410

THE 1968 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETIETH CONGRESS

SECOND SESSION

PART 4

The Dollar Deficit and German Offsetting

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

90-191 WASHINGTON : 1968

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price 10 cents

JOINT ECONOMIC COMMITTEE

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

WILLIAM PROXMIRE, Wisconsin, *Chairman*
WRIGHT PATMAN, Texas, *Vice Chairman*

SENATE	HOUSE OF REPRESENTATIVES
JOHN SPARKMAN, Alabama	RICHARD BOLLING, Missouri
J. W. FULBRIGHT, Arkansas	HALE BOGGS, Louisiana
HERMAN E. TALMADGE, Georgia	HENRY S. REUSS, Wisconsin
STUART SYMINGTON, Missouri	MARTHA W. GRIFFITHS, Michigan
ABRAHAM RIBICOFF, Connecticut	WILLIAM S. MOORHEAD, Pennsylvania
JACOB K. JAVITS, New York	THOMAS B. CURTIS, Missouri
JACK MILLER, Iowa	WILLIAM B. WIDNALL, New Jersey
LEN B. JORDAN, Idaho	DONALD RUMSFELD, Illinois
CHARLES H. PERCY, Illinois	W. E. BROCK 3D, Tennessee

JOHN R. STARK, *Executive Director*
JAMES W. KNOWLES, *Director of Research*

ECONOMISTS

WILLIAM H. MOORE — JOHN B. HENDERSON — GEORGE R. IDEN
DONALD A. WEBSTER (Minority)

THE DOLLAR DEFICIT AND GERMAN OFFSETTING

MEMORANDUM

BY

JOSEPH ASCHHEIM, Professor of Economics
THE GEORGE WASHINGTON UNIVERSITY

[This memorandum was presented for the record by Representative Reuss. See p. 448, Part 2, of the hearings record.]

CONTENTS

Page

INTRODUCTION ---------- 925

I. CONCEPTUAL ORIENTATION ---------- 925

A. General ---------- 925

B. Defense ---------- 926

II. THE MEANING OF "OFFSETTING" ---------- 928

A. The Record ---------- 928

B. Differences Between Agreements ---------- 929

C. Four Kinds of Offsetting ---------- 931

D. Compensation ---------- 934

III. CONCLUSIONS ---------- 936

THE DOLLAR DEFICIT AND GERMAN OFFSETTING

Introduction

It is coming to be widely recognized that quick termination of the chronic deficit in the U.S. balance of payments is necessary for the survival of the dollar as the leading reserve currency of the world. Accordingly, to merit consideration, corrective measures would have to feature all of the following attributes: (1) immediacy of impact, i.e., effectiveness not only over the long term but also in the short run; (2) sufficiency of magnitude, i.e., size of impact that would warrant the constraint to be adopted; and (3) consistency with preservation of the reserve-currency function of the dollar, i.e., strengthening rather than weakening both foreigners' and Americans' confidence in the viability of the dollar as a key currency.

Manifestly, whatever corrective measures have thus far (by the end of 1967) been introduced to counteract the balance-of-payments deficit, have fallen short under at least one, and probably two of the foregoing three counts. The search for corrective measures must, therefore, be stepped up in directions that may not have been ventured heretofore. Yet the scope for this search is not unlimited by virtue of the very presence of the above three qualifications.

I. Conceptual Orientation

A. *General.*—In attempting to orient the search for means of terminating the U.S. balance-of-payments deficit, it must be noted that corrective measures focusing upon the private sector are inherently inconsistent with preservation of the reserve-currency status of the dollar. In other words, measures that are explicitly or implicitly variants of exchange control imposed on households or firms are objectionable, because their adoption would only further undermine the precarious character of confidence in the dollar. The measures to be sought are, therefore, to be looked for, at least in the first instance, in the realm of the public sector.

In the case of the domestic side of the public sector, it is taken for granted—at least for the last 20 years—that government expenditures and their financing must be harmonized with economic stability. Thus, in the field of public finance, there is ready acceptance of the notion of varying the total size and the composition of financing for Government expenditures in conformity with a norm of economic stability. The time is now long overdue to apply to international finance what we take for granted in domestic public finance. Just as the Government sector has been rendered, at least in attempt, an equilibrating mechanism for the domestic economy, the Government sector must consciously be rendered an equilibrating mechanism for the open economy. It will then become as meaningful to speak of international public finance as it has been of domestic public finance.

As the first step to this end, the U.S. Government's presentation of its budget, both ex ante and ex post, should include the quantification of the balance-of-payments impact of the budget. The statement of this quantification should be as detailed as security provisions possibly allow. Thus, there should be a spelling out of the foreign-exchange costs and benefits of domestic U.S. Government expenditures and receipts, of the foreign-aid program and of the overseas military program. The breakdown should be both by region of the world and by country, unless compelling reasons to the contrary exist.

In using the Government sector as an equilibrator in the balance of payments, care must be taken to harmonize such use with the underlying rationale of international trade: pursuit of comparative advantage in the aim of the optimal worldwide allocation of resources. Accordingly, measures that reduce the balance-of-payments deficit but that also conflict with the optimal allocation of resources are not truly corrective measures, because they undermine the rationale for the conduct of international trade in the first place. Thus, to save foreign exchange by misallocating resources is to engage in waste. Hence, once the Government sector has been utilized to the full extent of its equilibrating capacity in the balance of payments, and a chronic deficit still remains, then consideration of a floating exchange rate system or of devaluation under the stable-exchange rate system is in order.

B. *Defense.*—There is direct relevance to U.S. defense expenditures abroad in the foregoing proposition that to save foreign exchange by misallocating resources is to engage in waste. One method of reducing the balance-of-payments impact of U.S. defense expenditures is to shift U.S. defense procurement from foreign sources to sources in the United States. This approach was first ordered by a Presidential directive in November 1960. The growing extent of the use of this approach has been set forth by the U.S. Treasury Department in the following statement:

> Beginning in January 1961, Department of Defense purchases * * * normally were "returned" to the U.S. when costs of U.S. supplies and services (including transportation and handling) for use outside the U.S. did not exceed the cost of foreign supplies and services by more than 25%. In mid-1962 the standard 25% differential was increased to 50%, and on a case-by-case basis could exceed 50%. These policies, which are continually re-emphasized, remain in effect today. Hence, in cases where the U.S. versus foreign procurement source is to be determined on price differential grounds, a 50% premium in favor of U.S. end products or services is acceptable automatically and cases over $10,000 where the price differential is over 50% continue to be forwarded to the Deputy Secretary or the Secretary of Defense for procurement source determination. From CY 1961 through FY 1967, about $340 million in procurements had been diverted from foreign products to U.S. products or services under this program, at an additional budgetary cost of about $75 million, or about 22%.
>
> Similarly, for Department of Defense procurements of goods and services for use in the U.S., case-by-case review procedures using the 50% differential as a "bench mark" were initiated in July 1962. The 50% differential was subsequently formalized as a part of the Department of Defense procurement regulations with

a clear statement that this policy would be kept in force only as long as is required by the U.S. balance-of-payments situation. From FY 1963 through FY 1967, based only on cases where foreign source bids were received, approximately $13 million in procurements which normally would have been foreign were returned to U.S. sources at an additional budgetary cost of approximately $4 million, or about 31%.

With respect to purchases of POL, in FY 1967 the Department of Defense returned to the U.S. somewhat over $100 million of the approximately $570 million which normally would have been earmarked for overseas procurement; thus, about 20% of Department of Defense overseas procurement requirements in FY 1967 were purchased in the U.S. Additional returns have been determined to be infeasible, principally on economic grounds, *e.g.*, the additional budgetary cost involved would greatly exceed any benefits in foreign exchange savings.[1]

Thus, the U.S. Defense Department does place a "feasibility" limit on the extent to which wastage of resources for the sake of serving foreign exchange should go. It favors, therefore, the exploration of other methods for reducing the balance-of-payments impact of U.S. defense expenditures.

The balance-of-payments impact of the U.S. defense program can also be reduced either by cutting back overseas defense commitments, or by altering the techniques of financing these commitments, or by a combination of the two approaches. So far as the approach of cutting back defense commitments is concerned, the Defense Department itself has stated:

> It is always possible to save on defense budgets or on balance-of-payments costs attributable to defense at the cost of adequate military resources to support an optimum strategy. For example, with greater limitations, we might be forced to give up political opportunities which might otherwise be available, or we might be obliged to cut back on the strategy of defending the United States at the frontiers of the non-Communist world, or we might accept increased risks of major war.[2]

In this study we shall assume that U.S. defense policy is outside the purview of the Joint Economic Committee and that, therefore, U.S. defense strategy must be taken as determined by those charged with this responsibility. Accordingly, the approach to be used will be that of alerting the techniques of financing the defense commitments and not that of altering the defense commitments themselves.

The financing of overseas defense commitments of the United States imposes two kinds of burden upon the United States: (*a*) the balance-of-payments burden; and (*b*) the budgetary burden. The balance-of-payments burden has come to be the object of international negotiation at least since 1959. On the other hand, the budgetary burden of these commitments has not, at least publicly, been explored as an object of international negotiation thus far. Instead, the approach adopted by the U.S. Government has been one of seeking agreements with allied nations to offset, at least partially, the foreign-exchange cost

---

[1] U.S. Treasury Department, *Maintaining the Strength of the United States Dollar in a Strong Free World Economy* (January 1968), pp. 140–141.

[2] U.S. Department of Defense in *The U.S. Balance of Payments—Perspectives and Policies*, staff materials and other submissions prepared for the use of the Joint Economic Committee, U.S. Congress (U.S. Government Printing Office, 1963), p. 79.

of the U.S. military presence in such nations whenever these nations are in persistent surplus position in their own balance of payments. The most substantial case in point by far is that of the Federal Republic of Germany, where in excess of 200,000 American troops have been stationed for a generation.

II. The Meaning of "Offsetting"

A. *The record.*—The most detailed breakdown by area of the U.S. balance of payments, published by the U.S. Department of Commerce, does not provide separate data for the Federal Republic of Germany or for the Republic of Vietnam. Apparently for security reasons, both of these countries are lumped together with other countries in their respective geographic areas. Thus Germany is listed in the category of "Other Western Europe," where the "other" means Western Europe, excluding the United Kingdom of Great Britain and Northern Ireland. In turn, Vietnam is in the category of "Other Countries in Asia and Africa," where the "other" means Asia and Africa, excluding Japan and South Africa.

In 1966, U.S. military expenditures abroad amounted to $3.7 billion, of which $1.4 billion was in "Other Western Europe" and $1.3 billion was in "Other Countries in Asia and Africa." In 1963, the U.S. Defense Department stated that "U.S. defense dollar outlays * * * in West Germany currently amount to about $700 million per year."[3] Under the impact of a rising general price level in Germany since 1963, it can be surmised that U.S. military expenditures in Germany have risen by at least 10 percent to a current level of $770 million per year. As these words are being written on January 19, 1968, a press report in the Washington Post[4] includes this statement: "The U.S. Government will begin talks with West Germany in March in a new attempt to recover the full foreign exchange costs of $800 million annually for its military establishments in that country, sources here said yesterday." Incidentally, the periodic leaking of the foreign-exchange cost clearly suggests that the security reasons for U.S. failure to disclose the U.S. balance of payments with West Germany are not compelling. In any case, we shall consider $800 million as the correct figure for U.S. military expenditures in Germany.

In recognition of the balance-of-payments impact of U.S. military expenditures in West Germany, a series of agreements was concluded between the United States and the West German Governments for the offsetting of such U.S. expenditures by the German Government. The first three agreements call for the offsetting of U.S. military expenditures in Germany by German expenditures in the United States for military procurement for the German Bundeswehr. The following are the offset target figures specified in the first three agreements:

Offset target figures in German-United States agreements, 1961–66

	Million
Calendar years 1961–62	$1,375
Calendar years 1963–64	1,375
Calendar years 1965–66	1,350

As there is typically considerable leadtime between the placing of orders for military equipment and its delivery, the transfer of funds from the German Government to the U.S. Treasury lagged the placing

[3] Ibid., p. 96.
[4] The Washington Post, Jan. 19, 1968, p. A–5.

of orders by 6 months. Accordingly, the last transfer of funds to the U.S. Treasury under the third agreement was effected by June 30, 1967.

A new type of offset agreement was announced by the U.S. Department of State on May 2, 1967, covering the fiscal year July 1, 1967, to June 30, 1968. This fourth agreement provides that the German Government will have: (a) the freedom to decide what levels of military procurement it wishes to undertake; (b) the intent to continue military procurement in the United States on a significant scale relative to the total German defense efforts; and (c) the willingness, through its Bundesbank, to purchase $500 million of U.S. Treasury notes (denominated in DM) maturing in 4½ years and redeemable before maturity only in the event that German official reserves drop by an extraordinarily large amount. The purchase of these nonmarketable, nonconvertible, interest-bearing U.S. notes is to occur at the rate of $125 million per quarter. Also reaffirmed is the agreement in the Bundesbank's "intention to continue its practice of not converting dollars into gold as part of a policy of international monetary cooperation." [5]

B. *Differences between agreements.*—The foregoing record of German-U.S. "offsetting" agreements to date raises a variety of questions. What is the significance of the quantitative difference between the two types of agreement? Is that also a qualitative difference between the two types of agreement and, if so, what is it? Which type of agreement is preferable from the U.S. standpoint, and which from the German standpoint? Are the two standpoints conflicting or coinciding? What are the implications of answers to the above questions for the content of future agreements?

Quantitatively, the second type of agreement is a distinctly narrower one than the first type. In the case of the military-procurement type of "offset" agreement there was an attempt by the parties to approximate a full offset of the foreign-exchange cost of the U.S. defense presence in Germany. Thus, in referring to this agreement, the Report of the Deutsche Bundesbank for the year 1966 states, "In the period covered by the Foreign Exchange Offset Agreement, the stationing of American troops in the Federal Republic was expected to give rise to expenditures on German goods and services in the amount of approximately DM 2.7 billion annually." [6] This amount is precisely equal to the annual offset-target figure of the 1965–66 agreement.

By contrast in the case of the "offsetting-by-lending" agreement of 1967, there is clear concession by the U.S. Government that the "offset" will be only partial. Thus in its January 1968 Report, the U.S. Treasury Department makes the following comparison between the two types of offset agreement.

> For six years until last June, we had a series of "military offset agreements" with Germany under which the German Government undertook to buy from the U.S. military equipment and services costing an amount which offset the bulk of our defense expenditures in Germany. The German Government did not renew the agreements for the period after June 1967 but expects to continue major purchases in the United States, although advance payments under the offset agreements (of which substantial amounts remain on deposit as of year-end 1967) will reduce our

[5] New York Times, May 3, 1967, p. 67.
[6] Report of the Deutsche Bundesbank for the year 1966, p. 28.

new receipts over the near term. During fiscal year 1968 the German Bundesbank agreed to invest $500 million in nonmarketable U.S. Treasury securities. This investment counts as a long-term capital inflow, reducing our payments deficit. It does not fully offset our expenditures in Germany.[7]

On the assumption of at least $800 million of U.S. military expenditures in Germany, the 1967 agreement provides for an offset of only five-eighths of such expenditures at most. Quantitatively, then, this second type of agreement was a retrogression from the first.

Apart from the quantitative difference, however, there are also some qualitative differences that render the second type of agreement preferable to its predecessor, from the German standpoint. In the first place, the termination of a commitment to a particular level of German military procurement in the United States removes the prospect of misallocation of resources that would be involved in purchasing U.S. military items that are either altogether unwanted by the Germans and/or available more cheaply elsewhere. Secondly, the Germans will receive interest income, which was not provided for in the military procurement type of agreement. Thirdly, the Germans, instead of buying outright American merchandise, are merely extending a loan to the U.S. Government, and will accordingly receive repayment of principal. Fourthly, the moderate term to maturity of the loan (4½ years) may be departed from in a German contingency. Fifthly, there is no advance commitment by the Germans to renew the loan when it expires; and if prior to expiration of the loan additional amounts were lent in the next few years, there would presumably be political pressure against an indefinite pileup of such loans in the realization that sooner or later, they must be repaid.

It is of more than passing interest that, before expiration of the third "offset" agreement involving military procurement, internal German political opposition to "offset" agreements was growing in volume and intensity. Indeed, the fall of Chancellor Erhard was partly attributed to German hostility to the "offset" agreements. Correspondingly, the rise of Chancellor Kiesinger is partly associated with his insistence on a different type of "offset" agreement from that involving defense procurement.

The acceptance of the first type of agreement by the Germans in the early sixties is understandable in terms of the buildup of the German Bundeswehr, which had commenced in the late 1950's. As the German defense buildup was beginning to taper off in the middle 1960's, and with the German recession of 1966 evoking calls from German industrialists for more Government orders from domestic industry, the military procurement type of "offset" agreement became increasingly objectionable on both economic and political grounds.

From the standpoint of the United States, the new type of agreement when compared to its predecessor, is a mixed bag. Commendable is the new feature of sparing the Germans the misallocation of resources that would be involved in their purchase of American military equipment that they don't want altogether or that is available more cheaply elsewhere. The United States should take pains to avoid the

[7] U.S. Treasury Department, *Maintaining the Strength of the United States Dollar in a Strong Free World Economy* (January 1968), p. 81. See also U.S. Department of Commerce *Survey of Current Business*, vol. 47, No. 12 (December 1967), p. 16.

imposition of a resource misallocation on its friends and allies, and this has been recognized in the new agreement. On the other hand, obtaining an intermediate-term loan is in the long run substantially less favorable to the U.S. balance of payments than would be the receipt of proceeds from the outright sale of American export products. For one thing, the payment of interest by the U.S. Government is in the nature of a U.S. expenditure in the U.S. balance of payments. For another, the principal of the loan itself must be incurred as a capital outflow upon maturity of the loan, if not sooner. Thus, while the pre-1967 offset agreements supposedly provided for a permanent offset, the 1967 agreement is in its entirety a temporary offset.

Accordingly, the latest "offset" agreement turns out to be a substantial retrogression of principle from the U.S. standpoint not only because $500 million is less than $675 million. The U.S. Government has acceded to the position of debtor to the German Bundesbank, thereby not solving, but only deferring the solution of, the problem posed for the United States by its defense expenditures in Germany. Yet, as already indicated above, the U.S. Government would be ill advised to revert in the future to the "offsetting by purchasing" formula in place of the "offsetting by lending" formula. Let us see why.

C. *Four kinds of "offsetting."*—Under the "offsetting by purchasing" formula, a complete and permanent offset to U.S. defense expenditures in Germany would imply an equivalent amount of German Government expenditures on U.S. goods and services over and above German imports from the United States that would occur anyway. It turns out that there is inherent in this very notion of full (i.e., complete and permanent) offsetting a misallocation of resources, namely, the waste of purchasing power that the offsetting government incurs in buying goods and services *over and above the imports that it would have bought even in the absence of the "offset" agreement.* Goods and services that country A buys in country B in excess of what country A would have bought in country B anyway are uneconomical purchases: such goods were outright unwanted or available more cheaply elsewhere. Thus, the very notion of "offsetting by buying" is an uneconomic notion. And to insist on full "offsetting by buying" instead of partial "offsetting by buying" is to insist on a full absurdity in place of a partial absurdity.

On the other hand, "offsetting by lending" is a misnomer and a misleading formula for two reasons. The first reason has already been mentioned above, namely, that the "offset," being a loan, is temporary. Secondly, even within its temporary duration the offset is also a misallocation of resources. For, under the "offsetting by lending" formula, a complete offset to U.S. military expenditures in Germany would imply an equivalent amount of German Government lending to the United States Government over and above any German Government lending to the United States that would have occurred in the absence of the "offset" agreement. Loans that country A makes to country B in excess of what country A would have lent to country B anyway are uneconomical capital exports: such capital would have been used to greater advantage by investment in country A itself or by being lent at more favorable terms to third countries.

So "offsetting by lending" also implies a misallocation of the offsetter's resources but is more palatable than "offsetting by buying," because the misallocation is temporary in the former instance while it is permanent in the latter. Furthermore, in the case of an "offsetting-by-lending" government with a substantial previously accumulated holding of the liquid liabilities, it is easy to evade the spirit of the "offsetting by lending" agreement while strictly complying with its letter. What the central bank of the offsetting government can do is to substitute the newly issued, special securities of the borrowing country for older, previously held securities of the borrowing country. Thus, the new, special securities of the borrowing country simply take the place of regular securities that would have been held in the absence of the "offsetting by lending" agreement in the offsetting government's central bank portfolio.

In light of the foregoing analysis, the rationale of the German Government's policy with respect to its offset agreements is demonstrably sensible and shrewd. It was easy for the Germans to agree three times to "offsetting by buying" because, for 5 of the 6 years involved, the build up of the German military establishment was occurring while the domestic German economy was booming, and for the entire 6-year period, the comparative-cost conditions favored the United States as supplier of militiary equipment. Little, if any, misallocation of resources was implied in the German procurement in the United States in that such procurement would on economic grounds have occurred in the United States even in the absence of offset agreements. Yet such buying does not fit the "offsetting by buying" formula because this buying was not over and above the buying that would have occurred anyway. At the same time, the outward semblance of "offsetting by buying" was conveyed by the fact that, in contrast to the pre-1960 period, there was a sharp rise in German military purchases from the United States; but, of course, this contrast itself derives from the absence of a large-scale German defense buildup prior to 1960.

No sooner was it clear that the defense buildup would taper off and that the domestic German economy was softening, than the German Government began reflecting the German polity's reluctance to continue "offsetting by buying." In other words, no sooner would the "offsetting by buying" have become genuine—involving purchases from the United States that would not have occurred in the absence of an offset agreement—than the Germans insisted on the switch to "offsetting by lending."

German shrewdness in switching to "offsetting by lending" is further indicated by a closer look at what the new type of offset agreement implies. Since the German Government pledged itself not to convert dollars into gold, the Bundesbank's purchase of the special 4½ year notes merely takes the place of its holdings of U.S. currency or of other U.S. Government securities or both. Thus, the German "offsetting by lending" turns out to be merely the substitution of one form of dollar-claim holding for another form of dollar-claim holding in the Bundesbank's foreign-asset structure.

Specifically, as shown in table 1, the Bundesbank's freely usable external assets, in addition to gold, consist of U.S. dollars, DM bonds of the U.S. Treasury known as Roosa bonds, and other assets. Introduced in 1963, the Roosa bonds are intermediate-term, interest-bearing, nonmarketable but convertible U.S. Government securities denominated in Germany currency. Since 1965, the Bundesbank's holding of

Roosa bonds has been diminishing. In contrast, as shown in table 2, the U.S. Government's 4½ year "offset" bonds introduced by the 1967 offset agreements have been rising as a component of the Bundesbank's foreign assets of limited usability. Without implying a strict 1 for 1 relationship, we are suggesting that the "offsetting by lending" thus far has essentially meant that the Bundesbank has replaced maturing Roosa bonds with newly issued "offset" bonds.

TABLE 1.—GOLD HOLDINGS AND FREELY USABLE EXTERNAL ASSETS OF THE DEUTSCHE BUNDESBANK, 1961-66

[In millions of deutsche marks]

Yearend	Gold	U.S. dollars	DM bonds of the U.S. Treasury ("Roosa" bonds)	Other assets	Total
1961	14,654	10,886		625	26,165
1962	14,716	10,785		285	25,786
1963	15,374	11,668	1,100	267	28,409
1964	16,992	7,712	2,700	475	27,879
1965	17,639	5,167	2,400	204	25,410
1966	17,167	8,307	1,400	211	27,085

Source: Report of the Deutsche Bundesbank for the Year 1966, p. 96.

TABLE 2.—THE DEUTSCHE BUNDESBANK'S EXTERNAL ASSETS OF LIMITED USABILITY, 1966-67

[In millions of deutsche marks]

End of month	Medium-term bonds of the U.S. Treasury [1]	IBRD debt certificates	Bilateral claims from former credits to EPU	Total
1966: December		1,454	420	1,874
1967:				
March		1,454	420	1,874
April		1,454	420	1,874
May		1,454	420	1,874
June		1,454	420	1,874
July	500	1,454	420	2,374
August	500	1,454	331	2,285
September	500	1,454	331	2,285
October [2]	1,000	1,454	331	2,285

[1] "These bonds were taken over by the Bundesbank under the United States-German agreement, concluded at the beginning of May 1967, on foreign exchange assistance in favor of the United States."
[2] Provisional.

Source: "Report of the Deutsche Bundesbank, October 1967," vol. 19, No. 10, p. 115.

Such replacement of Roosa bonds with "offset" bonds is admittedly helpful to the U.S. Treasury in that the German acquisition of Roosa bonds would not diminish the liquidity deficit in the U.S. balance of payments while the German acquisition of "offset" bonds does reduce the deficit. This is so because Roosa bonds, being convertible, are considered a liquid U.S. liability; while "offset" bonds being nonconvertible, are considered a nonliquid U.S. liability. There is thus involved a stretchout in the dollar-asset structure of the Bundesbank even when the "offset" bonds merely replace Roosa bonds. Given, however, the German policy of avoiding the exchange of dollars for gold, the replacement of convertible with nonconvertible notes is largely a matter of switching labels without changing the content. Alternatively stated, the 1967 agreement is significant for its reaffirmation of the German pledge not to exchange dollars for gold; it is not significant as an "offset" agreement because there is no genuine offset of U.S. military expenditures involved in it. There is merely the substitution of an intermediate-term nonconvertible debt instrument for an intermediate-term convertible debt instrument of the United States in the foreign asset structure of the Bundesbank.

Thus, "offsetting by lending", like "offsetting by buying", is a misallocation of resources when it is genuine, and is window dressing when not genuine. The Germans accepted "offsetting by buying" so long as it did not seriously risk misallocation of resources; they switched to "offsetting by lending" as soon as such a risk emerged. Present "offsetting by lending" does not seriously run such a risk because the offset-lending has thus far merely replaced a differently labeled lending. Hence, both kinds of offset agreements have up to this point been German window dressing.

Having discussed both "offsetting by buying" and "offsetting by lending," are we left with any meaningful type of German offset for U.S. military expenditures in Germany to consider? We certainly are. The alternative is outright German remittances to the U.S. Government in the amount equivalent to the U.S. military expenditures in Germany. This would be "offsetting by remitting."

The full amount of "offsetting by remitting" would itself be but a fraction of the U.S. budgetary burden of U.S. defense expenditures that are generated by the American presence in Germany. Thus, against the certain vocal German opposition to "offsetting by remitting", the bargaining position of the United States should be not the threat of U.S. troop withdrawal but the proposition that even "offsetting by remitting" is only partial compensation. In other words, there exists still another, a fourth formula for offsetting; namely, "offsetting by compensating," that is, "offsetting by budgetary cost sharing."

D. *Compensation.*—Purely for illustrative purposes, it can be shown that "offsetting by compensating" gets us into the order of magnitude that would offset the entire U.S. balance-of-payments deficit. To err on the side of underestimation of the budgetary burden of the U.S. defense presence in Germany, let us use size of manpower as our indicator. With American troops in West Germany at 225,000, they amount to 8 percent of the pre-Vietnam war Armed Forces of the United States. With non-Vietnam U.S. defense expenditures for fiscal year 1968 being estimated by the U.S. Bureau of the Budget at $50 billion,[8] the Germany-attributable component of the budget is 8 percent of $50 billion, i.e., $4 billion. Now Germany is not alone the beneficiary of these $4 billion of U.S. expenditures, but the entire Western Alliance including the United States; while the United States is not alone the beneficiary of total U.S. defense expenditures but the entire Western Alliance including Germany. Therefore, suppose that of the $4 billion U.S. budgetary burden of the U.S. defense presence in Germany only one-half, that is, $2 billion, is imputable to the Government of the Federal Republic of Germany. "Offsetting by compensating" would thus have meant surpluses in the U.S. balance of payments of 1965 and 1966 and a near two-thirds reduction in the U.S. balance of payments of 1967.

[8] The Budget of the U.S. Government for the Fiscal Year Ending June 30, 1968 (U.S. Government Printing Office, 1967), p. 77.

Under conditions of peacetime prosperity, a 50–50 formula for sharing the budgetary burden of the U.S. Defense presence in Western Europe among the members of the Western Alliance is a formula worthy of consideration, being as equitable as any with which to open the dialog. The Government of the Federal Republic of Germany and the Deutsche Bundesbank in particular have shown explicit concern over the percarious position of the U.S. balance of payments in urging that the United States put its fiscal house in order. At present the U.S. taxpayer alone shoulders the budgetary burden of a major U.S. military establishment in Germany. The U.S. taxpayer's burden has, since 1961, been further increased by the wastage of resources that is involved in the U.S. Defense Department's program of shifting defense procurement from cheaper foreign sources to costlier sources in the United States in order to serve foreign exchange.

Domestically, the U.S. taxpayer is being confronted with ever-rising burdens of national, State, and local government expenditures in connection with the wars on poverty, on urban decay, and on crime. The West European nations of NATO, and the Federal Republic of Germany first and foremost among these nations, must no longer be treated, in effect, as financial wards of the United States, whose own balance-of-payments positions can no longer withstand this fiscal drain without undermining the role of the dollar as a reserve currency.

On New Year's Day, 1968, the U.S. Secretary of State stated:

> Well, you may recall that when we first stationed troops in Europe we did not have at that time arrangements for neutralizing the foreign exchange burden of such troop deployments. But, that was back in 1951–52, at a time when there was a dollar gap, when we, ourselves, were a surplus country, when we were supporting the effort of the countries of Western Europe to rebuild their economies following the war. So, we did not work out at that time specific and formal arrangements for neutralizing the balance-of-payments results of defense measures taken within NATO, but in the recent years we, ourselves, have become a deficit country and we do believe that there should not be a balance-of-payments windfall arising out of troop deployments, the effect of which would be to increase the surpluses of those who are in a balance-of-payments surplus position. So this has given rise to our need for offset arrangements and other acts of cooperation in the handling of reserves and of international financial transactions.[9]

The time has come for a new call to our Western allies. Not only have the Foreign Exchange Offset Agreements been very largely window dressing, but burden sharing in NATO can no longer be confined to foreign exchange costs alone. The full budgetary costs of the U.S. military presence in Europe must be laid bare before the taxpayers of the United States and the nations of the Western alliance. In particular, the Federal Republic of Germany is the single greatest beneficiary of the U.S. military presence in Europe and has become the second greatest economic power of the Western world. It must now be invited by the U.S. Government not only to "offset arrangements and other acts of cooperation in the handling of reserves and

[9] Press briefing, U.S. Department of Treasury, Monday, Jan. 1, 1968, pp. 4–5.

of international financial transactions"[10] but also to offset arrangements and other acts of cooperation in the handling of the U.S. budgetary costs of the U.S. military presence in Germany.

III. Conclusions

There are four kinds of foreign exchange offsetting:

(1) offsetting by buying;
(2) offsetting by lending;
(3) offsetting by remitting; and
(4) offsetting by compensating.

Thus far there have been four United States-German Foreign Exchange Offset Agreements. Three of those involved "offsetting by buying" and the fourth, "offsetting by lending". The first three agreements were entirely window dressing. The fourth agreement is very largely window dressing.

It would be a blunder in the future to attempt meaningful offsetting by buying or offsetting by lending because both would imply a misallocation of resources. The United States should not sponsor international agreements with "teeth" in them, where the "teeth" imply wastage of resources.

Offsetting in the future should preferably be by compensating; at the very least it should be by remitting. The time is long gone that the U.S. could afford the window-dressing type of offset agreement. The U.S. Government should forthwith terminate this absurdity and invite the Government of the Federal Republic of Germany to share the fiscal burden of the U.S. military presence in Germany. An agreement to this effect would go a long way to eliminating the deficit in the U.S. balance of payments by helping to put the U.S. fiscal house in order, as the Government of the Federal Republic of Germany has been urging.

[10] Ibid., p. 5.

O