold now to warn the United States that our policy has been too expansionary.

September and October 1966 is, I think, a transitional period in the world economy. We have built into the system the mistakes of the past policies of the United States, which have, I think, been too expansive. Likewise Europe failed to raise taxes when they should have, bringing on an enormous squeeze in European capital markets.

Professor Despres said that any country with a good credit standing can always get credit. But interest rates on state bonds are 10 percent in Germany; they were 6 percent 2 years ago. This is a sympton of a fantastic credit squeeze that has been partly caused by the anticipations of inflation that have in turn had their roots in the U.S. balance-of-payments deficit.

The only thing the United States can do now is to use every possible measure it can to maintain its own domestic stability. It will simply have to ignore the balance of payments if we get into a serious depression, and it will have to pay attention to it if we undergo serious inflation, in the interests of world stability and preserving the system.

The problem now is that in this transitional period, with respect to current measures to stop the inflation, we run a great risk. The risk comes from the fact that in the past 2 months monetary policy has slammed on its brakes, and there has been a great squeeze in American capital markets. Credit is extremely tight, and this has already begun to have some effects in toning down the expectations about proper spending for 1967 of big business companies.

The results of this tight-money policy in July and August 1966 are going to be felt in 1967, and they are going to be substantial. They can hardly fail to be felt.

There has been no monetary contraction in the past 15 years that corresponds to what has gone on in the past 2 months. First we went too fast, then we went too slow. That was a mistake, because you shouldn't make abrupt changes in monetary variables. Policy has to move slowly.

Now if, on top of this, the authorities panic by looking at a continuing rapid rate of inflation in the United States, they may end up fighting the wrong danger. The tight-money policy may have already been enough to jerk the economy onto a stable growth rate again. Additional fiscal measures at this time, while they were completely appropriate 6 months ago may be quite inappropriate now.

I believe that strongly restrictive fiscal or monetary measures pose a real danger to the economy at this time. Great uncertainty has been created by the about-turn in monetary policy, there is uncertainty about what is going to happen to fiscal policy, and there is also the enormous burden that is on the British balance of payments this autumn. And next year, these problems, on top of the gold problem and increased gold hoarding, pose serious danger for the whole world economy.

Chairman Reuss. Mr. Salant?

Mr. Salant. Mr. Chairman, I didn't have the impression that Professor Despres was as complacent about the situation as Professor Mundell indicated, and I would like to see that cleared up. I also didn't have the impression that his view of what was required was simply a change in the U.S. attitude without any corresponding action resulting from that change. I hope he will be given an opportunity to answer that question.

I think what Professor Mundell has just said about the dangers of fiscal restriction, as I understand it at least, is based on the assumption that we are in for the effects of monetary restriction, that these will be felt in the future, and that as a result of adding fiscal restrictions to it, we will have too much restriction.

I would assume that some of this fiscal restriction that is intended as a result of the President's announcement yesterday, his recommendation specifically that the investment credit be suspended, and his statement that he will try to reduce Government expenditures, is intended to replace some of the present monetary stringency, and so I think Professor Mundell's view would be justified only if it were clear, which it is not to me, that it is too late to undo some of the effects of what may have been excessive monetary restrictions.

Chairman REUSS. Or maybe he believes—and we will be back to Professor Mundell in a minute—maybe he believes that the monetary authorities are going to be so masochistic that they are going to undo the effect of the fiscal action by refusing modestly to ease the monetary situation.

Mr. SALANT. I think it is possible to subscribe to everything that Professor Despres explicitly said, and still believe, which he may also believe, that the present situation is dangerous.

I think that probably all of us will agree that tight money, the tightness of money in capital markets in the United States and in Europe is a reflection, not only—well, I should say the tightness in Europe is a reflection—not only of European monetary policy, but of American monetary policy and of American policy with regard to the outflow of capital.

It is perfectly conceivable, and it has happened in the past, that tightness in the United States has as much effect in the countries to which capital would normally be flowing as it has on the capital markets of the United States, and it may have as much effect in retarding demand. So it is by no means clear that anything it does to benefit the capital account and the balance of payments isn't going to be offset by what it may do to the current account, and thus the whole balance of payments, which is a point to be taken into account if you think what happens to the balance of payments is that important.

What I should regard as more important about the monetary stringency, which is imposed all over the world by the joint actions of monetary authorities, and aggravated by our controls of capital outflow, is that it can slow up the rate of economic growth in all these countries, to the detriment of those countries and also to the detriment of less developed countries.

From that point of view, the situation can well be regarded as a critical one. From that point of view, if we want to stop price increases, I would say it would be desirable for there to be a more or less concerted action if restraint is needed, to substitute fiscal restraint for monetary restraint, and undo some of the present stringencies in credit and capital markets in all the advanced countries.

That is an item to be put on the agenda for international cooperation, if the subcommittee proposes to recommend one.

Chairman REUSS. Mr. Despres?

Mr. DESPRES. I feel I have sown more confusion than light, if one can sow light. Let me say what kind of an international monetary and financial environment I would like to see first and then say something about the present situation.

I would like to see an international monetary and financial environment in which the movement of capital between countries is substantially unrestricted, and I think this to be necessary for liberalized trade.

I don't think that close balance in the current account can be achieved in the modern world, or should be achieved in the modern world, and that accommodating capital movements have to play an important role as they would play under a system of freedom of international capital movements.

Under such a system, we would be the world financial center. As the world financial center, it would be our job to base our monetary policy, interest rates, and all the rest, not on the domestic stabiliza-

tion requirements, primarily, but first and foremost on what we concluded, in consultation with other countries—and I stress this because I have been called a jingoist—what we concluded to be appropriate, conducive to stable, noninflationary world economic growth.

This would mean that not only we, but other countries, would have to rely much more heavily for domestic stabilization purposes on fiscal policy, basing our monetary policy on international considerations, in the light of the world role of the dollar and of the U.S. financial markets.

Let me say this: That I think the importance of the financial role of the United States is not merely that it provides liquidity, and I think a great deal of confusion arises from the fact that people say the U.S. deficit has generated liquidity, as it has. That is only one-half of the picture, however, and if you think of the United States as a bank, the liquidity that it provides to other countries is on the liability side of the U.S. bank's balance sheet.

On the asset side are the loans and investments that we make in our role as financial intermediary. Now, if the deficit in our balance of payments were removed, the significance of that removal would be not merely that this source of liquidity was removed, but equally important—I would say, indeed, more important—is that this source of lending, financing on the asset side was removed, and from this point of view, none of the proposals for finding some international arrangement to substitute for the U.S. deficit make any contact with the problem, because the problem is not just to provide the liquidity.

These international arrangements—whether a Triffin plan or CRU, or something else—would not acquire the types of assets that U.S. lending and investing are acquiring, would not meet the financial needs which American financing activity is meeting. Moreover, using rigid formulas for growth of liquidity, they are undesirably inflexible and in this respect inferior to the informal Basle arrangements.

So that I would say that all the proposals for dealing with what is called the international liquidity problem are at least 50 percent irrelevant. I am not saying they are harmful, but they would not obviate the need for a U.S. deficit from the point of view of a healthy world economy.

Now starting from where we now are, the sacrifice which this would call for from us is a substantial sacrifice with respect to the use of monetary policy for domestic purposes, and actually I would say it would also require this sacrifice from other countries.

The Germans, pursuing highly expansionary fiscal policies, have sought through monetary policy, and without much success, to curb their inflation. Their first allegation was that monetary policy was ineffective because when they raised interest rates, it attracted funds from abroad. So that the Germans wanted the United States to pursue a tight money policy, in order to assist them in fighting their domestic inflation.

Now, I don't think just fighting a German and Dutch inflation is the correct role for American monetary policy either, but the interesting thing is that as we have tightened in this country, interest rates in Germany have gone up even more, money has got tighter, but the inflation seems to proceed. What I am really saying is although within a range monetary and fiscal policy can be thought of as alternative domestic stabilization devices, this is only true within a range.

We have found that in the United States tight money is not a good offset to an excessively expansionary fiscal policy, so that we wouldn't have been surrendering too much.

Now, I don't view the present situation without alarm or without concern. As I said, I don't think devaluation of the dollar is likely to be forced upon us, because I think there is that degree of international cooperation, despite the French.

I do think that the breakdown of the international capital market is bad news. I think the prognosis for trade restriction, for reduced aid, for deciding all these matters like foreign aid, military dispositions, not on their merits but on a very bad criterion, the balance-of-payments criterion, I feel all these tendencies are going to grow.

This is the thing that I do view with great and long-standing concern, and the thing that concerns me most is that I know of no proposal, among those currently circulating, which, if adopted, would meet the essential problem. So I am really much more concerned than other people.

I deplore the fact that the international negotiations among technicians haven't gotten anywhere, or have gotten a very little distance, but I regret even more that if any of the proposals that have been made had been adopted, it still wouldn't have met the problem, and the real point is that—as in the case of the multilateral nuclear force idea—the pretense of a nonexistent equality under which an attempt is made to frame proposals to conduct negotiations, when in fact there is a profound lack of symmetry in the situation of the negotiators—the attempt to maintain a facade of equality makes the whole thing not only of zero productivity, but I would say counterproductive.

The only solution, it seems to me is for the United States to understand its role and to act. And I think that action is of two sorts.

We can act to destroy this foreign central bank appetite for gold ourselves, but I think it is equally important to act to give them an important share, through OECD perhaps, in the determination of U.S. monetary policy so far as it affects the world level of interest rates.

Chairman REUSS. Who is the "them"?

Mr. DESPRES. The other members of OECD.

Chairman REUSS. Yes; not the foreign central bankers, but the governments.

Mr. DESPRES. This I regard as not the crucial question, although I would answer "Yes" to you. My feelings are that it would be better to have the governments do this than the foreign central bankers.

Chairman REUSS. Mr. Ellsworth?

Representative ELLSWORTH. Is it true, is it an accurate characterization of what you are saying to us, to say that you feel that the United States ought to quit worrying about having a deficit in its balance of payments, and that in fact, it ought to have a deficit in its balance of payments because of the fact that that permits these direct investments on the part of the United States all around the world, and that if the United States could change its mind and could view having a deficit in its balance of payments year after year as a positive good, that then there wouldn't be any necessity to create this artificial asset which these negotiations are revolving around? Is that what you are saying?

Mr. DESPRES. Yes; I am saying that. I am saying that not only American direct investment abroad, but American international lending——

Representative ELLSWORTH. Yes.

Mr. DESPRES. On quite a flexible basis——

Representative ELLSWORTH. Yes.

Mr. DESPRES (continuing). Is important, and that the international arrangements would not substitute for the American lending and investing. It would not be a sufficient substitute.

Representative ELLSWORTH. You are saying that really this concern about creating a new artificial asset, so people would have something else than dollars, sterling or gold, to put in their reserves, is really another way of just papering over what you regard as a very serious situation, and that ideally we shouldn't be worried about creating this new artificial asset.

What we should be doing is worrying about changing everybody's attitude, ours and everybody else's, toward the role of the United States in the financial world as it exists today. Is that what you are saying?

Mr. DESPRES. That is correct, and I think that if we changed our attitude about gold, other countries would change their attitude about gold.

Representative ELLSWORTH. I understand.

Mr. DESPRES. Fundamentally, I regard the dollar as the most desired, inherently the internationally most desired form of asset, and that gold is valued because we stand ready to buy it. Just as used to be the case for the price of wheat before wheat got in short supply, we are propping gold.

Representative ELLSWORTH. Let me ask a question to clarify something in my own mind. Would you explain to me or attempt to, so that even I can understand it, what exactly is the direct link between our having a deficit in our balance of payments on the one hand, and on the other hand our ability to engage in this financial intermediation function that you have talked about as a direct investor and as a lender.

Mr. DESPRES. Yes.

Representative ELLSWORTH. In other words, why is it necessary for us to have a balance-of-payments deficit in order for us to perform that function?

Mr. DESPRES. The United States typically has a surplus on current account, net exports of goods and services. If our lending and investing abroad precisely equaled the surplus on current account, then one could say that the function of the lending and investing was exclusively to effect real transfer of goods and services to other countries and one could call this, if one wanted, a position of balance.

What I am really saying is this: that American lending and investing abroad performs two functions. One, it finances real transfer of goods and services. Two, it is a trade in financial assets. It enables foreign countries to get financial claims of the type that they desire, while we provide financing to permit investments that go forward abroad. We not only export a part of our savings to the rest of the world but our financial markets help other countries to mobilize their savings for investment use.

Now this excess American lending and investing—in excess of real transfer—we choose to call a deficit. By so doing, we are in effect asserting that this role of financial intermediation, this role as banker, is not a valid role for a country to play.

What I am saying is that this isn't a deficit. The financial intermediation role is a valid role. Indeed, it is an essential role to a liberalized free world economy, and it falls to the United States because we stand at the apex of the world financial pyramid. Our role cannot be multilateralized just as our nuclear role cannot be multilateralized.

You see, the definition of a deficit, the traditional definition, the Department of Commerce definition, is that the deficit is the amount of liquid financial claims that other countries acquire from the United States as the result of our financial intermediation role, as a result of our lending and investing in excess of real transfer.

What I am really saying is that if we stopped doing this, we would leave a hole in the world's financial mechanism which would not be filled by any of these international monetary arrangements, and what is called a deficit, I am saying, should not be considered a state of disequilibrium. On the contrary, it is necessary to a healthy equilibrium.

Now the problem that I think concerns Dr. Mundell is this. If the United States is freed from constraints with respect to international lending and investing in excess of real transfer, which is what financial intermediation is, what is to keep us from doing either one of two things: one, easing up on credit extension and putting the world into an inflationary boom or, two, tightening up on credit and therefore imposing a severe depression on the rest of the world?

The first of these we have never done. The second of these we did do in the late 1920's. American tight money imposed for alleged domestic reasons, in 1928–29, hurt the rest of the world long before it hurt us, and imposed a depression on the rest of the world.

My answer to this is that we should commit ourselves to adopt a monetary policy geared to what seems to be reasonable from the point of view of stable world economic growth, and forgo the use of monetary policy, just to curb our private domestic boom or to provide extra domestic stimulus in a recession, and we should do this in consultation with the rest of the world, I mean arrive at our monetary policy in consultation with the major foreign countries.

Now, this is distinctly an American solution, and a true internationalist would say he would rather have a supranational central bank. I would rather have a supranational central bank, too, but I am stressing I would not rather have an international central bank, which is a very different thing.

I am also saying, I guess, that if you did have a central bank, the central bank would not only have to create liquidity, but it would have to be willing to acquire the kinds of assets that American lenders and investors acquire and that central banks usually don't touch, in order to replace the American deficit. It would also have to manage flexibly and not by rigid formula.

You know, I really think I have been talking in kind of classroom world federalist terms about this problem. I think that the world isn't ready for a true supranational solution, and I think that the very good second best is to recognize the existing organic structure

of world finance, and to adopt a setup which accommodates to what exists, instead of maintaining or seeking to maintain this pretense of equality.

Chairman REUSS. Why don't you settle for an international central bank of the sort which seem to be our Treasury's current negotiating position, plus a sweeping out of the intellectual cobwebs, if they are cobwebs, of people in governments generally on quasi-mercantilism, which you would describe as getting rid of the idea that there is something evil with lending long and borrowing short to do it, "ex-Humeing" the world in short? If we did all that, why wouldn't you be very happy?

Mr. DESPRES. Well, I don't regard that as—you didn't ask me this question—as a very likely outcome. You may not regard what I propose as a very likely outcome either. But the thing I had in mind is this.

I think a U.S. deficit ought to be a normal and a current feature of a healthfully growing world economy operating under liberalized trade.

Therefore, the International Central Bank or whatever other arrangements would have to keep providing reserves to us; we would be the client in the sense of the borrower or the recipient of owned reserves. I think this would be very hard to sell, and I think that——

Chairman REUSS. The compromise I was suggesting to you was one in which we would be able to continue to run deficits caused by our lending long and borrowing short, with the cheery acquiescence of the new enlightened central bankers of the world, but the need for long-term liquidity, quite a different thing, could be met by a Joe Fowler type international central bank. Why wouldn't that give you an answer on both questions?

Mr. DESPRES. That is all right. I don't see any separate long-term need for liquidity, apart from the need for financing appropriate payments deficits, but yes, that would be all right, would be my answer.

I would be reasonably happy if that were the outcome, but I don't see it as the outcome, because of the principle of symmetry or equality, from which all these problems are approached.

Chairman REUSS. Mr. Mundell?

Mr. MUNDELL. I agree with a great deal of what Professor Despres has said. But I think "financial intermediation" is a big word to explain what is in essence, a rather simple concept, which is that the foreign countries, whether companies, individuals, banks, or central banks, want to hold a certain amount of the dollars they have been getting. In this connection, the Robert Roosa distinction—in his recent book—between "reserve" currencies and "vehicle" currencies (in which the latter expresses the intermediation idea) is useful.

Central banks want to acquire liquidity every year, and the only two useful assets they can acquire are dollars or gold.

What many European governments have been arguing is that they don't like the idea of using dollars as their sole credit reserves in central bank hoards. I don't think it is useful in this connection to call their dollar holdings the results of "financial intermediation," and they don't think of it in these terms. They want an asset that isn't a liability of another country. They don't want to keep dollars as their sole currency reserve. They want to keep an international asset. That seems to be a legitimate aspiration.

I do not deny, of course, that any kind of international system you create, any kind of supranational bank, is going to be dominated to a very large extent by the United States; you can't evade the enormous influence of the dollar.

However, a new reserve asset would be more than a face-saving instrument, since it would involve certain control features. But all this takes us far afield.

Chairman REUSS. Mr. Ellsworth?

Representative ELLSWORTH. We could stay here all afternoon and I would like to.

Chairman REUSS. I think we have imposed very fully on you gentlemen, and we are very grateful. Thank you so much.

The hearing of the subcommittee is now adjourned.

(Whereupon, at 12:35 o'clock, p.m., the subcommittee adjourned.)

APPENDIX

(The following materials were subsequently supplied by Chairman Reuss for inclusion in the record:)

MITGLIED DES DIREKTORIUMS DER DEUTSCHEN BUNDESBANK,
Frankfurt, September 14, 1966.

Mr. HENRY S. REUSS,
Member, House of Representatives,
Capitol Hill, Washington, D.C.

DEAR MR. REUSS: I read in the New York Times of September 10, that Professor Despres has made the following statement before a Congressional Sub-committee:

"I think the West Germans have converted more dollars into gold than the French. They simply did it in a more discreet fashion."

This statement is factually completely wrong. As I assume that the Subcommittee was the one presided over by you, I send you enclosed a copy of a letter which I have sent to Professor Despres on the subject.

With best personal regards,

Yours sincerely,

OTMAR EMMINGER.

MITGLIED DES DIREKTORIUMS DER DEUTSCHEN BUNDESBANK,
Frankfurt, September 14, 1966.

Professor EMILE DESPRES,
Stanford University,
Stanford, California.

DEAR PROFESSOR DESPRES: I just read in the New York Times that at a panel session with a Senate-House Economic Sub-committee you made the following statement:

"I think the West Germans have converted more dollars into gold than the French. They simply did it in a more discreet fashion."

May I point out that this statement has no foundation in the facts.

During the 4½ years from 1962 to August 1966, the German authorities have only converted 25 million Dollars into gold with the US Treasury, in the sense in which the French authorities convert a large part of their dollar accruals by tendering them to the US Treasury for conversion into gold.

It is true that the German gold reserves have increased, during the period from 1962 through August 1966, by altogether 633 million Dollars (as against more than $3 bio in the case of France!). But most of the increases in the German reserve came about not through conversions with the US, but either through gold sales of the IMF in connection with support operations for the Pound, or through the gold distribution to members of the "Gold Pool", that is out of the net surplus of newly mined (and Russian) gold accruing on the London gold market.

These facts are illustrated in the following table:

Gold holdings of the Deutsche Bundesbank—Changes from 1962 to August 1966

[Mio $]

	1962	1963	1964	1965	1966 January to August	1962 to August 1966
U.S. gold sales			+225			+225
IMF gold sales			+93	+132		+225
German gold subscription to IMF					−103	−103
Transactions with London gold pool and other diverse sources	+15	+164	+87	+30	−10	+286
Total net change	+15	+164	+405	+162	−113	+633

This table needs a few comments:

(1) The item "US gold sales", as it appears in the US Treasury gold statistics, includes a special transaction in 1964, which in reality was a triangular transaction between Italy, the US and Germany. During the Italian foreign exchange crisis in the spring of 1964 (when a special support operation for the Italian Lira was mounted, with the participation of the US and of the German Bundesbank), it was agreed that the Italian authorities would pay $200 mio in gold to the German authorities; for technical reasons this gold went first to the US Treasury and from there to the Bundesbank. Thus, you find in the US Treasury statistics a purchase of $200 mio of gold from Italy and a simultaneous sale to Germany to the same amount.

(2) The gold sales by the IMF were part and parcel of the two special support operations for the Pound by the "General Arrangements to Borrow" (Group of Ten). While the "Ten" put up altogether 903 mio $ in credits to the IMF as a means of partially refinancing the IMF loans to the UK, they also sold some of their currencies to the IMF for this same purpose against gold. The Bundesbank which contributed the largest part to the credits under the G.A.B., also got a proportionately large share of these IMF gold sales.

(3) As to the London Gold Pool, the contribution and receipts of the participating central banks follow an agreed schedule.

While it is true that we have welcomed these various accruals of gold to our reserves, as they have brought the proportion of gold to total reserves more nearly to the intended magnitude, we have carefully avoided large-scale conversions at the expense of the US Treasury, in order not to "upset the apple-cart" at an untoward moment. We have fully explained this reserve policy of ours, including our considerations of international solidarity and cooperation, in the last two Annual Reports of the Bundesbank.

I do not want, however, to be misunderstood. All the foregoing considerations do not imply that we would not believe it to be justified, under normal circumstances, to convert any surplus dollars which may accrue to us beyond the limits which we consider proper. If the dollar has such a universal attraction as a reserve currency, this is due, at least in part, to the fact that the US authorities stand ready to convert it into gold for any legitimate monetary purposes.

With my best regards,

(signed) OTMAR EMMINGER.

(Dr. Despres' response to the foregoing follows:)

OCTOBER 3, 1966.

DR. OTMAR EMMINGER,
Mitglied des Direktoriums der Deutschen Bundesbank,
Frankfurt (Main), Germany.

DEAR DR. EMMINGER: I wish to acknowledge with thanks your letter of September 14. The interpretation which you placed upon my statement is alone sufficient to indicate that the statement needs clarification and elaboration, which I welcome the opportunity to provide.

Changes in German and French official reserves from the end of 1960 to the end of 1964, and from the end of 1964 to July 31, 1966 are given in Table 1 below. In Table 2, the percentage composition of German and French official reserves at each of these three dates is shown. These tables are derived from the figures on official reserves published in the September 1966 issue of the IMF's *International Monetary Statistics.*

Some of the significant points reflected in these tables are the following:

1. Total French reserves increased very substantially, while total German reserves showed only a moderate net increase during the period from the end of 1960 to the end of July 1966. This is ascribable to differences in the balance of payments positions of the two countries.

2. German official holdings of foreign exchange were steadily drawn down during the five and a half year period. French official holdings increased $0.9 billion from the end of 1960 to the end of 1964, and were drawn down $0.5 billion in the subsequent nineteen months. The decrease in French official holdings of foreign exchange in the latter period was slightly smaller than the reduction of German official holdings. The German decrease made possible a further increase in IMF and gold reserves in the face of a small payments deficit.

3. Taking the five and a half year period as a whole, the gain in French holdings of gold and IMF reserves has been ascribable primarily to the balance of payments surplus; the foreign exchange portion of French reserves has at all times

been rather small and only a small part of the gain in gold and IMF reserves is attributable to a change in the relative share of the foreign exchange component. The foreign exchange component increased from 19 percent at the end of 1960 to 24 percent at the end of 1964; reflecting the change in French policy regarding international monetary matters, this ratio has subsequently been reduced to 12 percent.

4. The increase in German holdings of gold and IMF reserves over the five and a half year period chiefly reflects a steady shift in the composition of German official reserves, and is due only secondarily to a net surplus in the balance of payments. The foreign exchange component has been steadily reduced from slightly over one-half at the end of 1960 to slightly over one-fourth at the end of July 1966.

In your letter to me of September 14, you have stressed that German gold acquisitions have not been effected through purchases from the United States Treasury. I find it difficult to detect the significance of this point. Since the United States stands ready to sell gold to foreign central banks and monetary authorities on demand, it follows that when the demand for gold of foreign monetary authorities exceeds the supplies forthcoming from net production, the IMF or Russian or Chinese sales, the difference is made up by withdrawals from the U.S. monetary gold stock. It makes little difference whether a particular country decides to buy its gold from the United States or from some other source. The significant decisions of foreign central banks and monetary authorities are their decisions with respect to the composition of their reserves.

In stating that "the West Germans have converted more dollars into gold than the French", of course I did not mean to imply that Germany's total acquisition of gold had been greater than that of France. The German balance of payments position since 1961 would barely have permitted this even if all foreign exchange holdings had been converted into gold. I did mean to indicate that the increase in gold holdings brought about by drawing down holdings of foreign exchange (chiefly dollars, one presumes) had been greater in the case of Germany than in the case of France.

Your letter made me aware that the statement from my testimony which the New York Times selected for quotation was subject to possible misinterpretation, which I hope this elaboration will eliminate. Let me add that the intention underlying these two sentences was not to critize German policy with respect to reserves. My intention was to prevent undue importance from being given to the recent change in French policies. I believe there is a tendency in many quarters to exaggerate the importance of the change in French policy on international monetary matters in jeopardizing stability of the international monetary system. Even before the change in policy France had continually held a relatively high fraction of its reserves in the form of gold. Moreover, the French payments surplus is unlikely to continue indefinitely at its present level. International cooperation, even without French participation, is strong and flexible enough to meet any additional pressures resulting from French actions. Consequently, I regard the present system, because of international cooperation, as relatively invulnerable—at least so long as a moderate deficit persists in the United States balance of payments. It is not the vulnerability of the present system but its adverse effect in reducing aid to the underdeveloped world, complicating and perhaps impairing collective defense arrangements and in hindering the international mobility of goods and capital which is the overriding problem today. The system is breeding a revived mercantilism and its apparent durability is not a source of much satisfaction to me. I regret that international cooperation, while strong enough to secure the system against crisis and breakdown, is not strong enough to reform it in a fashion conducive to free world growth, development and economic integration.

With cordial regards,

Yours sincerely,

EMILE DESPRES.

TABLE 1.—*Changes in official reserves*

[In millions of dollars]

	End of 1960 to end of 1964	End of 1964 to July 1966	1960 to July 1966
Germany:			
Gold	+1,277	+54	+1,331
IMF reserve position	+604	+305	+909
Foreign exchange	−1,031	−582	−1,613
Total	+850	−223	+627
France:			
Gold	+2,088	+1,388	+3,476
IMF reserve position	+417	+311	+728
Foreign exchange	+947	−526	+421
Total	+3,452	+1,173	+4,625

TABLE 2.—*Percentage composition of reserves*

	Dec. 31, 1960		Dec. 31, 1964		July 31, 1966	
	Germany	France	Germany	France	Germany	France
Gold	42	72	54	65	56	75
IMF reserve position	5	9	11	11	17	13
Foreign exchange	53	19	35	24	27	12
Total	100	100	100	100	100	100

(The following material was supplied by Professor Despres for inclusion in the record:)

Statement Submitted By Professor Despres

A proposal for strenghtening the international monetary system which was originally circulated in the spring of 1965 is outlined below. Its adoption—and, perhaps, merely its serious consideration—would bring to an end the state of nagging semi-crisis in the international economy which has persisted since 1959, and it would reverse the present growth of mercantilist restrictionism.

The central postulate underlying this proposal is that the dollar is not only "as good as gold" but is, fundamentally, much better than gold. In the present day world, gold derives its desirability as a monetary asset from the fact of its unlimited convertibility into dollars at a fixed price. The dollar is not merely a national currency; it is, indeed, the predominant international currency. It is widely used for commercial settlements not only in trade with the United States but in trade between foreign countries. It is the principal unit of account in international lending and borrowing, both long-term and short-term, even when both borrower and lender are foreign entities. Free world central banks and monetary authorities, other than those of the sterling area and the French community, settle their deficits and surpluses, in the first instance, by taking in or paying out dollar balances.

Except by special arrangements, gold is no longer used directly in settlements between foreign countries. Although foreign countries may elect to exchange dollars for gold or gold for dollars, the dollar is the medium of payment and gold simply a potential source of, or use for, dollars. The United States is the only country which stands ready to buy gold on demand or sell gold to foreign central banks and monetary authorities. Although other countries have defined the legal parity of their monetary units in terms of gold, all IMF members except the United States have taken advantage of the option provided under the Articles of Agreement of the International Monetary Fund to set the upper and lower support limits in terms of dollars. Since so large a part of the free world's international obligations—commercial and financial—is denominated in dollars, it is, in the last analysis, dollars and not gold which are desired for international settlements. The evolution of credit money over the past four or five centuries has proceeded to a point where gold has become a dollar substitute, rather than the dollar a gold substitute.

Whatever may have been the case in the past, the desire for gold as a monetary asset is today contrived and artificial. It rests upon the confident assumption that the United States government will always stand ready to supply dollars in exchange for gold without limit and at a price not less favorable to gold holders than 35 dollars an ounce. Certainly the anxiety which the U.S. government has shown in the face of gold losses has done nothing to weaken the confidence with which this assumption is held. Nevertheless, the United States, although completely committed to defending the dollar, has no comparable commitment to the defense of gold.

A second postulate is that the United States, as the world's financial center, faces a banking problem and not a balance-of-payments problem. This banking problem arises from an inflated demand for gold, itself a result of the present United States gold policy. The present state of contained crisis of the international monetary system can be corrected only by bringing about a genuine change in prevailing asset preferences—reducing the desire for gold and increasing the desire for dollars. Such a shift in asset preferences can be brought about by United States action alone and not by international negotiation to create some supplementary reserve asset. Within the context of prevailing asset preferences, any international agreement would be too limited in scope and too rigid in its operation to permit the needed re-establishment and development of an unrestricted, integrated, international capital market based upon the United States. By distributing liquidity on a symmetrical formula which does not take account of the special banking problems of the financial center, it would give reserves to countries that do not need them without appreciably easing the positions of those who do.

The present inflated demand for gold rests upon persistent belief in the possibility of dollar devaluation and the confident expectation that, in any event, gold can always be converted into dollars without limit at no less than $35 an ounce. A change in asset preferences can be effected only by changing these expectations. Only in this way will the actual demand for dollar assets be brought into line with the underlying character of the dollar's international role.

Despite repeated official statements of the U.S.'s determination to defend the dollar and the steps which have been taken for this defense, belief in the possibility of dollar devaluation underlies the bulk of the private speculative demand for gold and probably exerts some influence upon the decisions of central banks and monetary authorities with respect to the composition of their reserves. So long as we stand ready to convert gold into dollars without limit at $35 per ounce, the holding of gold becomes a safe potential source of dollars, risking little more than the interest foregone. The desirability of gold as a monetary reserve asset depends upon the fact that the conversion of gold into dollars is universally taken for granted. If convertibility of gold into dollars were convincingly limited, gold not eligible for purchase by the United States would lose its usefulness as an international monetary asset. International settlements between foreign countries are largely carried out in dollars, not in gold, and it is scarcely conceivable that foreign central banks and monetary authorities would agree to use in settlements among each other an asset not freely exchangeable for dollars.

The kinds of steps which, in my judgment, the United States should take to alter prevailing asset preferences are given below:

1) The present 25% gold reserve requirement against Federal Reserve notes should be repealed and it should be made more explicitly clear than at present that all the monetary gold which the United States holds would be used if necessary in defense of the dollar. Gold should be treated not as a last line of defense to be conserved and husbanded but as a readily available reserve to be employed alongside swap credits and forward exchange operations and IMF drawings and other newly developed financial devices. Although we have reiterated our determination not to devalue, continuation of the existing reserve requirements against Federal Reserve notes together with U.S. zealousness to avoid gold losses whenever possible has created a widespread impression that in the face of persistent gold losses, the U.S. would resort to devaluation long before its 13 billion dollars of monetary gold had been exhausted.

It is widely accepted that if a devaluation of the dollar should occur, this would be accompanied or immediately followed by a general devaluation of other currencies. Consequently, devaluation of the dollar would do nothing to improve the competitive position of the U.S. in world markets, even if such an improvement were desired for balance-of-payments reasons. The chief effect of a devaluation of the dollar would be the change in the U.S. liquidity position through a writing up of the dollar value of monetary gold holdings. If a 50% devaluation were undertaken with a 13 billion monetary gold stock, the new value of that stock would be 26 billion dollars. This is the only advantage, if it be deemed an advantage, to be gained from dollar devaluation. (Since devaluation would greatly weaken the rest of the world's willingness to hold dollars and dollar claims, even this advantage would be illusory.) It should be noted that devaluation would be utterly pointless even in terms of the liquidity position of the U.S. if it were deferred until our gold holdings were exhausted, since with a monetary gold stock of zero, there would be nothing to write up. A general devaluation of currencies at a time when U.S. gold reserves were exhausted would only increase the dollar fetching power of foreign gold holdings and of newly mined South African and Russian gold. Although exhaustion of the U.S. monetary gold stock would doubtless necessitate a suspension of gold payments, it would not necessitate devaluation, which is a very different thing, and would, in fact, render devaluation pointless, except as a means of providing massive windfalls to foreign monetary authorities and gold speculators and mining interests. It is well understood, of course, that the U.S., without gold of its own, would not find it attractive to supply such a windfall to others. Belief in the possibility of dollar devaluation rests squarely, therefore, on the assumption that there is some floor to United States gold reserves not far below present levels and that if this floor is reached, the United States would feel "forced" to devalue. This belief would be greatly weakened if convincing evidence were provided that there is no such floor. Elimination of Federal Reserve requirements against Federal Reserve notes, together with greater use of gold along with swap credits and other financing devices for day to day international payments purposes would go far to destroy belief in the possibility of devaluation.

2) In addition, the United States should announce a new policy with respect to the purchase of gold. While continuing to stand ready to sell gold without limit at the statutory price of $35 an ounce, the U.S. should impose strict limitation upon the amount of gold which it stands ready to buy at this price and should substitute firm credit lines for the monetary gold rendered redundant by quota limitations on U.S. purchases. This proposal involves no change in the price at which we would stand ready to buy gold. However, it would end the unlimited convertibility of gold into dollars, and it would substitute credit for the monetary gold made redundant by the quota limitations.

Special limitations regarding gold purchases would be made for underdeveloped countries, dollar reserve countries and Great Britain. In the case of all other countries, the United States should declare its readiness to enter into a series of bilateral and reciprocal gold purchase plus credit agreements along the following lines:

i) The U.S. would stand ready to make net purchases of gold at $35 an ounce in an amount not exceeding ⅓ of the monetary gold held by the other party to the agreement at the time of announcement of the new U.S. gold buying policy. The other party would agree to sell gold to us only when necessary for balance-of-payments reasons. (The remaining ⅔ of the other country's gold reserves, together with such gold, if any, as might be subsequently acquired, would be ineligible for purchase by the U.S.)

ii) Reciprocally, the other country would stand ready to buy up to this amount of gold from the U.S. when necessary for balance-of-payments reasons.

iii) Firm reciprocal credit lines (swaps) permitting drawing without specified maturity and covered by an exchange value guarantee would be established in amounts equal to twice the reciprocal commitments with respect to gold purchase. It would be mutually agreed that drawings under these credits would go hand in hand with gold sales in the ratio of two units of credit utilization to one of gold sales. Under such an agreement, a country wishing to obtain, say, 150 million dollars for international payments purposes would sell 50 million of gold to the U.S. and draw 100 million under its credit line. Thus, access to dollars through gold and credit combined would remain unimpaired, credit replacing the gold rendered unusable by U.S. purchase limitations.

In the case of countries holding the major portion of their reserves in the form of dollars (e.g., Japan, Canada) and of all underdeveloped countries, it seems appropriate to make eligible for purchase by the United States at $35 an ounce all gold reserves held by the monetary authorities of these countries on the date of announcement of the new gold policy. Swap credits would then be unnecessary. Any gold subsequently acquired by these countries would be ineligible for purchase by the United States.

Great Britain's position as a financial and reserve currency center justifies special arrangements. The U.S. should propose a reciprocal gold plus credit agreement similar in form to the reciprocal agreements outlined above, but making British gold eligible for purchase by the United States in an amount equal to the full British central gold reserve on the date of announcement of the new gold purchase policy. Britain would, in turn, stand ready to purchase an equal amount of gold from the U.S. and gold transactions would be meshed with drawings under swap credits in the ratio of 1 to 2.

Measures would also have to be taken with respect to the IMF in order 1) to assure that gold ineligible for direct sale to the United States did not reach us indirectly through the IMF as intermediary, 2) to assure the convertibility into dollars of existing IMF gold holdings, and 3) to prevent the IMF from becoming a dumping ground for gold ineligible for sale to us. These are matters of technical detail which raise no insuperable difficulties.

The steps outlined above surely would result in a marked shift in asset preferences from gold to dollars and would remove the elements of weakness which impair the effective operation of the existing system by preventing the United States from performing its appropriate banking function. A dollar reserve system would be established free of the critical weaknesses of the existing system.

The proposal outlined above should not be considered a rigid blueprint. It is undoubtedly susceptible of modifications and improvements. More important, its adoption or even its serious consideration in U.S. official quarters would require a radical change in prevailing official doctrine regarding the dollar's relationship to gold and the applicability to a world financial center of traditional notions of balance-of-payments equilibrium. So long as present doctrines are adhered to and so long as solutions are sought by attempting to negotiate multilateral agreements for supplementary reserve assets which do not give recognition to the in-

herent asymmetry between the position of a financial center and that of its clients, there is little reason to expect much improvement in the condition of contained crisis which has prevailed during the sixties. Thus, a radical change in the prevailing doctrine is needed. With such a change, the task of devising appropriate measures to end the crisis and provide an international monetary environment favorable to growth and development, and to commercial and financial liberalization, would be a simple task. It could be accomplished either by steps of the type outlined above or by other measures having equivalent effect.

The result would be the establishment, in effect, of a world dollar standard under which loan finance, short and long term, would be available to borrowers with credit standing at the market rates (with aid to underdeveloped countries at concessional terms). United States monetary policy, and the resulting level of interest rates, would have to be determined in full consultation with foreign governments and appropriate international agencies in order to provide financing terms consistent with world economic growth and stability. Purely domestic stabilization policy would then rely largely upon fiscal instruments, unless the requirements of both domestic and international stabilization coincided in pointing to a need for greater monetary expansion or restraint.

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