475

A FOREIGN ECONOMIC POLICY FOR THE 1970'S

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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A FOREIGN ECONOMIC POLICY FOR THE 1970'S

TUESDAY, SEPTEMBER 29, 1970

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Foreign Economic Policy met, pursuant to recess, at 10:07 a.m., in room S-407, the Capitol Building, Hon. Hale Boggs (chairman of the subcommittee) presiding.

Present: Representative Boggs and Senator Javits.

Also present: John R. Stark, executive director; John R. Karlik, economist; Myer Rashish, consultant; and George D. Krumbhaar and Leslie J. Barr, economists for the minority.

Chairman BOGGS. The subcommittee will come to order. I presume Mr. Strackbein is on his way.

Today we begin a series of hearings on a number of sensitive and important issues. We are examining the ways in which the U.S. economy responds to the growth of imports and how, on the other hand, we can stimulate our competitive ability to export. Tomorrow, we will look more carefully at how the industrial nations of the world share the burden of avoiding persistent balance-of-payment surpluses and deficits. On the third and final day of this series the longrun role of the dollar will be considered in the light of possible developments further altering the structure of the international monetary system.

Four well-qualified witnesses appear before us today. First is Prof. Robert E. Baldwin of the University of Wisconsin. Professor Baldwin has recently published a book on the effects of nontariff barriers to trade.

Next is Mr. Saburo Okita, president of the Japan Economic Research Center, and member of the Pearson Commission that studied aid to developing countries.

Third, is Mr. Paul R. Porter, president of Doxiadis Urban Systems, Inc., who is well known in the industrial world and is a former consultant to the Commerce Department on the U.S. trade position in the world.

Last, we expect Mr. O. R. Strackbein, president of the Nation-Wide Committee on Import-Export Policy.

We will proceed, gentlemen. I am sure Mr. Strackbein will be along.

Mr. Baldwin, we will start with you.

STATEMENT OF ROBERT E. BALDWIN, PROFESSOR OF ECONOMICS, UNIVERSITY OF WISCONSIN

Mr. Baldwin. Thank you, gentlemen.

Two general propositions should, in my view, serve as the boundaries for policymaking directed at adjusting the industrial structure of the U.S. economy to changed conditions of international competition. First, both workers and employers have the right to expect that they will not suffer serious economic injury from changes that significantly disrupt existing market conditions. We possess both sufficient humanity and wealth for this to be an economic right guaranteed by the Government. Secondly, citizens also have the right to expect that they will not be indefinitely taxed either implicitly or explicitly for the purpose of supporting any group that is highly inefficient in relation to comparable workers and employers in the rest of the economy. Affluent though we are, there are simply too many important immediate and long-range social and economic goals to be attained to be able to afford the luxury of needless inefficiency.

Most individuals concerned with trade policy seem to agree with both of these general guidelines. The difficult problem, of course, is to find the set of policies that meets the adjustment rights of employees and employers in those industries subject to disruptive competitive pressures at the least cost to the other members of the economy. As your previous hearings have brought out quite clearly, the growing competitive ability of other industrial countries has made this problem an increasingly serious one for the United States. Between 1964 and 1968 the volume of U.S. exports of manufactured goods rose only 27 percent in contrast to 50 percent for West Germany, 38 percent for France, 92 percent for Canada, 100 percent for Japan, and 47 percent for the world as a whole. Moreover, an important part of the export increase by these other countries was directed at the U.S. market.

As others also have previously pointed out here, the rise in U.S. export prices for manufacturers of 10 percent between 1967 and 1969 as compared to only a 3-percent rise in the prices of manufacturing exports for all countries as a whole explains in part our greater import competition and our decreased ability to compete abroad. However, this is not the fundamental reason for our competitive problem. The export position of the United States has been declining since the midfifties. For example, in 1952 the U.S. share of the exports of manufacturers by the major industrial countries was 35 percent whereas it was only 22 percent in 1968.

This decline has basically been due to the vigorous "catching-up" phase of growth that most other industrial countries have been going through in the last two decades. Such factors as the remarkable advances in communications and transportation technology, significant increases in the supplies of skilled and technically trained labor, and the existence of relatively large numbers of underemployed workers in agriculture have enabled these countries to introduce modern productive methods into their industrial sectors—often under the direction of international firms controlled from the United States—at an extremely rapid rate. We must expect the adjustment pressures in the U.S. economy that stem from this rapid industrial growth abroad

to continue and probably even increase in intensity during the 1970's, as more and more developing nations move into this rapid "catch-up" phase of development.

Rather than start out by outlining what seems to most economists to be the best ways of handling the adjustment problem, let me first discuss one method that is, I think, a very inferior way of meeting the problem; namely, by using import quotas. In the new trade bill reported out of the Ways and Means Committee, quotas are not only to be introduced on textiles made of wool or manmade fibers and on footwear, but they also can be used to limit trade when imports contribute substantially toward causing or threatening to cause serious injury to an industry.

The United States already quantitatively limits imports of cotton textiles, petroleum and petroleum products, certain dairy products, wheat, cotton, peanuts, and sugar. Quotas also can be imposed on certain meat products. Moreover, a voluntary agreement with Japanese and European steel producers limits steel imports into the United States.

Import quotas are the antithesis of what economic freedom is all about. They limit the quantity of a particular item that citizens can collectively consume and thereby lower their living standards by forcing them either to purchase the item from domestic producers or shift their spending to different products. Tariffs also tend to shift spending away from imports, but consumers as a group can at least import more if they wish to pay the higher price for imported goods.

Quotas, in contrast to tariffs, also lead to windfall profits that generally go to groups other than those that the Government wishes to help. This occurs because those who are fortunate enough to obtain permission to import can buy the protected product at its lower international price and resell it at its higher domestic price. A classic example of such windfall gains occurs in the oil industry. The rights or, as they are called in the oil industry, "tickets" to import a barrel of oil have sold for $1.25 each in recent years. This sum is the difference in costs between domestic and foreign oil. The resulting windfall gain is over one-half billion dollars annually.

If a tariff were used to restrict oil imports to exactly the same level as the quota does this one-half billion dollars would go to the Government as tax revenue. In view of all the other desirable programs that are competing for our scarce tax dollars, why should the Government not—at least as a minimum—substitute an import duty on oil for the quotas now used?

Another product line where the windfall gain is readily apparent is sugar. Here too the windfall is about one-half billion dollars, but at least in this case it goes to the less developed countries that export sugar to the United States rather than to U.S. importers.

Quotas and in some cases tariffs also decrease U.S. exports by having the effect of a tax on exports. The reason is that exporters use those products on which quotas or duties apply as intermediate production inputs into their export goods. Since they must pay the artificially inflated domestic price for a protected product whether they import it or purchase a comparable domestically produced item, the exporters are penalized in competing in foreign markets. Tariffs have an advan-

tage over quotas in that U.S. law permits the payment of drawback on imported items that are reexported. Drawback payments can also be made on exported manufactures made from "domestic merchandise which is of the same kind and quality as merchandise on which duty has been paid." Unfortunately, this provision of the law has been interpreted very narrowly and even exporters using products covered only by import duties cannot in fact obtain drawbacks in many cases.

In the case of quotas, however, the implicit export tax always applies since there is no payment of drawback to compensate for the price-raising effect of quotas on inputs used by exporters. Again, the petroleum case illustrates this point very well. In 1967 the United States exported 224 million barrels of petroleum products that were worth $1.7 billion. There is a small duty of about 10 cents per barrel on petroleum whereas the price differential between foreign and domestic oil that is attributable to the quota is $1.25 per barrel. Consequently, all that exporters of petroleum products were able to recover as a drawback was 10 cents per barrel rather than the $1.25 per barrel that represented their extra input cost compared to foreign competitors. The failure to obtain the entire $1.25 per barrel back meant that the costs of the petroleum products exported were 18 percent higher than if a tariff had been used to restrict them the very same amount as the quota system did. Thus, a research-oriented, high-skill industry in which the United States potentially has a strong comparative advantage position is severely penalized by the quota system. The implicit tax is not different in its effect than the kind of explicit export tax prohibited by the Constitution.

The voluntary quotas on steel imports pose an even more serious problem since steel is so widely used as a production input. A colleague of mine, Gerald Lage, has estimated that for every dollar's worth of steel kept out of the United States by import restrictions, there is a one-half dollar increase of imports or decrease of exports of products in which steel is an important component because of the higher costs of steel inputs. Thus, there is a direct and immediate adverse employment and output impact in domestic industries that rely heavily on steel as a production input.

Both quotas and tariffs have the tendency to benefit most those producers in an industry who least need assistance. In industries consisting of many firms there is invariably a wide variation in efficiency among firms. There are, for example, many firms in the textile and footwear fields that are making respectable profits. However, the price-raising effect of quotas or tariff help these firms as well as those who are suffering losses. The higher profits of the efficient firms encourage them to expand production. This, in turn, puts more competitive pressures on the marginal firms who then find that the quota or tariff has simply resulted in more competitive pressures from domestic firms in place of competitive pressures from foreign firms. The price-support program in U.S. agriculture resulted in rather similar problems. However, Congress has now wisely limited the size of payments to the large efficient firms.

A number of industries that are either currently pressing for quotas or special tariffs or already have them are ones that produce items heavily consumed by the poor. For example, the effect of existing cotton textile quotas is the equivalent of a 25 percent duty on all apparel

products. Imposing quotas on wool and manmade textiles will substantially increase this already high figure. Similarly present duties or quotas on food products are equivalent to a 10-percent import tax. More generally, the tariff equivalent of all tariffs plus the major nontariff trade barriers is about 12 percent for all consumption goods. Eliminating these protective measures will not reduce prices by the full amount of the tax, but a figure of 6 percent or one-half of the duty-equivalent level seems reasonable on the basis of previous studies. Why should the lower income groups pay a proportionately higher cost to subsidize inefficient industries in this country?

It should be noted, incidentally, that the relevant price effect of duties or quotas is found by comparing domestic and foreign prices of comparable items. How prices of quota protected items vary over time in comparison with nonprotected items, especially after the quotas have been in effect for some time, is not a very meaningful comparison. Consumers' living standards are lower than they otherwise would be because they cannot purchase protected items at the lowest available prices. One has only to price protected products abroad to verify that quotas and tariffs raise prices.

A final objection to quantitative restrictions is that they do not get the job done in terms of moving resources gradually out of depressed sectors. Instead they tend to build inefficiency into the system. Quotas that fix imports in absolute or market share terms tend to benefit efficient producers unnecessarily and put a new form of competitive pressure on the inefficient firms. In order to avoid the undue hardships that led to the quotas initially still higher quotas are necessary. A vicious circle of the need for greater and greater protection is set up. Moreover, quotas become administered by people within the Government who almost inevitably and quite understandably adopt a proindustry bias.

In the petroleum industry, we use quotas as a means of keeping oil prices high enough to insure sufficient domestic exploration to maintain adequate oil supplies for defense purposes. We are borrowing resources that rightly belong to future generations to be ready for a possible emergency today. Not only will higher and higher oil prices be needed to subsidize increasingly difficult exploration efforts, but we may well have run out of the oil we need for an emergency when and if it does come. We have managed to design a scheme that fits perfectly the description by Lewis Carroll of Alice's predicament of having to run faster and faster just to stay in one place.

The arrangement by which the rights to import are allocated under a quota system also encourage inefficiency. Usually they are allocated in proportion to imports in some previous period. Thus, new efficient firms are penalized in using the cheaper imports as inputs into their production activities. In addition, the guarantee to domestic producers of a certain size domestic market removes a good part of the beneficial effects of competition in stimulating technological progress as well as labor and managerial efficiency.

Most of us teaching in colleges and universities today are engaged in an intense and important intellectual struggle to convince the highly socially conscious, vast majority of the students that the American political system can operate effectively in bringing about needed changes. However, when Congress seriously considers adopting trade

legislation that continues or strengthens measures that restrict economic freedom, provide windfall profits to those who don't deserve them, hurt the poor in this country—to say nothing about depriving the poor of the developing countries of needed opportunities—deplete natural resources required by future generations, and foster inefficiency generally, the task of convincing students of the basic soundness of the American political system is made much more difficult. The economic cost of such legislation for this country or even its effects on our international political and economic relations is trivial compared to the loss of faith in the U.S. political system that this kind of measure can cause in the minds of students.

Though those of us who have been involved in trade matters for many years know that in most cases what is good for the country as a whole eventually emerges in this policy field, the youth of the country are not prepared to wait until "the long run" for their goals of greater social and economic justice to start to become true.

If quotas and even—though to a lesser extent—tariffs are not the proper instruments for domestic adjustment to international competition, what policies are? One prerequisite for any successful domestic adjustment is a vigorous full employment policy without inflation. We simply must be prepared to take the steps needed to get unemployment rates lower, even in so-called periods of full employment. This will make it much easier for redundant workers in particular industries to find new jobs.

A second important policy that will greatly ease the adjustment problem is greater exchange rate flexibility. To an increasing extent in the 1970's, intense import competition in low-skill, labor-intensive industries will put deficit pressures on the U.S. balance of payments. Given the rigidities and immobilities that exist within any modern industrial economy, this competition will create severe adjustment difficulties in the directly affected industries, if the exchange-rate mechanism is not used to facilitate the adjustment process. However, if the dollar gradually becomes cheaper to others and other currencies more expensive to us either by our devaluation or other countries' appreciation, the industries most affected by import competition will be helped immediately because foreign products become more expensive. Moreover, the encouragement to exports and other import-competing industries will open up new jobs into which redundant workers can move. As economists have often pointed out, a currency depreciation is equivalent to imposing a uniform tax on imports and subsidy on exports. It is surprising that those who have been complaining most about foreign competition are not strongly advocating greater exchange-rate flexibility in the international economy.

A third helpful approach to the adjustment problem of the 1970's would be for the United States to take the initiative in attempting to lower the many nontariff trade-distorting measures that exist and in preventing the introduction of new ones. The increase of these measures in recent years has, I think, contributed to some of the adjustment problems of certain American industries. We should be careful, however, to distinguish the difficulties of adjusting to changed international competition from the long-run benefits of trade. Unfortunately, leaders of the American labor movement now seem to be supporting policies that may benefit special labor groups in the short-run but

surely will greatly harm their members collectively, especially after several years.

As far as specific measures directed at firms suffering from intense foreign competition are concerned, there is not a great deal new that can be said. The problem is mainly that our programs are much too modest rather than that we need completely new policies. For example, the very successful program in Sweden that helps workers adjust to all sorts of changes in domestic or international competitive conditions costs an amount equal to 5 percent of Sweden's GNP. We should, in my view, begin moving toward a major program that ties together the problems of training and finding new jobs for minority groups who are discriminated against socially and economically, for the people who live in depressed regions, for workers and firms in declining industries, and for the many individuals who need additional training and education to avoid the obsolescence of their human capital. We cannot maintain full employment without inflation and—at the same time—rapid growth without such a program.

One important aspect of a program of this sort is that more careful planning than now exists will be required. For example, a depressed industry must draw up with the Government's help a plan for the gradual transfer of redundant workers and capital out of the industry. Certain firms must be closed down and others combined. Plans for keeping on the older workers until retirement and for hiring only a minimum of new young workers must be made and followed. Such provisions as grants to facilitate geographic mobility that cover travel and the costs of establishing a new household should also be part of the program. Although features of this sort are costly, the long-run costs to the U.S. economy of such adjustment assistance measures are less than trying to meet the problem by the head-in-the-sand approach typified by quantitative restrictions on trade and capital movements. Moreover, an outward looking adjustment assistance program implements the increasingly accepted view that we should be more concerned collectively both about the less fortunate among the present generation and all who are to follow in future generations.

Chairman BOGGS. Thank you very much, Mr. Baldwin. We will now hear from Mr. Okita.

STATEMENT OF SABURO OKITA, PRESIDENT, JAPAN ECONOMIC RESEARCH CENTER

Mr. OKITA. Mr. Chairman, in recent months we often hear about the increasing strain in the United States-Japan relations, particularly since the discord on the textile negotiation last spring between the two countries. Basically the United States-Japan relation is, and will be, a complimentary one—economically strong and politically stable Japan will be an important asset for the United States, and the friendly United States is a vital factor for Japan's future survival. Although I am now an independent economist outside of the Government I have been deeply concerned with the recent development in United States-Japan relations. From what I saw both in Tokyo and in Washington I felt that Japan was facing a serious choice, in connection with the recent textile negotiation, of either pushing forward the general policy of liberalization both of trade and investment or moving a step backward and compromising with the request from the U.S. Government.

Although Japan has been often criticized for its slowness in liberalizing its trade and investment, there has been much accomplished if we look back at what has been done in the course of the last 5 years or so. For many years both the Government and people were deeply convinced that export promotion was a top priority endeavor for the Nation in order to attain a viable economy and to improve the living standard of the people. With a scarcity of indigenous natural resources and a limited land area suitable for cultivation, the only possible way for Japan to improve her economic condition was to expand the export trade and with its proceeds to purchase what was needed to support a rising living standard of the people. Thus, "Export or Perish" was the slogan for the people and the Government for many decades. Another side of the coin of the same policy was to economize imports by increasing domestic production, both of industry and agriculture.

With this historical background the policy of liberalization meant a fundamental departure from the traditional economic policy in Japan. Being prodded by OECD and by the United States and other governments, Japan started the liberalization somewhat grudgingly. Like many other countries with parliamentally democracy, internal political obstacles were not easy to overcome, especially when the still numerous agriculturists and small-scale enterprises were to be affected by such policy. Step by step, however, the liberalization of trade and investment has been put into effect and in September 1970 the number of items under residual import restrictions was reduced to 90 as compared with 121 in December 1968. This will further be reduced to less than 40 by September 1971, which is about the same level of present West Germany.

Gradually people were convinced that liberalization was not something to be forced into by outsiders, but it was a policy to be pursued for the sake of Japan's own economic benefit. Remarkable improvement in the balance of payments, and the growing shortage of labor in recent years were the factors mitigating the strong antiliberalization pressure in domestic politics.

The above was the general background in Japan when the textile negotiations were conducted with the United States. The choice of the Japanese Government was to press forward with the policy of liberalization as it felt it necessary to ride on the momentum and further reduce domestic resistance against liberalization. It may be said that textiles are a speical case and they could have been separated from the general issue of trade liberalization. The textile industry in Japan, however, has been, unlike many other industries, one of the few which has developed mainly on private initiative without much dependence on government support.

Their center is located in Osaka, not in Tokyo where the Central Government is located, and the leaders of the industry are strongly colored with free trade ideas and proud of their independence from Government intervention. It was found rather difficult to impose "voluntary restriction" when the industry was unwilling to respond.

Another important aspect of the textile industry is the fact that textile goods imports into Japan are likely to grow very rapidly in coming years. Total imports of textile goods, from other Asian countries increased from $8 million in 1966 to $68 million in 1969. Textile imports, especially from the newly developing countries, may become

one of the major import items for Japan and in that respect Japan may face problems very similar to the present U.S. problems several years from now. Last year Japan was already the largest importer of raw silk in the world, although it was only 4 years ago that she became a net importer of raw silk. Three years ago Japan became a net importer of cotton yarn. One by one, traditional export items are turning into import items.

This is a natural outcome of the dynamic process of the international division of labor. The growing labor shortage and the rapidly rising wage level in Japan are among the fundamental reasons for the remarkable export growth of manufactured goods in recent years from Hongkong, China (Taiwan), and South Korea. Export items from these countries are similar to those of Japan some 15 years ago. Production of labor intensive products, including many items of textile goods, are now rapidly moving to other Asian countries where labor is still abundant and the wage levels are relatively low. In the United States market, for example, Japan's share of those items are declining while the share of the newly industrializing countries is increasing. The same products will start flowing into Japanese domestic markets.

If we introduce voluntary restrictions on textile exports to the U.S. market, then our industry will say, when they face the growing pressure from the newly industrializing low-income countries to import more textile products, that because the United States is imposing voluntary restrictions on our textile exports, why should we not follow the same practice and restrict the imports of textile products into Japan? This will mean that there may be a chain reaction of antiliberalization all over the world. Those who suffer most will be the poorer countries of the world which are striving to expand their exports of manufactured goods. Expanding export trade from newly developing countries, particularly those of manufactured goods, will be the most realistic solution for narrowing the economic gap between the rich and the poor nations. This is one of the reasons why the highly industrialized, high income countries should keep open their domestic market for the importation of manufactured products of newly developing countries. Although at the moment Japan has an export surplus with many of the developing countries, it is rather likely that the rapidly expanding inflow of manufactured goods from the developing countries will narrow the trade gap and this will greatly stimulate the expansion of export trade and the acceleration of economic growth of the newly developing countries of the world. Such a possibility is closely related to the import policy of the advanced countries including Japan and the United States.

Rapid economic growth of Japan is providing an expanding market for many of the developing countries. In the course of the last 5 years, from 1963 through 1968, total exports from developing South and East Asian countries increased by 19 percent while their exports to Japan increased 84 percent during the same period. Rapidly growing export trade and accompanying economic growth is a very important factor for the political stability in this region.

The present very high rate of economic growth in Japan depends partly on the transitional nature of its economic and social structure—from under-development to a highly industrialized stage. Most of the

present leaders in Japan, in business, in government, and in politics, were born to a poor society and their moral is "to work hard." In the course of time the younger generation, born to a more affluent society, will occupy more responsible positions and it is rather likely that the Japanese society will increasingly share the same problems found in affluent societies of the West. The growing labor shortage, an increasing concern about environmental problems, the rising demand for shorter work hours and more leisure will eventually bring down the rate of economic growth and export expansion to a more normal level. But at least for several years to come, Japan is likely to maintain a rather righ rate of economic growth. In spite of the rapidly expanding Gross National Product, there still is a "GNP-mentality gap" among average Japanese. Many of them feel that they are still poor especially in terms of housing and urban environmental conditions. In fact, in terms of per capita GNP, Japan is still 18th in the world (1968) although the total output is next only to the United States and the U.S.S.R. Economically, Japan is still one of the poorest members of the rich men's club.

Another important aspect of United States-Japan relations is the difference in the philosophy of economic policy, especially the role of the government in economic matters. An article appearing in a recent issue of Fortune magazine,[1] for example, describes Japan's export promotion measures as something very different and indeed almost heretical as compared to the practices of the West, especially with regards to the relation between business and government. Mr. George W. Ball stated in one of his recent articles: [2]

> American businessmen remain as an individual citizen who considers that the Government should keep its place and that a minimum of interference in business life is what the situation calls for * * *. That the Japanese business executive approaches his tasks and his enterprise with a totally different attitude has not been sufficiently understood in my country. Thus only a few Americans comprehend the extent to which even the most important Japanese companies are regarded as instruments of national purpose or recognize that many of Japan's greatest corporations and corporate groups were created by, or at least with the encouragement and assistance of, the Government, in order to facilitate the development of Japan as a modern economic power.

In my view the basic character of Japan's economic policy has been that of a "late comer" or a "catching-up" country. Highly developed western countries have relied on the workings of the market mechanism to open up new economic frontiers. The economic policies of late comer governments, because they are catching up, are very different. Thus, the late comer governments can plan the course of the development in advance and can use the selective approach in promoting industrialization or in expanding export trade. In discussing the economic policy of today's newly developing nations, I often feel that our own experiences as a "late comer" may have relevance to their problems of accelerating their economic growth and of expanding their export trade. Our current dilemma is that because of the very success we have had in modernizing the economy, accelerating growth and expanding our foreign trade we must now abandon these policies. Abandoning or drastically modifying policies that we have fol-

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[1] Fortune, September 1970. Time-Life, Inc., New York.
[2] Ball, George W., "Japan Urged To Reassess Its Attitudes," Pacific Community, October 1970.

lowed for several decades is not an easy task. Some of us feel that foreigners have sometimes been too impatient in expecting such changes. Until only 2 years ago we had a recurring balance of payments crisis and many people still wonder if the recent remarkable change is not merely a temporary phenomenon.

Incidentally, I was invited to speak to a convention held in Osaka of foreign traders and industrialists several months ago on the topic of Japan's foreign economic relations. Before my speech there was a ceremony in which awards were presented to those traders and manufacturers who had achieved particularly good results over the preceding year in increasing exports. In my speech I called for the promotion of imports rather than exports. This caused some unhappiness amongst the audience and they later criticized the government for lack of consistency in its foreign trade policy and in its complacency over the future of exports.

In spite of the various domestic problems, the government, and in particular the Prime Minister, is firmly determined to promote the liberalization of trade and investment. Accelerated steps are now being taken as exemplified in the recent announcements reducing the number of items under residual import restrictions and in liberalizing capital flows both into and out of the country.

In a few years we may find that a liberalized Japan is asking other countries to liberalize or at least not to introduce additional restrictive measures.

Let me now comment on some of the issues of United States-Japan trade relations, in particular, their implications for the U.S. domestic economy. As indicated in the table below, United States-Japan trade has expanded about 5 times during the last 10 years. For Japan, trade with the United States accounted roughly 30 percent of the total throughout the decade. For the United States 7.8 percent in 1960 and 13.6 percent in 1969. Looking at it from a different angle, Japan's exports to the United States accounted for about 3 percent of Japan's GNP and U.S. exports to Japan accounted for about 0.4 percent of GNP of the United States in recent years. It may be said that economically Japan is 8 times more sensitive than the United States in terms of trade between the two countries.

UNITED STATES-JAPAN TRADE, 1959-70

[Dollar amounts in millions]

	Exports to United States	Imports from United States
1959	$1,046	$1,115
1960	1,101	1,553
1961	1,066	2,095
1962	1,400	1,808
1963	1,506	2,077
1964	1,841	2,336
1965	2,479	2,366
1966	2,969	2,657
1967	3,012	3,212
1968	4,086	3,527
1969	4,957	4,089
1970 (January-June)	2,639	2,709
Percent increase over the period a year before	16.8	47.2

Source: Japanese customs return statistics, Ministry of Finance. (F.o.b. prices for exports and c.i.f. prices for imports.)

Although in 1968–69 Japan had a sizable export surplus with the United States, figures for the first half of 1970 indicated an almost balanced trade due to a sharp rise in Japan's imports from the United States, 47 percent above the figure for the same period a year ago. It is worth noting that the recent sharp increase in Japan's imports from the United States is due partly to the rapid expansion of imports of industrial manufactured items such as computers, machine tools, and airplanes. Out of total imports from the United States, the share of manufactured items (total of chemicals, machinery and other manufactured items) is rapidly increasing from 31 percent in 1965 to 42 percent in 1969. It is most likely that by 1975 United States-Japan trade will exceed $10 billion each way and the commodity pattern of the trade will be far more diversified than at present. By that time, for example, Japan may be exporting smaller computers while importing larger ones; Japan may be exporting smaller airplanes while importing larger ones; Japan may be exporting conventional power equipment while importing atomic power equipment; and so forth. Moreover, in many lines of industries, parts and components are likely to be exchanged between firms in the two countries and in some cases those produced in other Asian countries or Latin American countries may also be utilized extensively.

With the rising income and wages and growing shortage of labor, Japan will become an important market for manufactured goods as well as agricultural products and raw materials, both for newly developing countries and highly industrialized countries. If the U.S. economy is to maintain its vitality by advancing its frontiers in research and development, if the productivity of U.S. industries continues to rise, keeping pace with the rise of wage levels, and if the United States maintains its leadership in liberal trade policy, the rest of the world will be immensely benefited by prosperous international trade through the development of a dynamic international division of labor.

Chairman BOGGS. Thank you very much, Mr. Okita.

Now, Mr. Paul Porter.

STATEMENT OF PAUL R. PORTER, PRESIDENT, DOXIADIS URBAN SYSTEMS, INC.

Mr. PORTER. Thank you.

Chairman Boggs, I thank you for your invitation to testify.

For a quarter of a century I have been preoccupied with the international economy as a Government official and as a businessman. In 1968, after I had retired as chairman of a consulting company in international investment, I was invited by the Commerce Department to advise on export strategy, which I did for more than a year. In response to your invitation, I submit some conclusions drawn from these experiences concerning possible improvements in the adjustment processes of international trade and payments.

I will comment on what, in my view, are serious weaknesses in the organization of the executive branch to assess what is actually happening in international trade and payments. I will note what seem to me to be some policy errors which have resulted from the lack of a good assessment. Finally, I will offer suggestions for improvement.

As we all know, trade, investment, and the international monetary system are interacting elements of the international economy. Within the executive branch, they are treated, for the most part, as independent phenomena. Their interactions are largely ignored.

I was unable to find anywhere in the Government a single person or staff whose job was to monitor international trade, investment and the operations of the monetary system, to interpret what is happening, and to anticipate developments. Separately, these phenomena are, of course, monitored, interpreted, and to some extent anticipated but not in relation to each other.

So far as I know, this situation still prevails.

Fragmentation of responsibility within the executive branch for Government policies affecting the international economy has resulted, as one might expect, in tunnel vision on the part of Government agencies.

THE PREMISE THAT EXPORTS ARE IN TROUBLE

There is, for example, a widely accepted premise that our exports are in trouble. This premise has prevailed for more than a decade and over the years budgets for export financing and export promotion have consistently increased. Likewise, personnel for these purposes has steadily expanded. An accurate count is not available, but there appear to be about 2,000 employees of the Government who are occupied with exports on a full-time or part-time basis. The estimate includes persons engaged in data reporting and analysis.

On the premise that our exports are in trouble, a variety of measures of public assistance are provided. One pending piece of legislation would defer taxes on some export earnings. In effect, it would be a subsidy.

Superficially, there appears to be a basis for the premise. Our total exports have not grown as rapidly as those of Japan, Germany, Canada, and Italy. But it does not follow that our exports which compete with theirs have become less competitive. We should look beyond surface events to the composition of our exports and theirs.

The agricultural exports of Germany, Italy, and Japan are very small. At the beginning of the last decade, our total agricultural exports were nearly a quarter of our total. Last year they were one-sixth. The percentage change does not mean that the volume declined but simply that it stood still while the volume of nonagricultural exports rose. Our commercially financed agricultural exports—that is, those sold independently of Public Law 480—have hovered around $5 billion a year. They jumped sharply in the first 7 months of this year but the time period is too short to indicate a basic change.

It is a cause for concern that our agricultural exports do not grow but fast growth is not to be expected. Since the end of the war world agricultural exports have grown at about one and one-half times the rate of world population growth. In the same period nonagricultural exports have grown about three and a half times as fast as population.

Another difference is the portion of total exports financed as economic aid to developing countries. In our case, these include both agricultural exports financed by Public Law 480 funds and nonagricultural exports financed by AID. As recently as 1964 they amounted to $2.7

billion and were more than 10 percent of the U.S. total. Exports of this kind have since decreased by about $700 million.

If we separate aid financed exports and agricultural exports from the total, we find that our commercially financed nonagricultural exports, which account for four-fifths, are doing very well.

Let us look at their growth rate in recent years. In 1966 the rate was 11 percent; in 1967, 9 percent; in 1968, 15 percent; last year, 14 percent. Early in 1969 our exports were reduced by dock strikes but they made a strong recovery thereafter. In the first 7 months of this year the annual rate was 15 percent above 1969 exports.

The low trade surplus in 1968 and 1969 cannot be attributed to a weakness in exports—not when commercially financed nonagricultural exports grow at the remarkable rate of 14 and 15 percent a year.

One other circumstance should be noted about comparative export performance as a measure of competitiveness. A significant factor in the export growth of other industrial nations since 1965 has been the stimulus of inflation on our imports. When we look at exports to all markets other than the United States we find that since 1965 our growth rate for nonagricultural exports was virtually the same as that of Germany and Italy and was clearly exceeded only by that of Japan. It was significantly higher than that of other major trading nations.

Given this performance record it is difficult to justify a tax incentive or any other additional public assistance to our exports.

At this point I wish to digress for a minute to comment on an official statement by one Government department within the past 10 days which described exports in the first 7 months of this year as 20 percent above exports in the same period a year ago. A moment ago, using the same Census Bureau data, I described the annual rate of growth, for nonagricultural exports, as being 15 percent above 1969 exports. I wish to explain the apparent discrepancy and cite it as an example of a frequent deficiency in the quality of trade analysis by the executive branch.

The department's statement is technically correct. In the first 7 months of this year exports were 20 percent above exports in the first 7 months of 1969. The statement, however, did not note that in the early months of 1969 exports were sharply reduced by dock strikes. The basis of comparison is therefore too narrow and the apparent growth rate is exaggerated.

The department's statement is recognizable as a veiled argument that because exports are doing so well, import quotas to help our balance of payments are not needed. I also oppose import quotas. For that reason, among others, I regret that a government department weakens its case by careless analysis.

Another Government department has sought to make a contrary case with other selective trade data which is equally inadequate. The public, which is entitled to objective analysis, is the loser when departments of the executive branch use highly selective data to conduct in public their disagreements with each other.

A DIFFERENT VIEW OF THE DECLINE IN THE TRADE SURPLUS

The sharp dip in the traditional U.S. trade surplus has been used as a justification for particular adjustment measures which have been

proposed for both exports and imports. In the case of exports, a tax incentive and other measures of public assistance have been proposed. Quotas have been proposed for some imports. In each case the proposed adjustments are a consequence of tunnel vision—of a concentration on exports or imports as separate and presumably independent phenomena.

A different kind of adjustment is suggested by an analysis of the composition of the change in the trade surplus.

I have examined changes in U.S. trade balances with each of 75 trading partners which comprise about 98 percent of the U.S. foreign trade. Different base years were tested. Eventually, 1961 was selected as an appropriate base year because it was in that year that significant changes in the composition of the surplus began to become evident. However, since any single year may be subject to individual distortions, an average of 3 years, 1960–62, has been used as the base for measuring changes.

The average U.S. trade surplus in 1960–62 was $4.8 billion. Last year the surplus was $1.2 billion, or $3.6 billion less.

The decline was not universal. It occurred mainly in our trade with three countries: Canada, Japan, and Germany. These three are also our largest trading partners.

In 1960–62, the U.S. trade surplus with each was in the range of $400 to $500 million. Together they accounted for 30 percent of the total surplus. By 1969 we had large deficits with each. The adverse swing—from surplus to deficit—was $1.8 billion in the case of Japan. With Canada it was the same. With Germany it was $1 billion.

The total negative change for these three was $4.6 billion—a sum $1 billion greater than the overall decline in the trade surplus.

Stated another way, we increased our trade surplus with the rest of the world, in aggregate, by $1 billion while experiencing a decline of $4.6 billion with just three countries.

This is not a picture of a general decline in U.S. competitiveness in international trade.

Let us look further.

Our import surge began with inflation in 1965. In the last 5 years the average annual increase in U.S. imports from Japan was 22.5 percent. Imports from Canada grew at 19.5 percent a year; from Germany at 17.6 percent. For the three, in the aggregate, the average growth per year was 20 percent.

Imports from all other countries, in the aggregate, grew at a tolerable 9 percent a year.

These striking differences suggest that one important reason for the decline in our trade balances with Japan, Germany, and Canada was that the yen, mark, and Canadian dollar had become undervalued in relation to the U.S. dollar.

It is not suggested that an imbalance in currency prices was the only cause; German and Japanese exports to the United States have been helped by the fact that more than 1 million Americans in each of the past several years wanted a type of automobile which until recently the American automobile industry has failed to provide. However, when allowance is made for this and other special circumstances, there remain strong indications that a distortion in the price

of currencies had developed. This conclusion has been supportable for at least several years.

The conclusion, of course, is not novel. Within the last year it came to be the official view of the German and Canadian Governments. Each for its own reasons acted to increase the trading value of its currency.

The Canadian decision to allow a floating rate, presumably until the market indicates an appropriate fixed rate, is too recent for an appraisal of its effect on trade with the United States.

THE CASE OF THE GERMAN MARK

Our trade with Germany, however, has undergone remarkable change. In the autumn of 1968, in response to an international monetary crisis at that time, the Germans resorted to a de facto upvaluation of the mark. This was accomplished by a temporary reduction in border taxes on imports and in tax rebates to exporters. These actions had the effect of decreasing Germany import prices and raising export prices about 4 percent. A year later the exchange rate was officially upvalued by 8½ percent. The tax adjustments were withdrawn.

In 1969 U.S. exports to Germany rose 24 percent. In none of the preceding 4 years did our exports to Germany increase by as much as 2 percent. In 1969 U.S. imports from Germany actually declined by 3 percent. The average annual increase in our imports from Germany in the preceding 4 years had been 23 percent. In 1968 the U.S. trade deficit with Germany was $1 billion. In 1969 it fell to $0.5 billion.

In the first 7 months of 1970 it declined further to an annual rate of $225 million.

I do not suggest that these striking changes in U.S. trade with Germany are due wholly to the de facto and official upvaluations of the mark, or that trade analysis in itself is a conclusive measure of poorly alined exchange rates.

Nonetheless, the kind of analysis which I have just presented does seem to be appropriate to executive branch considerations of adjustments in trade and monetary policies.

THE CASE OF THE YEN

The pattern of Japan's trade with the United States and other nations suggests that an upvaluation of the yen is overdue.

The present value of the yen was established by the United States in 1949 when we were the occupying power. A new value for the mark was established in the same year by the United States, the United Kingdom, and France as occupying powers. The rates for both currencies were deliberately undervalued at that time in order to promote Japanese and German exports and to restrain their imports, thereby reducing the financial burden to the occupying powers.

Starting from a low economic base, both countries made a spectacular economic recovery. As they did, the 1949 exchange rates for the mark and the yen became progressively obsolete. Germany has twice upvalued the mark. The rate of the yen remains unchanged.

By virtually all customary criteria the yen is substantially undervalued. It thus causes a distortion in the price mechanism of the international economy. An appropriate adjustment in the price of the yen would simultaneously correct the underpricing of Japanese exports and the overpricing of other nations' exports in the Japanese market.

An across-the-board adjustment of this kind should be the objective of U.S. policy.

The course which we have followed of trying to adjust a trade imbalance commodity by commodity has been directed to marginal issues. It has also been ineffectual.

Two years ago our Government entered into a large scale commodity-by-commodity negotiation to persuade the Japanese to remove their import restrictions on a long list of items. The Japanese made concessions on chewing gum, hemp, and a few other minor commodities. The total effect was negligible.

Thereafter our adjustment policy swung to another extreme. For a year and a half the whole of our negotiating strength has been concentrated on trying to persuade the Japanese to accept a quota on a single export to the United States. Our negotiating credit has apparently been spent without benefit.

THREE SUGGESTIONS

I conclude with three suggestions:

First, a single agency of the executive branch should be given the responsibility of preparing periodic assessments of all significant developments in the international economy which affect American interests. International trade, investment, and monetary practices should be brought within a single focus so that the interactions may be better understood.

So that a detached and comprehensive view may be better assured, the responsibility should not be vested with an operating agency. The Council of Economic Advisers would appear to be an appropriate agency. An annual report to the Congress should be provided for by legislation.

Second, the influence of the United States should be used to help induce the International Monetary Fund to promote adjustments in exchange rates before obsolete rates cause large distortions in the price mechanism of the international economy.

Third, we should continuously appraise prospective adjustment measures for their consistency with basic goals.

As we look back over the quarter of a century since Bretton Woods we can discern three major objectives which the United States has pursued with fair consistency. They are:

Worldwide economic growth,
Greater freedom to trade and invest, and
The strengthening of order in the international economy.

Economic growth in the past two decades has been spectacular in comparison with any previous period in history subject to measurement.

In the two decades between the two World Wars, world production increased by one-fifth, an average growth rate of 1 percent a year.

World trade grew by one-half as much. Since 1950, after basic recovery from wartime disruption, world production has doubled. World trade has more than trebled. These are real growth figures after allowance for inflation.

This spectacular growth surely could not have occurred without greater freedom to trade and invest.

Greater freedom could not have been maintained without the creation of order in trade and monetary practices, for which GATT and the International Monetary Fund have been the primary instruments.

Before the United States takes any unilateral measures with regard to trade, we should ponder carefully the effect they may have on the maintenance of order in the international economy.

Chairman Boggs. Thank you very much, Mr. Porter.

Now, Mr. Strackbein, we will be happy to hear from you.

STATEMENT OF O. R. STRACKBEIN, PRESIDENT, THE NATION-WIDE COMMITTEE ON IMPORT-EXPORT POLICY

Mr. Strackbein. Thank you, Mr. Chairman.

The impact of imports on domestic producers naturally varies with the particular products concerned. No generalization would apply equally to all imports. In some instances imports are quite steady, supplying a rather stable share of the domestic maket, causing little or no disruption of domestic production and employment. Other imports may fluctuate from year to year, responding to conditions of supply both here and abroad. Agricultural commodities fall most readily into this category.

The real concern centers around imports that succeed in capturing a rising share of the domestic market, such as has occurred in a number of instances during the past decade. In those instances several interests are at stake. Workers may lose their jobs, or employment may stagnate in the face of general expansion. Companies may experience reduced profits, find it difficult to plan production for the future, or may even be forced out of business. They may also face the need of installing more labor-saving equipment in order to reduce costs or avoid becoming noncompetitive.

It is often said by economists of the free-trade persuasion that import competition is necessary to assure industrial efficiency and progress. They compare the competition from imports to competition within our own country. They also minimize the rigors of adjustment to rising imports as if they were of a kind with efforts to meet the upsets of technological advancement at home. New discoveries and inventions, they say, also cause disruption in this country and call for readjustment. There is need to reexamine production, to shift to new lines of production, to retain workers, and generally to make plainful adjustments to the new realities.

Our industries, they say, are constantly adjusting to new developments. Indeed, they say, it is this need to adjust that has kept our industries flexible and responsive to new conditions.

The value of competition to industrial regeneration and avoidance of stagnation may be conceded without imputing the same virtue to import competition.

To serve as a healthy stimulus competition—any competition—must meet at least two conditions: (1) The discrepancy in unit cost must not be so great that one competitor may still reap a profit while his rival, selling at the same level of prices, suffers a loss, and (2) the road to mass production as the key to a mass market through lower prices must not be preempted by special nontechnical advantages, such as an excessively lower wage scale.

It is not always recognized that competition among American producers, especially manufacturers, is of a special variety. This special function of competition is traceable to the discovery by American enterprise of the value of mass production as the supplier of goods to a potential mass market. Mass production itself, proceeding from inventive genius and fueled by the profit motive, would have been doomed but for a vision that saw in rising wages, hand-in-hand with increasing productivity, the blossoming of mass consumption as the absorbent of mass production. The link between production and consumption was seen as the key to material abundance if the two could be made to go forward together.

Further, the difference between an elastic and an inelastic demand had also to be appreciated. It would be no industrial miracle, for example, to mass-produce salt, so long as salt was only a staple of the diet. Only so much could be consumed, no matter how low the price. Mass production as the key to mass consumption had to be selective: it needed to be pursued with respect to products for which the demand was elastic. Lower and lower prices must be met by a growing consumer demand supported by ever greater purchasing power.

The classical American example is the automobile, although there are others. The automobile had a potentially high popular demand because it offered a great improvement in the mobility of individual people, at greater speed, going from place to place without the need of laying costly but yet limited trackage.

At the outset the building of an automobile was an expensive undertaking. If only a few cars were built only a few persons could buy them because of the high cost. The riddle was how to achieve lower costs so that more people could buy them because of the lower prices. The vision of a jackpot provided the motivation.

As we look around today we see that the internal combustion automobile succeeded only too well. Someone had to take the risk, however, in the beginning, of building more cars hoping that it he could offer them at a lower price, enough additional buyers could be found to absorb the increased output. Henry Ford is generally credited with both the vision and the courage to take that course. He saw the linkage between wage levels and consumer purchasing power and instituted the $5 per day wage midst outcries and skepticism from all sides.

Yet, his vision was clear. If technology would make possible the higher output per man it should be possible to strike a broader market as prices were brought still lower. This followed from the nature of the distribution of income. The mass market resided in those levels at which most of the income was centered. This would be the tens of millions of wage earners and salaried employees. A product that could be put within their reach—a product that would serve a universally useful purpose and for which the demand would, therefore, be elas-

tic—such a product would enjoy a bonanza if the question were solved, as indeed it was.

We come now to the other part of the contention that import competition performs the same service as domestic competition.

It is said that the displacement of the horse and buggy meant less immediate employment but that this disruption was not fatal. The new industry producing automobiles, after a time, employed more workers than were engaged in making the carriages, harnesses, et cetera. Unquestionably that is true.

However, to jump from that easily sustained fact to the conclusion that displacement of industries and their workers by imports is the same process, entitled to applause despite the temporary disruption, represents a malfunction of the processes of logic.

Some clarification is in order. Since World War II, foreign industry in the industrially advanced countries opted for our system of mass production. We gladly helped with the technology. The war had done some of these countries a disguised favor, so to speak, of bombing out many of their antiquated plants. We supplied much of the capital needed for rebuilding. In a few years many up-to-date plants arose in Western Europe and Japan.

Unfortunately those countries did not adopt that part of the American equation that calls for broad consumer purchasing power based on higher wages. Therefore their production outruns their consumer purchasing power or threatens to do so. They need a foreign market for their surplus output, which could be sold at home if wages were raised sufficiently. They look instead to this country for an outlet.

This development confronts us in effect with the American productive system coming back upon us from abroad in the form of competition with one of the prime factors partially lacking, namely, high wages. This condition strikes many American producers with a withering handicap; and American labor with a bleak outlook for full employment.

We continue to enjoy "growth industries," but in very recent times we have been able to observe a disheartening process so far as labor is concerned. Radio and television may serve as a handy example. Radio did not displace another industry in this country. The workers it added were largely net additions to employment. Even though in very recent years Japanese producers struck our greatest mass market by offering sets at prices that would spell disaster to our producers, our industry nevertheless had been left free for several decades to produce and market radio sets; and the process did not halt until nearly all households had a radio set.

The television situation is a little different. The cost has not been brought to a low enough level to tap the ultimate mass market, in the form of multiple sets per family. Here the Japanese and others rob our industry, but more particularly our electrical workers, of the final employment possibilities in this field, while our capital is free to go to foreign sources for production.

While the automobile was replacing buggies the workers making the automobiles were employed in this country. When foreign television sets, because of their low cost, displace American radios, the workers making the television sets are not employed here. Consequently

not only are our electronic workers displaced but what was a growth industry becomes a sick industry with no bright future to attract capital investment.

Import competition is thus seen to be of a different species from the domestic variety. In new growth industries early foreign competition, using our patents and their mass production, with low wages, may beat us to the mass market that in the past promised us employment-expanding growth. Imports may thus despoil our accustomed market development and expansion.

In the case of established industries, such as textiles, steel, footwear, et cetera, imports at low prices, instead of stimulating the domestic industry, may have precisely the opposite effect, if the cost gap is wide. If the outlook for profit is bleak, capital will shun the industry. The outlook is then not one that attracts both capital and talented enterprisers.

I am moved to say that the liberal-trade economists have evidently not adequately weighed these aspects of foreign competition and their negative influence on industrial expansion of the type that also expands employment.

We have in this country an unforgettable example of what the effort to become or remain competitive may mean. This example is rich in its message to those who speak so glibly about what American industry should do in order to hold a competitive position. They simply prescribe higher efficiency as the remedy without considering the means by which greater efficiency may be achieved. There is only one real source of greater efficiency, and that is the labor force. Since employee compensation accounts for some 80 percent of total corporate costs it is the very heart of production costs. Nothing else approaches this factor in weight.

Very well, labor costs can best be reduced by reducing the number of man-hours required to produce a given quantity of output. This means displacing workers. A 20-percent reduction in the total work force might make possible, say, a 10-percent reduction in cost.

The example alluded to above is provided by the coal industry. Its very existence was threatened by competition from imported residual fuel oil, by natural gas and diesel oil which replaced coal in our railroads. It was a question of sharply reducing costs or extinction. The industry succeeded in becoming competitive, not only at home but abroad. Today, in fact, coal is in short supply.

If one industry could meet such a challenge, why not any or all other industries? The question is a natural one and can best be answered by reference to the cost of the process. The number of coal miners was reduced by nearly 75 percent from 1950 to 1965, or from 480,000 to 140,000, representing a displacement of 340,000 workers. The result is best known by the name of Appalachia. The cost to the Federal Government has run into hundreds of millions of dollars and the cost in human misery has not yet been fully recorded.

How many such experiences could our economy tolerate? Should steel go through the same worker shakeout, if indeed the technology that would make it possible were on hand? Should the textile industry—an industry that with apparel employs over five times as many workers as were employed in the coal mines? Should the footwear

industry be put through the same paces, or many smaller industries scattered through the whole country? The fisheries, vegetable growers, glass and glassware, tile, optical goods, bicycles, a variety of hardware, household appliances, et cetera. A number of industries have already yielded to imports and are mere shadows of their former selves: watches, typewriters, sewing machines, binoculars, fisheries, radio receivers, cameras, et cetera.

The problem of adjustment is beset with difficulties that are not readily visible. If shoe and textile workers are to be evicted by imports where are they to go? To the high-paying export industries, as Mr. Houthakker of the Council of Economic Advisers has suggested, that is, the coal industry, the steel industry, the automobile industry or the aircraft industry, all of which are high-paying industries? A little reflection and look-about will tell us that these industries have troubles of their own. If only half the textile workers were displaced, in place of three-quarters as in coal, well over a million new openings must be found in other industries!

Would it perhaps not be better to regulate the flow of imports to keep them within reasonable bounds? In less than 10 years shoe imports have captured about a third of our domestic market. Other industries are suffering a similar invasion.

The problem of adjustment would become a serious additional burden on the taxpayer and the attendant human misery would but add to present discontent.

It is obviously a false exercise in economic thought to apply the principles of classical economics to situations that bear but little relation to those assumed. The assumptions for free trade include free competition and free play of all market forces. During the past 35 years this country and the whole world has moved far afield from laissez-faire economics. We have indeed moved in the opposite direction of regulation and public control.

Why then does anyone insist that free international trade could produce anything but disruption and confusion in these premises? Free trade would simply upset the finest laid plans of our economic planners who undertake to prescribe for their domestic economies. Here would be one free force, unbridled, unleashed to break through, around, or over any controls established for domestic production, labor agriculture, commerce, and trade. We have wage controls, interest, and money controls, taxes designed for social purposes, unemployment compensation, bank deposit insurance, farm output controls, many subsidies, et cetera. These are all interferences with the free market. If then we should open wide our seaward front we would soon compound our difficulties with contradictory and countervailing forces sufficient to sink the ship of state.

One more example must suffice as evidence of the unreality of the effort to inject classical economic theories onto the present-day economic scene. Our merchant marine offers an example as impressive as the coal industry.

Exposed as it is, without benefit or tariff or other competitive insulation, to foreign shipping, the maritime industry, wth the exception of coastal vessels, would today be extinct. What is left of it, carrying less than 6 percent of all our imports and exports under the American

flag, survives by the grant of Federal subsidies. Should our commercial aviation not enjoy a virtual monopoly of the American market, it would unquestionably be in the same condition as our merchant marine, and for the same reason.

To say this is not to say that either the maritime or the aviation industry is inefficient. This indictment only conceals an unwillingness to face the facts. The prime fact looms high indeed. It is not seen for reasons of inconvenience. Admission of the gigantic fact would upset comfortable existing policies and honored theories.

The wage differential between this and other countries is wide, nonnegotiable, and therefore persistent. This conclusion collides head on with economic theory, which in point of stubborness, is worthy of a tall monument.

Competition is supposed to bring unit wage costs, not wage rates, to a somewhat uniform level throughout the world, washing out wage and productivity differentials.

The only trouble with the theory is that it really has no chance in the world of economic controls and regulation. This is not the fault of the theory. It is a bad fault in economists who reason as if the world permitted the theory to operate.

Maritime wages are not out of line with industrial wages in this country. Shipbuilding, of course, is not a mass-production operation and therefore lacks the advantage that many of our other industries enjoy, or did enjoy but are now losing because of the development of mass production in the countries.

In the case of relative merchant marine costs, here and abroad, both with respect to shipbuilding and ship operation, we are not dependent on guesswork. The Federal Government makes wage surveys here and overseas to determine cost differentials. This differential is a little over 100 percent.

Countering the belief that competition will equalize costs is the fact that this differential increased by approximately 10 percent in a recent decade. How can the differential persist in the light of economic theory? The answer is that we do not have free competition. If we did we would not have 1 ton of civilian ocean-going shipping, other things remaining as they are, of course.

We face a situation in international trade that is the result of our industrial development on one level alongside that of the remainder of the world. We pioneered mass production and stumbled onto the vision of the mass consumer market based on high wages. We were so far ahead of the rest of the world in productivity that our higher wages were in many cases no handicap. Now, however, with the establishment of mass production abroad and the consequent great rise in foreign productivity, the wage differential looms as the stumbling block to free trade.

The processes of adjustment are too slow, too painful, and too disruptive to permit imports to run wild and confront our industries with the option of opening up abroad or losing foreign markets. The option is a cruel one for our labor unless it wishes to emigrate; and is often reluctantly exercised by industries who would rather give employment on the domestic scene rather than abroad. With appropriate regulation of imports the problem could be greatly ameliorated by making the domestic scene more attractive.

Thank you, Mr. Chairman.

Chairman BOGGS. Thank you very much, Mr. Strackbein.

Gentlemen, the usual procedure here is if you want to ask each other questions, it is perfectly in order, so if you wish to do that, we will be happy for you to proceed.

Mr. BALDWIN. I might comment in general on some of these issues. It seems to me very important that we keep separate in our minds two issues. One deals with the adjustment of particular selected industries within the total industrial structure; the second deals with the aggregate adjustment problem in terms of our balance of payments. The latter one, the general adjustment problem, must be met through such aggregative measures as exchange rate changes and holding down the rate of increase of wages.

As far as the first problem I mentioned—the particular one, Mr. Strackbein touched on—is concerned, I certainly fully agree with him that we should make it a matter of principle that no particular industry should be seriously hurt. However, I think he exaggerates the extent to which some of these industries are being hurt. As I look at some of the employment changes reported by the Department of Labor for the 1965 through 1969 period, I do not see any massive changes of the kind that I think some of his statements infer. But if we agree that some of them are significant, we should try to help these industries and make sure these workers are not thrown to the wolves.

I think he is right that some economists have developed a kind of doctrinaire, free trade point of view to the effect that free trade, no matter what its costs, should be followed. I think that is absolutely wrong. That does not mean that we should go to the other extreme and impose quantitative restrictions or very high duties, which then mean that we lose the benefits of trade, particularly, the benefit of increasing our standard of living by being able to purchase commodities at a lower price abroad than they can be produced at home. We must devise an adjustment mechanism by which we can shift workers out of hard-pressed industries into those industries that are highly competitive and be able to absorb greater employment.

You mentioned the maritime industry. Notice how we are using the word competitively differently. Given the high wages they must pay, the probably very efficient managers are, of course, trying to come up with all types of technological improvements. But in terms of the world economy, they are inefficient because they cannot maintain the productivity levels that are sufficiently high to compensate for the high wages they must pay in order to attract workers from other industries. It is the other American industries that keep the wages high and thus put the pressure on the maritime industry.

We greatly subsidize this maritime industry and I cannot see any reason why we should. I do not see why we cannot purchase our ships from other countries and stockpile them if you are worried about the defense problem here. After all, we could produce coffee here if we wanted to under certain conditions. But should we do that? Of course not. We can buy it cheaper from the Latin American countries. Why should we produce ships here if we can buy them cheaper abroad?

If one uses the argument that we will not be able to continue to increase wages if a free trade policy is pursued because we will be

importing everything, then you shift over to an aggregative framework; namely, you change your exchange rate so that you make our goods in the aggregate competitive enough so our exports can match our imports and still we can get the benefit of a much higher standard of living.

Chairman BOGGS. Do you care to comment, Mr. Strackbein?

Mr. STRACKBEIN. I do not know where to begin, he made so many.

Let us come back to the difference in competition, as I say, on the domestic scene as compared with competition from abroad. I have tried to make this clear, but I think a little additional light could probably be shed on it.

If you speak of—you have not brought in the term "comparative advantage" or "absolute advantage." But it seems to me that this is one of the things that is overlooked in speaking of the merchant marine as being inefficient. It is assumed that somehow or other, we do not produce as much per man-hour in terms of tonnage of freight carried as do our competitors. I would challenge that. I think that not only can it be shown that we do, that we are as efficient as other countries on that basis, and that the only real difficulty is that we simply do not, can't meet the low foreign wages.

Now, this does not, in my estimation, permit a comparison with the production of coffee in this country as being an example that is valid. In the case of coffee, for example, our climate is not adapted to coffee production as is the climate in the tropics or subtropics. Therefore, it would be foolish for us to try to compete in putting on a tariff high enough to make it possible to compete.

The advantage there is a natural advantage provided by nature. In the case of the merchant marine, the advantage to the foreign competitor is tht he pays lower wages than we pay in this country—not because they have better shipyards or that they have better crewmen to man their boats and so forth. They simply pay lower wages. That is the whole of it.

That same thing can be said about many of our other industries. In the case of steel, we are not able to compete. But yet, at least from such researches—very limited, I will admit—that I have been able to make, our output per man-hour in the steel industry is still higher than that of any other steel firm in the world. There might be individual exceptions, but on the average. Yet we cannot compete because we pay so much higher wages.

Again, this is not, then, a matter of relative efficiency. Actually, we should be able, if the competition were to be based strictly on man-hour efficiency, compete throughout the world as we are now doing in the case of coal, but we simply no longer have that kind of lead. We had a much greater lead at one time than we have now.

Chairman BOGGS. Do any other panel members care to comment?

Mr. OKITA. Mr. Chairman, I would just like to point out the fact that in comparing the international competitiveness, you should not compare wages directly, but should compare wage cost. That is a ratio of wage as compared to productivity. The level of wages is more or less determined by per capita national income. You cannot make the per capita national income equal among countries because there are poorer countries and richer countries. Poorer countries take advantage of

the relatively abundant unskilled labor and they have to pay lower wages and they are able to export labor-intensive products. This will enable those countries to raise their living standard and raise their per capita national income. Meanwhile, the higher income countries are able to develop industries created by the technology for higher productivity and, therefore, they can support higher wages.

Chairman BOGGS. What has been the increase in wages in Japan in the last several years?

Mr. OKITA. Last year, it was 16 percent over the year before last, the average industrial worker's wage. This year it will be over 17 percent.

Chairman BOGGS. What is the comparative wage situation now between Japan and the United States and, let us say, Western Europe?

Mr. OKITA. Including fringe benefits of workers?

Chairman BOGGS. Right.

Mr. OKITA. Now, in most of the basic industries, Japan's is about half or 40 percent of U.S. workers and 60 to 70 percent of European workers. This corresponds relatively to per capita GNP or per capita national income.

Chairman BOGGS. What do you think about the suggestion of Mr. Porter of upvaluing the yen?

Mr. OKITA. This is a very touchy question.

Chairman BOGGS. That is why I wanted to get your opinion.

Mr. OKITA. The Government of Japan is following a policy to push forward a liberalization policy first. The Government must overcome internal resistance working against liberalization. The surplus of foreign exchange is a good case to push ahead the policy of liberalization. But in case we continue to have surpluses in spite of the liberalization measures, I personally feel we should make reevaluation. That is my personal view.

Chairman BOGGS. Apparently, it worked out pretty well in Western Germany; do you not think?

Mr. OKITA. I had some discussion recently with some German economists and I heard the cases in their country. The upvaluation is probably a very new experience for Japan if it were to take place. The German has experienced already this twice and we are carefully studying their experience.

Chairman BOGGS. Senator Javits has come in.

Senator, we have a very distinguished panel here this morning. Would you like to ask some questions?

Senator JAVITS. It is a very distinguished panel, and, Mr. Chairman, I am embarrassed because I had to help a colleague by chairing another committee. Senator McGovern had to go to New York. If the Chair has other questions. I would greatly appreciate his asking them and I will get oriented here. I would like to ask some.

Chairman BOGGS. I would like to ask Mr. Porter a question.

I wonder if you would elaborate on your suggestion of one agency to deal with foreign economic policy? You may recall that we did create an office with a rank of ambassador in the Trade Expansion Act of 1962. Mr. Gilbert holds that position now. Would you elaborate on that a little?

Mr. PORTER. Yes; my recommendation was that a single agency

should assess what is happening in trade, in monetary practices, and in international investment and relate them all together. It is the lack of relating them together that I think is the weakness.

I have no criticism to make of the office of the special trade representative for its analysis of trade. I think it does a very competent job. But it is limited to trade.

We also need to take into account what is happening in international investment and happening in monetary policy. That is why I suggest that one agency should bring all three into a common focus.

Chairman BOGGS. Would you remove the Commerce Department from this area altogether?

Mr. PORTER. No; I would like to see the Commerce Department do a better job of trade analysis than they do, but I would not remove them from that role.

Chairman BOGGS. Of course, we could continue the Tariff Commission?

Mr. PORTER. Yes; my point, Mr. Chairman, was not that existing agencies should not continue to perform the operating responsibilities that they have. What I was proposing is that one agency should have the responsibility of assessing what is happening and trying to look further ahead by seeing the international economy as a whole, rather than as fragmented parts, which is the case today.

Chairman BOGGS. Does not the President have this function today? Is not that part of his function? Are you suggesting that maybe the Council of Economic Advisers be strengthened?

Mr. PORTER. Yes; I think it would be desirable that the Council of Economic Advisers submit each year a report to the Congress on what is happening in the international economy that affects American interests comparable to what they now submit with respect to the domestic economy. That is precisely what I had in mind.

Chairman BOGGS. Dr. Okita, one of the difficulties that arises in the question of our trade relations between the United States and Japan has been the many restrictive devices that Japan has with respect to American exports to Japan. Would you care to comment on that subject?

Mr. OKITA. Yes, Mr. Chairman.

As I stated in my statement, traditionally and historically, because of the nature of the economic structure, we followed more or less a protective policy, promoting exports and economizing imports by domestic production. This has been the policy followed by the Government for many decades. Now, this is exactly the policy that many of the newly developing countries want to follow and we are encouraging them to follow this policy.

Now, in fact, because of the success we have to discard that policy.

Chairman BOGGS. Do you mean by that that you have a completely free market for imports from Hong Kong, Taiwan, and Korea?

Mr. OKITA. That is a question for our next stage. So far, as I have indicated in my statement, the eightfold increase of textiles among imports from Asian countries indicate that there is relatively free access of their products to the Japanese domestic market. We admit that we still have some items, now about 90 items according to the Brussels Agreement classification, under the restricted items. But the

number will be rapidly reduced by September 1971. Actually, the Prime Minister gave special instructions just a few weeks ago to accelerate the procedure. Originally, the Government ministries were proposing 60 items remaining by September 1971, but the Prime Minister gave personal instructions to make it less than 40 items. This number is roughly comparable to the standards, for example, of the West German restriction on imports.

Chairman BOGGS. What about the question of American investment in Japan?

Mr. OKITA. This is another aspect of the question, investment into Japan. There is another aspect of investing from Japan to other countries. Restrictions on inward investment have been relatively strict in the past, again from historical background. But liberalization has been proceeding in the past 2 or 3 years. This aspect will also be accelerated in coming years.

Of course, we know there are questions about the 50–50 ratio of foreign and domestic ownership. We have two systems: Capital investment of 100 percent foreign capital and one with 50–50 foreign and domestic. We consider that the foreign investment should be liberalized as quickly as possible.

At the same time, when a foreign company is operating in a foreign country, the important thing is that they should be operated harmoneously with local people and the local government. This 50–50 joint enterprise may be somewhat unique for Japan, but we have found that this was a rather good compromise and a rather good arrangement. Sometimes, for dealing with labor problems, dealing with the Government, the local executives may have better judgment and better abilitv to manage affairs. On the other hand, for imported technology and other aspects, foreign marketing techniques, and so forth, the foreign executives may have better judgment. So in accordance with their abilities, both domestic and foreign executives will bring about better performance of corporations. That is one of our interpretations of this type of joint enterprise.

Chairman BOGGS. Mr. Strackbein, just one question before I yield to Senator Javits, because our time is limited.

You do not maintain that the troubles—former troubles, let me put it that way—of the coal industry were caused bv imports, do you?

Mr. STRACKBEIN. No; although imports contributed partly to the situation. What I was trying to illustrate is what is involved in terms of employment in becoming more efficient and operating at lower costs, costs low enough to withstand import competition or to gain a competitive status in foreign countries, both of which the coal industry has succeeded in doing, and it cost, as I say, the jobs of 3 out of 4 of the employees.

Chairman BOGGS. I am told one of the real problems in the coal industry is getting men to go into the mines.

Mr. STRACKBEIN. It probably is now, after the experience of their fathers and forefathers, what happened to them from 1950 to 1965. I do not think I would advise my son to go into the coal mines.

Chairman BOGGS. Despite the fact that the wages are very high?

Mr. STRACKBEIN. In spite of that fact; yes.

Chairman BOGGS. So that there are other considerations than wage considerations?

Mr. STRACKBEIN. Well, there are today undoubtedly greener pastures and nobody knows how long this great demand for coal will continue in view of the competition with atomic energy and other things that are involved, the Alaskan oil fields, oil findings, and the natural gas which today, of course, is facing a sort of decision because of its relative scarcity—but these are not permanent things to stake a future on. I do not think, actually, that a young man today would be inclined to go into the coal mines, because the future does not look too bright.

In addition to that, many of them are probably repelled somewhat by the safety conditions and the hard work to which they are subject.

Chairman BOGGS. Well, I think the argument you are making, though, could be applied to a great many industries. You mentioned aviation. Take the space industry. There are many people, very highly trained people, who have lost their jobs in aviation and space because of the cutback in these programs. I could mention many others.

Mr. STRACKBEIN. But I do not think they would have any difficulty in recruiting workers if the——

Chairman BOGGS. No; I do not think they have trouble recruiting workers, but I think the workers have trouble getting new jobs.

Mr. STRACKBEIN. It seems to me that is just the opposite of what we have been saying. Some of the difficulty with the coal mines is that they cannot recruit workers. But certainly, that is not the difficulty that the aircraft industry has. They would get plenty of responses if they had the openings.

Chairman BOGGS. But the point I was making was in connection with your observation that probably one of the reasons for not being able to recruit people into the coal mines was the uncertainty about the future. I was only replying by saying that this applied unfortunately in a great many industries.

Senator Javits?

Senator JAVITS. Thank you, Mr. Chairman.

Dr. Okita, I would like to associate myself with the Chair in the questions he has asked you regarding Japan's policy which seemed to us in the United States, I think, to be strangely unbalanced. I was there very early this year and had an opportunity to address myself to that subject.

I would like to add to two things on that, if I may: first, to thank you for appearing. No person from a foreign country like yourself needs to be under any, certainly cannot be under any order to appear, and need not appear unless he chooses to. Our own citizens are not ordered to appear, also, but they feel a certain conscience and duty to our country to give us the best of their judgment. But as to you, I think we have every right to be grateful to you for your willingness to undertake to enlighten us on your point of view and expose yourself, as it were, to questions that might seem to be uncongenial and unfriendly. So I thank you first and foremost for enabling us to have the benefit of your wisdom and information.

We are puzzled by one thing in this country, and that is the fact that there seems to be a lack of consciousness by Japan of its own industrial power. You testified as to that yourself, I noticed in reading your

statement. It is one of the reasons why we have wondered why it is that Japan should not be more forthcoming in terms of leadership on the matter of generalized preferences for the developing countries. I notice in your statement that you made quite a plea for opening domestic markets for the importation of manufactured products of newly developing countries, and you do point out that there have been large increases to Japan.

But, of course, we all know, as a rather sophisticated people, that the size of the increase, which may be phenomental because they started from such a low base, does not necessarily prove that a nation is doing everything of which it is capable in the international community to serve a given international purpose. So could you give us any idea as to the position of Japan respecting this whole-world effort to do more for the developing areas through trade? And also, what you see ahead in that regard in terms of policy?

Mr. OKITA. Mr. Chairman Javits, I should first express my thanks for giving me this opportunity to be present at this hearing. I do feel that sometimes the presence of some foreigners at this kind of meeting will be a useful one and that I myself will very much benefit in listening to the statements just made here in this meeting by other experts.

Concerning the question about Japan's position, the first about the lack of consciousness of strength. I mentioned somewhere in my statement that we Japanese still have a kind of: GNP mentality gap. Because the GNP is growing very fast, the mentality of the people—those in the government, politics, business—does not really respond to the size of the GNP. They do not come up with the size of the GNP. They may come up to that size of GNP after some years with some delay. And this delay in statements by the Government may cause some difficulties with other governments, especially the United States. But in a condition like the GNP increasing from $100 billion in 1966 to $200 billion in 1970, the adjustment in mentality is bound to lag behind the GNP increase. This is one point I should like to make by way of answering your first question.

But I should say that the growing, especially in the past several months, we notice in the views expressed in newspapers, in TV, and other cases, that the Government and the people gradually will come to realize the various international responsibilities accompanying the higher economic output.

Of course, we have been too much concerned with trading. We have been concerned too much of the production aspect. Now people argue very much, why should we not pay much more attention to the improvement of environment or living conditions, urban development, especially housing. This will gradually divert available resources from directly productive investment to indirectly productive investment or nonproductive investment. This is bound to happen in the course of years to come.

Your second question was the generalized preference to be given to the exports from less developed countries, especially on manufactured items. This has been negotiated in OECD and many other places among industrialized countries. Japan was one of the members, I should say somewhat passive in their attitude. This is, again, partly because of our employment structure. We still have some 18 percent

of our labor force in agriculture. Although it declined from 40 percent in 1955 to 18 percent last year it is still much larger compared with other industrial countries—such as in the case of the United Kingdom, they have 3.5 percent of their labor force in agriculture, and many other industrial countries which have labor forces in agriculture of less than 10 percent.

Also, we have a very large number of employees in small industries. They are directly competing with the very similar products which the developing countries want to export. I can predict that the course of 5 or 10 years will further reduce employment in agriculture and small industries which may compete or conflict with the interests of newly developed countries, and it will become much easier to accept the larger inflow of commodities exported by them.

My interpretation is that this is just a matter of transition, because changes are taking place so rapidly and many of us feel that we are still relatively poor, and we still have a very large element of the backwardness in our industrial and employment structure. But in the course of the economic growth, this backwardness will be rapidly wiped out in coming years. So that is my projection of possible changes in our economy.

Senator JAVITS. Dr. Okita, thank you very much. But it does lead me to make this observation. All countries, certainly major countries live with a time bomb in their midst, or in the midst of the world. I have rather considerable doubt that all of this is going to wait for that nice pace that you see as you look forward down the road for Japan. For example, I think the United States is in imminent danger—I call it danger; Mr. Strachbein would probably call it blessing—of adopting a quota law. Now, suppose we do adopt a quota law. Could you give us any prediction of the Japanese reaction?

Mr. OKITA. I cannot predict what will happen then. Actually, we have been told by Americans mostly about the benefit of freer trade, and somewhat reluctantly and grudgingly we have followed your advice. Now, we are facing a situation where the teacher is changing his philosophy. Honestly speaking, we feel somewhat at a loss about what should we follow next.

Senator JAVITS. Dr. Okita, I could tell you a lot of other habits that we have taught you that were very good if taken in moderation.

Mr. OKITA. That I should agree. I feel that personally, as an economist, our rate of economic growth is a bit too high. This creates various problems, and we should moderate our rates of economic growth. But we find sometimes that a high rate of economic growth in Japan is a kind of built-in phenomenon and not very easy to break up.

But many factors will come to that result in coming years. Some of the reasons I gave in my statement, and I should, of course, agree that some moderation is necessary and, in fact, government has recently announced that they should introduce a new system, a kind of early warning system, watching one export item exported in a specific market. If it is growing too fast, the government will give cautious warning to exporters and to the industry not to concentrate and not to hurry in expanding their exports. This announcement was recently made by one of the government ministers.

Senator JAVITS. Dr. Okita, I do not wish to detain you much further. But it just seems to me that Congress has to face a very serious trade problem in the United States, and it seems to me, while regrettable, that it was impossible to anticipate this problem, but that we have to fully expiate it in conflict and, as you say as an experienced economist, and I agree implicitly with everything you say, you are very desirous of the finest relations with the United States. I do, as you, deprecate what may happen, especially as there is no prediction as to what may happen.

Thence, there are the same pressures in Japan which have prevented your Government from being able to come to an agreement which may also bring about a response which would be most inimical to the trade between us, to the trade of the world, and to those relationships between ourselves and the leading industrial, commercial, and financial power in Asia—to wit, Japan, which could be extremely harmful to all our hopes for that part of the world. I would still use this forum so graciously furnished by my chairman, Congressman Boggs, to express the hope as a longstanding worker in this vineyard that Japan will not wait for the decree and will not then react unilaterally, but that bilateral and, even, preferably multilateral action may be taken to head off the awful decree of some variant of a trade war, temporary or permanent.

Mr. Chairman, my time is up.

Chairman BOGGS. Gentlemen, thank you for coming. You have been very helpful to the subcommittee. I might say the record will be open, if you care to add to the record or to the discussion, we shall be very happy to hear from you.

I must go. Senator Javits will preside.

Senator JAVITS (presiding). Professor Baldwin, I notice you spoke approvingly of adjustment assistance in Sweden as a percentage of GNP.

I wondered whether you had any concept of the order of magnitude of that kind of program in this country? I think we have run it very poorly. If it can be run at all, any suggestion you might have on that score would be welcomed. People generally do not like to negotiate a bill with the Government. They would rather sell the goods.

Mr. BALDWIN. Senator, I do not know what fraction of our GNP that the various programs, which could be termed adjustment assistance, come to. I do know, of course, that they are widely scattered and not very well integrated. What I would like to see is a move where we bring together those programs directed at the poor and minority groups, those directed at people in depressed areas, those directed at the aged, and, of course, those directed at particular industries hurt either by import competition or some technological or other development within the economy, bring all those together into a massive social program of assistance that would facilitate movement of resources out of declining areas, declining skills, and thus keep the economy operating in the most efficient manner possible.

I do not think the adjustment problem is a matter of coming up with new ideas. I think we all know what we need to do. We need to have better planning in industries that are declining so that you can make sure, for example, that if you protect them with quotas, you do

not merely attract more young people into these industries. The old people gradually will retire, but then you have a new cohort that you cannot suddenly throw out because it is difficult for them to adjust. We should use retraining programs; not let the new people come into declining industries; let the old people retire; make firms merge, and so forth—these adjustment steps are followed in European countries all the time. The British, the French, and the Swedes all have much more carefully integrated programs of assistance than we do. But they involve essentially the same measures that we have scattered in various programs in this country—unemployment insurance, aid to help people move, retraining programs, all of these things.

Senator JAVITS. Professor Baldwin, would you think this could all be done very much better with an institute of adjustment assistance which would operate on two levels? One level really to enable business either to retool or sell out, convert in other areas. That is mostly a loan operation. It would enable individuals by early retirement, transitional pay——

Mr. BALDWIN. Retraining.

Senator JAVITS (continuing). Retraining, relocation, but it could do it flexibly. I think this business of the formidable facade of a Government department where you absolutely get lost, makes people really discount adjustment assistance. That is my experience. They pay no attention to it whatsoever and they do not consider it to be a factor. In a great sense, they are right, the way it is run.

What do you think about that?

Mr. BALDWIN. This institute would be a Government institute?

Senator JAVITS. It would be a governmentally owned corporation. It would be an Institute of Government Assistance.

Mr. BALDWIN. With autonomy?

Senator JAVITS. With real autonomy, where you could go get a check at the teller's window and not file applications and wait until you are dead.

Mr. BALDWIN. That sounds like an excellent idea.

Senator JAVITS. Do you think that might help?

Mr. BALDWIN. Yes; I certainly think we have to change our existing programs so that from this—you do not get tied down in bureaucracy. We had a fairly good adjustment assistance program under the Trade Expansion Act that was not used for years because of a lack of communication and understanding between the Tariff Commission, the Commerce Department, and the President as to what can and should be done.

Senator JAVITS. Would any other panelist like to make a comment?

Mr. PORTER. Senator, may I just say in response to your question that I think it is a very good idea. But I would like to stress one other thing. That is, we must think in terms broader than just trade adjustment. Quite a few of our difficulties are at least made more difficult by too much rigidity in the international monetary structure today. More flexibility adjustment in adjusting exchange rates would at least ease some of the problems of trade adjustment.

Senator JAVITS. Very good. Dr. Okita, I have just one other question. Then we shall quit.

I might suggest to you that many Americans will look to Japan

for a leadership role in Asia respecting the development of Asia. Asia is very cognizant, however, of the history of the Asian coprosperity sphere and other tragic events of the past. But we do see in the Asian Development Bank, in the Private Investment Company of Asia (PICA) with which I have had a lot to do myself, in the World Bank, in the International Finance Corporation, in the IDA, many such opportunities, including also the technical assistance program of the United Nations, and so forth. What do you think of the prospect for Japan in a really major way, becoming a partner of the United States, and other developed nations in a really massive economic development of Asia?

Mr. OKITA. Last year, I was on the Pearson Commission, one of the eight Commissioners, and I was on the side of recommending to the Government to take positive policies in economic assistance to developing countries. Now I am working as an acting chairman of a Foreign Economy Cooperation Advisory Council of the Government. Since recent months, gradually, we are moving ahead, as you, Senator, have just mentioned, to take more positive policy.

Just recently, last June, the Government introduced a target of reaching 1 percent of GNP as total resources flow to developing countries by 1975. In the past, the Government did not commit the target year for increasing the flow of resources to developing countries.

I am somewhat optimistic about the possibility of Japan taking part in this effort, especially stimulating the economical growth and development of other Asian countries. But on the other hand, I personally feel that with the larger flow of aid, the important thing is to stimulate those countries to develop their industries, especially to stimulate the expansion of export-oriented industries, because the basic thing for them is to enable them to earn their foreign exchange necessary by way of exporting their products. In view of the world market conditions, increased exports of primary products, the prospect is not promising. We see in many countries around Japan which succeeded in expanding export of manufactured goods are succeeding in attaining accelerated economic growth. So one of the very important measures to help those countries is to stimulate their industrial development, especially of export industries.

As you pointed out, Japan also should try to open our domestic market as much as we can for their products. We hope that Japan could play a constructive role in that part of the world.

Senator JAVITS. Thank you very much, gentlemen. It is very kind of you.

The subcommittee will now stand adjourned until tomorrow morning at 10 o'clock in this same room.

(Whereupon, at 12:25 p.m., the subcommittee recessed until the following day, at 10 a.m., Wednesday, September 30, 1970.)

A FOREIGN ECONOMIC POLICY FOR THE 1970'S

WEDNESDAY, SEPTEMBER 30, 1970

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Foreign Economic Policy met, pursuant to recess, at 10:08 a.m., in room S-407, the Capitol Building, Hon. Hale Boggs (chairman of the subcommittee) presiding.

Present: Representatives Boggs and Reuss.

Also present: John R. Stark, executive director; John R. Karlik, economist; Myer Rashish, consultant; and George D. Krumbhaar and Leslie J. Barr, economists for the minority.

Chairman BOGGS. The subcommittee will come to order.

At the annual meeting of the Governors of the International Monetary Fund, held in Copenhagen last week, the Managing Director, Pierre-Paul Schweitzer, asserted that "from the standpoint of the functioning of the international monetary system, by far the most important problem is posed by the deficit in the balance of payments of the United States." On the other hand, two of the distinguished witnesses who testified yesterday emphasized the need for somewhat greater flexibility or more prompt adjustment of exchange rates if persistent surpluses and deficits—with all the accompanying unhappy side effects—are to be avoided. I might say we happen to have here as a member Mr. Reuss, who is chairman of our own Subcommittee on International Exchange and Payments.

Today our attention turns to the mechanism through which trading nations share the burdens of adjusting their external accounts and to the techniques, both explicit and subtle, by which such burdens are distributed. A variety of policy tools can be used to affect a nation's balance of payments, ranging from trade restrictions and controls over capital movements through techniques to induce domestic inflation or deflation, to exchange rate changes or even alternations in the dollar price of gold. Our panel of eminently qualified witnesses will, I am sure, articulate a variety of opinions on how the responsibilities of international payments adjustment should be shared.

The first witness today is Professor Haberler of Harvard University. I understand that among other accomplishments, he taught Mr. Rashish.

Also, Professor Oppenheimer from Oxford University; Kurt Richebacher from Frankfurt, Germany, a long-time student of international payments; and finally, Professor Triffin of Yale University, the man who alerted the economics profession and the public in general to the

need for a facility to provide additional international liquidity. The special drawing rights mechanism now functioning under the supervision of the IMF is the outcome of the concern that Professor Triffin first stimulated. I understand he is still active today in working for monetary union in both Western Europe and the Far East.

Professor Triffin has been before this committee on several occasions. We are happy to have him back. We are happy to have the entire panel.

We will start with you, Mr. Haberler.

STATEMENT OF GOTTFRIED HABERLER, GALEN L. STONE PROFESSOR OF INTERNATIONAL TRADE, HARVARD UNIVERSITY

Mr. HABERLER. Mr. Chairman, thank you very much for the opportunity to speak to this committee on these important problems. Let me apologize that I was not able to send in my prepared statement in advance. I have been traveling abroad, and it just was not possible. But you have it before you. Let me now summarize briefly what I say in that prepared statement.

I discuss the balance of payments, mainly from the American standpoint. It is generally recognized that for the United States the balance-of-payments problem presents itself in a different way than for other countries because of the special position of the dollar. The dollar is the world's most important reserve currency, the intervention currency for foreign central banks and the most important transactions and investment currency throughout the world for private traders and banks.

The most important consequence of the special position of this dollar is that the United States could not change the exchange rate, could not devalue the dollar in terms of other currencies even if it wanted to. Suppose we wanted to depreciate the dollar, say, by 10 percent. The result simply would be that most other countries, practically without exception, would go along and the exchange rate would remain the same. Similarly, if we wanted to make the dollar flexible, we could not do it because other countries would continue to peg their currencies to the dollar.

Now, the question arises whether this special position of the dollar does not constitute a severe handicap for American economic policy in that area. Does it not limit our options? Other countries can change their exchange rate when they get into trouble; we cannot do that.

My answer is definitely that the special position of the dollar is not a handicap. In order to explain the reason for my answer, let me very briefly review the striking and somewhat paradoxical changes which have occurred in the last 3 years.

You will remember that at the end of 1967, there appeared a huge deficit in our balance of payments which caused a flight from the dollar and a severe crisis. The Johnson administration, reacting very strongly, introduced controls on capital exports and proposed other stringent controls which were rejected by Congress.

Then in April of 1968, the international gold pool through which the leading countries were feeding gold speculation was closed down and the two-tier gold market was introduced.

Then later in 1968, the situation unexpectedly improved. Enormous amounts of foreign capital flowed into the United States, attracted by high interest rates and the booming stock market. It is true that the traditional surplus on the trade account disappeared, but for the whole year of 1968, our balance of payments was in surplus for the first time in many years, both on the liquidity basis and on the official settlement basis. But it was generally realized that the improvement was temporary because it was an unnatural thing for the richest country in the world to import capital on a large scale.

The expected deterioration of the balance of payments recurred in 1969. In short, for the whole year of 1969, the deficit on the liquidity basis was higher than it ever was before. It is true the official settlement balance was in the black in small amounts, but the liquidity balance to which most people pay attention had a deficit larger than it ever was. But despite this deterioration in the balance-of-payments position, nothing happened to the dollar. The exchange markets were quite. While other currencies had to devalue, the pound in 1967, and the French franc in the summer of 1968, and still other currencies were under the cloud, the American dollar was not touched by the speculation.

Now, this is paradoxical, because the much smaller deficit in 1967, and early in 1968, caused such an enormous change adverse to the United States, whereas the much larger deficit in 1969, did not even cause a ripple.

What is the explanation? One reason is surely that the inadequacy of the "liquidity definition" of deficit, became quite clear because the liquidity balance was in huge deficit, while the settlement balance still had a large surplus. Or to put it the other way around, the fact that the official dollar holdings abroad declined from $15.6 billion in December 1967 to a little over $10 billion in July 1969, reassured foreign central banks about the position of the dollar. This explanation is further supported by the fact that when the official settlement deficit became large again this year, there was again criticism of the American policies and position, and recently some criticism on the part of the IMF Chief. So this is one reason.

But I am convinced that the deeper and decisive reason for flu paradoxical change is a different one. It is, I believe, that the events of the last few years have made it quite clear to the financial leaders, central bankers and economic journalists and so on, that the world is practically on a dollar standard, whether they like it or not. True one can argue that the world has been on the dollar standard ever since the war, but it was regarded as temporary and as an essentially unstable and unsustainable situation. It has been assumed that foreign countries would not go on indefinitely accumulating dollars and that sooner or later the dollard exchange standard would have to be terminated somehow.

There was indeed a period of increasing mistrust of the dollar which reached its higher point of intensity late in 1967 and early 1968. But since then, the situation has changed. The fact is that the dollar balances abroad have become so large that conversion of dollars into gold on a large scale is practically out of the question.

It has just been increasingly realized by officials as well as experts

and financial journalists that the dollar is, in fact, inconvertible into gold, at least for large sums. If a foreign central bank came and said they wanted a billion dollars worth of gold, they would be told politely they could not have it. And they know it, so they do not even ask for it. I think this is a fact. But it is also true that the fact has never been acknowledged. If you ask an American official or a foreign official, point blank he will deny it.

But on the other hand, it would not be hard to cite speeches and statements by officials, by financial journalists and so on, which show quite clearly that the de facto inconvertability of the dollar is fully recognized.

Now, let me very briefly discuss the implications of this assessment of the situation for American policy. The policy implications, I think, are perfectly straight forward. The American balance-of-payments policy should be passive, as Secretary of the Treasury, Mr. Kennedy, said the other day. We cannot change the exchange rate and we should not introduce any direct controls.

How about inflation? We should, of course, do everything we can to stop inflation. This is, after all, the declared policy. I feel very strongly that inflation must be stopped, or at least sharply slowed down for domestic reasons, to eliminate the distortions and inequities that are constantly inflicted on the social economy by inflation. Stopping or slowing inflation would be a good thing also for the balance of payments and for the international status of the dollar. At the present time, there exists no conflict between domestic and balance-of-payments objectives. On both grounds, inflation has to be reduced. But we should be aware that the conflict between domestic and international or external objectives can easily arise for two reasons.

The speed with which we reduce inflation is limited by domestic considerations. If we do it too fast, too much unemployment is created and too much slack in the economy would appear. So there are limits on the speed with which inflation can be reduced. And it is not certain that the feasible or acceptable speed of this inflation is sufficient from the balance-of-payments standpoint. This is the one conflict which may already exist. The sharper conflict could come into existence as to the direction of policy: (*a*) from the domestic; (*b*) from the external standpoint. If a country has a weak balance of payments when it suffers from unemployment and slack, then you have a conflict. From the balance-of-payments standpoint, you should contract from; from the domestic standpoint, you should expand. On the other hand, a surplus company which suffers from inflation has also a conflict. From the internal, the equilibrium standpoint, it requires tight money. From the national standpoint, it requires easy money. Germany may be said to be in that dilemma at the present time.

Now, when other countries find themselves in such a predicament, such a dilemma, they can escape from it by changing the exchange rate, or, still better, by making it flexible, as Canada did recently. But the United States can't do it. What should we do in such a case?

My answer is, and I think that this is shared by many economists—I am not quite sure about all other members of the panel—but my answer is that the United States should conduct its monetary policy in such a way as is best from the domestic standpoint, from the stand-

point of having price stability, full employment, and growth, rather than might be necessary from the balance-of-payments point of view.

To repeat, at the present time, such a conflict does not exist, but if it came into existence, then it seems to me that domestic requirements, whatever they are—I am not going to spell them out in detail—should take precedence over the external considerations.

But now let me briefly discuss whether this state of affairs is acceptable, whether the solution of the conflict, if it came, which I indicated would be acceptable from the point of view of other countries. Let me distinguish three cases. Let's be optimistic and assume that we are able to reduce the rate of inflation to a domestically acceptable level, let me say not more than 2 percent for over good and bad years. In that case, I am quite sure that the balance of payments would improve, although private liquid foreign dollar holdings would probably continue to grow as before, the situation would not be difficult.

But, even in that case, the possibility exists that a few other countries would find themselves with growing official dollar holdings, get more dollars than they want, either because they do still better than we do as far as inflation is concerned, or because there are structural changes in the world economy which helps them. Now, any country which earns more dollars than it wants to hold has three policy options. It can either upvalue its currency or make it flexible; it can step up its own inflation—that is, what the Japanese have been doing; or thirdly, they can remove controls, border taxes, and that sort of thing. I think any of these three options, and I do not see any other, would be acceptable from the American standpoint.

Now, to be a little more pessimistic, hopefully unrealistic at the same time, and assume that our inflation is 4 or 5 percent. In that case, of course, our deficit will be larger. There will be more countries which earn more dollars than they want. But their options are still exactly the same. They can either match our inflation, they can upvalue their currency, or they can eliminate some of their controls. Any one of these options would be all right from the American standpoint.

It is true that in that case, if inflation were a little too rapid, the real value in terms of purchasing power of foreign dollar holdings would go down. There would be a loss there. But they would suffer an even greater loss when they hold gold and when they hold SDR's.

Now, let me be still more pessimistic, really quite unrealistic, and assume that our inflation is 6 or 7 percent. Then, of course, there will be trouble. The deficit will be still larger and still more countries would earn more dollars than they want. But I say it is still true in that case that they have only the three options which I mentioned. However, there would be a strong inducement to look for a replacement for the dollar as an international reserve and international transactions currency. It would probably stimulate Europe to go ahead with its monetary unification in order to present a European currency which could serve as a substitute for the dollar.

But I need not spin that out any more. I believe we are not at that point. I personally believe that inflation will not get that bad. And let me also say that the Europeans are still very far from mone-

tary unification. They have not been able to harmonize their internal policies sufficiently as would be necessary to create the European currency as a substitute for the dollar.

So my general conclusion, then, is that with American inflation moderate by world standards, gold unavailable, and no real substitute for the dollar yet in sight as an international reserve currency, the dollar standard is safe, with a wide margin to spare.

I think that is all I have to say. If I had 5 more minutes, I would—may I speak 5 more minutes on SDR, so if that will come in later——

Chairman BOGGS. Let's say 2½ minutes.

Mr. HABERLER. Let me say how the SDR's fit into the picture. In my mind, they do not make much difference. They will replace dollars in international reserve growth. But I think it will not make much difference.

The second question on which I may make a short statement is about the link between SDR's and development. I agree with what Harry Johnson told this committee last May, that such a link should not be established. Let me briefly list the reasons:

The first reason is that SDR's will have trouble getting established even without this additional complication. The second reason is that to link the SDR's with development means to finance development in an inflationary way. Quantitatively, this is perhaps not very important, but the principle is bad. To these two reason of Harry Johnson, I would add two others. Third, development aid should go through the Government budget. That means Congress should vote how much it wants to spend on aid. That decision should not be left to international officials.

The fourth reason why I would oppose the "link," at least at the present time, is that the distribution of aid to less developed countries between the industrial countries should not be left to market forces, as they would be if you had the link with SDR's. In general, I am in favor of market forces, but this is a political decision which should be made consciously and explicitly and not left to the market forces. The rule that every country should devote a certain percentage, 0.7 percent, of its national income to foreign aid, some such rule, is certainly much more equitable than leaving this decision to the market, as would be the case if SDR's and development were linked.

Thank you, Mr. Chairman.

Chairman BOGGS. Thank you very much, Dr. Haberler.

(The prepared statement of Mr. Haberler follows:)

PREPARED STATEMENT OF GOTTFRIED HABERLER

THE BALANCE OF PAYMENTS ADJUSTMENT MECHANISM FROM THE AMERICAN STANDPOINT

INTRODUCTION

It is generally recognized that for the United States the balance of payments problem presents itself in a different form than for other countries because of the special position of the dollar. The dollar is the world's foremost reserve currency, the intervention currency for foreign central banks and the most important transactions and investment currency for national and multinational corporatios, for private traders and banks throughout the world.

An important consequence of this special position of the Dollar is that the US

could not devalue the Dollar unilaterally in terms of other currencies even if it wanted to. Suppose the U.S. Government decided to reduce the gold value of the dollar by 10% (which would be quite legal under the Brettonwoods Charter because, unlike most other countries the U.S. has not used up the authority to change the original parity by 10% without requiring permission from the Fund). The result would be that most other countries would go along so that the value of the dollar in terms of other currencies, as distinguished from its value in terms of gold, would remain unchanged. (The resulting 10% rise in the value of gold might well whet the appetite of the gold hoarders, without appreciably increasing world liquidity.) Similarly the US could not unilaterally let the dollar float in the exchange markets, because most other countries would continue to peg their currencies to the dollar.

The question arises, does this special position of the dollar not constitute a severe handicap for the conduct of US foreign economic policy? Specifically does it not seriously limit the options that the US has in dealing with a balance of payments deficit? My answer to these questions is definitely *no*. The US is not handicapped, if it plays its cards right.

The reasons for this answer will be best explained by briefly reviewing the striking and somewhat paradoxical changes in the US balance of payments and position of the dollar that have taken place during the last three years.

SOME RECENT DEVELOPMENTS

It will be recalled that the bad showing of the U.S. balance of payments in the last quarter of 1967 caused a flight from the dollar into gold and some other currencies. The Johnson Administration took fright and imposed severe controls on capital exports and proposed a number of other controls (including an unprecedented tax on U.S. tourists abroad) which fortunately were rejected by Congress. In April 1968 at the height of the crisis the international gold pool through which the leading countries, the U.S. carrying the main burden, had been feeding gold speculation was closed down and the two-tier gold market was established.

Later in 1968 the picture unexpectedly improved. Huge amounts of capital flowed into the United States, attracted by high interest rates and a booming stock market and spurred by the collapse of the French franc as one of the world's strongest currencies and the invasion of Czechoslovakia. Thus in 1968, for the first time in 11 years, the U.S. balance of payments showed a small surplus both on the liquidity and official reserve transaction basis. But the traditional surplus on trade account disappeared and the overall improvement was clearly of a precarious nature. The richest country in the world importing capital on a large scale is obviously an unnatural and probably an unsustainable phenomenon.

The expected deterioration of the balance of payments recurred with a vengeance in 1969. The liquidity deficit for the whole year was at the record level of $ 7,2 bill and in the first two quarters of 1970 it was not much better, $ 5,5 bill and $ 4,8 bill respectively. It is true that until 1970 the balance on the official reserve transactions basis was satisfactory (a surplus of $ 6,1 bill in 1968 and 2,7 bill in 1969). But it was to be expected that when the inflow of private capital decreased or reversed itself, officially held dollar balances would increase. This happened in 1970 on a very larger scale; In the first quarter 1970 the official transaction deficit reached alltime record of $ 11,5 bill and in the second quarter $ 7 bill (annual rates).

The traditional surplus of exports over import (trade balance) almost vanished in 1968 and 1969 but has shown a vigorous improvement in 1970, although it is still much smaller than it was in the good years 1963 and 1964.

The paradoxical thing is that the unprecedented deterioration of the external balance in 1969 has not even caused a ripple in the exchange market as far as the dollar is concerned, while several other major currencies were under the cloud. This is in sharp contrast to the impact of the much smaller deficits in 1967 and early 1968.

What is the explanation? One reason surely is that the inadequacy of the "liquidity definition" of deficit was brought home by the fact that in 1969 official settlement balance was in large surplus ($ 2,7 bill) while the liquidity deficit rose to a record high. In other words the fact that official dollar holdings abroad fell substantially from $ 15,60 bill Dec. 1967 to $ 10,-bill July 1969 has helped to reassure foreign central banks about the position of dollar. This explanation is supported by the fact that the recent sharp rise of official dollar holdings abroad

(to $ 14,8 bill May 1970) has not failed to cause expressions of concern and exhortation addressed to the U.S. Government by foreign central bankers and recently by the IMF chief.

I am convinced however, the deeper and decisive factor that accounts for the strikingly changed situation is a different one. It is, I believe, that the events of the last few years have made it clear to the financial leaders, central bankers, economic journalists etc. that the world is practically on the dollar standard whether they like it or not. In a sense the world has been on the dollar standard ever since the last war (or earlier). But it was not widely accepted and was regarded by many influential experts (from Jacques Rueff Triffin) as an essentially unstable and unsustainable situation. Other countries, it was said, will increasingly become reluctant to hold additional dollar balances and would sooner or later lose confidence in the dollar. There has indeed been a period of increasing mistrust and suspicion of the dollar which reached the point of greatest intensity late in 1967 and early in 1968. But since then the system has regained its stability. What accounts for the change?

The political events of 1968, the studetns and workers rebellion in France which led to the departure of deGaulle and turned overnight the French Franc from one of the strongest currencies in the world into a weak one—this and the invasion of Czechoslovakia have created a feeling of insecurity in Europe and by contrast revived the confidence in the U.S. and the dollar. True, France has regained a somewhat precarious stability, but this was offset by the continued weakness of the Pound and the political and economic troubles in Italy.

On the technical level the decisive events were the insulation of the American and the world's monetary gold stock from the private gold market and from gold speculation through the introduction of the two-tier gold market. Equally important is the realization that the dollar has become *de factor* inconvertible into gold, at least for large sums. Dollar balances abroad should have become too large for conversions; the point of no return has been passed.

The *de facto* inconvertibility of the dollar into gold for sizable conversions has, of course, never been acknowledged officially and if asked point blank U.S. as well as foreign officials would probably deny it. It is nevertheless a fact, in my opinion, and it would not be difficult to cite numerous statements by responsible officials as well as of knowledgeable economists, financial journalists etc. which show full awareness of the *de facto* inconvertibility of the dollar. If one of the large dollar holding central banks were to ask for a billion dollars' worth of gold, they would be told that they cannot have it. Because they know it, they don't even ask. Nobody wants to rock the boat.[1]

IMPLICATIONS FOR POLICY OF THE U.S.

The policy implications for the U.S. of our assessment of the situation are straightforward. American balance of payments policy should be passive. The U.S. cannot change the exchange rate and should avoid direct controls. How about inflation? The U.S. should of course do all it can do to stop inflation. This is the declared policy goal anyway. I feel strongly that inflation must be stopped or at least sharply slowed down for domestic reasons, to put an end to the distortions and inequities that are constantly inflicted on the social economy by inflation. Stopping or slowing inflation will be good also for the balance of payments and the international status of the dollar. At the present time there exists no overt conflict between domestic and external (balance of payments) considerations. On both grounds inflation should be brought to an end as soon as possible. But a conflict between domestic and external objectives may arise in two ways and in a sense may be said already to exist.

First there are limitations on the speed with which inflation is slowed, limitations imposed by the amount of unemployment and loss of output growth which rapid disinflation entails. And the domestically feasible or acceptable rate of disinflation may well be insufficient from the balance of payments point of view. Second the conflict between domestic and external requirements may be sharper: If a country has a weak balance of payments when it suffers from unemployments

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[1] For a rigorous analysis of this problem see Lawrence H. Officer and Thomas D. Willett "Reserve-Asset Preferences and the Confidence Problem", *The Quarterly Journal of Economics*, Vol. 83, Nov. 1969 P. 688–695 and the same authors "The Interaction of Adjustment and Gold Conversion Policies in a Reserve Currency System", *Western Economic Journal*, March 1970.

and slack rather than from inflation, domestic considerations call for monetary expansion while the balance of payments requires monetary contraction. Contrariwise if a surplus country suffers from inflation, internal equilibrium requires tight money (high interest rates) while external equilibrium requires the opposite policy. At present Germany may be said to be in this predicament.

Other countries when confronted with such a dilemma can always escape by changing the exchange rate or, still better by letting their currency float as Canada did again recently. The U.S. cannot do that. What should it do?

My answer is, and many economists share this view, that the U.S. should conduct its monetary policy, or to express it in a somewhat broader fashion, its "demand management policy" in such a way as is best for the achievement of domestic policy objectives (price stability, full employment, growth) rather than as would be indicated by balance of payments desiderata.

To repeat, at the present time, in my opinion there exists no conflict between internal and external requirements. But if a conflict should arise, either with respect to speed and intensity of disinflation or with respect to the direction of monetary policy, domestic policy objectives should take precedence over balance of payments considerations. This implies that we should not create more unemployment or temporary retardation of growth than may be necessary to deal with inflation in view of our domestic objectives and priorities.

IMPLICATIONS FOR REST OF THE WORLD

But is this state of affairs acceptable from the point of view of other countries or of the rest of the world?

Let me distinguish three cases.

First assume the U.S. succeeds in reducing the rate of inflation to a domestically acceptable level, say a rise in the cost of living of 2% or less on the average of good and bad years. In that case we could expect a substantial improvement in the balance of payments as we did during the stable period of 1960–1965. Private liquid foreign dollar holdings would continue to grow as they have almost uninteruptedly for more than 10 years. There is nothing that can and should be done about it although it would mean (unless official foreign dollar holdings declined) a continuous deficit of the liquidity balance.

But the possibility cannot be excluded that a few countries would also see their official liquid dollar balances go up. But there certainly would not be many such cases because only very few countries could match that inflation performance. (Theoretically it is possible that some countries have balance of payments surplusses even if they had more inflation than the U.S. because of shifts in international demand in their favor. But I do not think that this would happen often or on a large scale. Even if it did happen it would not affect my basis agrument.)

Now, any country that earns, for any reason whatever, differential inflation or structural change, more dollars than it wants and more than the U.S. is able to or willing to convert into gold or SDR's has three choices: It can upvalue its currency in terms of dollars (or let it float up); it can step up its own inflation; or it can reduce import restrictions and export subsidies. Each of these options would be acceptable from the American standpoint.

Secondly make the pessimistic and hopefully unrealistic assumption that the U.S. gets stuck with a rate of inflation of say 4–5% as at present, which is clearly too much from the domestic standpoint.

In that case the US balance of payments will be in deficit and more countries would find their official dollar balances growing faster than they wish. But their policy choices would still be the same as above and each of them would be acceptable from the American standpoint. I would doubt, however, whether many countries would be in that position for the simple reason that over the years most countries have spontaneously *more* than matched the US inflation of recent years. It is true that under inflation dollar balances private and official depreciate in terms of real purchasing power. This constitutes a loss, but higher interest rates resulting from inflation provide at least a partial offset which gold does not offer and SDR's cannot match.

Thirdly let us be still more pessimistic and assume that the US rate of inflation goes up to, say, 6 or 7% a year. This certainly would cause trouble. Still more countries would find their dollar balances accumulating too fast and would become restive. But their options would still be the same as in the previous cases—

matching inflation, offsetting changes of the exchange rates, elimination of border taxes and tax refunds on export. Great dissatisfaction with the US inflation would stimulate the search for another reserve and private transactions currency, perhaps in the form of a European or Common Market currency.[2]

Fortunately this point has not been reached. Inflation in America is not likely to become that bad and the Europeans are not ready for monetary unification. They are still far from the high degree of policy harmonization that would be required for real monetary integration.

My conclusion is then this: With US inflation moderate by world standards (including most industrial countries), gold unavailable and a real substitute for the dollar as international reserve, transactions and investment currency not yet in sight, the dollar standard is safe, with a good margin to spare.

All in all this is, in my opinion, not a bad system either from the American standpoint or from that of the rest of the world.

SPECIAL DRAWING RIGHTS AND THE "LINK"

How do the SDR's fit into the picture? The answer is, I believe, that they make very little difference, at least if issued, as planned at present, in moderate amounts. Unless annual allocations went far beyond the present size, SDR's will be, as in fact they are meant to be, a substitute for dollar balances. They will replace some dollars in official reserves. SDR's are, of course, not for private use and the accumulation of privately held dollar balances will presumably continue. Partial or total substitution of SDR's for dollars in the growth of (official) international reserves may make the dollar standard psychologically and politically more palatable for some countries, although the interest yield of dollar balances is much higher than that of SDR's. The fact that the introduction of SDR's sharply reduces the likelihood of a change in the gold price cannot fail to strengten the position of the dollar.

The suggestion made by some European officials at the Copenhagen meeting of the IMF that further allocation of SDR's should be suspended until the US balance of payments deficit—presumably on the official reserve transaction basis—has substantially disappeared does not make much sense. Such a suspension would simply result in a *pro tanto* greater accumulation of official dollar balances.

I come now to the "link", the proposal to channel all or part of the SDR's allocated to the industrial countries through IBRD or IDA for the use of development aid to less developed countries (ldc's). In my opinion there are a number of reasons why no such link should be established.

First as Harry Johnson and others have pointed out, the SDR's will have enough trouble to get firmly established and properly managed even without the additional formidable complications created by the connection with aid. These difficulties will not only exist at the beginning when the "link" is introduced but will continue to complicate the management of the SDR's indefinitely. Once the "link" exists there is bound to be continuous pressure on the part of the ldc's to increase the allocation of SDR's and to raise the portion channelled through IDA. Pressure from one side will inevitably create counterpressure from the other side. An inkling of what can be expected was provided by the well authenticated report (The *New York Times*, Sept. 29, 1970 and *The Economist*, Sept. 26, 1970, p. 72) that a movement was under way to organize the ldc's in the Fund for the purpose of voting against any reform of the Articles of Agreement, such as the proposal to widen the margin of permissible deviations of the exchange rate from the par value ("band proposal"), unless such a reform was coupled with the link—in other words to link "the link" with "the band" (or with the "crawl").

Secondly, as was also pointed out by Johnson, the link is essentially a proposal for inflationary financing of development aid. With a moderate allocation of SDR's and only a portion channelled through IDA the inflationary effect may quantitatively be a negligible at least at first. But it is bound to increase and the principle is bad anyway.

Professor Machlup[3] has shown that an increase in international liquidity

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[2] If the private demand for dollar balances declined (if there was "a flight from the dollar") it would take the form of a rapid rise of official dollar balances: for dollars sold by the private sector must find their way into official balances. Official dollar holders abroad (foreign central banks) can get rid of their dollars only by letting their currency appreciate (depreciating the dollar) either openly or in a disguised and messy form e.g. by manipulating border taxes and similar devices or by inflating sufficiently themselves.

[3] *Remaking the International Monetary System. The Rio Agreement and Beyond.* Baltimore 1968.

through a rise in the gold price and in gold production is more inflationary than an equal increase in liquidity brought about by the creation of SDR's. It is for exactly the same reason that the "link" must be said to be more inflationary than the present method of SDR-creation.

Thirdly, for two reasons the sums and resources devoted by the donor countries for development aid should be voted and appropriated through to ordinary budgetary process, and not be provided as a by-product of international money creation. For one thing when aid goes through the government budget no extraneous inflationary elements are introduced. For another thing Congress should legislate and appropriate the sums it wishes to devote to foreign aid. The decision should not be left to international officials.

It might be objected that congressional approval of acceptance of the SDR's will be required anyway. But this does not in any way invalidate or weaken the case against the "link".

In the first place when debating whether the proposed additional supplies of international liquidity is of the optimal or proper size Congress should not be influenced, as it inevitably would be in case SDR's were linked with aid, by extraneous considerations. In the second place if it is realized that aid given by channelling SDR's through IDA represents in principle, no less of a burden than aid extended through the ordinary procedures, it is not clear why it should be easier to persuade Congress to agree to the link than to appropriate aid through the budget. The fact of the matter is that the proponents of the link hope through the link to increase the volume of aid. But the success of this strategy depends essentially on the spreading the erroneous notion that for the donor countries the cost of aid via SDR's is nil or at least less than aid via the budget.

This brings me to the *fourth* reason why I am against the "link". It should be clear that for the industrial donor countries collectively providing aid by buying back from ldc's the SDR's which were distributed via IDA implies the same economic burden as giving aid in the ordinary ways. The economic burden or real cost of aid consists of the export surplus, the transfer of real resources from the donor to the recipients. But the distribution of the total burden among the industrial countries may well be different under the two methods, except perhaps in the very long run.

Under the tradition method an attempt is being made to approach a roughly equal, if not equitable, distribution of the burden by striving for a uniform GNP percentage of aid contribution from all industrial countries, the famous 1% or 0,7% target. True, the goal has not yet been reached and it is by no means clear whether a uniform GNP percentage is the ideal formula. But the postulate of an equitable distribution is at least explicitly acknowledged and deviations from the postulated ideal is measurable.

Under the link system the distribution of the burden, or to put it differently the contribution of different countries, is practically impossible to foresee. It will depend partly on the size of the quotas of the various countries in the Fund, partly on the pattern of balance-of-payments surplusses of the industrial countries which the infinitely complex system of world market forces and national policies of scores of countries will produce.

The difference between the two systems is about the same as the difference between a) a national tax system that distributes the national tax burden among tax payers somehow according to individual incomes and/or wealth and b) a tax system which distributes the tax burden by means of a lottery. It should not be difficult to decide which system is preferable.

Chairman BOGGS. Now, Dr. Oppenheimer, we will hear from you.

STATEMENT OF PETER M. OPPENHEIMER, LECTURER IN ECONOMICS, OXFORD UNIVERSITY

Mr. OPPENHEIMER. Thank you, Mr. Chairman. May I say first that I regard it as a great honor to be asked to appear before this committee and that it is a pleasure to be in Washington.

Chairman BOGGS. Very pleased to have you.

Mr. OPPENHEIMER. I have submitted a rather lengthy prepared statement as well as a short piece published elsewhere for the record.

I fear the thought that I may never have the opportunity to appear before a committee like this again tempted me to submit rather a lot of material; and I have neglected the danger that if I submit too much, I will never be asked again.

Chairman BOGGS. We will make your material a part of the record at the end of your oral statement.

Mr. OPPENHEIMER. I shall summarize the prepared statement I have prepared and like Professor Haberler, I shall focus mainly on the particular situation of the United States. But before I do so, may I make a few general remarks about balance-of-payments policies and the range of choice available to governments.

The modern approach to balance-of-payments questions views them as one dimension of the general problem of managing the economy. In this area governments have two aims: Balance-of-payments equilibrium, the external aim, and a satisfactory level of output and employment at home, the internal aim. We talk about external and internal balance in that sense as being the objectives of government.

Now, to achieve these two targets, governments in principle need two types of policy weapons: monetary and fiscal policy, which determines total expenditure by domestic residents on all types of product; and the exchange rate, which regulates the level of home production costs in international terms and thus determines the division of expenditure, both by home residents and foreigners, as between the home country's products and foreign products.

You did mention in your opening statement, Mr. Chairman, a number of alternative weapons which are often mentioned in this context—such as trade controls, capital controls, or direct intervention in the wage bargaining process to affect the level of production costs at home directly. I would prefer to exclude these alternatives from a statement of this kind, because it seems to me that although governments are often tempted to use them and still do not like the thought that the exchange rate is the policy weapon to focus on from the external standpoint, it is the case that many of these alternative weapons are either undesirable or ineffective or both.

If I could just amplify that very briefly, so far as trade controls are concerned: these are, of course, supposed to be banned under various international agreements to which the major industrial countries are subject. This has not prevented such countries from resorting to trade restrictions on a temporary basis—Canada, France, and the United Kingdom have all used them in recent years. But it seems to me that the temporary use of restrictions has in no case contributed to the correction of payments disequilibria in the medium or longer term.

If one thinks of using them in the longer term—as opposed to just a temporary use and then getting rid of them again—one faces two important arguments against them, apart from the international obligation point. The first is the basic case for free trade, which says that if you do want to interfere with free trade, you should base such interference on the need to manipulate the allocation of real resources for social reasons and not on the need to correct payments disequilibria.

Secondly, in the longer run, selective restrictions tend to prove self-defeating, while comprehensive ones are formally equivalent to the

use of exchange rates, only much more costly and bureaucratic. Certain countries, notably France in the 1950's and one or two developing countries have been through a process where you begin by imposing import controls. This raises your costs at home. Soon you require export subsidies and you end up with a tangle of bureaucratic controls which has eventually to be cleared away by substituting a devaluation.

Controls on international capital movement are not subject to the sanction of international agreements. Quite a number of countries, including the United States of course, have used them. But there is an argument here analogous to the earlier argument about restraints on trade, that interference with international movement of capital should be governed by real resource considerations, by the desire to maximize the social return on investment, and not by arbitrary constraints on the exchange rate mechanism.

Perhaps I could just say a quick additional word about that. The difference between trade and investment, I think, is that in the case of investment, interference with market forces is more frequently justified than in the case of trade. The reason is that the conflicts of interest are much more complicated. It is not simply a matter of conflicts between, say, private firms and the Government, but between two or more national governments, each of them trying to maximize its share of the tax and other benefits that can be extracted from the activities of the international firm. It is not a matter of governments interfering with free markets. It is governments clashing with each other.

If you have, for instance, a U.S. firm operating in the United Kingdom, you might get an argument between the British and United States Governments about how the total profits tax paid by that firm should be apportioned between the government of location and the government of nationality of the firm.

Well, could I now, having on the whole rejected alternatives to the exchange rate as weapons of external policy, come to the special position of the United States. The precise way in which an exchange rate operates to correct an external disequilibrium varies from country to country and will depend partly on the size of the country. Large countries are affected in a different way from small countries.

The U.S. balance of payments is, I think, the most important example of the way in which one country's problems interact with others. Indeed, the U.S. balance-of-payments problem and the policies that should be pursued to deal with it can't be understood without deciding just what sort of monetary system we are in. In other words, we cannot say by what sort of adjustment mechanism the United States should pursue its targets of internal and external balance until we have decided the nature of our monetary system.

Now, the words "monetary system" here mean more than just a set of rules and institutions. They mean a general equilibrium structure; that is to say, a set of conditions which allows all countries to achieve an equilibrium position on their balances of payments simultaneously. At the present time the world is poised between three different systems in this sense, each of them having different implications for U.S. balance-of-payments policy. These three systems are as follows:

We have first the Bretton Woods system, the system dating from

the Bretton Woods Agreement of 1944; we have second, the dollar standard about which Professor Haberler spoke and on which I agree with most of what he had to say. Third, we have something halfway between the Bretton Woods system and the dollar standard, which is not yet properly defined, but which appears to involve a significant role for special drawing rights in the structure of international reserves.

Under the Bretton Woods system, a central logical position is occupied by gold. The United States has chosen for political reasons to ignore this fact and many economists, for what I can only describe as emotional reasons, have supported the U.S. attitude; so I want to emphasize this point particularly. Perhaps I should say for the record that despite my surname, I have no South African connections.

In the Bretton Woods system, the U.S. exchange rate is the dollar price of gold. This is an exchange rate no different from any other, although it operates somewhat differently from others. The IMF articles of agreement explicitly provide for changes in the gold price because it was recognized at Bretton Woods that such changes might be necessary in order to insure equilibrium of the system.

Under the Bretton Woods structure, the part of the system that is ultimately affected by an incorrect price of gold is the U.S. balance of payments. This is because the U.S. Treasury is the residual buyer or seller of gold in the system and when insufficient new gold is coming forward from new production to satisfy the demand for additional reserves by other countries, then the gap will be filled by a deficit in the U.S. balance of payments, involving some combination of foreign accumulations of dollars and rundowns of the U.S. gold stock.

Now, there has been a lot of discussion among economists and others about the causes of the persistent U.S. payments deficit in the 1950's and 1960's. I list some of the factors that are commonly mentioned: Marshall aid, U.S. price inflation in the 1950's, the U.S. propensity to invest overseas, the catching up of European technology and the Vietnam war. There are others. The point I am trying to make is that to list these is not wrong; they did take place, they did affect the outcome. But it is superficial because, if inflation and overseas investment and other things had not kept the United States in deficit during this period, then the policy responses of other countries would have insured the same result. In other words, there would have been another round of devaluations on the 1949 pattern of other currencies against the dollar, or some other set of comparable policy moves. In this sense, the real and profound cause of the U.S. deficit all these years was the inadequate inflow of new gold reserves to the system. By the same token, of course, a substantial increase in the gold price would have cured and would still cure the U.S. deficit for the time being.

I stress the word "cure." Not "finance." For the most important impact of a big rise in the gold price is not the upvaluation of the existing gold stock but the effect on flows of newly mined gold. This would be achieved mainly by the increased value of each ton produced and by a decline in private purchases of gold, not by an increase in tonnage mined, which might be rather small.

I calculated a few years ago that in 1966, on certain assumptions, a gold price of $70 an ounce would have produced an annual inflow of $1,500 million of new gold reserves to the world system, which is about three times as much as the annual figure we actually saw in the 20 years preceding.

Now, just how a higher gold price and the resulting inflow of new reserves would have cured the U.S. deficit—that is to say, what parts of the U.S. balance-of-payments accounts would actually register an improvement—can't be specified in advance. By my earlier argument, this will depend on the response of all the other countries in the system to the increased inflow of reserves. You would probably get some upvaluations of other currencies, you would get some lowering of interest rates in other areas, and so on. All parts of the U.S. balance of payments would be affected indirectly. This is what I mean by saying that the price of gold does not operate quite like other exchange rates. Under the Bretton Woods system, the price of gold is a national policy weapon, but one which affects the balance of the entire system and ties it together.

Let me deal more briefly with the other two systems, because there is less that can be said about them, in the sense that their structure is not as clear as that of the Bretton Woods.

The dollar standard we have heard about from Professor Haberler and I would agree with much of what he said. Under the dollar standard, the United States cannot logically have a balance-of-payments target. Its capital controls and other balance-of-payments policies would have no rationale in that system. U.S. policy would still need to be directed to securing internal balance, but external balance would be taken care of automatically by other countries. The problem with this system is that we really don't know whether countries other than the United States or even the United States itself wants a system of this kind. We have been willy-nilly pushed toward it by the unwillingness to raise the price of gold. But whether anyone actively wants a dollar standard is quite a different matter.

I come to the third system. The scheme for Special Drawing Rights in the International Monetary Fund seems to provide a way of avoiding a dollar standard on the one hand and an increase in the price of gold on the other. Under certain assumptions it can do this. But they are pretty implausible assumptions. The assumptions are that first the countries outside of the United States come to regard their allocations of these special drawing rights as in every way equivalent to balance-of-payments surpluses. Second, these countries agree to create special drawing rights permanently on the scale sufficient to meet their entire demand for reserves. What this means is that a SDR-based system would be one in which the rest of the world adjusted its exchange rates in such a way as to insure a zero balance of payments in every country, including the United States; and at the same time, SDR's would be created on a sufficient scale to meet all countries' demands for reserve increments.

Now, the trouble with this scheme, when you view it as a solution to current problems, is threefold: First, it underrates the difficulty of securing continuous agreement among the major countries on what the system needs by way of new reserves. I would like to stress that the

Bretton Woods system did not require such agreement. All it required was for every country, including the United States, to pursue the twin goals of internal and external balance.

Second, the SDR system overrates the likelihood that countries will ever be prepared deliberately to eliminate even small surpluses in their flows of external payments. Governments find it politically valuable, especially when there is an election coming up, to be running surpluses. You are comfortable, you do not have to put on taxes for balance-of-payments reasons. You can go to the electorate and say the balance of payments is strong. I think many people in the United States underrate the importance of this because the balance of payments in the United States is a small problem relative to the size of the economy compared with other countries. But it is an important point. In my view, an efficient monetary system would allow other countries to run small surpluses if they choose to do so and not try to compel them away from this, because it probably will not succeed.

Third, the SDR scheme doesn't deal with the problem of gold and the dollar. It just tries to push it under the carpet. I would like to put the point to you in this way: Ask yourselves this question: Are U.S. policymakers supposed to be free to change the dollar exchange rate by their own volition? If not, then the world is implicitly on the dollar standard and SDR's are largely make-believe. If the United States is supposed to be free to change its exchange rate by its own volition, then we are back on the Bretton Woods system because the U.S. exchange rate is the price of gold.

The only qualification that could be made here is that we may be moving toward a situation where the U.S. authorities will feel free to raise the dollar price of gold by a small amount, say 10 percent, with the idea of securing a valuation of the dollar relative to a few other currencies. Of course, such a depreciation of the dollar vis-a-vis other currencies could also result from a larger increase in the gold price which other countries followed but not quite all the way. But a relative currency depreciation of the dollar would not be the main rationale of a big increase in the gold price under the Bretton Woods system. And it is conceivable that some of the rationale of a big increase in the gold price is being removed by the introduction of special drawing rights.

But I confess that I cannot see clearly whether this is really so. I do not see clearly where the international monetary system is going, and I do not believe that anybody else does either. Certainly, the negotiations of the past 7 years have not produced anything of the intellectual caliber or comprehensiveness of Bretton Woods. In this case, I do not see any early solution to the U.S. balance-of-payments problem.

Other speakers have referred to the recent remarks of the Managing Director of the IMF in Copenhagen, in which he said for the upteenth time, that "from the standpoint of the functioning of the international monetary system, by far the most important problem is posed by the deficit in the balance of payments of the United States."

Quite so. But what I would have liked to hear from the Managing Director is how he proposes that the United States should cure its deficit.

Thank you, Mr. Chairman.

Chairman BOGGS. Thank you very much, Dr. Oppenheimer.

(The prepared statement of Mr. Oppenheimer, with attachment entitled "The Outlook for the Present World Monetary System," follows:)

PREPARED STATEMENT OF PETER M. OPPENHEIMER

THE BALANCE-OF-PAYMENTS ADJUSTMENT PROCESS

POLICIES FOR INTERNAL AND EXTERNAL BALANCE

The modern approach to balance-of-payments questions views them as the external dimension of government management of the economy. Taking one year with another, governments aim to maintain an optimum level of output and employment ("internal balance") and to avoid either persistent deficits or excessive surpluses in their foreign payments ("external balance"). On the deficit side the balance-of-payments constraint is the way in which the universal need to operate within one's available resources makes itself felt in an open economy. On the surplus side, countries wish to avoid undue sacrifice of real resources, as well as inflationary pressures resulting from excessive export demand and from the expansion of the monetary base as the central bank accumulates foreign-exchange reserves.

In order to achieve the twin policy targets of internal and external balance, governments and central banks normally require two types of policy weapon. Monetary and fiscal policy determines the total expenditure of domestic residents, both on home products and on foreign products through imports or overseas investment. The exchange rate regulates the level of home production costs in international terms, and thus determines the division of expenditure both by home residents and foreigners as between the home country's products and foreign products.

It is not suggested that monetary and fiscal policy and the exchange rate are the only factors influencing expenditure; merely that they provide sufficient leverage for governments to determine the final outcome, given the propensities of individual economic units in the private and public sectors. Experience has not shown this assumption to be unreasonable.

In what follows I shall first say something more about the significance of exchange rates and of possible alternative policy instruments. I shall then point out some of the ways in which the exact nature of the adjustment mechanism may differ, depending on the economic structure and size of a country. In the case of the United States, which is not only very large but remains the pivotal country of the world monetary system, the adjustment process cannot be understood without considering the nature of the system as a whole.

THE EXCHANGE RATE AND ITS USE

The immediate purpose of altering an exchange rate is to lower or raise the home country's cost level in international terms. It is, of course, *money* costs that are meant here, not "real" costs or output per man. An equilibrium structure of exchange rates will be under which national differences in money-wage rates correspond approximately to national differences in labour productivity. There is, however, more than one technique by which exchange rates can be managed so as to achieve or maintain an equilibrium structure. This question has been examined at length in the recent report of the International Monetary Fund on *The Role of Exchange Rates in the Adjustment of International Payments*. The par-value system of the post-war period has been based on the idea of fixed but occasionally adjustable parities, with small margins of fluctuation on either side. Parities are supposed to be changed only in a situation of "fundamental disequilibrium", i.e. when internal and external balance cannot be simultaneously achieved at the existing parity.

For example, Germany was in fundamental disequilibrium in 1960–61 and again in 1968–69, because, without an upvaluation of the D-Mark, the reduction of the huge external surplus on current account would have required an unacceptably high rate of price inflation inside Germany. Similarly, the United

Kingdom was in fundamental disequilibrium for most of the 1960's because, at the exchange rate of $2.80 to the pound, it was able to keep its balance of payments out of deficit only in bringing the expansion of output to a halt and creating an unacceptable degree of slack in the economy. The "acceptable" amount of unemployment or inflation—and hence the definition of fundamental disequilibrium—varies not merely from country to country but from time to time in the same country, depending on the government in power, the nature of social security provisions, and so on. This, however, does not affect the validity of the concept.

The main alternative technique for altering exchange rates is to allow them to vary continuously, for the most part in response to market forces rather than government intervention. In this case the idea of "fundamental disequilibrium" has no application, since external balance is maintained on a day-to-day basis. The Canadian authorities decided earlier this year to abandon at least temporarily the fixed parity of the Canadian dollar—as they did once before in 1950, for a twelve-year period. A number of voices have also been raised recently in the United Kingdom in favour of floating the pound sterling. I agree that there are cases in which a floating or steadily crawling exchange rate is probably the best policy. An obvious example is when a country undergoes continuous and rapid, but not accelerating, inflation, in the manner of some Latin American states. However, if one is thinking about the nature of the international system as a whole, then I would endorse the I.M.F. report's vindication of the par-value system. Nothing has happened in the past twenty years to suggest that that system suffers from basic flaws or deficiencies.

It is true (as the I.M.F. report also says) that governments have sometimes treated the exchange rate as a political totem rather than as a technical weapon of policy, and have failed to make adjustments promptly. "Promptly" means, in the case of a deficit country, before excessive foreign debts have been accumulated; or, in the case of a strong surplus country, before a serious inflationary spiral has set in at home. Sometimes also it may mean, before firms and industries have adapted their structure to a disequilibrium exchange rate. But this is merely an argument for educating governments to adjust parities more promptly, and therefore probably by smaller amounts, in future. It is not an argument for abandoning the idea of fixed parities altogether, unless it can be shown that national economic management as a whole would be better with a generalized system of floating rates. Advocates of such a system tend to assume (rather than demonstrate) that this would be so, but I do not think their assumption is justified. This is mainly because, with floating rates, the national economy is deprived of a safety valve. Mistakes of monetary and fiscal policy can no longer be partly absorbed by changes in the external balance, but will be fully reflected in domestic prices and output and (of course) in the exchange rate. It is here also that the danger of wide oscillations in exchange rates, reflecting speculation or hedging on top of misjudged policy measures by governments, cannot be ruled out.

The foregoing discussion has assumed that there is no satisfactory alternative to the exchange rate as an "expenditure switching" weapon. This assumption is still not very readily accepted outside academic circles. Two kinds of alternative weapon are conceivable:

(i) control of domestic wage and price trends, or "income policy"; and
(ii) controls on international transactions.

In each case, however, there are doubts about the feasibility and effectiveness of the measures, or about their desirability, or both.

Incomes policy is supposed to contribute to balance-of-payments adjustment mainly through its use by deficit countries to slow down their rate of inflation (assuming, of course, that fiscal and monetary policy is being used to prevent inflationary pressures from the demand side). Surplus countries may also be prepared to allow their costs and prices to increase at a slightly faster rate than before. But this is rare; surplus countries will usually get their inflation involuntarily. Where serious inflation reflects the exercise of market power by Trade Unions—as in the United Kingdom at the present time—I think it is imperative that governments should try to influence wage bargaining for the sake of price stability and general economic management. This, however, is a difficult social issue, on which government attitudes fluctuate. And so far it has not in fact been shown that incomes policy can be a reliable weapon for controlling inflation or for correcting balance-of-payments disequilibria. I shall therefore say no more about it here.

As regards controls on international transactions, a distinction has to be drawn between the current (goods and services) account and the capital account. For the industrial countries, restrictions or new tariffs on current transactions are forbidden under Article VIII of the I.M.F. Articles of Agreement, the O.E.C.D. Code of Liberalisation and the General Agreement on Tariffs and Trade (G.A.T.T.)—as well as other commitments suh as those of E.E.C. or E.F.T.A. membership. This has not prevented countries from resorting to such measures on a temporary basis during the past few years; but I do not know of any case where the temporary use of restrictions on current payments has contributed to the correction of payments disequilibria in the medium and longer term.

Furthermore, the use of restrictions in the longer term (if one wishes to consider this) is inferior to the use of exchange rates in normal circumstances, for two reasons. The first is the basic economic case for free trade, which need not be repeated here. This argument does not say that there should never be any departures from totally free trade; only that such departures must be justified by their contribution to the socially desirable allocation of real resources, and not by the need to correct payments disequilibria.

The other argument agains trestrictions on current payments in the longer run is that selective restrictions tend to prove self-defeating, while comprehensive ones are formally equivalent to the use of exchange rates, only much more costly and bureaucratic. Suppose, for example, that a country begins by imposing import tariffs or quotas. Higher profits in the import-competing sector will tend to be followed by faster wage increases there. These increases will tend to percolate through the rest of the economy and will impair the competitiveness of the export industries. The resulting loss of export receipts may even come to exceed the initial import saving, leaving the balance of payments worse off than before. The argument is strengthened if import restrictions extend to capital goods and other industrial inputs; in this case import curbs directly impair export competitiveness. Thus. import controls lead sooner or later to the need for export subsidies, and eventually the whole mess has to be cleared up by substituting a devaluation. France went through this kind of process in the 1950's, and a number of developing countries have also experienced it.

Of course, devaluation is an even more powerful cause of cost inflation than import curbs, and policy-makers must allow for this. Unlike import controls, however, devaluation gives the export industries a cost advantage in international terms; and they will end up less competitive than before only if the proportionate rise in their unit costs exceeds the amount of the devaluation.

Controls on international capital movements are not ruled out by the I.M.F. Articles, and many countries make use of the them. Relevant policy measures include not only administrative controls on overseas investment or foreign security issues, but also fiscal measures such as the Interest Equalization Tax or changes in company taxation designed to alter the relative tax burden on home and overseas profits. The comparative tolerance accorded to such measures, however. is hardly justifiable on the grounds that they are a desirable means of managing the balance of payments. To the extent that a country wishes to invest its gross national savings abroad rather than at home, balance of payments equilibrium requires a corresponding surplus to be generated on current account—with the help of exchange-rate changes where necessary—so that the appropriate volume of resources is transferred abroad each year. To limit net overseas investment to whatever surplus on current account happens to emerge at prevailing prices and exchange rates (and assuming full employment at home) is not an optimum policy. The argument here is analogous to the earlier argument about the gains from trade. The balance between home and overseas investment should be governed by real-resource considerations—by the desire to maximise the social return on investment—and not by arbitrary constraints on the exchange-rate mechanism.

The difference between trade and investment is that in the case of investment there are additional factors which justify interference with the market mechanism (on real-resoruce grounds) more commonly than in the case of trade. The basic issue is how the returns from an investment are to be distributed. This depends on the country-location of the investment, on arrangements for company taxation and other factors. The conflicts of interest involved here are not simply between the private firm and the government, but also between two or more national governments, each one trying to maximise its share of the total tax and other benefits that can be extracted from the activities of the international

firm. One would not expect any government to stand aside here on the spurious grounds that "investment was a matter for the market to decide". I need hardly add that I am here confining myself to strictly economic considerations, leaving out the question of national sensitivity or xenophobia about who owns what.

So far as effectiveness (as opposed to desirability) is concerned, capital controls probably get somewhat higher marks as a balance-of-payments weapon than trade controls; but not much higher. The United States and the United Kingdom have both had some success in recent years with measures to encourage a shift in the financing of investment projects from home to foreign markets. But there is no reason to suppose that such measures can, in general, enable countries to dispense with adjustment of the current account through the exchange rate. This conclusion also obtains some support from the persistence of regional unemployment problems within nation states, often despite government efforts to channel capital to the regions concerned.

SIZE, ECONOMIC STRUCTURE AND THE ADJUSTMENT PROCESS

The precise way in which an economy responds to governmental policies for "internal and external balance" will depend upon the structure of the economy concerned and on its position in world markets. For example, consider an industrial country which devalues in order to cure a deficit. The aim of the devaluation is to reduce the country's absorption of resources at full employment. This means that, on the expenditure side, there must be less consumption and/or domestic investment at full employment than would otherwise have occurred. But what exactly is involved on the production side? The interesting question, which may affect the size and speed of the adjustment, is how far the composition of output has to change, and factors of production have to be moved from one industry or firm to another. At one extreme, it is possible for the composition of output to remain completely unaltered. A number of firms may simply find it profitable to sell more of their output abroad than before; or may find their product able to replace imports in parts of the home market. At the other extreme, it may be necessary to go through a laborious process of shifting manpower and capital into the export and import-competing goods industries, which may significantly delay the adjustment process. As pointed out earlier, it is desirable that exchange rates be altered promptly, so as to prevent the capital structure of industry as far as possible from adapting itself to a disequilibrium situation.[1]

Moreover, this may be desirable not only in one's own interest but also in that of other countries. For example, suppose that, in a multi-country world, country X is allowed to run a persistent deficit for some years, while country Y remains in equilibrium. When X finally devalues, it may rob Y of some of its more recently developed export markets and push it into payments deficit. Interactions of this kind depend on the size of the relevant countries' foreign trade in relation to world markets. If either X's or Y's trade is "small", i.e. if at least one of them is perfectly competitive in world markets, then there is no problem. Larger countries, however, will be affected.

THE UNITED STATES BALANCE OF PAYMENTS AND THE WORLD MONETARY SYSTEM

This brings me to the special and critical case of the United States. The United States is not only the largest economy in the world monetary system; it is also the key-currency country, in the sense that other countries maintain their exchange rates in terms of U.S. dollars. The dollar itself remains formally tied to gold at a price of $35 per fine ounce. Now, by what means can the United States pursue the twin targets of "internal and external balance"? What sort of adjustment mechanism applies to it?

These questions cannot be answered without considering the nature of the monetary system as a whole. The words "monetary system" here mean more than just a set of rules and institutions. They mean a general equilibrium structure,

[1] Of course, if the payments disequilibrium is due to an autonomous shift in world demand patterns or to technological change, then some industrial restructuring will almost certainly be required in any case and will not be avoidable through a quick change of the exchange rate. However, an expanding economy normally has some flexibility of industrial structure at the margin; and a "correct" exchange rate will perform a vital role in helping to guide newly available resources to the right sectors.

i.e. a set of conditions which will allow all countries to achieve an equilibrium position on their balances of payments simultaneously. At the present time the word is poised between three different systems in this sense, each of them with different implications for U.S. balance-fo-payments policy. These systems are:

(1) the Bretton Woods system;

(2) a dollar standard; and

(3) something half-way between the first two, as yet ill-defined but involving a significant role for Special Drawing Rights in the structure of international reserves.

(1) Under the Bretton Woods system a central logical position is occupied by gold. Since the United States has chosen for political reasons to ignore this fact, and since many economists for emotional reasons have supported the U.S. attitude, I would like to give this point particular emphasis. (Incidentally, despite my surname, I have no South African connections.) Under the Bretton Woods system the U.S. exchange rate is the dollar price of gold. This is an exchange rate like any other—though it operates in ways which are somewhat different from other exchange rates. The I.M.F. Articles explicitly provide for changes in the price of gold, because it was recognized at Bretton Woods that this might be necessary in order to ensure equilibrium of the system. The part of the system that, under the Bretton Woods structure, is ultimately affected by an incorrect price of gold is the U.S. balance of payments. This is because the U.S. Treasury is the residual buyer or seller of gold. When insufficient new gold is coming forward from new production (and, conceivably, from existing hoards) to satisfy the demand for additional reserves by countries other than the United States, then the gap will be filled by a deficit in the U.S. balance of payments, involving some combination of foreign accumulations of dollars and declines in the U.S. gold stock.

There has been much discussion in the literature about the causes of the persistent U.S. deficit of the 1950's and 60's. Marshall Aid, U.S. price inflation in the 1950's, the U.S. propensity to invest overseas, the catching up of technology in Europe and the Vietnam War are among the factors that have been mentioned. Of course these factors influenced events, but it is superficial to describe them as causes of the U.S. deficit. If inflation and overseas investment and other things had not kept the United States in deficit during these years, then *the policy responses of other countries* would have led to the same result. In other words, there would have been another round of devaluations on the 1949 pattern, or some other set of comparable policy moves. The real and profound cause of the U.S. deficit was the inadequate inflow of new gold reserves to the system. This is an additional reason for saying that incomes policy or controls on trade and capital flows will not be effective in ensuring balance-of-payments equilibrium for the United States in the medium term. By the same token, a substantial increase in the gold price would have cured—and would still cure—the U.S. deficit for the time being.

I stress the word "cure"—not "finance." For the most important impact of a big rise in the gold price is not the upvaluation of the existing gold stock, but the effect on *flows* of newly mined gold. This would be achieved principally by the increased value of each ton produced and by a decline in private purchases; increases in the tonnage mined would probably be small. It is difficult to estimate exact numbers; but, on certain assumptions, I calculated a few years ago that a gold price of $70 an ounce in 1966 would have produced an annual inflow of $1,500m. of new gold reserves to the world system—about three times as much as the annual average for the 20 years 1945–65.

Just *how* a higher gold price and the resulting annual inflow of new reserves would cure the U.S. deficit, i.e. what parts of the U.S. balance-of-payments accounts would register an improvement, cannot be stated in advance. For, by the preceding argument, this depends on the response of all the other countries in the system to the increased inflow of reserves. This is what is meant by saying that the price of gold does not operate quite like other exchange rates. Under the Bretton Woods system, the price of gold is a national policy weapon which affects the balance of the whole system and ties it logically together.

(2) An alternative to the Bretton Woods system is the dollar standard. If the U.S. authorities were to complete the job that they half-did in March 1968 and renounce any connection between the dollar and gold, then the United States would cease to have a balance-of-payments target. Its capital controls and other balance-of-payments policies would no longer have any rationale. U.S. policy

would still need to be directed (obviously) to securing internal balance, but external balance would be taken care of automatically by other countries. Foreign monetary authorities would simply have to decide whether and at what level they would continue to take in dollars from the exchange market; and their decisions would determine the price of the dollar from day to day. Some countries might choose to float their currencies against the dollar, and others not. (Note that "dollar standard" does not mean that the dollar exchange rate vis-a-vis other currencies could never change.)

If countries agreed on such a system it could work perfectly well. However, it is not clear that countries (including the United States) really want a system based on the dollar as the only reserve asset.

(3) The scheme for Special Drawing Rights in the I.M.F. is supposed to provide a way of avoiding a dollar standard on the one hand and an increase in the price of gold on the other. It can do this only if countries outside the United States (a) come to regard their allocations of S.D.R.s as equivalent in every way to balance-of-payments surpluses; and (b) agree to create S.D.R.s permanently on a scale sufficient to meet their entire demand for new reserves. In other words, the S.D.R. system would be one in which the rest of the world adjusted its exchange rates in such a way as to ensure a zero balance of payments (taking one year with another) in every country, including the United States. At the same time, S.D.R.s would be created on a sufficient scale to meet all countries' demands for reserve increments.

The trouble with this scheme, viewed as a solution to current problems, is threefold. First, it underrates the difficulty of securing continuous agreement among the major countries on what the system needs by way of new reserves. (Note that the Bretton Woods system and the dollar standard do not require such agreement.) Secondly, it overrates the likelihood that countries will ever be prepared deliberately to eliminate even small surpluses in their flows of external payments. Governments find it politically valuable, both abroad and at home, especially near election times, to be running modest surpluses. In my view, a realistic and efficient monetary system would allow them to do this and not try to force them away from it. Thirdly, the S.D.R. scheme does not really deal with the gold/dollar problem, but tries to push it under the carpet. The issue can be put in this way. Are U.S. policymakers supposed to be free to change the dollar exchange rate by their own volition? If not, then the world is implicitly on a dollar standard, and S.D.R.s are largely make-believe. If yes, then we are back with the Bretton Woods system, at any rate until gold has been fully demonetised.

Or perhaps not quite. It may be that we are moving towards a situation in which the U.S. authorities will feel free to raise the dollar price of gold by a small amount, say 10 percent, with the idea of securing a devaluation of the dollar relative to a few other currencies. Of course, such a depreciation of the dollar vis-a-vis other currencies might also result from a large increase in the gold price, since other countries might follow the dollar not quite all the way. A relative currency depreciation of the dollar, however, would not be the main rationale of a large increase in the gold price under the Bretton Woods system. It is conceivable that some of this rationale (as outlined above) is now being removed by the introduction of S.D.R.s; but at this stage it is impossible to be sure.

I confess that I do not see very clearly where the international monetary system is going. and I do not believe that anybody else does either. Certainly the negotiations of the past seven years have not produced anything of the intellectual calibre or comprehensiveness of Bretton Woods. This means, *inter alia*, that no early solution to the U.S. balance-of-payments problem is in sight. For there is no ready-made alternative to an increase in the price of gold as an adjustment policy for the U.S. government. At the recent Annual Meeting of the I.M.F. in Copenhagen, the Managing Director emphasised for the umpteenth time that "From the standpoint of the functioning of the international system, by far the most important problem is posed by the deficit in the balance of payments of the United States." But he who wills the end must will the means. And it seems to me that the I.M.F., by its inability or unwillingness to prescribe an actual cure for the U.S. deficit, has failed in its duty as guardian of the Bretton Woods system.

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The Outlook for the Present World Monetary System

PETER M. OPPENHEIMER

Symptoms of Disorder

TENSION and uncertainty in the world monetary system have shown themselves, during recent years, in three broad ways.

First, several countries have felt constrained by balance-of-payments weakness to adopt measures detrimental to free trade and payments. Earlier in the 1960s we had the Canadian and British import surcharges; later examples are the British and French limits on tourist spending, the increased tying of development aid by the United States and other countries and, most striking of all, the progressively tightening controls on capital exports from the United States since 1965. It is true that balance-of-payments problems did not prevent the successful conclusion of the Kennedy Round tariff negotiations in 1967, which means that a substantial further cut in import duties on industrial goods is now in progress. Nevertheless, recourse to restrictive measures has become too prominent to be overlooked, especially in the case of the United States, where such controls were regarded as unthinkable less than a decade ago.

Second, there is the tightness of international money markets in the last three or four years. This trend reached a climax in the second quarter of 1969 with the interest rate on three months' Eurodollars touching 13 per cent. It may be noted in passing that the Eurodollar market is more of a "perfect market" than are national credit markets, and the trend of interest rates is, accordingly, a better indicator of general market conditions than is the case in national credit systems. The major impulse to higher money rates after 1965 came from national monetary policies. The United States played the biggest part but several other countries contributed, including Germany, the U.K., France, and Japan. In March 1969, even the Italian authorities instructed their banks to repatriate their net overseas assets, thus further straining the situation in the Eurocurrency markets. It is true that these markets continued to expand without interruption and even at an accelerated pace, but one is still left with the impression that the major industrial countries were forced into ever more intense competition for a limited pool of hot money.

Third, the difficulties of the dollar and uncertainty over the source of

future increases in world monetary reserves have called into question the Bretton Woods system as a whole. Ad hoc swaps and other credit arrangements have kept things going, and commercial confidence in the dollar has not so far been affected; but the failure of policy makers to rectify the underlying disequilibrium of the system and put the future growth of world reserves on a reasonably secure footing has made a breakdown look more and more likely. The major victim of the situation so far has been sterling. The lack of autonomous growth in world reserves is making it almost impossible for Britain to achieve the prolonged surplus that she needs in order to repay the short- and medium-term debts piled up since 1964.

Two further points may be noted in this connection. First, the problem has not been solved by the realignment of Common Market currencies in 1969. The upvaluation of the German mark and the devaluation of the French franc should certainly leave the balances of payments of the EEC countries in better shape; but they have not altered the underlying position of the dollar. Secondly, the move to a two-tier gold price in March 1968 has, in itself, made little difference to the situation. Obviously, it eased the immediate pressure on the dollar by putting a stop to the massive drain of gold from American reserves. But the suggestion advanced by some commentators that the world is now on a dollar standard and that the United States no longer has a balance-of-payments problem must be interpreted as either advocacy or forecasting. The system has taken a step toward a dollar standard, but so far the American authorities remain concerned about the external balance of the United States and see no real scope for easing the restrictions on international payments imposed in recent years. The official price of gold is still $35 an ounce and, in the last resort, foreign monetary authorities can obtain gold from the Treasury of the United States at this price. Moreover, while the Treasury may be reluctant to sell gold, no one claims that it is reluctant to buy—except, ridiculously enough, from South Africa.

Fashionable "Solutions"

A number of changes in international monetary arrangements, designed ostensibly to remove the tensions listed above, are being initiated or debated. They fall under two main headings: reserve creation and exchange-rate flexibility.

So far as reserve creation is concerned, the first $3½ billion of Special Drawing Rights have now been issued, and further issues of $3 billion are agreed for 1971 and 1972. However, the timing and scope of SDR creation over the longer run remain to be agreed; and, of course, until the scheme has been operating no one can be sure what effect it will have on national economic policies. It is quite clear, however, that major problems concerning the status and acceptability of SDRs as

reserve assets remain unresolved, chief among them being the relationship between SDRs and gold.[1] SDRs are denominated in gold. They, therefore, preclude demonetization of gold and could not operate (except perhaps in a limited regional form not corresponding to present intentions) if the link between gold and the dollar were officially severed. If SDRs are to succeed in easing the dollar problem and the tensions related to it, they must have the effect of either (a) persuading the surplus countries to adjust their surpluses away more completely and effectively than hitherto; or (b) enabling the United States to finance a continuing deficit of, say, $2 billion a year without further deterioration in its international liquidity position. Neither of these alternatives looks likely—the first because the allocation of SDRs to surplus countries involves no additional inflationary pressure for them and no additional loss of real resources; and the second because it implies agreement to create not less than $5 billion and probably nearer $10 billion of SDRs a year (assuming SDRs are distributed in proportion to IMF quotas), and such agreement is highly improbable.

It has been suggested that limited flexibility of exchange rates combined with an inconvertible dollar may be another way of solving the problem of reserves, either in conjunction with SDRs or independently of them. This is the approach advocated by (among others) William Fellner.[2] I doubt, however, whether it can prove satisfactory, and for the reason stated by Fellner himself:

> No country should be pressured politically into holding or accumulating dollars, but I suggest that it is equally reasonable to lay down the principle that no country can complain legitimately of excess dollar-holdings or accumulations if it can reduce its holdings or acquisitions to the desired rate by an orderly, gradual revaluation of its currency in relation to the dollar.
>
> At any rate, if the principle expressed in the preceding sentence is rejected, then it is difficult to see how an increase of the price of monetary gold could be avoided. Indeed, an increase of the gold price would *reflect* the nonacceptance of the principle just formulated, and gold-revaluation would be a natural corollary of the nonacceptance of that principle.

In my view the "principle" enunciated by Fellner is liable to rejection on the simple Keynesian grounds that it confuses savings with liquidity preference. Whether or not countries want to add to their external reserves over time is a different question from the mix of assets that they

[1] A further important issue is how far drawings on SDRs will eventually be repayable. So far the "average use" formula has provided only for 70 per cent nonrepayability *during the first five years.*

[2] In his paper "A 'Realistic' Note on Threefold Limited Flexibility of Exchange Rates," in Part IV.

wish to hold in their reserve portfolios. Hardly any central bank at present considers that it has an excessive external surplus, but quite a number feel under pressure to hold more dollars than their own preferences would dictate. Currency revaluations are irrelevant to this problem. SDRs, on the other hand, may merely introduce further complications. It is unlikely that a reserve system comprising a fixed gold stock, dollars, and SDRs can function unless countries renounce sovereignty over the composition of their reserves. In return for this, however, they will probably claim a bigger voice in each other's financial policies, thus aggravating a major cause of present tensions. All in all, neither SDRs nor the possibility of gradual alterations in exchange rates seems likely to bring about a decisive strengthening of the monetary system.

Limited exchange-rate flexibility may, nevertheless, make a contribution to the balance-of-payments adjustment process in particular instances. Politicians and public opinion in several countries need to be convinced (a) that exchange rates sometimes have to be changed in the modern world and that premature decisions to abolish the possibility of changing them (such as by means of Common Market arrangements) can only lead to trouble and, ultimately, to a reversal of the decisions in question; and (b) that exchange-rate changes are not a political catastrophe but a normal technique of economic policy. If the advocacy and/or use of sliding parities or wider bands can in particular cases contribute to these objectives, well and good—though it does not seem to me obvious that they can.

In any case, there are also disadvantages attaching to both sliding parities and wider bands as alternatives to the present system of adjustable pegs.

With regard to sliding parities, three problems need to be considered. First, an exchange-rate adjustment of 2 per cent per annum for a period of years risks neutralization through an equal and offsetting change in the trend of domestic wages and prices. How real this danger is will depend on the extent to which money-wage bargains are constrained (from above or below) by world market prices of the home country's tradable goods. It is not difficult to imagine such a constraint operating in Germany or in several other European countries.

Second, even if this first worry proved unfounded, a sliding parity, particularly of the discretionary kind, could not rule out the need for bigger jumps in exchange rates in the event of large or obstinate disequilibria, and so would do little to alleviate the problems of speculation and hot money movements.

Third, a system of sliding parities would heighten the conflict between internal and external objectives of monetary policy. It is true, as Thomas Willett points out, that the various weapons developed in the 1960s to ease this conflict and to strengthen control over international

capital movements—such as interest-equalization taxes, forward-exchange policy, regulation of the foreign operations of commercial banks and similar measures—could be further refined and adapted to a crawling peg system.[3] The point is, however, that many of these devices, which sooner or later give rise to economic inefficiencies, would have been unnecessary if the Bretton Woods system had been operated properly in the first place. To accept their indefinite continuance as part of a package for reform of the system is to forget what half the discussion over reform has been about.

Wider bands are free from the third and to some extent from the second of these objections. They would enlarge the scope for disparities between national interest-rate levels and, by increasing the size of possible losses from mistaken speculation on a change in parities, would help to deter speculative movements of capital. But their efficacy as a weapon of basic balance-of-payments adjustment is, like that of crawling pegs, open to doubt. Basically this is because of the comparatively narrow limits on automatic exchange-rate movements that would still obtain under a band system. To push the rate beyond the limit set by the band would obviously require some other type of exchange-rate flexibility. Moreover, exchange-rate movements within the band would be subject to quick reversal by random factors, and this would weaken the incentive for industry to switch production and marketing plans from home to foreign markets (or vice versa). In other words, industry could not be sure that a 4 or 5 per cent depreciation or appreciation within the band would be *held.*

Prospects

The difficulties enumerated in the first section of this paper have not so far halted the rapid growth of world trade and production, which has characterized the postwar period. International monetary cooperation has cushioned or offset short-term upheavals in the exchange markets, while regular consultations in Paris, Basle, and elsewhere have limited scope for mutual misunderstanding of national economic policies. On the other hand, such consultations have not prevented the gradual undermining of the Bretton Woods system. There is no reason why the monetary improvisations of the 1960s, which have culminated in SDRs, should not continue and develop further in the 1970s. The expansion of world trade would then be maintained, but the tendency to use direct restrictions on international payments would be confirmed rather than reversed. This seems, in fact, the most likely prospect.

Exchange rates will continue to be changed by one means or another from time to time, but fancy new techniques for sliding, spreading, or

[3] In his paper "Short-Term Capital Movements and the Interest-Rate Constraint Under Systems of Limited Flexibility of Exchange Rates," in Part IV.

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hop-skip-and-jumping are unlikely to put the monetary system on an altogether firmer foundation.

The extreme tensions on world money markets will also subside, at least temporarily, with the next recession in the United States—which may be imminent. But this is a cyclical matter and again will not indicate a fundamental strengthening of the monetary system.

The one measure that could make a decisive contribution to the stability of the system for the next generation is a doubling (or more) of the price of gold. This has been clearly and, in my opinion, conclusively demonstrated by Milton Gilbert in his Princeton Essay in International Finance, No. 70, *The Gold-Dollar System: Conditions of Equilibrium and the Price of Gold.* Gilbert's analysis amounts to a restatement of the Triffin-Kenen model of the gold-exchange standard, drawing attention to the role of the price of gold as a national policy weapon governing the possibility of equilibrium in the balance of payments of the United States. Most economists still reject Gilbert's conclusion because, as Harry Johnson put it at the AEA meeting in December 1968, they are "professionally prejudiced" against it. The points usually put forward against a rise in the gold price are:

(1) the immediate benefits from it would be unfairly or inappropriately distributed;
(2) it would cause inflation;
(3) it would provide only "a breathing space," solving no long-term problems, and another price increase would be needed sooner or later; and
(4) the monetary use of gold (or any other real commodity) wastes resources.

Point (1) is a pure value-judgment with no analytical force. One could equally well maintain that it was unfair to hold the gold price down to $35 an ounce for many years while other prices doubled and trebled. As for American "promises" not to raise the gold price, central bankers should know better than to put their trust in princes. Rather, they should read their Tobin and choose their portfolio assets with a proper eye to the risks involved.

Point (2) may well worry the French or Swiss authorities, who might, indeed, find themselves with local inflationary pressures on their hands —similar perhaps to those faced by the Italian authorities at the time of the Italian "wage explosion" in 1963—but I cannot see why it should worry anyone in the United States. If the United States concentrated on managing its own economy and balance of payments and left it to other people to manage theirs, we should all get along much better.

As to point (3), if this means that a rise in the gold price now would not solve all international monetary problems forever, it is obviously

true but hardly an argument. If, however, it means that a higher gold price would not make a serious contribution to world monetary stability for the next generation then I think it is false. Indeed, I do not see how anyone who has understood Gilbert's paper could advance this view. In this connection I want particularly to stress the point that the United States, contrary to what is often asserted, it not unable to alter its exchange rate in the present system. The dollar price of gold *is* an exchange rate. A substantial increase in it would help the United States to equilibrate its external accounts, and not merely to go on financing deficits. This is because it would lead to a substantial annual inflow of new monetary gold and would, thereby, relieve the pressure on the United States to act as a net supplier of reserves to other countries.[4]

Point (4) is correct as a matter of pure logic, but is of little quantitative importance—especially when account is taken of the fact that no one has a clear idea of how the world monetary system would actually work without gold. Demonetization would be a step into the unknown and could easily lead to wider restrictions on international trade and payments.

In conclusion, I should like to re-emphasize that the purpose of this note has been to discuss the prospects for the *present* monetary system and the possibilities of reversing the undesirable trends that have affected it in the past few years. I consider that the present system is perfectly viable if its rules are properly operated, and I doubt whether any coherent alternative to it is in sight. Whether it is the best possible system that human ingenuity can devise is, of course, quite another question.

[4] A detailed analysis may be found in P. M. Oppenheimer, "The Case for Raising the Price of Gold," *Journal of Money, Credit and Banking* (August 1969).

Chairman BOGGS. Now, Mr. Richebacher, we will be very happy to hear from you.

STATEMENT OF KURT RICHEBACHER, ADVISER, DRESDNER BANK, FRANKFURT, GERMANY

Mr. RICHEBACHER. Thank you, Mr. Chairman. You have given me the honor to appear before this committee. As your chairman wrote to me, you want to discuss the adjustment problem, in particular the consequences of failure to adjust. Also, you wish to consider the ways in which events in the United States and abroad will influence the future evolution of the international monetary system and how possible changes in the system might affect the United States.

After a full week of speeches at the IMF conference at Copenhagen about international monetary problems, it seems hard to add anything of substance. However, it is my impression that we are only going over old arguments, whilst the drift for direct controls and import quotas continues. To be frank, in my view there is too much generalizies, too much wishful thinking, and a tendency to see someone else's faults and not our own. It is essential in my opinion that we define the problems as specifically as possible, consider carefully the degree of seriousness which we attach to them and rule out what is not acceptable or workable. To put it in the language of today, we have to tell it like it is, even in one or two questions. Please forgive me if I specify where I see the problems.

Though there is every reason to be dissatisfied with the international adjustment machanism in general, Great Britain, France, and Germany have recently undertaken major efforts to redress their payments deficit. For the time being monetary strains between European currencies have been relieved. Certainly this does not assure a permanent solution, but so much more the focus of attention turns to the United States and the dollar. This appears still to be the dominant problem, considering above all that the stability of the international monetary system is so crucially dependent on the health of the key currency.

The recent strong expansion of world reserves seems to have given new impetus to uneasiness. The U.S. liquidity deficit has remained very large—indeed it has trended upward—even though the dollars it generated for a time did not flow into central banks. With the rise of international money markets, commercial banks became willing holders of dollar balances. Dollars were even drawn out of central banks. Between 1967 and 1969, official dollar reserve holdings declined from $15 billion to a 10-year low of $10 billion. More recently, as European central banks have moved to a policy of sharp restraint, they began to pull in dollars. This shift is accentuated when an easing of monetary conditions in the U.S. tends to reduce rates in the Eurodollar market, thus reducing private incentives to hold dollars. As a result of these developments, official holdings of dollars have risen sharply again this year, with the increase already mounting to $5 billion and bringing the total back again to $15 billion.

While world dollar reserves for many years have been stable and at times even declining, private holdings of dollars, mostly by com-

mercial banks—dollars as liabilities of U.S. commercial banks—soared over 10 years from $7 billion to $27 billion. In my opinion this fundamental change in the flow and in the holdings of dollars requires a reinterpretation of what we have to consider as international liquidity. Obviously, central banks no longer function as principal, but as residual holders of dollars. Some of the central banks have even employed elaborate techniques to keep dollars away from their own portfolios.

It does not change the liquid character of a dollar if commercial banks instead of central banks acquire and hold them. Every dollar from U.S. deficits accruing to commercial or central banks adds equally to the international stock of potential high-powered money, primarily of course to the originally receiving nations. These dollars represent potential high-powered money because every national central bank is prepared to buy and convert them into local currency in unlimited amounts and at practically fixed prices. And contrary to a widespread belief, the dollar balances retain their highly liquid quality even if the commercial banks relend them to banks abroad, for example, the U.S. banks. These interbank loans take the form of short-term deposits and as such they serve for the lending banks as liquid secondary reserves, thus encouraging and facilitating national and international expansion in their lending.

Federal Reserve statistics give us a breakdown of maturities of Eurodollar deposits in foreign branches of U.S. banks. In May 1970 a total of $26.2 billion comprised $4.1 billion overnight and call money, $9 billion due within 1 month, a further $5.2 billion within the second month, and $3.1 billion within the third month. Combined this amounts to around $21.5 billion out of the $26.2 billion.

Liquidity in reality was superabundant, and contributed to the worldwide surge of inflation we have all been living through. The obsolete concept of identifying international liquidity exclusively in terms of official reserves, I fear, played its role to let governments rush into the ill-timed implementation of the SDR program, just when the U.S. balance of payments was about to generate international liquidity at an unprecedented pace. SDR's are a splendid instrument for orderly growth of international liquidity. But what matters is not the control a single component, but the control of the aggregate of gold, dollars and SDR's and together their overall increase is definitely out of control.

Moreover, through the process of lending and relending dollars from bank to bank the market pyramids dollar deposits, thus increasing the short-term liquid reserves of private banks all over the world. Last year dollar assets in the Eurodollar markets shot up by around $20 billion, according to the statistics of the IBIS, to nearly $60 billion, whilst the original flow of dollars from the U.S. deficit was $7 billion.

Completely disregarding these tremendous accruals of dollar balances to commercial banks, many experts were misled by the slow rise and temporary decline of world reserves into concern about an insufficiency of international liquidity. Typically, in its annual report 1969 the International Monetary Fund arrived at the conclusion that "a case can be made for the view that by 1968 global reserves ease has not only been declining but also had become less than adequate."

As I see it, because of these liquidity effects, countries should consider a substantial reduction of the U.S. liquid payments deficits as the central issue of monetary control. U.S. deficits weaken our ability to overcome inflation. But I also want to point out why—in contrast to others—I do not attach any rational importance whatsoever to the question of how dollars distribute or shift between commercial and central banks.

Now, what can be done? My basic assumption, to be frank, is that the U.S. deficit will continue at a high level. True, we see an improvement in the trade balance. With European resources unusually strained and the U.S. economy cooling off, some such improvement had to come. It reflects the differences in the timing of the business cycles between the United States and Europe. At the same time, the U.S. capital account moved into higher deficits as we always see it happen when monetary conditions in the United States ease relative to Europe. Basically, because of one factor or another, the United States continues to experience large liquidity payments deficits.

My next assumption is that we all want to avoid direct controls over imports and over capital movements, and I further assume that it is in our common interest—American and European—to have an international monetary system that allows economic stability to every participant. It is, of course, easy for the Europeans to say that the United States of America should have adjusted just like any other country, through internal deflation or through devaluation. But it is far too common to overlook the reasons why the United States is more constrained in its adjustment policies than other countries. We should, I think, approach the problem with a greater sense of realism than is sometimes done.

In Copenhagen there were stern demands that the United States should resume financing their deficit by selling gold. I have been wondering what such an exercise could be good for. An exchange of dollars into gold is useful only as a means to an end. A U.S. deficit has its expansive monetary efforts on the rest of the world whether the reserve gains take the form of gold or dollars. What matters is whether, through demanding gold, the reserve-currency country will be forced to adjust through adoption of a more deflationary domestic policy. I am sure that the United States will provide gold up to a point, but without accepting the inherent automatic contraction of the money supply. The Federal Reserve will take domestic compensatory action, putting domestic economic objectives first. Therefore, I do not consider this a constructive proposal. This road can only prove a dead end.

Another starting point for our considerations must be that the United States does not have primary control over its exchange rate. It it raises the gold price, other countries could and would certainly fall in line, and in the end the exchange rate structure would not be much different from before, if at all. Through the higher gold price we would add once more to international liquidity, without any benefit for the trade competitiveness for the United States.

On the other hand, people in the United States should understand that most European countries individually refuse to revalue against the dollar. This necessarily entails moving upward against every other currency, even though price or cost relationships may not be out of

line at the existing exchange rates. The German revaluation should be regarded as exceptional, even in the special circumstances of Germany itself. Having gone through the list of possible alternatives for adjustment, I realize that I have excluded practically everyone either as unworkable or as unacceptable. I think you would agree that we should avoid controls which could lead to a trade war. As a European, I would also exclude inflation in Europe as a regular method of adjustment. After all, inflation is in nobody's interest. Inflation is never a one-way street as we can see now with all the industrial countries sharing alike in the inflationary surge. We in Europe, in addition, see an asymmetry in this form of adjustment. The foreign sector is so large with us and so small with you that we are bound to get a disproportionate impact.

One of the alternatives receiving more and more attention has been to safeguard greater economic stability through a general increase in exchange-rate flexibility. But, apart from the fact that there is very strong resistance in countries to revalue their currency in isolation, the EEC countries have made the important decision to narrow the margin of fluctuation of their national currencies with each other. If these present efforts are successful, we can look forward to a world monetary system in which the European countries move together as a group against the dollar. This idea is spreading quite fast in Europe. At first, the focus of attention was on the internal aspects—that is, on the question of inside economic coordination as a means to avoid disequilibrium between the six. Lately there seems to be a shift of attention to the external considerations and implications. My impression is that we are not yet very far in thinking through the evolutionary process which may result from these developments. Can I leave with you as I close a few questions which I cannot answer, but concern me and which require careful study as and if we move down the road toward these paramount changes in our traditional international monetary relationships.

If such a currency bloc would ever emerge which more or less regularly tends to revalue its currencies against the dollar, it helps the United States from the point of view of international competitiveness and thus it would certainly contribute to prevent trade war. But it would probably bring far-reaching monetary implications. If such revaluations become a clear pattern, there will be reactions in the capital account which may well offset the benefits for the trade sector. The mechanics are the business and bankers tend to borrow in a weaker currency, but to hold the stronger ones promising windfall capital gains. What will be the outcome for international money and capital markets. considering the huge masses of existing foreign dollar holdings? What will other countries do? Which one will tie their currencies to the EEC-bloc? Which ones will remain with the dollar? Over time any system in which the dollar is losing its relative values will bring into question its role as a desirable instrument in its worldwide depository function.

Personally, I am an advocate of fixed exchange rates. Every other solution can only be second best. However, I try to be realistic. Being aware of the gravity of the problem of continuous U.S. liquidity deficits, being also aware of the various constraints on adjusting this

imbalance, there is hardly a freedom of choice. My advice is that we should begin to concentrate on exploring the benefits and the dangers inherent in a two-bloc system.

I wanted you to understand the monetary problems which are arising to Europe, what matters to us about your deficits, just as you can be assured that the majority of Europeans familiar with these things have a lot of understanding for your problems.

Thank you.

Representative REUSS (presiding). Thank you, Dr. Richebacher. Sie haben es wirklich erzählt, wie es ist.

Mr. RICHEBACHER. Thank you.

(The following table was subsequently supplied for the record in the context of Mr. Richebacher's oral statement:)

INTERNATIONAL DOLLAR HOLDINGS

[In millions of dollars]

	U.S. liquid liabilities to foreigners		Dollar assets of reporting European banks [1]
	Official institutions	Banks and other foreigners	
1960	11,078	7,591	
1961	11,830	8,275	
1962	12,748	8,359	
1963	14,387	9,214	
1964	15,428	11,001	9,000
1965	15,372	11,478	11,590
1966	13,600	14,387	16,060
1967	15,653	15,894	19,890
1968	12,548	19,518	30,420
July 1969	9,980	27,945	
December 1969	11,984	28,374	47,570
May 1970	14,776	27,271	

[1] 8 European countries report regularly about their external position of their domestic banks to the Bank for International Settlement, Basle.
The 8 countries are: Belgium, France, Germany, Great Britain, Italy, Netherlands, Switzerland, and Sweden.

Representative REUSS. Professor Triffin, we will be happy to hear from you.

STATEMENT OF ROBERT TRIFFIN, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. TRIFFIN. Let me first apologize for having been unable to mail to you in advance a written copy of my prepared statement today. I am just back from 3 months of intensive consultations both in Europe and with a dozen governments of Asia about the very problem which you have asked us to discuss before this committee. Let me say that I have testified over the years on this subject before.

An agonizing reappraisal of the role of the U.S. dollar in the international monetary system is now underway and will have momentous implications for U.S. economic policy in the 1970's. The U.S. dollar has enjoyed since the last war a near monopoly as the international currency, (1) for settlements, (2) for central bank stabilization interventions in the exchange market, and (3) as a result, for the accumulation of international monetary reserves. As the system now operates, foreign central banks are bound by the IMF rules to purchase from

the exchange market any dollar overflows that would push the exchange rate of the dollar on their market below 99 percent of its official parity. Each country remains, of course, legally free to turn back such dollar accumulations to our Treasury and to ask to be reimbursed in gold metal. But the depletion of our gold reserves makes it painfully obvious that we could not meet for long massive demands for such gold conversions.

Foreign central banks have thus refrained increasingly from such requests lest they trigger thereby a formal suspension of gold payments by the United States and a major crisis of the international monetary system.

This means, however, that any deficits we may incur are being underwritten and financed in effect by the continuing piling up of dollar balances as monetary reserves by foreign central banks. This has political as well as financial and economic implications, as foreign countries my be led thereby to underwriting and financing through their own monetary system U.S. deficits springing from policies in which they have no voice and which may be at times highly distasteful to them.

The dollar exchange standard as it now operates entails the satellization of other currencies as subordinate members of a "dollar area" whose fate is determined by the success or failure of our own national policy decisions.

If I look at the record over the last 20 years, for instance—I ask you to turn to table 2 of my prepared statement which I distributed to you—we have increased by about $110 billion our foreign assets and investments, but only $25 billion of this huge amount has been financed by current U.S. savings and about $9 billion by a decline in previously accumulated monetary reserves. About 70 percent—$76 billion—has been financed instead by foreign capital inflows, and of that amount, $36 billion was derived from dollar accumulation by foreign commercial and central banks—that is to say, by the printing presses of foreign countries. This absorption of dollar deficits by the monetary system of foreign countries has risen from an average of $1 billion a year in the 1950's to more than $2.5 billion in 1968 and nearly $8 billion in 1969 alone.

The layman is understandably puzzled by the constant and often contradictory gyrations in the two official measurements of our overall deficit; that is to say, the so-called liquidity balance and the balance on official reserves transactions. Underlying such gyrations, to which Professor Haberler referred, there are however, two persistent features of our balance of payments over the last 10 or 20 years which are worth noting. I ask you to turn to table 1 of my prepared statement for the figures I have been mentioning.

The first feature is the large and steady growth of U.S. capital exports—primarily direct investments and foreign aid— from about $9 billion a year in the early 1960's to about $11 or $12 billion today. This is really extraordinary, because of all the balance-of-payments figures, there is none that is as stable as this one and I wish that economists would pay more attention to that. Indeed, it is a normal function of the major financial market in the world today to export U.S. funds. The amount of those exports is by no means excessive in relation to

the GNP of the richest and most capitalized of all developed countries. It is very far from the 10 percent of GNP, which it was for Britain before the First World War; it is not even 1 percent of GNP, as hoped by the United Nations today. In 1969, it was less than one-tenth of 1 percent of our GNP.

The exports of U.S. capital, however, have exceeded by far our dwindling current account surpluses. These have shrunk to less than $1 billion in both 1968 and 1969. They are recovering now to about $3 billion this year, but this amount is still far from sufficient to finance our capital exports. Moreover, this recovery is the byproduct of a sort of mini-recession in this country which we may not wish to stand for long.

The second characteristic of our balance of payments is that this large gap between our exports of American capital on the one hand, and our dwindling current account surplus on the other must, of course, be financed either by losses of monetary reserves or by inflows of foreign capital. And what is characteristic is that this has been financed overwhelmingly by influxes of foreign funds, by imports of foreign capital, rather than by declines in gross U.S. reserves. These inflows of foreign capital, however, may take different forms, explaining those contradictory gyrations in the various measurements of our deficit.

First of all, when there is a boom in Wall Street or when interest rates have been pushed here to sufficiently high levels, much of the capital inflow comes from private traders and investors. This was the case, for instance, in 1968, with nearly $7 billion of nonbank capital imports into the United States. When this happens, both our liquidity balance and our balance on official settlement show a surplus, which may be conforting for the time being.

Second, however, when this source of financing, which might be regarded as more or less normal, tapers off, we may instead borrow large amounts of funds from foreign commercial banks, particularly through the Euro-dollar market. This amounted to the record figure of $9.5 billion in 1969, and could not, of course, continue indefinitely. When this happens, it deteriorates our liquidity balance, but it improves our balance on official settlements. Our debts are taken over by private commercial banks abroad, rather than by foreign central banks.

But, and this is what is happening in 1970, when both of those sources of financing fail us, then at that point, foreign central banks are forced by the rules of the IMF to pick up the tab in order to prevent these dollar overflows from pushing the dollar exchange rates below 99 percent of partity. This is what has been happening in the first part of this year at an unprecedented rate of more than $10 billion a year.

The financing of large, persistent and even increasing U.S. deficits by central banks of foreign countries can't continue forever. What can be done about it? Well, the basic solution can't lie—I agree with other speakers in this respect—in a sharp curtailment of our capital exports. For the reasons I have already mentioned, this would be as undesirable economically and politically as it would probably be unfeasible in practice. The richest country in the world today can't shirk its economic and political responsibilities in this respect.

We must, therefore, improve our current account balance. And it has indeed been improving substantially this year.

The conviction has spread from academic to official circles, however, that the American competitiveness in world trade cannot be preserved and reconciled with a high level of employment and of economic growth without some changes, some readjustment, of the exchange rate between the dollar and the currencies of the European Economic Community. Our own officials have expressed over the last year a cautious but increasing interest in IMF reforms that might facilitate and accelerate such readjustment through small but prompt parity changes, through wider bands between buying and selling rates, through the technique called "crawling pegs," and so on.

These suggestions met at first with strong opposition on the part of the European Economic Community, particularly as they were very worried about the fact that under the present mechanism of exchange interventions in the market, this might introduce great instability between their own currencies and destroy the economic and monetary union toward which they are working. It seemed to me, however, that I saw in Copenhagen that this opposition was now in the process of weakening. The Community is still opposed to immediate moves toward more flexible rates, but it is in fact preparing to make them more acceptable or even desirable for them by a total overhaul of the mechanism of interventions in the exchange markets, alowing the currencies of the Community to move together in relation to the dollar, as mentioned by Dr. Richebacher. This would entail in time a lesser use of the dollar and a greater use of European currencies themselves, in these stabilization interventions. I discussed this at length in a recent (last July) article of the Morgan Guaranty survey.

Let me close with two observations. First of all, I remain somewhat skeptical, less enthusiastic than my academic colleagues, about current proposals for various reforms of exchange rate flexibility. I would like to distinguish two forms of exchange rate flexibility. The first is one of mere permissiveness, telling people that the IMF rules are changed so as to enable them to move their exchange rate more freely, if they wish, than is now the case. I doubt whether this would really produce the results that we want, and my doubts are reinforced by what we saw in the case of Germany until about a year ago.

Germany was perfectly free under the rules of the IMF to propose an exchange revaluation of the mark. Not only was it free to do so, but foreign countries begged the Germans to revalue the mark. They thought, in fact, they had come to such an agreement in November 1968. But for various reasons of domestic policy, the Germans waited 1 year to do something which they were begged to do. Simply to say now that any country can revalue its exchange rate is not going to make it happen.

On the other hand, a complete automaticity of exchange rate changes in answer to market forces would be, to my mind, as inappropriate as it is likely to prove unnegotiable in practice. Exchange-rate adjustments may be the most appropriate, or even the only practical, remedy to only one of the three major sources of balance-of-payments disequilibria. It is not a remedy to the other two. Exchange-rate readjustment would clearly be maladjusting in fact in the case of

temporary, reversible, disequilibria calling for temporary financing, from national reserves and foreign assistance, rather than for day-to-day correction, since such changes in parity would then be themselves the source of basic maladjustments once the temporary factors have ceased to operate.

Second, they would be equally inappropriate as a cure for overspending or underspending types of disequilibrium that should be cured by the readjustment of a country's overall spending rate to the country's productive potential at stable or approximately stable prices. As long as a country spends more that it can earn, even at full employment, and after proper adjustment for normal and feasible levels of capital exports or imports, as long as this is the case, devaluation might well improve the current account, but only at the cost of accelerating domestic inflation, because it would reduce merchandise available in the domestic market by increasing exports and decreasing imports. Therefore, you would remedy your balance-of-payments disequilibrium only at the cost of accelerating domestic inflationary forces and price rises when you are in a state of excess demand as we were in 1968.

Third, however, exchange-rate readjustment may provide the best or only remedy to international price disportions that have made some countries' national cost levels undercompetitive or overcompetitive in world trade.

But the same panacea should not be applied to all three problems. It can be applied to the third but not to the other two. Countries should be allowed to accumulate or lose reserves to the extent needed to bridge temporary disequilibria or to gain the time necessary for the timely collection of inflationary or deflationary fiscal or monetary policies. They should not, however, be allowed to export indefinitely to the rest of the world inflationary or deflationary pressures arising from undercompetitive or overcompetitive price and cost levels that they are unwilling—and would often be unable—to correct through domestic policies. As already mentioned, deficit countries are already unable to do so, as their losses of reserves finally deprive them of the means of continuing stabilization interventions by their central bank on the exchange market. They are ultimately forced to let their exchange rate depreciate or to seek external assistance and to accept the lender's advice as to the policy readjustments required of them as a condition for such assistance.

The same discipline should be applied on surplus countries as well as on deficit countries. I have suggested for this result the adoption of what I call a "fork," to distinguish it from the bank, a fork defining the maximum limit of fluctuations in each country's international reserves. Each country would be invited to define a normal reserve level and would be free to deplete or to increase such reserves at a certain rate over time. But huge or prolonged reserve increases as well as reserve depletion should force it to discuss with the IMF the policy adjustments needed to restore equilibrium in its balance of payments. These decisions should center on changes of domestic policies as well as on changes in exchange rates, depending on the origin of the disequilibria.

If, however, such consultations failed to produce agreement between the country and its partners, it should then be enjoined from further

stabilization interventions in the exchange market. It would then have to let its exchange rate appreciate, or depreciate so as to keep its reserves within the permissible range of fluctuations.

Of course, various compromise and transitional solutions might then be negotiated. Rather than bar abruptly all further interventions on the market, these might be gradually tapered off in amount, for instance, or limited to what is necessary to keep exchange rate adjustments within the range of an agreed "crawl." There I would rejoin my academic colleagues: Not as an automatic panacea for all problems of balance of payments disequilibria, but only in the cases where it is really appropriate.

This suggestion may be deemed too harsh on national monetary sovereignty to be negotiable in practice. All I can say is that it would preserve a far greater degree of sovereignty than alternative proposals for continuous enforcement of crawling pegs long before the limits of my proposed "fork" have been reached. So I think in fact such a proposal would be more negotiable than the proposals which are now advanced, since it would leave more discretion to countries within the limits of the proposed "fork."

This does not, alas, exhaust the list of monetary reforms calling for negotiation in the future. May I close with a mere reference to former proposals of mine which have already been debated and largely endorsed by the Joint Economic Subcommittee on International Exchange and Payments under your charmanship, Mr. Reuss. As you know, these proposals call first of all for the setting up of an international conversion account designed to deal with the overhang of gold and reserve currencies in the international reserve system. They call also for a different system of allotment of special drawing rights in support of internationally agreed policy objectives rather than, as of now, in support of all and any national policies, no matter how maladjusting these may be deemed by the international community itself and by prospective lenders.

The second of these proposals is already on the agenda of the next meeting of the International Monetary Fund and Bank, since developing countries insisted once again—and rightly, to my mind—in Copenhagen for development aid with SDR's for financing. As for my proposal for an international currency account, I am very much afraid that clarification agreements regarding the future role of gold and national currencies in the international monetary system will prove the only alternative to recurrent gold and foreign exchange crises and the only way to consolidate the momentous progress already achieved toward a national international monetary system through the adoption of the SDR agreement.

Let me mention in closing, Mr. Chairman, that the SDR system may be put in real jeopardy in the next few years. Because after all, the argument on which SDR's were sold to the international community is that they would be needed to prevent a decrease in the international reserve pool. But if the trend of the first months of this year were to continue and we were to flood the international reserve pool with billions of dollars each year, foreign countries could hardly agree that they have to add still more to the system in the form of SDR's. Therefore, we might lose the potential of this reform; that is

to say, the possibility of arriving at a rational management of the international reserve system.

Thank you.

(The prepared statement of Mr. Triffin follows:)

PREPARED STATEMENT OF ROBERT TRIFFIN

PROPOSED REFORMS IN THE INTERNATIONAL ADJUSTMENT MECHANISM

1. Contrary to a widespread misapprehension, the international balance-of-payments adjustment mechanism has worked pretty effectively since the war among the major developed countries, with two glaring and devastating exceptions.

2. The first of these exceptions is that of the persistent surplus countries, such as Germany. Their surpluses do not put pressure on them to readjust either their internal policies or their exchange rates. They are left free, in fact, under the present system, to follow all or any of the following courses of action:

First, they may accumulate enormous excess reserves as a result of what used to be called in the OEEC "bad creditor policies." That is to say, they may follow unnecessarily deflationary internal or restrictive external policies and maintain an overcompetitive exchange rate.

Second, having pursued bad creditor policies and accumulated large reserves, they are rewarded in consequence by their ability to pursue later "bad debtor policies," and run large deficits without ever having to go to the IMF to ask for assistance, at least for a long time.

Third, they can decide unilaterally to impose deflation upon the rest of the world by insisting on gold settlement of their surpluses far in excess of current gold accretions. Or, on the contrary, they may decide freely to invest these surpluses in the financing of one country or another, through dollar or sterling accumulation for instance.

Fourth, they can later change their minds and suddenly decide to put pressure on Britain by converting their accumulated sterling into dollars or, vice versa, on the United States by converting their dollars into sterling, or on both countries by converting sterling and dollars into gold metal at the risk of bringing down the whole international monetary system.

I don't say that they have done this in fact. On the contrary, Germany has probably followed better internal policies, on the whole, than its neighbors. It has financed very generously, maybe too generously, its surpluses through dollar and sterling accumulation. It failed, however, until a year ago, to help correct these surpluses through price or exchange rate adjustments. Morally, the German authorities may possibly have been right; one sympathizes with them. Practically, they failed to recognize that they could not be right against everybody else, and that the revaluation of the mark was the only practicable policy and far more feasible and less damaging than any of the availabe alternatives, i.e. persistent German surpluses entailing inflationary pressures for them and deflationary pressures for others; impossible reductions in wage levels abroad; unwanted price and wage increases in Germany; or a spiral of devaluations abroad, including a devaluation of the dollar. The devaluation of the dollar would be very difficult to endorse as long as the dollar remains the kingpin of the international monetary system and would, moreover, entail, under the present system, an appreciation of gold, whether desirable or not for its own sake.

3. The second exception is that of the reserve-center countries, whose *national* currency is accepted by other countries in *international* settlements and accumulated by them as *international* reserves. Reserve-center countries are enabled thereby to remain in deficit for long periods of time, without being compelled to readjust either their domestic policy or their exchange rate. They get far too much "rope to hang themselves." They may escape for a long time the full pressure of their deficits, but at the cost of building up a precariously held foreign indebtedness exposing them later to sudden discipline through crises.

I would like to quote here very briefly a few figures to document this observation. It is striking to think that in the last year before the First World War for instance, the United Kingdom, having been the first full-developed country in the world, had a current account surplus estimated by statisticians at about 10 percent of GNP. Last year, the two major financial markets of the world, the

United States and the United Kingdom, had a combined current account surplus not of 10 percent of their combined GNP—that would be about $100 billion—not even of 1 percent of their combined GNP, as hoped for by the United Nations—that would be $10 billion—but a combined current account surplus of somewhere around $2 billion only.

I think that this drying up of the ability of the two major financial markets of the world to finance capital exports is something which is extremely worrisome. And yet, of course, their export of domestic capital continues. I think it is very unrealistic and difficult to believe that you can adjust your capital account to your current account by closing down the City of London or by closing down Wall Street, or by closing down the various programs of foreign assistance and intervention to which dollar and sterling diplomacy are condemned by their world-wide responsibilities.

The two accompanying Tables summarize, in that light, the evolution of the U.S. balance of payments and international investment transactions.

The stability of U.S. capital exports—at a rate of $10 billion to 12 billion a year—contrasts sharply with the drastic decline in our current account surplus—from $8 billion in 1964 to less than $1 billion last year and an annual rate of $2 billion to $3 billion in the first half of this year (see Table 1, lines I and II). The increasing shortfall of our current account surplus in relation to our capital exports (line III) meant that the latter had to be increasingly financed by inflows of foreign capital and/or *losses* of U.S. reserves. In fact, our gross foreign reserves declined remarkably little, and even increased substantially in 1968 and 1969 (line III B3,b). Most of the growing shortfall shown on line III was covered by huge inflows of foreign capital:

a. Primarily ($6.8 billion) from non-bank investors attracted by the boom of Wall Street and high interest rates in 1968 (see line IIIA);

b. Primarily by an unprecedented level of borrowings from foreign commercial banks ($9.4 billion) in 1969 (line III B2);

c. Primarily by a record level of borrowings from foreign central banks ($10.4 billion, at an annual rate) in the first quarter of this year (see line III B3,a), when we reimbursed part of our previous borrowings from foreign commercial banks (line III b2).

TABLE 1.—THE BALANCE OF PAYMENTS OF THE UNITED STATES

[In billions of dollars]

	1964	1968	1969	1970 at annual rate: 1st quarter	1970 at annual rate: 2d quarter
I. Current account	7.8	1.4	0.8	2.2	
II. Exports of U.S. capital, including errors and omissions	11.4	10.2	12.0	11.3	
III. Shortfall (I−II) (financed by)	−3.6	−8.8	−11.3	−9.1	
A. Foreign capital inflows (−), excluding B	−.5	−6.8	−4.6	−3.3	
B. Settlements balance	−3.1	−2.0	−6.6	−5.8	8.7
1. Special financing and SDRA allocation (−)	−.1	−.3	.1	−1.2	−1.3
2. Liabilities (−) to foreign commercial banks	−1.5	−3.4	−9.4	6.9	−.4
3. Net reserves	−1.6	1.6	2.7	−11.4	−7.0
(a) Liabilities	−1.4	.8	1.5	−10.4	−3.0
(b) Assets	−.2	.9	1.2	−1.1	−4.1
Memorandum:					
1. Liquidity balance	−2.8	.2	−7.2	−7.1	−6.0
2. Total inflows of foreign capital (−): (III-A+B-2, 3)	−3.3	−9.4	−12.6	−6.8	

BRIEF COMMENTS

1. Note the extraordinary stability of group II, in the face of a strong decline of group I surpluses.
2. Note the predominat role of various forms of capital inflows in the financing of the increasing "shortfall" resulting from the maintenance of high levels of U.S. capital exports in the face of declining current account surpluses.
3. Note the shift from nonbank capital inflows (IIIA) in 1968, to borrowing from commercial banks (III-B-2) in 1969, and to borrowing from central banks and the IMF (III-B-3a) in the 1st quarter of 1970.

Table 2 summarizes, from a different source of estimates, the evolution of our international accounts over the last twenty years (1950–1969). We increased, over these twenty years, our foreign assets and investments (other than monetary reserves) by some $110 billion, from about $28 billion at the end of 1949 to about $138 billion at the end of 1969.

TABLE 2.—FINANCING OF U.S. FOREIGN INVESTMENTS, 1950–69

[In billions of dollars]

	Annual rate of change					Total 1950–69
	1950–59	1960–64	1965–67	1968	1969	
Total, U.S. assets and investments abroad	3.3	7.4	7.1	10.6	7.8	110
Financed by—						
1. Current U.S. savings	.4	2.9	2.4		−.9	25
2. Losses of reserve assets	.5	1.0	.6	−.9	−1.3	9
3. Foreign capital	2.4	3.5	4.2	11.4	10.1	76
(a) Nonbanking	1.4	1.8	2.1	8.8	2.3	40
(b) Banking	1.0	1.7	2.2	2.6	7.8	36

Sources: Derived from—1. "International Investment Position of the United States" tables of the Survey of Current Business; 2. For preliminary 1969 estimates, table 3 of "U.S. Balance of Payments and Investment Position" Federal Reserve Bulletin, April 1970, p. 325.

Only $25 billion of these $110 billion, however, were financed by our current surpluses, and another $9 billion by the drain on our gross monetary reserves. The remaining $76 billion was financed by foreign capital inflows, of which $40 billion by private investors, and $36 billion by foreign central banks and commercial banks. These bank borrowings rose from an average of about $1 billion in the 1950's to as much as $7.8 billion in 1969. Foreign countries were becoming more and more monetary "satellites" of the dollar area, financing our huge deficits through their own printing press.

4. The Managing Director of the IMF called, at Copenhagen, for the restriction of balance-of-payments pressures on the U.S., through a slowdown of such financing and a greater use of gold and SDR's in the settlement of our deficits.

This would entail indeed a drastic overhauling of the role of the dollar in the international settlements system. The rules of the IMF now force all foreign countries' central banks to intervene in the exchange market and by any overflow of dollars that would bring down the dollar rate below 99% of its official parity. These rules were accepted, in happier days, when foreign central banks were in fact free to demand, at any time, the reimbursement in gold of the dollars purchased by them from the market. They were increasingly induced, however, particularly since 1960, to forego the actual exercise of that right, lest it force us to suspend formally the gold convertibility of foreign dollar liabilities exceeding by far our available gold holdings.

5. The renewed drive toward full monetary union of the European Economic Community, spectacularly launched at the Summit meeting of heads of state and governments at the Hague, last December, undoubtedly owes much of its inspiration to the desire of those countries to recoup their monetary sovereignty and to be able to limit the automatic underwriting and financing of our deficits entailed by the present functioning of the dollar-exchange standard.

6. In the most optimistic hypothesis, this goal could be achieved by the elimination of our deficits, and the restoration of a normal balance-of-payments pattern of the United States. As the richest country by far in the world today, we should restore a decent level of current account surpluses, enabling us to maintain *and finance* an adequate level of capital exports, public and private. This is the proclaimed aim of this Administration—as of previous ones—and modest progress in this direction has been made this year. Our current account surplus has risen from less than $0.8 billion last year to an annual rate of about $3 billion in the first half of the current year. This, however, is still only a fraction (about a third?) of the estimated surplus needed to finance our capital exports at the current level without substantial

deficits in our monetary settlements balance. Further progress toward that goal might, moreover, be reversed by a full resumption of economic activity beyond the current semi-recession levels, entailing a substantial degree of unemployment and severe limitations on various types of federal and state expenditures.

One of the most glaring shortcomings of current policies is the reluctance of the Administration to supplement its demand policies by income policies (unpleasontly dubbed "jawboning") designed to combat "cost-push" inflationary pressures. While clearly ineffective to offset "demand-inflation" (or "overspending"), income policies can be effective as an *adjunct* to correct demand policies, and are particularly needed at this juncture to check excessive price increases and wage claims which management and labor have come to consider as "normal" and justified as a result of long years of demand inflation.

Overspending was certainly the prime mover of domestic inflation as well as balance-of-payments shortfalls until a year or two ago. It reached, according to my estimates, a record level of about $46 billion beyond our productive potential at stable prices in 1968.[1] Its impact on domestic prices and costs gradually made these undercompetitive in international trade, adding independent fuel to our balance-of-payments deficits.

The conviction has thus spread, in recent years, from academic to official circles that the ultimate solution of our balance-of-payments problem will require not only the abatement of current inflation, but also an exchange-rate readjustment between the dollar and some of the strongest currencies of persistent surplus countries. We have argued—and are still arguing—that the present IMF rules should be revised so as to facilitate such readjustment through such techniques as "crawling pegs", "broader bands" between official buying and selling intervention rates in the exchange market etc. This was discussed in Copenhagen, and will continue to be debated over the forthcoming months.

Among the numerous and vital issues that will be raised in this debate, I would like to single out today three observations that your Committee may wish to consider.

7. The first is whether the prospective readjustment of the dollar rate toward other currencies should be effected through a change in the parity of the dollar itself, or through a change in the parity of other—particularly stronger—currencies.

Many Europeans are arguing that the first solution is the only proper one. The main problem arises from the U.S. deficits and calls for a devaluation of the dollar.

We take the opposite position for a number of reasons, some of which I find myself very compelling:

(a) I am only moderately impressed by the argument that a dollar devaluation would benefit mostly South Africa and the USSR.

(b) A dollar devaluation would, of course, be detrimental to our prestige and run counter to most solemn promises and commitments repeatedly voiced by Administration officials and several of our Presidents. This argument, however, is obviously more convincing to us than to the foreigners.

(c) A dollar devaluation would penalize the countries that have cooperated with us in the past by refraining to convert into gold the increasing dollar claims accumulated by them as a result of our deficits; and it would reward the countries that denied us such cooperation and converted their dollars into gold metal.

(d) Most convincing of all, to my mind, is the fact that a dollar devaluation would entail an increase in official gold prices, at the very time when the SDR agreement offers the world a sensible alternative to the absurd and anachronistic role of gold in the determination of the world pool of monetary reserves. From that point of view, this would be a retrogressive step in the path toward the rationalization of the world monetary system.

This latter argument, however, would lose most, or all, of its force if gold could be definitely divorced from the SDR system, and parity changes measured in relation to the SDR unit itself rather than in relation to gold. Unfortunately, we are still far from international agreement in this respect, and several years of study, education, and negotiations will be necessary to reach a satisfactory solution, no matter how obvious and inescapable it is in the long run.

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[1] See Table 7, pp. 36–37, of my study on *The Fate of The Pound*, the Atlantic Institute, Paris, 1969.

8. Secondly, any system of flexible exchange rates, or even of discrete parity changes, vis-a-vis the dollar would create very difficult problems for other countries as long as the dollar retains its present near-monopoly role as the international currency for settlements, interventions in the exchange markets, and reserve accumulation by foreign central banks. Surplus countries must now accumulate dollars if they wish to avoid an upward revaluation of their own currency. While they might—and should at times—accept such a revaluation as an alternative to indefinite dollar accumulation, they find it extremely difficult—if not downright impossible—to accept it, as long as it entails revaluing—and thus increasing their competitive costs in international trade—not only in relation to the United States, but also in relation to all other countries which do not revalue simultaneously with them.

The countries of the European Economic Community are particularly conscious of this problem, since independent revaluations by each of them in terms of the dollar would entail, as a mere by-product, corresponding changes in the pattern of exchange-rates between the currencies of the Community itself. This would run exactly counter the basic objective of reaching full monetary union among themselves, solemnly affirmed at the Hague Summit Meeting. It is extremely doubtful, moreover, whether even the present Rome Treaty liberalization commitments and Agricultural Common Market could survive for long such exchange-rate instability among them.

The countries of the European Community will therefore be increasingly impelled toward joint policy decisions in this respect, and will have to develop new mechanisms of market interventions to dissociate the pattern of intra-Community exchange-rates from the fluctuations of the dollar itself in the world exchange market. This may take the form of a European Reserve or Exchange Equalization Fund, long advocated by Jean Monnet's Action Committee for the United States of Europe, and partially endorsed recently in the preliminary report of the Werner Committee to the Community.[2]

I am just back from an extensive tour of Asia, organized by the United Nations Economic Commission for Asia and the Far East (ECAFE), in which ECAFE plans for trade expansion and an Asian Payments Union were discussed at length, in each country, with Cabinet Ministers, Central Bank officials, and Senior civil servants. A Ministerial Council of the region will meet next December or January to examine jointly these ECAFE proposals. While far more modest than those now debated in the European Community, they would nevertheless initiate a similar move toward regional monetary cooperation and a lesser dependence on dollar and sterling settlements for intra-ECAFE transactions.

The complexities of any rational management—toward which we are now moving—of the international monetary system should indeed require the decentralization of the increasing and awesome responsibilities placed on the IMF by such an evolution. Regional monetary groupings—in Europe, Latin America, Asia and, some day, Africa—should assume a growing responsibility for cooperation in solving intra-regional balance-of-payments problems, enabling the IMF to simplify and streamline its own operations by concentrating them on the interrelationships between such regional groups.

9. Thirdly and finally, I have great doubts about the feasibility, appropriateness, and effectiveness of any system of either automatic or permissive exchange-rate flexibility, and would like to present to you some alternative suggestions for the reinforcement of needed adjustment policies.

Mere permissiveness is unlikely to force timely upward revaluation on surplus countries. Germany resisted for more than a year the pleas of other countries to do so. While reserve depletion ultimately forces deficit countries to devalue or cease supporting their rate on the market, reserve accretion does not put similar pressure on the surplus countries, and the IMF is barred by its Articles of Agreement to request any change in parity, even "if it is satisfied that the change is necessary to correct a fundamental disequilibrium,"[3] as damaging to other countries as to the country—or countries—with an undervalued exchange-rate.

Collective leadership—by the IMF, or by regional monetary groupings—should be provided to *initiate* desirable parity changes as well as to block changes regarded by the collectivity as unnecessary and maladjusting.

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[2] See my article on "A Common Currency for the Common Market" in the *Morgan Guaranty Survey*, July, 1970, pp. 3–8.
[3] Article IV, Section 5(f).

On the other hand, complete *automaticity* of exchange-rate, parity, changes in answer to market forces would be as inappropriate as it is likely to prove unnegotiable in practice. Exchange-rate adjustments may be the most appropriate—or even the only practicable—solution to only one of the three main sources of balance-of-payments disequilibria, but not to the other two.

They would be clearly maladjusting in the case of temporary, reversible, disequilibria calling for temporary financing—from national reserves and/or foreign assistance—rather than for day-to-day correction, since they would then be themselves the source of basic maladjustments once these temporary factors have ceased to operate.

Secondly, they would be equally inappropriate as a cure for "overspending" or "underspending" types of disequilibria, that should be cured instead by the readjustment of overall spending to the country's productive potential at stable—or approximately stable—prices. As long as a country spends more than it can earn—after proper adjustment for "normal" and feasible capital exports or imports—devaluation might well improve its current account, but only at the cost of accelerating internal inflationary pressures through the consequent reduction of imports and encouragement of exports. Conversely, if surpluses are the result of deflationary policies, upward revaluation of the currency would add further fuel to internal deflation and unemployment by curtailing exports and encouraging imports.

Thirdly, however, exchange-rate readjustments may provide the best—or even the only—remedy to international cost and price distortions that have made a country's cost levels undercompetitive, or overcompetitive, in world trade.

The same panacea should not be applied to all three problems. Countries should be allowed to accumulate or lose reserves to the extent needed to bridge temporary disequilibria and/or to gain the time necessary for the timely correction of inflationary or deflationary fiscal year monetary policies.

They should not, however, be allowed to export indefinitely to the rest of the world inflationary or deflationary pressures arising from under competitive or overcompetitive price and cost levels that they are unwilling—and would often be unable—to correct through domestic policies. As already mentioned, deficit countries are already unable to do so, as reserve losses finally deprive them of the means to continue stabilization interventions by their central bank on the exchange market. They are ultimately forced to let their exchange-rate depreciate, or to seek external assistance—from the IMF, for instance—and accept the lenders' advice as to the policy readjustments required of them as a condition for such assistance.

The same discipline should be applied on surplus and deficit countries alike by the adoption of a "fork" defining the maximum limit of fluctuations of each country's international reserves. Each country would define a "normal" reserve level[4] and would be free to deplete, or increase such reserves at a certain rate over time. Huge or prolonged reserve increases as well as reserve depletion, however, should force it to discuss with the IMF the policy readjustments needed to restore equilibrium in its balance of payments. These would center on changes of domestic policies as well as on changes in exchange rates, depending on the origin of the disequilibria.

If, however, such consultations fail to produce agreement between the country and its partners, it should then be enjoined from further stabilization interventions in the exchange market. It would have to let its exchange rate appreciate, or depreciate, so as to keep its reserves within the permissible range of fluctuations. Of course, various compromise and transitional solutions might then be negotiated. Rather than bar abruptly all further interventions on the market, these might be gradually tapered off in amount, for instance, or limited to what is necessary to keep exchange-rate adjustments within the range of an agreed "crawl."

This suggestion may be deemed too harsh on national monetary sovereignty to be negotiable in practice. All that I can say is that it would preserve a much greater degree of legitimate sovereignty than alternative proposals for the continuous enforcement of "crawling pegs" long before the limits of my proposed "fork" have been reached.

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[4] International agreement on such "normal" reserve levels could be guided, for instance, but only as a first approximation, by assigning to each country a share of world reserves equal to its share in world trade.

10. This does not exhause the list of international monetary reforms calling for negotiation in the future. May I close with a mere reference to former proposals of mine which have been debated, and largely endorsed, already by the Joint Economic Subcommittee on International Exchange and Payments: proposals for an International Conversion Account—designed to deal with the overhang of gold and reserve currencies in the international reserve system—and for a different system of allotment of Special Drawing Rights, in support of internationally agreed policy objectives rather than—as of now—in support of all and any national policies, no matter how maladjusting these may be deemed by the international community itself and by prospective lenders.

Representative REUSS. Thank you.

I will just start out at the point you left off with, Professor Triffin. You said that the reason for the selling point of SDR's was that they provided a method of providing sufficient liquidity for the reserves of of the world and if the world is to be drenched with dollars, that rationale tends to disappear. Are you saying that you, yourself, are concerned about this, that this is not just a matter of somebody's argument being knocked out from under him, but that really, if we continue to inundate the world with dollars, there is not much of a case in such a 3-year period for big issues of SDR's?

Mr. TRIFFIN. That is right, Mr. Chairman, and I was, I must say, very much surprised at the statement made in Copenhagen by the Minister of Foreign Affairs of France, Giscard d'Estaing. He made this point. But I am glad to say that he also said he would not put in question the agreement on the creation of SDR's for the first 3-year period, but he would question its renewal for the following years. Where I was very surprised at his own policy conclusion is that he seemed to suggest that the amount of SDR's that would be created after that would depend on the amount of dollars that flowed into the international reserve system. If lots of dollars came in, as was the case in the first part of this year, he would not create more SDR's. If few dollars came in, the fund should create more SDR's. This would seem to make the whole SDR system really the garbage can of the failures in our own policies and I doubt whether this would be something that would be satisfactory in the end.

Representative REUSS. However, was that not the basic SDR philosophy, that the money masters would look at the probable inputs of gold—that soon got ruled out—and dollars—that remains—and then figure up how much you need?

Mr. TRIFFIN. I think this was, in a sense, a first step in the right direction, but only the first step. I remember that President Kennedy himself, in his first balance-of-payments message, said that in the future, it would be undesirable to continue to let the international monetary reserve system be determined by the vagaries of U.S. balance of payments and by excessive flows of dollars or sterling into the system and that some new type of assets would be necessary, not only to fill the gap but to substitute for dollars and sterling in the international reserve system of the future. I think this has been the long-standing view of most of the people who have been thinking about this problem.

Representative REUSS. But as has been pointed out by everyone of you, there is no mechanism now for stemming the inundation of dollars?

Mr. TRIFFIN. That is right.

Representative REUSS. So Giscard was right, wasn't he, in the thing you just quoted?

Mr. TRIFFIN. He is right, I think, in the sense that certainly if no other mechanism was found, this would be the implication. But I would remind you of all the discussions that have taken place before your own subcommittee by people like Machlup, Bernstein, myself, and so on, all suggesting for that purpose, something I have called myself an "International Conversion Account," which was endorsed very strongly by your subcommittee.

Representative REUSS. And still is.

Mr. TRIFFIN. This I think is the answer, not that of Giscard d'Estaing.

Representative REUSS. I was addressing myself to his remarks that if the system is uncritical of massive international flows of dollars, and you put in SDR's, which I dearly love, it nevertheless does not make sense to add a finite amount to an unlimited amount.

Mr. TRIFFIN. The purpose of the SDR reform was to have a more rational management of the growth of world reserves. That obviously still remains our major objective, I think.

Representative REUSS. SDR is a nice tool to have when we get a method of controlling the various other faucets.

I want to do a little more clearing up—obviously, it may be, Professor Haberler, that this linkage between SDR's and development aid is going to be academic, because maybe the SDR faucet is going to be turned off, though I hope that will not be the case. But I could not quite follow your criticism of the linkage when you talked about market forces. I wonder if you could spell out why you were opposed to linkage and the part market forces play in your opposition?

Mr. HABERLER. Let me try to put it this way: the link—that is, turning over SDR's to IDA and let them spend the money—that imposes a burden on the industrial countries; they to have to rebuy the SDR's by greater exports. This is the burden which I say should go through the budget. Now, if you do it by giving the SDR's to IDA, then the market will decide which country it will pay which have the export surplus and so carry the burden. If we channel the SDR's through the budget then each country has to carry its own burden and the distribution between the industrial countries is determined by that decision.

Representative REUSS. I am a little surprised at you, Adam Smithian, that you are objecting to this. Why is it not a good idea to have the market determine who supplies machinery for the developing countries? Why is that not, if anything, better than allowing each country to make its own foreign aid allocations and then tying expenditures to each country's industry?

Mr. HABERLER. I did not think of tying aid.

Representative REUSS. If they do not tie it then, it is the market that allocates expenditures.

Mr. HABERLER. I am very much against tying.

Representative REUSS. But if you do not tie it, then it is the market that allocates in the case of a budget expenditure as in the case of a linkage expenditure.

Mr. HABERLER. Then it all goes in the balance of payments and if we have in the long run an equilibrium in the balance of payments, then we export more; this is our burden. Of course, if we have inflation and do not generate, as we have not done recently, an export surplus, then it is different. But if you go through the IDA, that is, if you adopt the link, then nobody can tell beforehand which country will carry the burden and which not.

Representative REUSS. How can you tell in the case of untied foreign aid? You can't tell there either.

Mr. HABERLER. The country, of course, may run temporarily a deficit, and then temporarily, it does not effectively transfer the aid. But I take it that the country can't have a permanent deficit.

Representative REUSS. Let me pass to another topic.

This is not a central point. I just wanted to get something through my head, but maybe you, Professor Triffin, can help me.

Mr. TRIFFIN. Thank you very much, Mr. Chairman. I would say I agree fully with you on this point. I am sorry to have to express total disagreement with my friend, Professor Haberler. Of his four arguments, I think his first is of some tactical validity, that it might have been unwise to start a complicated negotiation about the link right after the adoption of the SDR system; let the SDR system first be accepted and well established. Well, it has been accepted and is well established now. I even hope that we will be forced very soon to a reopening of the question of the link. It will be under study this year, as you pointed out yourself.

The second objection, that the system would be inflationary, I really can't see at all. It seems to me that any amount of financing which is granted to various countries through SDR creation may have exactly the same inflationary implications or worse. If we receive \$800 or \$900 million automatically of SDR's every year, no matter whether our policies are maladjusting or adjusting, whether they are inflationary or not, it seems to me this is just as bad, or worse, than allotting the SDR's, with your eyes open, to support policies on which there is general agreement. I do not think, in fact, that the surplus countries which accumulate SDR's would be willing forever to underwrite blindly all and any national domestic policies that may exist in the world. If they disagree, for instance, with the escalation of the war in Southeast Asia or the takeover of their enterprises by the U.S. capital, they will not like to continue the SDR financing of our deficits, when ascribable to such causes. Professor Haberler has a point in wanting this to be controlled by Congress, but as I understand it, SDR allocations in the end are reviewed also by the U.S. Government and by Congress.

Finally, on the question of market force, I fully agree with you. The proposed link would not leave the amount of SDR's to be determined by market forces, either. They would be determined by the need for international liquidity. The increased potential derived by the Fund from the creation of SDR would be distributed to the countries not according to market forces, but according to joint international decisions. After that, market forces would determine who earns them through balance-of-payments surpluses, but in a way which is highly desirable and to which I can see no possible objection.

Mr. HABERLER. May I briefly answer?

Representative REUSS. Certainly. I am going to have to absent myself for a couple of minutes. I will return. I will certainly read the record of what has been said in my absence.

Mr. Rashish, will you recognize Mr. Oppenheimer and then Mr. Haberler for full rebuttal?

Mr. RASHISH. Yes, sir.

Mr. HABERLER. Very briefly now, the first point, I think it is a continuing complication if you link the SDR's with development aid. It is not only at the first introduction that it would have complicated things if it had been linked right from the beginning, but it will be a continuing complication and there will be pressures to increase the SDR's and counterpressures not to on this ground. This could be developed further, but let me now simply say it would be a continuing complication, and I think this is not a good idea to complicate the reserve creations in such a way.

Now, the second thing, is it inflationary or not? I think it is inflationary in the sense that if you distribute the SDR by giving them to IDA and if IDA pass them on to the underdeveloped countries and they spend it, you have a net increase in demand. If you use the present system, if you give the SDR's to each country independent of its balance of payments, then, of course, some countries will spend SDR's and others will receive SDR's relieving inflationary pressures in the first, intersifying them in the latter. The first round inflationary effect which you have in the other case disappears.

If the country which spends SDR's experiences a deflationary effect because it can import more by using SDR's, you have the counter effect in the other countries. So there is a net difference between the two methods of issuing SDR's.

But let me repeat what I said before: Quantitatively with the present allocations, it is perhaps not an important consideration. Furthermore I did not want to say that who gets the SDR's in the end is determined by market forces. That is determined by the decision of the IDA or international bank or whoever gets them and allocates them. But I said the final burden, which consists in developing an export surplus to acquire the SDR's, that will be then distributed by market forces. That I thought was undesirable.

Mr. RASHISH. Mr. Oppenheimer?

Mr. OPPENHEIMER. The case for the link between SDR's and aid seems to me quite strong. The idea of SDR's is that they should not merely provide reserves for countries other than the United States, but should also be associated with a greater willingness of those countries to upvalue their currencies when necessary against the U.S. dollar.

Now, in order to make the typical government willing to upvalue its exchange rate, you have to subject it to pressure through actual flows of payments. Making a book entry of *x* million dollars worth of SDR's on the first of January 19—does not put any pressure on anybody to do anything, whereas if you give SDR's in the first place to developing countries and they spend them and there is what has been called a burden—I would rather not use that word because

whether it is a burden or not depends on whether countries want the surplus or not, then th SDR's reach Germany, Japan, and other countries through actual flows of payments and these countries will be subject to some pressure to alter their exchange rates.

I would say that if SDR's are to be a substitute for inflows of gold in a modified Bretton Woods system, then it is essential that they appear in the system through an actual flow of payments and not just as a book entry. It seems to me that the link with aid is a way of doing this.

Mr. RICHEBACHER. I just want to stress that many people in Europe think that the SDR's came at the wrong time. They have given an additional inflationary impetus in two ways: as far as they have been used to finance imports this has added to international demand for goods. But this is not all. Recently, I was in a smaller European country and we talked about their balance of payments. They said to me, look, we have got a certain amount of SDR's. Our balance of payments is in deficit, and, normally, we should take measures to adjust. But with the SDR's we have a little more room to wait with adjustment. So the amount of SDR's actually used might not be very impressive. What counts, however, is that they may have contributed to postponing domestic adjustment measures. That effect may not be unimportant.

Mr. RASHISH. Mr. Karlik has a question.

Mr. KARLIK. Well, maybe to preface it, we have an immediate problem with the U.S. balance of payments in terms of the trade bill and in terms of complaints from other countries. Dr. Haberler says that the world is more or less on a dollar standard and we do not have to worry too much, things are going to go ticking along. Professor Triffin is worried about recurring exchange crises.

Dr. Richebacher seems to, in the long run, look forward to some sort of European currency, with perhaps fluctuations between the European bloc and the dollar bloc. But that is not an immediate prospect.

Professor Oppenheimer has suggested maybe introducing a link is a good thing in promoting adjustment, but again, that is a long-term prospect. He did mention an increase in the price of gold as a cure for the U.S. balance of payments.

Now, there are a number of immediate ways to handle this pressure. One solution that has been advocated in these hearings is revaluation of the yen upwards. I would also like to hear maybe Mr. Oppenheimer speak to the idea of perhaps a 5-percent across-the-board ad valorem surcharge on imports into the United States and an equivalent across-the-board export subsidy, because a change in the price of gold is not in the offing. While it does not have the same kind of effects on the capital account, this is a type of substitute for a change in exchange rates vis-a-vis the dollar.

Mr. OPPENHEIMER. Should I answer?

Mr. RASHISH. Yes.

Mr. OPPENHEIMER. Certainly, a uniform 5-percent tariff on imports and a uniform 5-percent subsidy on exports is, in formal terms, equivalent to a devaluation of the dollar on trade account. The question that

one must raise is how this would affect the totality of other countries in the system. Initially the tendency would be to improve the U.S. balance of payments. One may assume demand elasticities and so on are such that it would improve the U.S. balance of payments, and worsen that of other countries. The crucial question is, how will this immediate short-run impact affect the policies of those other countries? What will be their policy response?

Before SDR's, you could say quite categorically, unless the United States was in grossly excessive deficit before, that the rest of the world would take measures which would tend to restore the United States to its "normal" level. In other words, U.S. measures of that kind to improve the U.S. trade and payments balance would put some other countries—small sized, medium sized, somewhere else around the world—in difficulty.

Of course, it is the less competitive countries that would be hit first. All right. They would have to take measures. They would have to deflate or take other steps. This would be followed by a chain reaction in other countries. So in the long run, even in the medium run, it would not improve the U.S. balance of payments.

The question we now face is, does the issuance of SDR's make a difference to the situation? Do countries regard SDR's as a full substitute for payments surpluses and would the system be immune to this kind of chain reaction if the United States tried it on? I do not think it would be so immune at the present time. But give SDR's another 5 years—if it is agreed to go on issuing them—and maybe we will reach a position where the world would be immune from the chain reaction; and then the United States could go ahead. But I do not think a categorical answer can be given at this time.

Mr. RASHISH. Professor Haberler?

Mr. HABERLER. May I comment on that? I fully agree with Dr. Oppenheimer that a uniform export subsidy plus a uniform border tax is equivalent to a evaluation of the dollar, but I would put them differently. You assume that the United States is in some fundamental equilibrium, that we have no disequilibrium in our balance of payments and, therefore, some other counrties would not accept the improvement in our balance of payments which would result from such a scheme.

You would have to say also that the depreciation of the dollar, if it were possible, could not be made to stick because it will improve our balance, somebody else's gets into a disequilibrium and will counteract. But I think it is correct to say, whatever final repurcussions are, that such a scheme would initially improve the American balance of payments.

But let me say now something else, namely, that I think it would be a most undesirable way to improve the American balance of payments. This is a complicated question. Let me make it brief. If you are interested, I have written an article on that and would be happy to put it in the record.

(The article referred to above for inclusion in the record by Mr. Haberler follows:)

[Reprinted from "Approaches to Greater Flexibility of Exchange Rates—The Bürgenstock Papers," Copyright 1970 by Princeton University Press]

Import Border Taxes and Export-Tax Refunds Versus Exchange-Rate Changes

GOTTFRIED HABERLER

IT IS well known that a uniform ad valorem tax of X per cent on all imports plus a uniform ad valorem subsidy of X per cent on all exports is equivalent, as far as commodity trade is concerned, to an X per cent devaluation of the currency. Similarly, an equal and uniform reduction of the rate of tax and subsidy is equivalent to an appreciation of the currency.

The reader may recall that prior to the devaluation of sterling in 1931, Keynes had recommended a system of import tariffs and export bounties. He claimed that such a scheme would be much superior to devaluation because it would avoid the depreciation, in terms of gold, of British foreign assets denominated in sterling. "This proposal would avoid the injury to the national credit and to our receipts from foreign loans fixed in terms of Sterling which would ensue on devaluation." "A plan of this kind would be immeasurably preferable to devaluation."[1] At first he recommended a uniform ad valorem duty on all imports and an equal uniform ad valorem bounty for all exports. But he later dropped the uniformity principle and recommended different percentage taxes and subsidies for different commodities. Keynes must, thus, be regarded as the inventor of what later became known as the "Schachtian" system of international trading. This system was admired and advocated for adoption elsewhere in different variations and guises by Keynes's more radical disciples. But Keynes himself later returned to more orthodox trading methods, and, in his famous posthumously published article on the American balance of payments,[2] sharply rejected the modern stuff "gone silly and sour" of his radical erstwhile followers, who in the meantime had become his critics.

Later on, the proposal to substitute import taxes and export subsidies for a change in the exchange rate was occasionally mentioned in the literature, but it was only in the postwar period that the idea gained popularity and was put into practice.

During the crisis of the French franc in November 1968, when France was urged to devalue her currency and Germany to appreciate

[1] See Addendum I, which Keynes, together with six others, submitted to the "Macmillan Committee" report. Committee on Finance and Industry, *Report* (London, 1931), pp. 199 and 200.

[2] *Economic Journal* (June 1946).

hers, a stop-gap "solution" was adopted. Germany offered what the Germans now call an *"Ersatz* upvaluation" of the German mark in the form of a 4 per cent reduction of the border tax and a 4 per cent reduction of tax refunds on exports, and France agreed to an *"Ersatz* devaluation" of the franc of the same nature. When the German mark was at last upvalued in October 1969, the change in the border tax was rescinded. (In this connection the German word *Ersatz* is preferable to the English "substitute," because the German word carries the connotation of an inferior, unsound, makeshift replacement for the real thing.)

In the current discussion, the idea of a tax-subsidy scheme as a substitute for exchange-rate changes is linked with the theory that, quite apart from balance-of-payments and exchange-rate problems, *general* internal taxes, such as turnover, value-added or income taxes, should be levied on imports and refunded on exports, presumably in order to avoid distortions and unfair burdens on domestic producers of importable and exportable commodities. In addition there is the questionable theory that only indirect taxes, such as the turnover or value-added tax, justify adjustment at the border, not, however, direct taxes such as the income tax. This principle has been enshrined in the GATT regulations, which permit border taxes and tax refunds on exports to offset the effect on cost of production of indirect taxes, but not of direct taxes.

It is unfortunate that the two issues—the macroeconomic tax-subsidy schemes for balance-of-payments purposes, on the one hand, and the microeconomic border-tax adjustments to avoid distortions and inequities on the other—are being linked, because the two issues are in fact entirely independent problems and should be dealt with each on its own merits. I will take up the second problem first.

MICROECONOMIC ASPECTS OF BORDER-TAX PROBLEMS

Contrary to what is often assumed, there is no justification, on grounds of allocative efficiency or avoidance of distortions and inequities, for protecting domestic production from foreign competition, on account of *general* taxation, by border taxes and refunds on exports. The confusion results from not distinguishing between *specific* taxes and *general* taxes. It would indeed be absurd for a country that has a high specific tax on whiskey, Great Britain for example, *not* to tax imports or to forego export possibilities by *not* refunding the tax on exports of whiskey. The reason is that a specific tax does distort the comparative cost situation; in other words, it creates a difference between private and social cost and, therefore, requires adjustment at the border. A perfectly general tax does *not* distort the comparative cost situation and, therefore, does *not* require adjustment at the border.

The difference was lucidly demonstrated by David Ricardo more than 100 years ago:

> For the same reasons that protecting duties are not justifiable on account of the rise of wages generally, from whatever cause it may proceed, it is evident that they are not to be defended when taxation is general, and equally affects all classes of producers. An income tax is of this description . . .
>
> . . . The rise of wages, a tax on income, or a proportional tax on all commodities, all operate in the same way; they do not alter the relative value of goods, and therefore they do not subject us to any disadvantage in our commerce with foreign countries . . .
>
> A tax, however, which falls exclusively on the producers of a particular commodity tends to raise the price of that commodity . . .
>
> . . . If no protecting duty is imposed on the importation of a similar commodity from other countries, injustice is done to the producer at home, and not only to the producer but to the country to which he belongs. It is for the interest of the public that he should not be driven from a trade which, under a system of free competition, he would have chosen, and to which he would adhere if every other commodity were taxed equally with that which he produces . . .[3]

As can be seen, Ricardo also knew that it makes no difference whether the tax is direct or indirect so long as it is a general tax. The often repeated proposition that a general indirect tax, say a value-added tax, can be "shifted" while the income tax cannot be shifted, is entirely irrelevant. In fact, it is not at all clear who shifts the tax on whom. Everybody on everybody else?[4]

[3] See "On the Protection of Agriculture" (1822), *The Works and Correspondence of David Ricardo,* edited by P. Sraffa, Vol. IV (London, 1951), pp. 216–217.

[4] A theoretical qualification may be in order. The incidence of a "general" tax on different products and industries may after all be uneven. If this could be clearly demonstrated, an offsetting tax on imports or subsidy on exports would be in order—in theory at least; in practice, it is clearly impossible to cut things that fine. We simply do not know enough about the incidence of general taxes on different commodities to make possible tolerably accurate offsets by export subsidies and border taxes. But if a country thinks it can establish a distorting effect of a general tax, it clearly would be better to change the tax law in order to make the tax more nearly neutral or truly general than to attempt a complicated offsetting operation at the border. This is precisely the reason why Germany a year ago changed from a turnover to the value-added tax. The former, it was held, had certain distorting effects. In this switch, the Germans changed the rate of border taxes and export tax refunds. They claimed that no increase in the average rate of border tax or tax refund on exports was implied. American officials, on the other hand, asserted that the adjustments made in taxes and refunds have raised the average rate and thus constitute a "protectionist" measure. (It is more correct to say "constitute a depreciation of the mark.") It need not be decided here who was right in this dispute.

MACROECONOMIC (BALANCE-OF-PAYMENTS) ASPECTS OF BORDER-TAX PROBLEMS

I come now to the macroeconomic balance-of-payments aspect of the problem. The question is this: what are the advantages and disadvantages of substituting a tax-subsidy system for a change in the exchange rate? That this problem is entirely independent of the existence and height of domestic taxes becomes clear if one reflects that the rate of import tax and export subsidy that is required in any given case depends on the magnitude of the balance-of-payments disequilibrium in conjunction with the elasticities of demand and supply of exports and imports, but has nothing whatsoever to do with internal tax rates, for example the rate of value-added tax or turnover tax or income tax, that a country happens to have. Moreover, there is no reason to assume that a switch from a general income tax to a general value-added tax would influence the balance of payments in any systematic fashion.[5] Suppose it is desirable to use the tax-subsidy method rather than appreciation or depreciation of the currency: why should a country not use the tax-subsidy method if it would require an import tax and export subsidy much in excess of the internal tax rate? Or even if, in case of an extreme surplus country, restoration of equilibrium in the balance of payments would require a negative border tax, in other words, an import subsidy and a negative export subsidy, in other words, an export tax?

But now I come to the basic point: I maintain that the case *against* using the tax-subsidy system for balance-of-payments adjustment is overwhelming.

The fundamental objection to the tax-subsidy system is that, in actual practice, the rate of tax and subsidy will never be uniform. Even if it were uniform for merchandise, it would not apply to services. Thus, it does not apply to tourism, a very important item in the balance of payments of many countries.[6] But even in the commodity sphere there are always exceptions and exemptions, and the temptation is practically irresistible to discriminate and differentiate between commodities and, implicitly, between countries. (Remember that Keynes quickly pushed on from recommending a uniform tax-subsidy to recommending outright discrimination.)

An additional very weighty objection, which applies especially to the

[5] It is true, however, that under the existing GATT rules such a switch enables a country to impose a border tax on imports and to grant tax refunds on exports. This is precisely what the French did in November 1968.

[6] For example, if, in November 1968, the French franc had been devalued and the German mark upvalued, German tourists would have spent more in France and French tourists less in Germany, thus contributing to the restoration of balance-of-payments equilibrium. Tourist expenditures have been shown to be quite sensitive to relative price changes.

United States, is that for countries that do not practice general export subsidization the introduction of the tax-subsidy system would imply adding an entirely new dimension to commercial policy, and would necessitate setting up new administrative machinery. It is easy to see that there would be a standing invitation and temptation to use this new instrument for *other* purposes and there would be constant pressure from certain industries to obtain special treatment.

In the United States it has been proposed by influential economists, Henry Wallich for example, that the tax part of the full tax-subsidy scheme should be in the form of a uniform import surcharge. The author of the proposal correctly described the import surcharge as equivalent to "one half of a depreciation of the currency." He went on to say that if after a year or two it turned out that the surcharge were not enough to restore equilibrium, the other half could be added by dropping the surcharge and depreciating the dollar outright.

The import surcharge would be administratively much easier to apply than the full tax-subsidy scheme because it would require no, or little, additional bureaucratic machinery. But it would be a protectionist device because it leaves out exports. And to refer to it as "the first half of a depreciation of the dollar," which may or may not be followed later on by the other half, i.e., by full devaluation, could easily bring about massive speculation against the dollar. Suppose after six months or a year it appeared that the surcharge was not sufficient to restore equilibrium, the possibility of an outright devaluation of the dollar would become very strong—everybody would know it and many would act accordingly.

Another danger is that an import surcharge, once it has been in force for some time, would be difficult to remove, even if the balance of payments improved, because domestic industries would have become used to the added protection. Proponents of the surcharge answer this criticism by referring to the Canadian and British examples. Canada, in 1962, and Great Britain, in 1964, imposed surcharges on imports, and both countries abolished them within a reasonable period. The argument is, however, not convincing. Canada devalued her dollar drastically at the same time when she imposed the surcharge and, therefore, quite naturally, soon found she could get along without the surcharge. Great Britain eliminated her surcharge under fire and bitter criticism, especially from her partners in EFTA, who pointed out that the surcharge violated both the spirit and the letter of the EFTA agreement, and a year after she abolished the surcharge she was forced to devalue anyway. Thus, in both cases, the import surcharge was an unnecessary interlude that produced international ill will and frictions, and nothing else.[7]

[7] To bolster their case, the British Government argued that the GATT rules that permit the use of import quotas but forbid import duties (including surcharges) in

I conclude that the border tax on imports and tax refund on exports is an inferior, messy, wasteful, and inefficient substitute for exchange-rate adjustments. The United States is, for the reasons given, in an especially poor position to use this instrument. But the United States is, as far as economic logic and sound principles are concerned, in a strong position to urge the surplus countries to reduce the rate of their border tax and export-tax refund. The ideal solution would be for the surplus countries to drop the system altogether and, thus, get rid of the distortions the border taxes and export subsidies entail, because they are not truly general or neutral. This would be in the true interest of the surplus countries themselves.

The question arises why the method of the border tax and export-tax refund has become so popular. There are two main reasons. The first is the mistaken but widely held view, which was criticized above, that there is a case, apart from balance-of-payments considerations on microeconomic grounds, for border adjustment of general internal taxes. The second reason is, of course, the general aversion to exchange-rate changes. The reason for this aversion will not be discussed in the present paper. Let me say only that border taxes, surcharges, and the like are part and parcel of the general tendency to substitute controls for policies that rely on market forces. General border taxes and export-tax refunds are a part of generalized exchange control; they are better, no doubt, than other measures of control (such as quotas and other quantitative restrictions) but objectionable and inefficient nonetheless because they never are truly general.

An advantage claimed for rebates of border taxes and export taxes over exchange rate changes is that rebates do not apply to capital transactions and leave the value of outstanding assets and liabilities unchanged; as a consequence, they do not induce, it is asserted, anticipatory capital flows in the same manner exchange-rate changes do. However, the validity of this argument is open to serious doubt. As soon as it is generally realized that border tax adjustments (with or without rebates of export tax) are nothing but a substitute for exchange-rate adjustment, the possibility of the latter will always loom in the background. It then becomes very doubtful whether the tax-subsidy method is in fact superior to the adjustable-peg system, from the point of view of avoiding speculative capital movements, and the tax-subsidy method is certainly inferior to a regime of flexible rates that does not offer the same easy target to the speculator as the adjustable-peg system does.

It is often said that the border-tax adjustment has the advantage, over

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case of balance-of-payments difficulties are inconsistent and ill-advised. I would go along with that criticism of the GATT provisions; if import restrictions are to be used at all, duties are a lesser evil than quotas. But the point is irrelevant, for my argument because the question is whether *any* import restrictions are necessary.

exchange-rate adjustment, that it can be more easily removed when the situation demands a change in policy. This may not be so easy, as was pointed out above, and, in any event, easy reversibility would be an advantage of the tax-subsidy method only in comparison with the current practice of a rigid, quasi-immutable exchange rate; but this alleged advantage of the tax-subsidy method disappears when compared with any system of exchange-rate flexibility.

It should also be observed that many objections to exchange-rate changes, whether valid or not, equally apply to the border tax. For example, if it is said that, for the members of the European Common Market, exchange-rate changes are unacceptable because they "counteract the process of economic integration," it should be clear that border taxes (or any other substitute for exchange-rate changes) are just as disruptive and retrogressive on integration.[8]

[8] I would deny that exchange-rate changes interfere with economic integration. If the countries of the EEC are unable (as they undoubtedly are at this time), to "harmonize" their financial and monetary policies sufficiently to forestall the emergence of serious balance-of-payments disequilibria, exchange-rate changes are the most efficient and integrative (or least disintegrative, if you wish) method of correcting imbalances.

Mr. HABERLER. The main objection for the United States to do such a thing, the main objection to my mind is that it would add a new dimension to American foreign economic policy. We have no general scheme of tax refunding on exports. So we would have to introduce this additional administrative device, and you can be quite sure that neither the border tax nor the tax refund would remain uniform. There would be differences. Essentials would be taken out. So you really get a very messy kind of adjustment. It is not a clean substitute for devaluation, but a messy, discriminatory substitute for devaluation. For that main reason, I would not recommend this particular method.

Mr. OPPENHEIMER. Could I just quickly answer? First, I understood the question as referring to possibility, not desirability. I fully agree with Professor Haberler, indeed I say in my statement, that this kind of equivalent is messy and undesirable compared with a straight exchange rate change.

Further, I was not assuming that the U.S. balance of payments is in fundamental equilibrium, certainly not; I think it is in fundamental disequilibrium.

But what does one mean by this? The United States can be in fundamental disequilibrium and yet measures taken by it could still set off a chain reaction in other counrties which were initially in equilibrium, such as to neutralize the measures the United States took. This is the peculiarity of the United States position in the system. But certainly I was not assuming that the United States is in fundamental equilibrium.

Mr. TRIFFIN. I would agree with other speakers that such a system of taxes and subsidy would, if accepted by other countries, improve our current account. It would also tend possibly to deteriorate very seriously our capital account because it might be taken as the harbinger of general devaluation and, therefore, you might have a flood of speculative capital going out at that time.

I would like to make a second observation. If this is recognized, it seems that a clearcut readjustment of exchange rates would be better than any method of this sort. Would it be acceptable to foreign countries, and particularly to the surplus countries in Europe and Japan and so on?

The point I would like to make—and this is important from the point of view of the U.S. Congress as well as from the point of view of foreign countries—is that they cannot hope to preserve forever their present excessive handicap of overcompetitiveness in relation to U.S. producers in international trade. Because even if they are willing, instead of appreciating their currency, if they are willing to continue to absorb dollars and pick up the tab of our deficits, this may be very pleasant for the Treasury, but it does not cut any ice with the American producers, whose exports suffer or who are flooded with foreign imports. Therefore, if the correction does not come through exchange rate adjustment, I am very much afraid that the pressure of business and labor for various forms of trade restriction and protectionism will become irresistible.

I think this is far worse than a change in exchange rate. Because once engaged in that path, after you have given it to textiles, you

have to give it to the shoe industry and after that to others. I think it is a path that would really reverse all the progress we have made since the war.

Mr. RASHISH. I would like to come back to a question that was raised a moment ago about how much of a contribution to stability the balance of payments equilibrium the U.S. revaluation of the yen would make. We have seen the Canadian dollar float and revalued de facto, similarly the German mark. Over the longer term, what effects would accrue from those actions, and what effects would accrue from the additional action if the Japanese were to revise the yen? Do you think these changes would make any substantial difference in terms of the U.S. balance of payments?

Mr. RICHEBACHER. Isolated exchange rate adjustments are generally not sufficient. They have to be combined with internal demand management. The big surplus of Germany in 1967–68 clearly reflected the lack of domestic demand, created by deflationary policy. To decrease a current surplus it is always necessary to increase domestic demand relative to output.

If the German surpluses diminish, this is the result of domestic expansion plus revaluation. I do not believe in isolated changes of polarity.

I know too little about the domestic demand situation of Japan to be able to make any judgment about how a revaluation of the yen affect the Japanese external balance. I do not believe a simple revaluation of the yen would not cause much of a change.

Mr. OPPENHEIMER. I would say that revaluation of the yen would, in general, help the U.S. balance of payments, but not by enough to make major inroads into the problem. The United States, through its inflation of recent years, has undergone some deterioration in competitiveness and a revaluation of the yen would help to restore the previous situation. But after all, the United States was in deficit by a substantial amount long before the inflation of the 1960's got going. I do not see why a revaluation of the yen could be expected to take us right back to the 1940's.

Mr. TRIFFIN. I would differ somewhat on that, because I think that in 1964, for instance, in spite of, again, the official measurements of the deficit, we were, in fact, pretty close to basic balance. We just had an abnormal level of capital exports in 1964, but we were close to basic balance. The position deteriorated enormously from 1964 to 1968, and maybe still part of 1969, owing to a demand inflation of unpredecented magnitude.

I wrote a booklet on "The Fate of the Pound," in 1969 for the Atlantic Institute. You might be interested in seeing table 7 in that pamphlet, in which I estimated that in 1968, we were spending for consumption and investment, public and private, about $45 billion more than the maximum productive capacity of the economy at stable prices. Then obviously, we could not avoid balance-of-payments deficits as well as domestic inflationary pressures.

And if you were to change exchange rates, this would not, as I said before, provide a real solution. It would cure, maybe, the deficit—it would improve our current external imbalance. It would decrease exports and increase imports. But the $45 billion of overspending that

were overhanging our economy would then all have had to be absorbed by domestic price rises rather than spilling over into balance-of-payments deficits.

So if you have a situation of overspending, as we clearly had in 1968, then I do not think that revaluation would be a permanent remedy. On the other hand, if you no longer have a situation of excess demand in the United States, then I think that, of course, the revaluation of the yen would be a help, even though it would not be enough. You would need, in addition, a revaluation of a number of other currencies of major surplus countries. This would be very significant.

In fact, I would myself think that the change in exchange rates that might occur under such a situation need not be enormous. I would be surprised if it exceeded 4 or 5 percent. We must not think, when we mention exchange rate readjustment, that the value of the dollar in terms of foreign currencies is going to be halved. There is nothing of that sort implied in our remarks.

Representative REUSS. Let me, if I may, see if we can distill out some universal truths from this symposium. I am going to put a number of propositions that I think would probably be agreed to by all the panelists and I think in the interest of letting everybody go to lunch soon, let me hear, if I may, dissents from these propositions.

Proposition No. 1. For a whole variety of reasons, including international, it would be highly desirable if the United States got its inflation under control without, at the same time, producing too marked a deviation from full employment. I do not think anybody would dissent from that.

The suggestion made at Copenhagen, and made many times before was that the United States, if it wants to control inflation without departing too much from full employment, would do well to adopt some sort of an incomes policy.

Mr. TRIFFIN. I would like to stress that very much, Mr. Chairman. Just as an income policy was bound to be ineffective in the state of overall demand inflation, which I described as haivng been the case in 1968, it can be and must be a powerful adjunct to correct demand policies. And it is very much needed now, because when you emerge from a period in which you have had really excessive demand and in which prices were going up, you also have a situation in which trade unions expect that prices will go up. They were accustomed to be able to gain large wage increases and, once the habit is taken, it takes something to break it.

I think it is totally understandable except for political reasons associated with the nature of the campaign in the last election, that this is not generally admitted by the administration. I think that in private, in fact, many officials agree that at this stage, an incomes policy is really a necessary adjunct to correct demand policies and can be successful where it could not be in isolation of such policies.

There would be, I am sure, concensus among us on that point.

Representative REUSS. Do not press it too far.

I consider myself having achieved something for having Professor Haberler sit still for my proposition. I do not want to press it too far.

Mr. HABERLER. It is a big proposition.

Representative REUSS. Second proposition, under U.S. policy, ex-

ternal dollar deficits are not desirable. It would be well if we got our balance of payments under control and then incurred deficits, if necessary, when the world needed dollars, rather than inadvertently leaking them out as we now do. The single most promising way of getting our balance-of-payments deficits under control, apart from the anti-inflationary measures already discussed in earlier propositions, is by reducing our greatest balance-of-payments leakage, our military expenditures abroad.

Mr. TRIFFIN. I think this would be all the more necessary as, of course, there are social expenditures which will prove necessary to cure the rifts in our society.

Representative REUSS. Yes, there again, I am with you, Professor Triffin, but I do not want to lose votes on the rest of the panel. So I am stating these propositions in as neutral a fashion as I can.

Mr. OPPENHEIMER. Could I make one small qualifying comment on your last proposition, Mr. Chairman?

Representative REUSS. Yes.

Mr. OPPENHEIMER. I would certainly agree that the best way as of now, given political constraints, of going about correcting the balance of payments would be to cut down on overseas military expenditure. I would also say that is desirable on other grounds, too. But I would not expect it to have a very big net effect on the balance of payments.

Mr. RICHEBACHER. Do not worry about us getting too few dollars. Whenever we need them, we will pull them out from your system by borrowing from your banks.

Representative REUSS. About any conscious policy by us to create a dollar outflow.

Mr. RICHEBACHER. I have the impression that there is too much worry about an ever-threatening shortage of world liquidity. I tend to look at it the other way around. There is very much elasticity in the system in the sense that in a time of need foreign banks would go to the reserve center and borrow which is tantamount to creating international liquidity. The market helps itself to a large extent.

Mr. TRIFFIN. Could I add one point?

I am in disagreement here with my friend, Mr. Oppenheimer. I would say that cutting inflation by a reduction of military expenditure is a more promising way than an equivalent reduction in other types of expenditure. Other types of expenditure increase the taxable wealth out of which you can recoup some revenue, while military expenditures do not do that. Therefore, it is more difficult to maintain an anti-inflationary policies with large military expenditures than with large expenditures of a different type.

Representative REUSS. This will be noted, though I think agreement on the general proposition that I stated was across-the-board.

Mr. TRIFFIN. Yes.

Representative REUSS. Proposition No. 4. The advice given at Copenhagen, if it was given at Copenhagen, and I have not seen the text, to central banks to, in effect, get some gold from the United States is not particularly good advice and it would be well, if it were given, that it were not followed.

Mr. RICHEBACHER. It does not lead us to anywhere.

Representative REUSS. I put this on a hypothetical basis, because I have not seen the text.

Mr. OPPENHEIMER. The word "gold" did not feature in what was said.

Representative REUSS. Reserves, but that includes gold.

Mr. TRIFFIN. I would have preferred to express it in a way with which I would agree, Mr. Chairman, to say that foreign countries should limit their willingness to absorb an indefinite amount of dollars to finance our deficits. Whether as a result of that they should either take gold or appreciate their currencies is another matter.

Representative REUSS. You are getting into my next proposition.

Did you have any comment, Professor Haberler?

Mr. HABERLER. I just wanted to say I fully agree with your first and your last proposition. On incomes policy I am afraid we cannot solve that in 5 minutes.

As to military expenditures, if the situation were such that we could reduce it, there would be, certainly, an effect on the balance of payments which would be desirable all around.

But I agree with Dr. Oppenheimer that we cannot be sure that it would make a big impact on the balance of payments, because the money which we do not spend on the military we probably would spend on something else. It becomes very complicated, then, how that would affect the balance of payments.

Representative REUSS. Your qualification is noted, though I thing it is really no more than a qualifiaction, because if we spend the savings from the military on do-good foreign policy adventures of an equivalent amount, I admit that we then have not saved anything.

Mr. OPPENHEIMER. Mr. Chairman, I must comment briefly on your proposition about the Copenhagen statement. This is a very difficult one to answer because one has to try to guess, given the context in which that statement was made, what was in the managing director's mind as being the consequence of such a move if his advice were followed. I am not sure what was in his mind. Therefore, by the same token, I am not sure whether I agree with him.

But if you allow me to forget the context in which the statement was made, then I would say that I am in favor of countries trying to convert their dollars at the U.S. Treasury, and obliging the United States to say no explicitly to demands for gold. This is what is often called a crisis in the monetary system; but I do not think it would be such a crisis.

Mr. TRIFFIN. It would force the issue of the international conversion account for serious consideration.

Mr. OPPENHEIMER. I would be in favor of forcing that issue. But I doubt very much whether the Managing Director of the IMF had that in mind when he made his statement. Therefore, I have difficulty answering your question, Mr. Chairman.

Mr. HABERLER. Why rock the boat? You say you would be in favor of their asking for gold and getting it; that would be a dangerous thing.

Representative REUSS. You are in favor of the United States ending convertibility?

Mr. OPPENHEIMER. Yes.

Put it this way: I am in favor of the United States admitting that convertibility is no longer with us, because the facts do not permit it.

Representative REUSS. I do not want to slow down my stating of

propositions and I have one more to go. But I do find it interesting that you should take that view, which is the view of Professor Marklup, too, I think, and one that I am sympathetic with. I find it a little inconsistent with your raise-the-price-of-gold point.

Mr. OPPENHEIMER. I do not think it is inconsistent. I want the United States to choose one or the other alternative. Renunciation of the $35 gold price will give the Europeans a chance to decide what they want to do with their gold. Maybe they will raise the price in terms of their currencies. That will leave the United States with the choice of whether it wants to go on floating against gold or come back to it at a higher price.

Representative REUSS. Or they can go to Triffin's gold-dollar-SDR conversion account.

Mr. OPPENHEIMER. That would be more difficult, because if the United States said gold was not available it is a little hard to see now what would be the items in the gold conversion account.

Representative REUSS. It would be as available as any other country's gold.

Mr. TRIFFIN. I am anxious to get to the last point of your concensus, but if after that, we still have a few minutes of time, I would like to express the reasons why I disagree with the idea of an increase in the price of gold.

Representative REUSS. Fine. You will be recognized for that. Let me just clear this last point.

Proposition 5 is that it would be desirable if there were a better mechanism than there is now for countries other than the United States to limit the output of dollars. Such a mechanism—without indicating any order of preference—could either be Triffin's gold-dollar-SDR conversion account, whatever it is, or could be the adoption of the Common Market's unitary currency, which would probably enable the Common Market countries to sit still for a revaluation vis-a-vis the dollar without fear of getting out of phase among themselves. I mention those two possibilities, and agreement with this proposition does not mean that you have to agree with either one of these alternatives. The proposition goes simply to the need for the evolution of some system whereby, through revaluation or other means, the United States ability to push out infinite amounts of dollars is curtailed.

Is it in agreement that it would be desirable to have such a mechanism?

Mr. HABERLER. You did not mention flexibility in that connection.

Mr. OPPENHEIMER. Quite. Such a mechanism would be desirable—to the extent that it does not already exist.

Representative REUSS. It has been said, including by you, that flexibility does not really work for the United States as long as it is the sole banker.

Mr. RICHEBACHER. You can have flexibility with a bloc system.

Representative REUSS. Then I will mention flexibility.

Mr. TRIFFIN. It is implicit in what you say about a Common Market monetary area, I think.

Could I say, for one, that I applaud wildly all five of your points and express my full agreement with them.

Representative REUSS. Fine. Now, you wanted to make additional comment?

Mr. TRIFFIN. Yes; about a remark made by Professor Oppenheimer about the price of gold.

I think that one of his main arguments was that it would be difficult to reach agreement continuously about the amount of SDR's that would be needed to preserve a proper level of world liquidity. But it seems to me that reaching agreement about the changes in the price of gold that would produce the right level of liquidity would be even more difficult to come by, and that if you can agree on how much liquidity is needed, it will be easier—and much less expensive—to say how many SDR's have to be created than to decide what price of gold will provide the amounts of liquidity that will be desirable. Therefore, I disagree very completely with him on that.

I agree on the last point that the SDR agreement as it now stands does not deal with the enormous overhang of gold and dollar and sterling balances in the world monetary system. But that rejoins the point which has been made very often before this committee in favor of an international conversion account or some mechanism of that sort.

Representative REUSS. I had some difficulty, Mr. Oppenheimer, with your proposition that an increase in the gold price to, say, $70 an ounce or whatever, and the resultant bringing into the monetary system of gold, largely by diminishing the private absorption of it, would in and of itself reduce to zero the U.S. balance-of-payments deficit.

Mr. TRIFFIN. It would not.

Representative REUSS. If that is what you were saying, I do not quite see why, once we had reduced our deficit to zero, we could always throw our balance-of-payments off again by whatever idiotic adventure we wanted to undertake.

Mr. OPPENHEIMER. I did not say that, Mr. Chairman, because I do not think there's any action which the United States can take which could in and of itself reduce its balance-of-payments deficit to zero. You must always look at the repercussions on the system, because the United States is so big, it is such a substantial part of the system. It is not just one country in a world of many countries, it is a quite dominant element. Therefore, the burden of my argument, and I repeat it so that it will be in the record, is that the repercussions which the rise in the gold price and the consequent inflows of new gold reserves would produce in the rest of the system and in the policies of other countries would lead to the U.S. deficit being reduced to small proportions. This is simply the converse of my proposition that it was the inadequate inflow of gold throughout the whole post war period which caused corresponding policies to be adopted in the outside world, such as to maintain——

Mr. TRIFFIN. But the same result would flow from the improper creation of SDR's.

Mr. OPPENHEIMER. Conceivably, if they were linked with aid or brought into some other payments flow.

Representative REUSS. This clarifies it very much.

Thank you all, gentlemen, you have helped us a good deal.

We now stand in adjournment until tomorrow at 10 a.m.

(Whereupon, at 12:15 p.m., the subcommittee was adjourned until 10 a.m., Thursday, October 1, 1970.)

A FOREIGN ECONOMIC POLICY FOR THE 1970'S

THURSDAY, OCTOBER 1, 1970

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Foreign Economic Policy met, pursuant to recess, at 10:05 a.m., in room S–407, the Capitol Building, Hon. Hale Boggs (chairman of the subcommittee) presiding.

Present: Representatives Boggs, Reuss, and Conable.

Also present: John R. Stark, executive director; John R. Karlik, economist; Myer Rashish, consultant; and George D. Krumbhaar and Leslie J. Barr, economists for the minority.

Chairman BOGGS. The subcommittee will please come to order.

Today is the last session in this series of hearings on the U.S. position in international commerce as affected by the domestic and external adjustment mechanisms. We have now reviewed the internal consequences of trade expansion and the distribution of responsibility for balance-of-payments adjustment among the industrial countries. Today we plan to focus on how events in the United States and abroad may affect the evolution of the international monetary system and how these developments might either reinforce or diminish the external monetary functions of the dollar.

Our panel of witnesses today is eminently qualified to discuss these questions. First is Mr. Franz Aschinger, adviser to the Swiss Bank Corp., and former financial editor of Neue Zürcher Zeitung.

We are happy to have you here today, sir.

Next is Mr. Harold Cleveland, vice president of the First National City Bank; Prof. William Fellner of Yale University, who I understand is delayed but will be here, and Mr. Walter S. Salant, senior fellow at the Brookings Institution.

We will proceed with Mr. Aschinger.

STATEMENT OF FRANZ E. ASCHINGER, ADVISER, SWISS BANK CORP., AND FORMER FINANCIAL EDITOR, NEUE ZÜRCHER ZEITUNG

Mr. ASCHINGER. Mr. Chairman, gentlemen, I am very grateful to this distinguished committee for inviting me to testify in these hearings.

If, in my home country, Switzerland, the balance of payments of the United States attracts even more interest than our own external accounts and if we are obliged to initiate our economic students into

the mysteries of the different U.S. balance-of-payments statistics, this is due to the immense importance that your country's external balance has for the entire international monetary system. Indeed, the weight of the economy and foreign trade of the United States in the world economy as a whole is so preponderant that the repercussions of its internal and external performance exert a profound influence on virtually all other countries. Moreover, since the dollar is the sole vehicle—intervention—and reserve currency in general use, the stability of the whole montary system is heavily dependent on the price stability and the payments position of the United States.

The present functions of the dollar as an international currency are, for the time being at least, irreplaceable. A strong dollar is a necessary requisite to a stable international monetary system. The crucial question is, therefore, how the position of your currency can be preserved for the foreseeable future.

In order to play its role, the dollar must be stable, both internally and externally, and must be not overabundant. The target of the United States, as the main economic and reserve center, should therefore be reasonable price stability, with annual price increases not exceeding, say 2 to 3 percent, and a reasonable balance-of-payments equilibrium. A reasonable external equilibrium might entail some overall external deficit, justifiable on account of the ever-increasing demand for dollars as an international transaction and reserve currency. How large such a deficit could be is difficult to forecast. Dr. Bernstein guesses that an average annual deficit in the order of $1 to $1½ billion on a liquidity basis, corresponding to a virtual balance on an official reserve basis.

Will—I ask—the United States, after a bout of intensive inflation and a long, practically unbroken chain of external payments deficits, be able to achieve these aims?

Let me first make some general remarks on the problem of combating inflation.

While the recent slowdown in domestic business activity due to restrictive policies has been less severe than during previous postwar recessions, anti-inflationary successes have been disappointingly slow. This is why the return to general price stability today deserves highest priority. If the United States were to fail to reach this target, it would not only be token defeat on the home front against the political, social, and economic evils of inflation, it would also lead to a stepping up of inflation throughout the world. The degree of inflation in other countries, as Prof. G. Haberler recently pointed out, is largely determined by the drift of prices in the United States. Moreover, if the purchasing power of the dollar continues its recent heavy decline, its status as a reserve currency would certainly suffer accordingly. Other countries would become increasingly reluctant to hold additional dollar balances and to peg their currencies to the dollar.

Avoiding inflation need not imply a recession. Only when domestic inflation has become rampant and protracted, can a subsequent curb be hampered by employment and growth factors. While in other countries inflation is often primarily imported, inflation in the United States is essentially of domestic origin. This fact should facilitate avoiding and curbing inflation in this country.

The question is, whether present internal measures are sufficient for curbing inflation. It is not so much the recent tendency to relax monetary policy which causes concern abroad. The disturbing element lies in the development of the budget situation. Control of the budget is in danger of getting out of hand it seems to us. The prospective deficit exceeds the budget forecasts by many billions. Without further measures the deficit in the unified budget—I quote Bernstein—could attain $15 billion. But even if the immediate objectives of the administration to reduce the deficit to $10 billion were achieved, this would not be adequate to combat inflation at the present time.

I now turn to the balance-of-payments requirements of a strong dollar.

The present basic weakness of the U.S. balance of payments is essentially the lack of an adequate surplus in the current accounts. The fact that the trade surplus has shrunk from $6.8 billion in 1964 to not even one-tenth of that amount in 1968 and 1969, was mainly attributable to rising domestic inflation. While nonmilitary exports from 1964 to 1969 rose by 43 percent, imports, mostly due to demand presures and cost inflation, nearly doubled. If, conversely, the trade surplus has in the first quarter of the current year, despite a still high level of imports, again increased to $2.1 billion and to $3.4 billion in the second quarter, this is an encouraging sign that restraining demand pressures produces a healthy effect on the external balance.

By pursuing anti-inflationary domestic policies it should be possible to curb cost inflation and to improve the commercial surplus still further. The ratio of imports to exports has risen from an average of 75 percent between 1960 and 1964 to nearly 100 percent in 1968 and 1969. If that ratio were reduced to only 90 percent, and if annual exports continued at the puresent level of over $40 billion, a $4 billion trade surplus per annum would result. The current balance of payments, which in 1969 showed a surplus of $4.3 billion (excluding military transactions), could then be restored to its traditional level of nearly $8 billion in the years 1961 to 1967, enough to cover at least the expenditure of foreign military and economic aid. With a GNP of nearly $1,000 billion this should not be too difficult a target to achieve.

Restoring a reasonable price stability would not only improve the trade surplus. It should, in the longer run, also have a healthy effect, directly and indirectly, on several other important components of the balance of payments: Net income from U.S. investments abroad and foreign investment in the United States, which suffered last year from the upsurge of interest rates, would probably increase with falling rates. The net surplus in the travel account should also improve. And the long-term capital flow would be directed in favor of the United States, if the competitiveness of its economy were improved and profits of U.S. corporations were again increasing.

Although the balance of payments of the United States certainly contains many items which are not responsive to the classical adjustment measures and although there may be important structural factors agitating against a reestablishment of thte balance-of-payments equilibrium (I refer in particular to the narrowing of the productivity gap), orthodox fiscal and monetary measures nevertheless remain the key to restoring a sustainable, reasonable eternal balance.

As long as the present precarious balance-of-payments situation continues, the need for controlling capital outflows seems to me indispensable. If in my home country the internal capital market tightens, due to demand inflation, and if the current balance-of-payments loses its traditional surplus or dips into the red, the Swiss central bank, on a statutory basis, temporarily suspends foreign loan issues. It seems logical to us that capital investments abroad should not be financed at the expense of reserve. For the United States this dilemma does not exist because its deficit which is increased by its investments abroad, is financed by the accumulation of dollar balances and by capital borrowings abroad. However, seen from an external vantage point, it appears strange that U.S. direct investments abroad increase the American external deficit which in its turn is financed by foreign countries. If the United States as the richest country is to provide the world with real resources, its capital outflow must be covered by the export surplus of goods and services.

Investments abroad have, it is true, contributed greatly to increase the investment income in the external balance of the United States. From $1 billion, immediately after the war, investment income has grown to $8.8 billion in 1969, thus improving the balance of payments. On the other hand, the extensive foreign investments, which are at the source of higher investment income, are a heavy load for the external balance. Though capital exports from the United States are normally highly desirable, an outlay of $4.7 billion in 1969 for direct investments of foreign securities issues seems to be a heavy burden at a time when the current balance of payments is so weak.

This leads me to the important question: Will all realizable internal measures be sufficient to restore the external balance? Or is the balance of payments disequilibrium of a fundamental, structural nature? The opinion is often voiced that the dollar is hopelessly overvalued. I am still reluctant to share this pessimistic view. Assuming that a restrictive policy, under present conditions, is continued with vigor, the restoration of a reasonable balance-of-payments equilibrium in the terms I have described should still be possible by normal internal adjustment measures. However, should the monetary and fiscal measures and the restrictions on capital outflows prove ineffective, then the question of exchange rates would, of course, have to be raised.

Under the terms of the Bretton Woods agreement, the onus of devaluation is primarily on the overvalued currency. However, in view of the dollar's special status, this standard procedure is widely regarded as unfeasible, since a change in the dollar parity could impair its role as an international currency and have grave repercussions for the entire monetary system. Furthermore, were the dollar to be devalued, the vast majority of countries—so it is argued—would follow, thus defeating the object of the exercise. According to this latter theory, instead of devaluing the dollar, it should be up to the surplus countries to revalue their currencies.

In view of the immense foreign dollar balances, a dollar devaluation would certainly be difficult and risky. But the proposed alternative, namely revaluation of the other currencies, would be no easy process either. It is, moreover, doubtful if this method would be an adequate and reliable adjustment procedure.

An appreciation, as you know, Mr. Chairman, of a nondollar currency would not only imply a change of its parity vis-a-vis the dollar but also vis-a-vis all other currencies. For this reason, a number of countries whole currencies are undervalued in relation to the dollar would probably not revalue for reasons of political situations at home. On the other hand, if the parity of an overvalued dollar were adjusted, a greater number of countries could probably be expected not to follow or only partly to follow a devaluation of the dollar. As a result, the adjustment effect of the method of revaluation of other currencies would probably be small for the dollar. Moreover, if surplus countries were expected to revalue frequently vis-a-vis the dollar, speculative capital movements could easily take on enormous proportions. Such revaluations would also reduce the incentive for the deficit countries to improve monetary discipline, and thereby might intensify the inflationary trend.

All these considerations emphasize, in my view, the overwhelming need for restoring the U.S. payments balance by internal means.

Yet there seems, however, to be increasing lack of concern over the balance of payments in many quarters of this country. There is widespread belief that the introduction of a two-tier gold price system and the reluctance of foreign central banks to convert dollars into gold have made the dollar impregnable. The fact that the dollar, despite a confusing and deficitary balance-of-payments situation and despite the acceleration in the decline of its purchasnig power, stood firm in the recent past, is regarded as demonstrating that the United States, under a virtual dollar standard as it exists today, need no longer worry about its balance-of-payments deficits and price stability. It is also considered as evidence that the dollar cannot only survive as a reserve currency without convertibility into gold, but is becoming even stronger.

But a close look reveals to me that the strong position of the dollar in the recent past has been influenced by temporary factors. It was primarily caused by the high borrowings of Eurodollars by banks in the United States and the great attraction of the dollar as an investment currency because of the high interest bearing placements in the Euromarket. This situation would, however, be reversed, and has already been reversed, if, due to a relaxed U.S. monetary policy, great amounts of these funds were paid back to the Euromoney market and were to increase the reserves of foreign central banks, causing them an extraordinary inflow of dollars, as it is feared, for instance, in our country.

Another uncertainty factor are the large "volatile" private dollar balances held abroad. If such private dollar assets, as a consequence of lower interest rates in the United States or of a confidence crisis in the dollar, or in the case of another currency becoming a candidate for revaluation, were to be converted into other currencies, foreign central banks could receive great amounts of dollars which could prompt them to revive their request for dollar conversions into gold.

Such risks could, it is true, be eliminated if the U.S. Treasury were formally to renounce its readiness to sell gold to monetary authorities at a fixed price. The United States would henceforth be under no obligation to convert official dollar assets into gold. The gold/dollar

standard would in that way be formally abolished and be replaced by a formal dollar standard.

What would, under a factual or formal dollar standard, be the position of the dollar as an international currency? Some people feel that under such circumstances the United States would not have to worry any more about its balance of payments, but that it would be up to the other countries to shoulder the burden. The dollar under the shield of a dollar standard is often visualized as a kind of a monetary "sun," around which the other currencies would have to orbit.

This notion, that the dollar standard would be immutable, is in my opinion an error. The point of no return in the transition to a dollar standard has not yet been passed and never will be. Should the United States, even after having introduced a gold embargo, neglect to control inflation and her balance of payments, the surplus countries would sooner or later be compelled to secede from the dollar reserve system.

This becomes clear when we look at the dollar standard from the point of view of the outside world. The dollar, as a reserve currency, can be compared to a master watch with which other watches must be synchronized. If the master watch itself is inaccurate, it can no longer serve as a standard for others. Acceptance of the dollar standard means that a country must tie its currency at a fixed rate to a dollar against which there is no more option into gold. The country concerned must commit itself to buying eventually an unlimited amount of dollars at a fixed rate and to holding unlimited excess dollars as monetary reserves.

If the external payment position of the United States were in balance and if prices here were reasonably stable, there would be no problem. However, if the internal purchasing power of the dollar were in the long run to drop more than in other countries, as appears to be the tendency at present—I agree that in the recent past, there has been a change—and if the U.S. balance of payments continued to run at heavy deficit, surplus countries that had submitted to a dollar standard would suffer from imported inflation in a variety of ways. Excess dollar holdings could build up to such a scale as to cause an inflationary inundation and make the countries concerned highly dependent on a single powerful debtor. Moreover, if the dollar would become increasingly overvalued, it would lose its attraction as a reserve currency.

Under such conditions, the countries concerned could hardly be expected to accept their fate passively. The simple truth is, as put by Dr. Edward Bernstein: "No international monetary system can be devised under which foreign central banks can be induced to acquire unlimited amounts of dollars for an indefinite period of time." If the dollar standard were accompanied by substantial U.S. balance-of-payments deficits and by a high rate of inflation in the United States this would infringe the economic sovereignty of other countries and would give rise to growing political and economic friction between friendly nations. And it would surely be unreasonable to expect the surplus countries not to attempt to make themselves at least parity independent from the dollar in one way or another.

In principle, three alternatives would be open to them: First, they could appreciate their exchange rates individually, or, with a greater

impact, collectively. The drawbacks of this course, the weaknesses, have already been outlined. Frequent resort to it would also undermine the internal status and international status of the dollar.

A second method of breaking the "yoke" of an abused dollar standard would be to let the other countries float against the dollar. Once the dollar was without a fixed gold price, other countries would have the choice either of pegging their currencies to the dollar or of maintaining their gold parities and unpeg against the dollar. Such a step would, however, necessitate the countries concerned banding together, pegging their rates to each other, and pursuing a common intervention policy, vis-a-vis the dollar.

A third theoretical possibility of avoiding a state of impotence under a dollar standard would be for other countries to introduce two categories of dollars: those bought and sold by the central bank at the official rate and those whose price would be determined on the free market. This would, however, require far-reaching exchange control. Such a system was practiced in my own country during and immediately after the war, albeit under different circumstances; but it is unlikely to become a practical alternative again. Nobody expects that this would happen in my country.

The process of secession from the dollar standard would probably be neither smooth nor easy. It would split the Western monetary system into two distinct monetary blocs. It could give rise to political tensions and frustrations within the Western World. It would lead to permanent monetary unrest and a succession of currency crises. Moreover, it is questionable whether external equilibrium could be restored by such methods. To quote the Governor of the Swiss Central Bank, Dr. Edwin Stopper:

> If there is no substantial improvement in the U.S. balance of trade and if the excessive inclination toward inflation in the United States and elsewhere is not eliminated, even a de facto dollar standard does not guarantee lasting monetary stability.

An obvious question is: What practical chances are there of a breakaway initiative by the surplus countries? If you give me a minute, Mr. Chairman, I would like to extend also on the question of monetary integration in Europe.

The recent decision of the Common Market countries to accelerate the creation of a European monetary union clearly indicates the undercurrent of opinion against continuing indefinitely to finance the huge and persistent U.S. deficits. This drive toward monetary integration, it is true, in line with the original commitments of the Common Market countries. Nevertheless, it is unlikely that the decision of the EEC members to step up monetary integration could have been taken had there not been the strong incentive for gaining a minimum of independence from a dollar standard. The EEC countries have realized that their sole effective recourse lies in a common policy vis-a-vis the dollar.

The thoughts and worries which preoccupy many European monetary authorities in this connection emerge from recent remarks by Baron Ansiaux, Governor of the Belgian Central Bank:

> We have every reason to be grateful to the United States. But it will not expect us, I am sure, to push the gratitude to a point of not taking whatever measures are necessary to insure our own equilibrium and the future of the EEC if * * *

it would be impossible, for internal reasons, to safeguard the monetary stability of the U.S. economy. To conduct such an independent policy would scarcely be possible for isolated countries.[1]

Paving the way for eventual European monetary union is clearly a difficult and time-consuming operation. It presupposes a whole set of harmonizing measures in respect of economic policy and the surrender of national sovereignty to supranational bodies. Some initial steps—short- and medium-term mutual financial assistance between EEC members—have already been taken. But the decisive economic measures to synchronize economic targets and policies are still in the planning stage. Many political difficulties will have to be overcome before this economic harmonization materializes.

Closer coordination of economic policy within EEC would, of course, have to be welcomed not only as a means to European integration but also as an important contribution to improving the international adjustment process in general.

A European monetary union can at best be developed parallel to further economic integration. But common monetary measures in the sense of gaining more independence toward the dollar would not necessarily have to await full monetary union. Preliminary steps could be taken by the Common Market countries should the external situation require it. Coordination of exchange-rate policy could, if necessary, take a more rapid turn. A narrowing of the margins to the parities among the Common Market countries is already planned, at least on an experimental basis, for the next future. This implies a concerted intervention policy toward the dollar. Exchange-rates policy is designed to become a field of collective consultations and decisions. Much, of course, will depend on the dollar. A continuation of the unfavorable development of the U.S. balance of payments or a formal decision by the U.S. Treasury to close its "gold window" would certainly greatly encourage attempts to break away from a dollar standard in Europe. There is even the danger, a real danger, that such steps could be taken prematurely for political reasons.

Any move by the EEC countries to make themselves more independent from the dollar standard by evolving a common monetary policy would, of course, lead to the creation of two monetary blocs and could increase tensions in the monetary system. It would also mean that the United States could henceforth less afford balance-of-payments deficits. The balance of payments, instead of ceasing to be a problem for the United States, would have to become a matter of even greater concern.

However, the dollar can only be strong again if it is based on a reasonable balance-of-payments equilibrium. Without an improved external balance of the United States, the international monetary system cannot recover.

My conclusion coincides with what in the last day has been said by the Managing Director of the International Monetary Fund in his speech before the annual meeting: "From the standpoint of the functioning of the international system," he said, "by far the most important problem is posed by the deficit of the balance of payments of the United States. The need to rectify the U.S. payments position is the

[1] Address before the Anglo-Belgian Chamber of Commerce, London, Jan. 17, 1970.

most urgent remaining task in the field of international payments."

And Herr Karl Blessing, former Governor of the Deutsche Bundesbank, in his recent address before the Jacobson Foundation in Basle, terminated in a similar sense by saying that as things stand, a strong dollar means a strong system and a weak dollar means a weak system.

My voice, Mr. Chairman, is only a humble voice amongst many Europeans.

Thank you, Mr. Chairman.

Chairman BOGGS. Thank you very much, Mr. Aschinger.

Now we will be very pleased to hear from Mr. Cleveland.

STATEMENT OF HAROLD VAN B. CLEVELAND, VICE PRESIDENT, FIRST NATIONAL CITY BANK, NEW YORK, N.Y.

Mr. CLEVELAND. Thank you very much, Mr. Chairman. Let me say how pleased I am to have been asked to come here. The work of this subcommittee has been enormously valuable to everyone concerned with international monetary questions, and not least to those like myself who are halfway between the academic world and the world of international banking.

Like Dr. Aschinger, I would like to concentrate my remarks on the dollar problem and on its possible or probable consequences for the international monetary system, particularly for the system of pegged exchange rates. As he pointed out very clearly, the deficit of the United States is much less a problem in present circumstance for the United States than it is for the rest of the world. In fact, the nature of the problem is obscured if one tries to grasp it in terms of the usual logic, whereby a payments deficit is a problem for the country in question because it impairs that country's international liquidity—through loss of reserves—and therefore leads to speculative pressure on the exchange rate.

The dollar problem is not, in present circumstances, of this kind. It is a problem—for other countires—precisely because it does not lead to an impairment of the international liquidity of the United States, nor to serious speculation on a change in the dollar's parity. The problem is that this immunity from balance-of-payments discipline, coupled with the size of the U.S. economy, makes it possible for the United States to exert a large, one-sided influence on monetary conditions in other countries—so long at least as other countries adhere to a system of pegged exchange rates. To put it in political terms, hegemony, not liquidity, is what the dollar problem is all about.

I need not dwell at any length on the reasons why, in present circumstances, the U.S. dollar is now thought to be immune to devaluation. Dr. Aschinger brought them out clearly. While the United States is thus deprived of a key instrument for balance-of-payments adjustment, it is by the same token relieved of the necessity to be concerned about its balance of payments at all.

Let me say a few words of a more theoretical kind about the monetary mechanisms through which this monetary hegemony makes itself felt.

When the U.S. Federal Reserve System causes the domestic money supply to grow more rapidly than the domestic demand for money is

growing, an internal adjustment process is set in motion which tends in time to eliminate the excess of money. People spend more and invest more in financial assets, in an effort to achieve the desired distribution of their total wealth as between cash on the one hand and financial and real assets on the other hand. If there is slack in the economy, output will accelerate and unemployment will fall; if there is not, the main effect will be on the domestic price level. The rise in output increases real income and thus raises the demand for money. If prices also rise, the real value—purchasing power—of people's cash declines.

By these processes, the demand for money will be raised and the supply of money in real terms will tend to fall, eventually restoring equilibrium between the domestic demand for and supply of money.

If the United States were a closed economy, this is all that would happen. But since the United States participates in an international monetary system which is open and characterized by pegged exchange rates, a part of the initial excess of money will flow out, giving rise to or aggravating a balance-of-payments deficit.

If controls are put on capital outflows as we have done in the United States, they will change the character of the outflow; that is, they will affect whether the money flows out in the form of private bank deposits, for example, or in the form of additional spending for foreign goods and services, rather than in the form of additional spending for foreign financial assets or for plant and equipment located abroad. But unless it is a very comprehensive and effective system of exchange control, it will probably not affect the country's net balance-of-payments position. For this reason, I doubt that the U.S. Federal Reserve and OFDI control programs have made any net reduction in the U.S. payments deficit, although they have certainly affected the channels through which funds flow out.

Now, if the United States behaved as other countries do when they have a balance-of-payments deficit, the outflow would help to restore internal monetary equilibrium and thus to restore balance-of-payments equilibrium. This is normally what happens in other countries. Faced with a loss of reserves, the authorities are under pressure to allow the outflow to affect the domestic money supply, in order to protect the reserves and the exchange rate. In the case of the United States, however, the central bank is free of this constraint. Indeed, the Federal Reserve routinely offsets the effect of a net monetary outflow on the reserves of the banking system.

To put these points in a more general frame, I might say that in an open international economy, characterized by exchange rates which are pegged, money will tend to flow from regions of higher monetary pressure to regions of lower pressure, to use a meteorological metaphor. It will flow from countries where its supply is more excessive or less deficient relative to the demand for money, to countries where it is less excessive or more deficient relative to demand. Changes in monetary conditions under a pegged rate system are accordingly widely diffused among the countries which form a part of the system, wherever these changes may have originated.

It follows, of course, that a country which is immune from the normal discipline of reserve losses is able to act as a sort of international central bank, supplying money without any definite external

limit to the rest of the world. If it also happens to be a very large country, its balance-of-payments deficit may accordingly exert an important influence on monetary conditions abroad.

Of course, it might happen that the United States would choose for purely domestic reasons to limit its money creation to an amount which is consistent with what other countries would like to have—to increase their international reserves or to satisfy the private demand for holding dollars abroad.

That much, at least, of the U.S. payments deficit is not in any real sense problematic; it is not a problem to other countries, as Dr. Aschinger observed in his remarks. Yet even if one assumed that the United States would behave consistently in this acceptable way, one would have to question whether an international monetary system consisting of sovereign governments would continue to find acceptable in the long run a system which puts many countries' money supplies, partly in the control of one country's central bank.

There is another point about the monetary influence abroad of the U.S. payments deficit which I think is sometimes overlooked. Money which moves internationally is different from ordinary, domestic money. When it is exchanged for local currency, it becomes what the monetarist economists call "high-powered money." It is the equivalent of central bank credit in a country's banking system. It enlarges the credit base of the local banking system, permitting a multiple expansion of bank credit and hence of the local money supply. If, for example, there is a 5 percent local reserve requirement—or conventional bank-liquidity ratio—with respect to demand deposits, a net inflow of $1 million of foreign exchange will result in a $20 million increase in the local money supply.

Of course, the local central bank can act to offset the domestic monetary effect of the inflow by raising reserve requirements or through open market operations. But there are severe practical limitations on how much of this can be done, particularly in a short time. The result is that an inflow which is large relative to the existing level of a country's bank reserves will normally produce a large increase in the local money supply.

I think this explains a fact which has sometimes puzzled observers; namely, that the U.S. payments deficits which are, after all, in absolute size, rather small relative to foreign countries' total money supplies, nevertheless seem to have a big leverage on those money supplies. The reason, of course, is that this is the wrong comparison to make. The comparison should be between the size of the U.S. deficit and the size of the surplus countries' total bank reserves, or "base money," as it is often called.

This leverage phenomenon in the U.S. balance-of-payments situation, also explains another rather puzzling fact. We all know that the economic size of the United States, measured for example by GNP or foreign trade, has declined rather substantially relative to much of Western Europe and Japan. Yet it would appear that the international monetary weight of the United States—that is, the influence which U.S. domestic monetary policy exerts on monetary conditions in other countries—has increased.

The explanation of this paradox may be the growing number of

dollars held abroad in private hands, reflected in the statistics of the Eurodollar market. These funds constitute a large pool of potential high-powered money, which moves in and out of other countries, exerting a highly leveraged effect on local monetary conditions.

Such movements of funds from the Eurodollar market in and out of local currencies, particularly in Europe, are quite responsive to changes in U.S. domestic monetary policy, as Dr. Aschinger pointed out—another factor in the hegemonistic role of the United States in the international monetary system.

Let me come finally, Mr. Chairman, to the question of the limits of this hegemony—what is likely to be done about it, where it is likely to lead. There are, I think, three main options for countries other than the United States. One is to grin and bear it, to accept the de facto dollar standard and live with it, on the ground that other things could be worse and that, after all, it has not on the whole worked out too badly.

The second alternative, and the one most favored in academic circles, is for other countries to allow their exchange rates to float individually with respect to the dollar. The third is the formation of some sort of European monetary unit or bloc, within which exchange rates are held in close alinement, but which move or float more widely vis-a-vis the dollar.

Over the next few years, we are going to see a good deal of this last tendency and we may see more situations in which individual rates float separately.

I have not included among the options that most beloved of the more optimistic reformers of the international monetary system. By that I mean a system of collective control by the main industrial countries over the creation of international reserves.

This concept involves the critical assumption, or hope, that the collectively created and controlled reserve assets—SDR's, for instance—would gradually come to replace the dollar as the principal dynamic element in international reserves. Since a payment deficit is, to a large extent, a reflection of domestic monetary policy, this assumption means that the governments would be making collective decisions about each others domestic policies.

I am doubtful of the political relevance of any such concept, at least as applied to the United States. But without this element of joint domestic policymaking, the SDR scheme is just another device for creating international liquidity which does not qualify in a substantial way the special position of the United States in the international monetary system, nor limit the hegemonic role of the dollar.

Another possibility that I also did not mention—Dr. Aschinger did, only to dismiss it—was the use of controls by European countries to block dollar inflows, accompanied perhaps by the separation of their exchange markets into two compartments: one with a fixed rate for ordinary commercial transactions and the other with a floating rate for financial transactions. I also dismiss it, as a major alternative, although controls of various kinds may well proliferate, simply because I do not think it would work very well. Countries would find that they could not insulate their domestic money markets except by comprehensive exchange control on all transactions. Countries would probably be, in present circumstances, unwilling to go that far.

Now, just a word on floating exchange rates. As you know, Mr. Chairman, economic theory demonstrates in an elegant way the point that when a country has a floating exchange rate, its money supply cannot be substantially influenced by changes in external monetary conditions. This is true, as a matter of theory, and to the extent that there has been experience with floating exchange rates, it has been demonstrated to be true in practice.

But this is a world where everything has the defects of its virtues. The gain in autonomy for domestic monetary policy is achieved at the cost of losing control over the exchange rate. A floating rate will be immediately affected by changes in monetary policy in neighboring countries, with results possibly detrimental to particular domestic economic sectors or groups. And if the country chooses to counter the effect on its exchange rate of such changes by altering its domestic monetary policy, it has thereby accepted the external constraint on its monetary policy which the floating rate was supposed to avoid.

We need not look any further than our neighbor to the north for a contemporary example. The Canadian dollar, which was floated in May, has continued to inch up after its initial jump, apparently mainly because the U.S. Federal Reserve's monetary policy has been more expansive than that of the Bank of Canada. Profits in Canada's export industries have accordingly been squeezed. The Canadian authorities, intent on their struggle with inflation, have been reluctant to ease domestic monetary policy enough to drive the rate down again.

My conclusion is that a decision by a country whether or not to float its exchange rate involves a tradeoff between the advantages of monetary autonomy, which are partly political, and the disadvantages which may be involved for particular economic sectors or classes when the exchange rate moves in response to changing monetary conditions abroad. The smaller the country and the larger its foreign sector, the more likely it is that this tradeoff will appear to favor a fixed rate.

This point about size leads directly to the question of a European monetary bloc. What may be unattractive for a small or even a middle-sized country individually may be quite attractive for a large group of countries which follows a common external exchange-rate policy.

I agree with Dr. Aschinger that a bloc of this kind, to be effective in countering the power of the dollar, would not have to be a full monetary union with a supranational central bank. Nor, indeed, would the members have to renounce the right to alter from time to time the parities of their currencies with respect to each other and outside currencies. It would suffice for the member governments and central banks to hold the exchange rates of their currencies in close alinement, while moving them or allowing them to move within considerably wider limits with respect to the dollar.

An arrangement of this kind would be the more effective for its defensive purpose because it would tend to reduce the holding of private dollar balances in Europe. The practice of holding private dollar balances abroad depends to a considerable extent—perhaps to a very large extent—on the virtual absence of exchange risk to the holder. But if European exchange rates were less likely to change with respect to one another than with respect to the dollar, business firms

which desire to hold balances in currencies other than their own national money would be inclined to hold more funds in the stronger European currencies and fewer in dollars. The Eurocurrency market would become just that; it would become more a Deutsche mark, Swiss franc and guilder market and less a dollar market. I would suppose that European banks, including American banks in Europe, could readily adapt their operations to accommodate this change.

An obvious point about a European monetary bloc is that, by acting jointly with respect to their exchange rates, the members would be less reluctant than they are now to appreciate their rates against the dollar. If their rates were appreciated together, only their trade with countries whose currencies remained pegged to the dollar would be adversely affected. If there were a European exchange rate bloc, a substantial part of the Eastern Hemisphere would probably peg its exchange rates to European bloc rates rather than to the dollar. It would be a very big area in monetary and economic terms, substantially larger than the Common Market—even the enlarged Common Market—itself.

How probable is this development? It is not, I suppose, for tomorrow. Yet it is not nearly as remote as it seemed only a few months ago. Technical studies have in fact been completed in Europe, as you probably know, Mr. Chairman, which show how the Common Market countries could move toward greater variability of their exchange rates vis-a-vis nonmember currencies, while keeping their rates with each other closely alined. I understand that small, initial steps may be taken as early as next year, as I believe Dr. Aschinger confirmed in his remarks.

There are practical and political problems in any such an arrangement. The central banks would probably have to be able to agree on a day-to-day or week-to-week basis on where to keep their exchange rates with the dollar. Some degree of reserve pooling would result, de facto if not de jure. The members with stronger currencies would, in effect, have to lend or give dollars to the members with weaker currencies, to maintain the agreed parity with the dollar. Or conversely, the stronger currencies would have to absorb more unwanted dollars in order to keep the joint parity with the dollar low enough to suit the weaker currencies.

Yet progress in the direction of a European monetary unit of this kind seems likely. At the IMF meeting in Copenhagen last month, the French and Italian finance ministers both indicated in rather clear terms their support for this concept, as an objective.

For the United States, the implications are very considerable, although I have not developed them at much length in my prepared statement. Certainly, there would be drawbacks for the United States. We would have to take our balance of payments seriously. We would have to take seriously the possibility of speculative pressure on the parity of the dollar.

The role of the dollar in Europe would be changed. The holding of dollar balances, which has undoubted advantages for U.S. businesses and banks, would probably diminish. Eventually, the use of the dollar as an official reserve asset in Europe might also be affected. European central banks might, in time, refuse to hold any large amount of dol-

lars as reserve assets, preferring to allow their currencies to appreciate jointly vis-a-vis the dollar rather than accummulate dollar claims in their reserves. The European central banks might, instead, use each other's currencies (or a European version of the SDR) as their principal reserve asset (apart from gold), and maintain their exchange rates with each other by buying and sellling European currencies. The declining role of the dollar abroad would involve a loss of certain intangible political and psychological benefits.

Yet in the last analysis, the larger political interests of the United States might be better served by such a change in the international monetary system, which might tend to reduce the present friction on monetary questions between the United States and Western Europe, while helping to heighten Europe's sense of its own unity and responsibility for its own fate.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Cleveland follows:)

PREPARED STATEMENT OF HAROLD VAN B. CLEVELAND

THE DOLLAR PROBLEM AND ITS REMEDIES

Unlike most balance-of-payments deficits, the deficit of the United States is less a problem for the United States than for the rest of the world. The real nature of the problem is obscured, in fact, if one tries to grasp it in terms of the usual logic, whereby a payment deficit is a problem for the country in question because it impairs that country's international liquidity (through loss of reserves) and therefore leads to speculative pressure on the exchange rate.

The dollar problem is not of this kind. It is a problem—for other countries—precisely because the U.S. deficit does *not* lead to an impairment of the international liquidity of the United States, nor to speculation on a change in the dollar's parity. The problem is that this immunity from balance-of-payments discipline, coupled with the size of the U.S. economy, makes it possible for the United States to exert a large, one-sided influence on monetary conditions in other countries—so long at least as other countries adhere to a system of pegged exchange rates. Hegemony, not liquidity, is what the dollar problem is all about.

It is perhaps unnecessary to dwell at any length on the reasons why the U.S. dollar is now thought to be immune from devaluation. The United States is still the largest world trader. If the U.S. Government sought to devalue the dollar in order to strengthen the trade balance, most other countries, fearing the competitive impact, would follow the dollar down. Nor, for the same reason, is a joint decision by a group of other countries to appreciate currencies against the dollar likely—for the time being, at least.

While the United States is thus deprived of a key instrument for balance-of-payments adjustment, it is by the same token relieved of the necessity to be concerned about its balance of payments at all.

MONEY AND THE U.S. BALANCE OF PAYMENTS

When the U.S. Federal Reserve System causes the domestic money supply to grow more rapidly than the domestic demand for money is growing, an internal adjustment process is set in motion, which tends to eliminate the excess. People spend more and invest more in financial assets, in an effort to achieve the desired distribution of their total wealth as between cash on the one hand and financial and real assets on the other hand. If there is slack in the economy, output will accelerate and unemployment will fall. If output is already growing at or close to capacity, the effect will be to raise prices. The rise in output increases real income and thus raises the demand for money. If prices also rise, the real value (purchasing power) of people's cash declines. By these processes, the initial excess supply of money in the country will be eliminated through a rise in the demand for money and a fall in the (real) money supply.

If the U.S. economy were closed, this is all that would happen. But, since the United States participates in an open international economy characterized by

pegged exchange rates, the initial excess of money in the United States will also affect the U.S. balance of payments. A part of the excess will be spent and lent abroad, giving rise to a net outflow of funds.

If the initial excess of money causes U.S. prices to rise relative to prices in the rest of the world, there will also be an additional outflow. U.S. residents now have an incentive to spend more for imported goods and services, since they can now get more for their money abroad. The higher domestic price level also tends to cause residents to lend and invest more abroad—i.e., to buy more foreign financial assets—because it raises the real value of financial assets denominated in foreign currencies compared to the real value of domestic financial assets. Outflows of funds due to the higher U.S. price level are in addition to the outflows arising directly from the initial excess of money.

More generally, in an open international economy with exchange rates pegged, money will tend to flow from countries where the supply of money is more abundant (or less deficient) relative to the demand for money, to countries where it is less abundant (or more deficient) relative to demand. Money, like the earth's atmosphere, flows from regions of relatively high pressure to regions where pressure is relatively low.

These general propositions follow logically from the tenets of contemporary (neo-quantity) monetary theory. They are easier to state than to support empirically, however. Nevertheless, such statistical evidence as we have been able to develop supports the conclusion that the balance of payments of the private sector of the U.S. economy (the overall balance on the official settlements basis, after government transactions have been excluded) is functionally related to the growth of the U.S. money supply, to the growth of real income in the United States and to growth of real income in the other industrial countries. Since the demand for money is a function of real income, these two real income variables may appropriately be taken to represent the demand for money in the U.S. and the rest of the world, respectively.

When the U.S. money supply grows faster, the U.S. payments deficit tends to increase, *ceteris paribus*. Similarly, when real income in the United States grows more slowly, or when real income in the other industrial countries speeds up, the deficit also increases. For, an intensification of the demand for money abroad has the same effect on the U.S. balance of payments as an easing of the demand for money at home: both tend to cause an outflow of funds from the United States, unless their effect is offset by slower growth of the U.S. money supply.

According to theory, changes in the rate of growth of the rest of the world's money supply should also have a determinate effect on the U.S. balance of payments. Our calculations do not show it, however. The explanation may be that the U.S. money supply has sufficient leverage on the rest of the world's money supply—for reasons explained below—that the effects of the two variables cannot be separated by the econometric techniques employed.

The U.S. payments deficit also appears to be greatly affected by still another monetary variable; namely, the foreign demand for dollars to hold as cash balances. As such balances are probably in the main working balances of firms engaged in international trade and production, it seems reasonable to assume that this demand is functionally related to world trade. And there is, in fact, a highly significant correlation between changes in world trade and changes in the U.S. payments deficit. The correlation tends to confirm the widely accepted view that there is a transactions demand for dollars abroad, whose pull gives rise to a large part of the U.S. payments deficit.[1]

The Mechanics of Monetary Hegemony

If the effect of these monetary outflows on the U.S. domestic money supply were not offset by further money creation, the outflows would assist the internal adjustment process to restore equilibrium between the country's demand for money and the domestic money supply. By the same token, it would also restore balance-of-payments equilibrium. In other countries, this is what normally hap-

[1] The empirical evidence summarized in this and the preceding paragraphs is based on a model of the U.S. balance of payments developed by Arthur B. Laffer in his unpublished paper, "An Anti-Traditional Theory of the Balance of Payments" (February 1969). I am indebted to my associate Robert Goodman, Associate Economist, First National City Bank, for checking and interpreting the results of this useful model.

pens because the outflow of funds tends to reduce the country's international reserves. The authorities are accordingly under pressure to allow the outflow to affect the domestic money supply, in order to protect the exchange rate. In the case of the United States, however, the central bank is free of this constraint and routinely offsets the effect of a monetary outflow on the reserves of the banking system.

A country which is immune from the normal discipline of reserve losses, is both able and likely to act as a sort of international central bank, supplying money without any external limit to the rest of the world. And if it is also a very large country, its balance-of-payments deficit may exert an important influence on monetary conditions in other, smaller countries.

Money which moves internationally is different from ordinary money. When it is exchanged for local currency, it becomes what monetarist economists like to call "high-powered money". Like central bank credit to the banks, it enlarges the credit base of the local banking system, permitting a multiple expansion of bank credit and hence of the local money supply.

If, for example, the local reserve requirement (or the conventional bank-liquidity ratio) for demand deposits is 5 per cent, a net inflow of $1 million of foreign exchange will result in a $20 million increase in the local money supply, unless the local central bank acts to absorb the additional reserves through open market operations or by raising reserve requirements. There are practical limitations, however, on the amount of reserves which can be absorbed in this way. An inflow which is large relative to the existing level of bank reserves will therefore normally produce a large increase in the local money supply.

This explains the seemingly puzzling fact that U.S. payments deficit which are quite small relative to the domestic money supplies of other countries nevertheless exert a large influence on local monetary conditions. The relevant comparison is not between the magnitude of the U.S. deficit and the money supplies of other countries but between the U.S. deficit and the local supplies of "base money" (bank reserves and foreign exchange held by banks).

The fact that the dollar abroad is, or may become, high-powered money also explains another puzzling fact. The economic size of the United States (measured by GNP or foreign trade) has declined substantially relative to much of Western Europe and Japan. Yet the monetary weight of the dollar abroad—the influence which U.S. domestic monetary policy exerts on monetary conditions in other countries—seems to have increased, particularly in Europe. The explanation appears to be that the growing number of dollars held abroad in private hands (reflected in the mushrooming Eurodollar market) constitutes a large pool of potential high-powered money which can move in and out of other countries, exerting a highly leveraged effect on local monetary conditions.

Such movements are, moreover, quite responsive to changes in U.S. domestic monetary policy. Last year, for example, when the Federal Reserve arrested the growth of the U.S. money supply, dollars flowed out of the European banking systems and back to the United States, transmitting to Europe some of the monetary stringency in the United States. This year the opposite is occurring. Dollars are flowing back to Europe from the United States, enlarging the European credit base, in some cases—Germany, for example—by much more than the countries concerned would like.

The Limits of Hegemony

Such is the sum and substance of European objections to the U.S. deficit. The objections are not financial primarily. European central banks do not fear for the security of their claims on the United States, which are largely covered by some form of exchange-rate or gold-value guarantee. The essential problem is political. Sovereign nations are inevitably dubious of a system which permits a foreign power to exert so much influence on their domestic economic conditions.

That is why, it seems to me, the dollar problem will not go away even if the U.S. deficit narrows considerably in the future. I refer to that part of the deficit which is genuinely a reflection of excessive monetary expansion in the United States, and not simply the result of a foreign demand for dollars to hold as working balances and the desire of other countries to add to their official reserves.

It is true that the dollar problem has been greatly intensified by the experience of the last five years. The excessive expansion of the U.S. money supply in the period 1965–68 and its inflationary impact in Europe made Europeans much more

aware than they had previously been of the transatlantic monetary leverage of a U.S. payments deficit. The impact on European interest rates and central bank reserves of the Federal Reserve's restrictive monetary policy in 1969, along with price inflation, was another sharp reminder of monetary dependency.

No doubt these memories will fade if the Nixon Administration and the Federal Reserve continue to demonstrate that the United States can manage its fiscal and monetary affairs without periods of excessive monetary expansion alternating with periods of severe monetary stringency. I doubt, however, that the European Common Market countries, at least, will stop looking for means of limiting the hegemony of the dollar, so far as its impact on their own economies is concerned.

THREE OPTIONS

In considering what to do about it, other countries have three main options:

(1) to continue to peg their exchange rates to the dollar, taking the consequences for their domestic monetary conditions;

(2) to protect their monetary autonomy by allowing their exchange rates to float individually; or

(3) in the case of the members (present and future) of the European Common Market, to create a European monetary unit within which exchange rates are pegged to each other but can be moved in a coordinated manner *vis-a-vis* the dollar.

You may wonder, Mr. Chairman, why I have not included among the options the favorite of the more optimistic reformers of the international monetary system—collective control by the main industrial countries of the creation of international reserves. To affect critically the role of the dollar, however, it would be necessary that the collectively created and controlled reserve assets (SDR's for instance) replace the dollar as the principal dynamic element in international reserves. The United States would accordingly have to pursue a domestic monetary policy such that its payments deficit could be financed within the limits of its own reserves. In effect, countries participating in the system, in making decisions about creating reserve assets, would also be making decisions about each other's monetary policies.

I am doubtful of the political relevance of any such concept, at least as applied to the United States. Yet without this element of joint domestic policymaking, the scheme would be no more than the SDR facility is today—another device for creating international liquidity which fails to limit in any substantial way the hegemonic role of the dollar.

FLOATING RATES

If a country allows its exchange rate to be determined by the supply of and the demand for its currency in the exchange markets, the movement of the rate will tend to equate the relative attractiveness of the country's money and that of foreign monies, in terms of their command over goods and services. The rate will move, in other words, so as to eliminate any economic incentive for funds to flow, net, from one country to another. It follows that when a country has a floating rate, its money supply cannot be altered by changes in monetary conditions abroad. By floating its rate, even a small country can thus achieve a considerable measure of monetary autonomy.

In this world, however, everything has the defects of its virtues. The gain in monetary autonomy brought by floating the exchange rate is achieved at the cost of losing control over the exchange rate itself. For a floating rate will be immediately affected by changes in monetary policy in neighboring countries, with results possibly detrimental to particular domestic economic sectors or groups. The movement of the rate can be arrested or reversed by an offsetting change in the country's own monetary policy. But in the circumstances, such action may be inappropriate or politically difficult.

We need look no further than Canada for a contemporary example. The Canadian dollar, which was floated in May, has continued to inch up (after its initial rise), apparently because in recent months the U.S. Federal Reserve's policy has been considerably more expansive than that of the Bank of Canada. As a result, profits in Canada's export industries have been squeezed. The Canadian authorities, intent on a struggle with inflation, have been reluctant to ease domestic monetary policy enough to drive the rate down again.

In sum, a decision to float the exchange rate involves a trade-off between the advantages of monetary autonomy and the disadvantages which may be involved for particular economic sectors when the rate moves up or down in response to changing monetary conditions abroad. The smaller the economy and the larger its foreign sector, the more likely it is that this trade-off will appear unfavorable to a floating rate. For this reason, widespread adoption of floating rates seems to me unlikely, although we shall probably see more of them in the future than we have in the past.

A European Exchange-Rate Bloc

Of the three options, the most potentially effective in limiting the rule of the dollar would be the adoption by a group of countries of a common policy with respect to their exchange rates. The most likely participants are of course the members (present and future) of the European Common Market, owing to their sense om political solidarity and their desire to increase it, along with a shared concern about the dollar problem.

A bloc of this kind would not have to be a full monetary union complete with supranational central bank, in order to reduce greatly the impact of U.S. monetary policy on monetary conditions in Europe. Nor would the members have to renounce the right to alter from time to time the parities of their currencies. It would suffice for the member governments and central banks to hold the exchange rates of their currencies in close alignment, while moving them or allowing them to move within considerably wider limits vis-à-vis the dollar.

Under such an arrangement, the European governments would be in a position to resist unwanted inflows of dollars by revaluing their curencies jointly against the dollar. A joint revaluation would not represent the competitive threat to European industry which separate revaluations may involve, because it would affect only the trade of the European bloc with the United States and with countries whose exchange rates remained pegged to the dollar. The dollar would become, in its relations with European currencies, more like other currencies are now. In consequence, European governments and central banks might become increasingly disinclined to hold dollar claims in their official reserves, insisting on settlement with the United States in gold or SDR's, and preferring to have their currencies appreciate against the dollar rather than to accumulate dollar reserves.

An arrangement of this kind would be the more effective for its purpose, because it would tend to reduce the holding of private dollar balances in Europe.

The practice of holding private dollar balances abroad depends to a large extent on the virtual absence of exchange risk to the holder, as compared with the risk involved in holding other currencies. At present, European exchange rates are freer to move with respect to each other than with respect to the dollar, owing to the use of the dollar as the sole intervention currency. If, however, European exchange rates were held within narrower intervention limits with respect to each other, while the intervention limits with respect to the dollar were widened, business firms in Europe which desired to hold balances in currencies other than their own national money would then be inclined to hold more funds in the stronger European currencies and fewer in dollars. The Eurocurrency market would tend to become more a Eurodeutschemark, Swiss franc and guilder market and less a dollar market.

A move of this kind raises difficult practical problems for the Common Market governments and central banks. The central banks would probably have to come to agreement on a day-to-day or week-to-week basis on where to keep their exchange rates with the dollar. Some degree of reserve pooling would also be involved, *de facto* if not *de jure*. Nevertheless, progress in the direction of a European monetary unit of this kind seems likely. Technical studies have been completed in Brussels which show how the Common Market countries could move toward greater variability of their exchange rates *vis-a-vis* non-member currencies, while keeping their rates with each other closely aligned. At the IMF meeting last month, the French and Italian Finance Ministers both indicated support for the concept as an objective. Small initial steps may be taken as early as next year.

For the United States, an arrangement of this kind would have undeniable drawbacks. The United States would have to take its balance of payments more seriously, if it wished to prevent a periodic depreciation of the dollar relative to European currencies. The present immunity of the United States from balance-

of-payments constraint on domestic policy making would be considerably lessened, although at the same time, the option of devaluing the dollar *vis-a-vis* European currencies would be opened. The present role of the dollar in Europe has its advantages for U.S. business firms and banks. There are intangible political and psychological benefits as well.

Yet, in the last analysis, our larger political interests might be better served by such a change in the international monetary system, which might reduce the present friction on monetary questions between the United States and Western Europe, while heightening Europe's sense of unity and responsibility for its own fate.

Chairman BOGGS. Thank you very much, Mr. Cleveland.

Now, Mr. Fellner.

STATEMENT OF WILLIAM J. FELLNER, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. FELLNER. Mr. Chairman, thank you for having invited me to come to these hearings. It is an honor to be a member of this panel. I intend to express myself very briefly and also quite freely, since I have no excuse for using the kind of caution which for understandable reasons often leads official representatives of countries to be less explicit about precarious problems.

I will begin my remarks by formulating three propositions and then deriving some conclusions from these propositions.

(1) I take it for granted that putting an end to the sharp inflationary trend of the past years must be counted among the top-priority objectives of our domestic economic policy, and success in this respect will have a favorable effect on our balance of payments, too. Nevertheless, my first proposition here is that even if our anti-inflationary policies should yield results with longer lags and more gradually than would be desirable from the American and from the international point of view, even then the United States would be practically certain not to run into balance-of-payments difficulties in any usual sense of this term. Countries that might at any time consider themselves oversupplied with dollars will either allow their money costs and their prices to rise to levels at which their surpluses are significantly reduced, or they will revalue their currencies upward in relation to the dollar.

To be sure, they can supply themselves to an increasing extent with means of "international liquidity" such as are alternatives to dollar holdings; but, depending on the quantitative relations prevailing in each period, this will either not interfere with their willingness to accumulate dollars at the unchanging dollar rates or will merely strengthen their desire to reduce their dollar intake by upward revaluation or by letting their domestic prices rise.

To this I will add, still as part of my first proposition, that a degree of upward revaluation of foreign currencies relative to the dollar which would be so great as to be the equivalent of the dollar's collapse in foreign markets is practically certain not to occur. One of several reasons for this is that a revaluation of such dimensions would increase American competitiveness abroad very substantially. In principle, foreign countries could let the dollar drop very low and introduce offsetting trade restrictions on a substantial scale, but they would find it impossible in practice to administer such a policy jointly. They

must also be aware of the fact that this policy would have even more harmful consequences for them than for the United States. Policymakers have their moments of irrationality, as do the rest of us, and a shift of the United States toward protectionism and trade restrictions could have unpredictable consequences. But well-meaning individuals have the intense hope that such a shift will not occur and, at any rate, it is impossible to build predictions on the assumption of thorough irrationality, irresponsibility and self-defeating behavior.

The reasonable expectation here is that if in spite of our hopes our deficit should remain large for some time, then we shall either continue to contribute to inflationary developments abroad, or shall cause some foreign countries to revalue upward in an orderly fashion, or shall give rise to both of these processes. I will certainly not suggest that this is reason for taking a superior or cynical attitude, but it is my conviction that dramatic events far exceeding those here envisaged are not in store. In some foreign markets the value of the dollar may gradually become adjusted downward, in others presumably upward but, generally speaking, the foreign value of the dollar will not become reduced to such an extent as to cause us serious trouble.

(2) I now turn to my second proposition. In the past it was occasionally maintained, and indeed it is still occasionally maintained that those of us asserting the validity of the foregoing diagnosis claim for the U.S. privileges that other countries do not possess. This charge, however, is ill-founded. The price any country must pay if it consistently oversupplies the rest of the world with its currency is adoption of a sufficiently restrictive monetary policy or devaluation; in practice any country has a choice between these two methods (each of which can be supplemented by further measures which usually are very ineffective).

In the United States we are in fact going through a phase of pronounced monetary tightness, but what mainly matters is that to my knowledge our policymakers do not object to upward revaluations of foreign currencies, that is, to measures that are equivalent to the devaluation of the dollar in relation to the currencies of countries considering themselves oversupplied with dollars. The fact that we cannot ourselves take any meaningful step toward changing dollar rates in foreign markets is not of our making. This fact results from the practice of the other countries to peg their currencies to the dollar. Recognizing this fact of life does not mean claiming privileges for the United States. Similarly, it is not the result of American power politics that the other countries would be very reluctant to revalue upward in relation to the dollar to the same extent to which they may be willing to revalue upward in relation to a chronic deficit country of small international significance. This fact is the consequence of the size and of the efficiency of the American economy. In this regard there really does exist a difference between the United States and a number of smaller countries whose balance-of-payments problems might well include the risk of collapse of their currencies in foreign markets. But the difference is not of our making, except in the sense that the American economy is of the making of this country's population.

(3) A third proposition will end this section of my remarks. A disservice would be done to the rest of the world by pretending that

American policymakers will be guided by the principle that in the event of large balance-of-payments deficits we shall adopt that degree of monetary-fiscal tightness which may at any time be required for achieving some fixed balance-of-payments target at given exchange rates. In the first place, American policymakers will not in fact be guided by this principle—they will clearly try to avoid throwing the economy into a major slump with a view to the balance of payments or for any other reason—and secondly doing so would be very wrong on their part not only from the American but also from the international point of view. On the other hand, emphasis must be placed on the fact that getting price-level movements under control is one of the most important tasks for American policy, and there is good reason to assume that any progress in this respect will indeed reduce the dollar supply to foreign countries. However, we must remember that balance-of-payments positions may change not only because of differential inflation rates but also because structural factors affecting international demand are changing gradually.

Now, Mr. Chairman, with your permission, I will try to develop some conclusions from these propositions.

To the extent that currencies are managed by central banks—that is, are not allowed to fluctuate quite freely—there exists a common interest in what evasively is called the appropriate degree of international liquidity—appropriate amounts of mutually acceptable liquid assets in the hands of official institutions. What anyone may regard as appropriate liquidity depends on conflicting considerations. On the one hand, we may fear that if too much liquidity is created, then there will be a growing tendency to engage in inflationary policies, and a growing tendency on the part of each country to achieve balance-of-payments adjustment by keeping up with the most inflationary members of the international community; on the other hand, we may fear that if too little international liquidity is created then countries not possessing enough liquid assets for engaging in the domestic policies of their choice will introduce trade restrictions the avoidance of which should be one of the prime objectives of international economic arrangements. Unless official institutions should wholly refrain from operating in the currency markets—which will not be the case in the predictable future—appropriate regulation of the stock of internationally acceptable liquid assets will remain a legitimate problem. Yet this will inevitably have to be played by ear, and I find it very difficult to avoid the conclusion that the now popular tune makes too much of the liquidity theme and far too little of the exchange rate flexibility theme. We live in an inflationary epoch in which the exchange rate structure is forced into a straitjacket and maladjustments resulting from arbitrary currency rates are often wrongly diagnosed as liquidity problems.

When market forces place downward or upward pressure on a currency in relation to the dollar, the rate of the currency in question should be adjusted with reasonable promptness. The objection that this would lead to violent fluctuations for purely temporary reasons is unconvincing because the reasons which policymakers can recognize as purely temporary will usually be so recognized also by the market which therefore will smooth out these fluctuations. Normally currency

rates would move appreciably only if there really is need for equilibrating forces. The rise of a country's currency rate contributes to eliminating its balance-of-payments surpluses; or, to turn the wording of the same statement around, the decline of a country's exchange rate in relation to other countries contributes to eliminating its deficit. Moving large amounts of international liquidity across the borders is no substitute for adjustment.

Prompt adjustment of rates in very small steps under the influence of market forces—so-called crawls extending over periods that would usually turn out to be of limited duration—would not be disruptive because interest rate differentials between countries and forward markets would enable traders and financiers to do business under orderly conditions. If Western countries made it their habit to adjust their exchange rates in very small installments, the large shocks which have repeated themselves so often in past years could be avoided.

The antecedents of these past jerkey modifications of the rate structure have included restrictive practices, large speculative movements of liquid assets between nations, and very great uncertainly as to when and by how much—by what inevitably arbitrary percentage—the authorities will change the rates. But over the years it has almost always turned out that these costs of abrupt modifications could have been avoided by very small and gradual adjustments if these small adjustments had been started in time, in response to market forces. Instead, there has been reliance on international liquidity to postpone adjustments until the cumulative consequences of initially small disequilibria made it necessary to introduce major changes in the midst of crises.

So my main analytical conclusion is that more emphasis should be placed on small and gradual adjustments with enough international liquidity to avoid adjustments until these must be made under highly disruptive circumstances, or until the formerly less inflationary countries have outdone the most inflationary ones in inflationary practices.

It is, of course, conceivable that some countries would make use of exchange-rate flexibility for engaging in even more pronouncedly inflationary policies coupled with a consistent lowering of their currency rates. But I do not believe that this would develop as a typical attitude even in countries that have shown low resistance to inflationary policy proposals, because a consistent deterioration of a currency in foreign markets is a much louder, much more readily noticeable warning signal than are losses of reserves of which the public usually remains unaware. Moreover, it is up to each country to decide upon its domestic policies by its own lights. What a country can rightly expect from the currency system of the world is that other countries should not drag it into an inflationary or deflationary process which it would have wished to avoid, and this is an objective that cannot be achieved without a reasonable degree of exchange-rate flexibility.

I would like to continue my remarks, which will not be long, by trying to take a look into the future as well as I can.

While some of the preceding statements are blunt and "undiplomatic" and while official agencies usually dissociate themselves from such statements, I believe that during the 1970's an increasing concern with exchange-rate flexibility and a somewhat reduced concern with international liquidity will in fact become observable.

I conclude this not merely from views occasionally expressed by enlightened individual members of the central banking community but also from the recent report of the Executive Directors of the International Monetary Fund. I mean the report on the "Role of Exchange Rates in the Adjustment of International Payments" which was released in September 1970. Most of this report is written in what essentially is the Bretton Woods spirit but at the end the report nevertheless arrives at the conclusion that three modifications of the system deserve further study—at present no more than further study. Jointly these modifications—or perhaps slightly stretched versions of these—could indeed create the kind of leeway for limited exchange rate flexibility with which I was concerned in the preceding section of my remarks. The modifications which according to the report deserve further study are permission to introduce over a limited period a very slow change of a country's parity at an annual rate not exceeding, say, 3 percent;" a slight widening of the margins around the parity points; and the permission to float a currency temporarily, in search of a new parity rate, under circumstances to be worked out with the IMF.

Mr. Chairman, I was referring to pages 71 through 78 of the report, to which I call attention.

My hopeful forecast is that along such lines or similar ones more flexibility will be introduced into the exchange rate structure, and that in conjunction with this change we shall observe a lessening of the belief that more interantional liquidity is the answer even to those specific difficulties which arise from maladjusted exchange rates in an inflationary epoch.

Now, I shall summarize my remarks quite briefly in a few sentences. A significant reduction of the inflationary price movements of the past years is an urgent task of our economic policy. Success in this regard will serve the interests of the international community as well as those of the United States. However, even if the effects of our anti-inflationary policies should show with longer lags than we hope, or if various structural factors should strengthen the trade position of other countries relative to ours, the United States would still be practically certain not to get into balance-of-payments difficulties in the usual sense of this term. Countries considering themselves oversupplied with dollars will either engage in orderly upward revaluation of their currencies in relation to the dollar—this being the equivalent of an orderly devaluation of the dollar in relation to those currencies—or they will let their money costs and prices rise and thereby diminish their dollar surpluses. Gradual changes of the opinions held in influential circles make me hopeful that the 1970's will bring increased flexibility of exchange rates and will bring reduced concern with international liquidity in cases where apparent illiquidity results in fact from the overvaluation of specific currencies in relation to others. Constructive American policy should promote slow and gradual exchange rate adjustments relative to the dollar in the directions indicated by market forces, and it should abstain from trade restrictions and controls which would once more lead the world down the road of economic isolationism.

Thank you very much, Mr. Chairman.

Chairman BOGGS. Thank you very much, Professor Fellner.

Now, to conclude our panel, Mr. Walter S. Salant, senior fellow, the Brookings Institution.

Mr. Salant, we are very happy to have you here.

STATEMENT OF WALTER S. SALANT, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. SALANT. Thank you, Mr. Chairman. I want to express my appreciation, as did the other members of the panel, for the honor of being invited here, but not only for that reason; I also value very much the opportunity to have heard what I regard as outstanding statements by the other panelists.

Our assignment is to discuss how events in the United States and abroad might influence the further evolution of the payments system and how future reforms may affect the United States and modify the international role of the dollar.

I will say little about how future reforms might affect the international role of the dollar, and concentrate on a few developments and what I think they imply for the general direction in which we should seek to move the payments system.

The views I shall express are, of course, my own and not necessarily those of my colleagues at the Brookings Institution.

The developments on which I shall focus are, first, the increasing economic integration of the world; and, second, our newly acquired ability to control the level and growth of net international monetary reserves through the creation of special drawing rights in the International Monetary Fund.

And on the latter point I shall say some things which will appear to run in quite the opposite direction from some of the things that Professor Fellner has just said, but which on close analysis will prove to be different but not incompatible with them.

The prospective development that appears to be most fundamental is the continuation of the process of world economic integration, a process that has been going on for decades. Its most dramatic facet—or at least the one most publicized in recent years—is the rise of the multinational corporation. We have all heard the statement that American corporations in Europe are, or will be, the third largest "country" in Europe, and have seen very high estimates of the volume of American production abroad. There are, of course, also multinational corporations with main bases in countries other than the United States. The process of integration, however, goes far beyond anything that can be accounted for by the rise of multinational corporations alone, That international trade is growing faster than total world production probably is not accounted for wholly, if at all by such corporations. Over the years, international transport costs and tariffs have fallen relative to other costs, and other economic and institutional barriers to trade have also been reduced. Revolutionary improvements have increased travel and improved communications. These changes in turn have increased the familiarity of nationals in one country with the markets, businesses, laws, and other institutions of foreign countries.

These changes are reflected not only in the rise of international trade relative to world production, but in other ways, some of which are equally dramatic. They show up, for example, in the increased mobility of labor within Western Europe, specially within Western Europe. There we find vast movements of labor between countries, with some 1,600,000 members of the German labor force in 1970 being citizens of other countries, and about one-quarter of one-third of the Swiss labor force consisting of foreigners.

Similarly, the volume of capital that moves across international boundaries has grown prodigiously, partly because the very large corporations with international operations move liquid balances and long-term funds readily across national boundaries, but not only for that reason. The general increase of information and speed of communications has increased the international mobility of capital owned both by businesses and individual investors. We have the enormous growth in Eurodollars. The dollar liabilities of banks in eight European countries reporting to the Bank for International Settlements, which were less than $10 billion in 1964, amounted to $46 billion at the end of 1969. The liabilities of banks in nondollar currencies other than those of their own countries also quadrupled, growing from $2½ to over $10 billion in the same period. Corresponding developments have occurred in the bond market.

These developments have made net balance-of-payments positions; that is, surpluses and deficits, much more sensitive to given changes in economic relationships between interest rates in one money market and another, between costs and prices of tradeable goods in different countries, or even wage rates, income taxes, and other economic variables. This development in turn has given rise to increased concern about national surpluses and deficits in international payments.

It has also given rise to the objection by some countries that they have lost the capacity to control their own monetary policies, owing to the increased influence of outside forces combined with the political resistance to the conventional means of adjusting to them. This is a major factor in the dissatisfaction with the monetary system under which countries attempt to maintain fixed exchange rates.

These payments difficulties have given rise to intensified effort to increase receipts from foreign sources and to reduce payments to foreigners by means that, in most cases, would reduce real world income even if they did not stimulate retaliation, and that in addition do induce retaliation, and consequently are at least partially self-defeating. Governments discriminate against foreign sources in their own procurement. They tie their development aid in open or concealed ways, and engage in a number of other practices with which we are all familiar.

The second set of developments that appears to me relevant to the international payments system has to do with the growth of net international monetary reserves. Here I refer to reserves in forms other than national currency; that is, dollars and other national currencies. During most of the 1960's the persistence of deficits led most people to think that the process by which balance is supposed to be restored under fixed exchange rates did not work well, and in the view of some, that is did not work at all. To a substantial degree, however, I think

the persistence of deficits—I say to a substantial degree, not entirely, by any means—I think the persistence of deficits reflected not a failure of that process, but rather a stringency in the growth of world monetary gold stocks—their failure to grow rapidly enough in the years before 1965 and their actual shrinkage between then and early 1968, when the policy of selling monetary gold stocks to the private market was terminated.

When monetary gold stocks decline, the sum of deficits must, as a matter of arithmetic necessity exceed the sum of surpluses, if surpluses and deficits are symmetrically defined. Even when monetary gold stocks grow, if that growth falls short of the sum of the increases that individual countries desire enough to compete for successfully, at least one country loses out. The amount of total surpluses and deficits depend on the growth of net monetary reserves, surpluses being smaller and fewer and deficits being larger or more numerous the smaller the growth of monetary gold stocks. When these stocks actually diminish, at least one country must have a deficit, no matter how well the adjustment process works. A single country can get rid of a deficit under such conditions, but only by forcing it on another country. Under those conditions, the situation is like a game of musical chairs. If there are fewer chairs than players, somebody is bound to be without a seat. If he were more nimble he might get a seat, but that would not solve the problem of seating everyone, since he could get a seat only at the expense of somebody else.

The reason for this is that decreases in total monetary gold stocks give rise to imports for which there are no corresponding exports, so that when you add up the net balances of all countries, the result is not zero but a deficit. Furthermore, if monetary gold stocks actually grow, but grow less rapidly than the surpluses of one group of countries, then all other countries taken together must, again as a matter of arithmetic necessity, have a deficit in their combined balances of payments, even though the surplus countries increase their reserves by no more than they need in the light of the growth of their economies, their international transactions, or what other criteria you use to measure adequacy.

I have explained the technical reasons for this result more fully elsewhere, and I won't spend any more time on the technical aspects of this result.

The danger of decreases in monetary gold stocks ended, as I said, in March 1968 when central banks stopped selling gold to the private market. A method of creating necessary increases in net monetary reserves was provided by the agreement to create special drawing rights. In the 1970's therefore, it should be possible to satisfy the world's need for growth of net reserves, which was not the case during the 1960's.

I consider that important, mainly because it will eliminate a source of imbalances that has confused the diagnosis of the world's monetary troubles.

Here, as you see, I am agreeing with Professor Fellner that there has been some confusion, but I am calling attention to a confusion in the direction opposite to the one to which he called attention.

The confusion I refer to is between two different kinds of disequilibria. One is disequalibrium between the global demand for and sup-

ply of additions to net monetary reserves. The other is disequilibrium among currencies. Both kinds of disequilibria can induce surpluses and deficits, and the persistence of both appears to reflect failure of the mechanism for adjusting imbalances.

But the mechanism for adjustment that concerns economists and monetary officials, and that changes in the exchange-rate system are intended to improve, is only the mechanism for restoring equilibrium in relationships among currencies. The two diseases have the same symptoms. Because the first disease, imbalance the demand for and supply of additions to net reserves, was little recognized, the second disease was in my opinion exaggerated. And so, therefore, was the weakness inherent in the system of fixed exchange rates. What should be different in the 1970's is that a way has been found to prevent the first disease. As a result, the deficits resulting from it should cease to be a problem, and the inadequacy of the adjustment mechanism, which is the chief remaining cause of dissatisfaction with the monetary system, should not appear so large.

Another point that needs to be taken into account in assessing the need for changing the monetary system is the world financial role of the United States. You will recall that increases in U.S. liquid liabilities to private foreigners, as well as in those to foreign monetary authorities, are not considered to be U.S. receipts under the liquidity definition, but rather a means of financing the deficit. Some portion, although not all of what has been called the U.S. deficit in the 1960's, that is, the liquidity deficit, and also some smaller portion of the less persistent deficit on the official settlements definition, has reflected the provision by the United States of liquid assets to private foreigners in response to their demand for increased holdings of such assets as their transactions and their wealth grow. The U.S. financial community satisfies this demand on better terms than foreign institutions do. Under normal conditions it pays higher interest on short-term money than foreign institutions, and provides long-term funds at lower rates. In other words, the United States has been an international financial intermediary. To this extent the liquidity deficit reflects not a disequilibrium, but the performance of a normal economic function.

Performance of this intermediary function and failure to recognize it for what it is has also led to exaggeration of the true adjustment problem.

Thus, both the inadequate growth of net monetary reserves and financial intermediation by the United States led the world to exaggerate the problem of disequilibrium among currencies. The belief tended to justify itself. But it remains true that part of the problem is a nonproblem, and another part has been remedied.

This does not mean, however, that there is no problem of payments adjustment in the true sense of maintaining and restoring equilibrium among currencies. There is. It arises mainly from differences in national movement of money costs per unit of output and in rates of growth of real national incomes. In the major industrial countries these differences develop gradually. Given adequate reserves, their payments effects do not call for dramatic remedies if the remedies are not unduly postponed and are pursued persistently enough.

Besides recognizing that there is a true adjustment problem, I also

recognize that in some cases it is more easily solved when exchange rates have some flexibility. Clearly, when countries have allowed the general level of their money costs to rise too high relative to other countries, a reduction of the foreign exchange values of their currencies is necessary to restore equilibrium. And if such a rise in relative costs is in the making, gradual changes in the exchange rate may prevent serious equilibrium from developing.

But before we draw the conclusion that the flexible exchange rate pasture, or one of the many such pastures, is greener, a number of points deserve fuller consideration. Experience has taught the difficulties of fixed rates, but we have had very little experience with flexible rates. We should not put ourselves in the position of the judge in the two-girl beauty contest who awarded the prize to the second contestant after seeing only the first.

The difficulties of the fixed exchange rate system result from the fact that its operation requires action which governments of the modern world often are unable or refuse to take. Deficit countries in which aggregate demand is more than adequate or less than adequate to provide high employment in most cases resist the standard fixed rate therapy of reducing aggregate demand. Surplus countries with high levels of employment do not want to expand aggregate demand because that is inflationary. There may be comparable resistance, however, to exchange rate adjustments. In this connection I shall merely mention a few points.

While economists generally assume that the monetary authorities will allow the rates to move, the governments of deficit countries may like declines in the prices of their countries no better or even less than they like losses of reserves under fixed rates. Such declines are commonly regarded as harmful to national prestige.

A second problem arises because the adjustment of exports and imports needed to eliminate surpluses and deficits generally requires changes of prices in the adjusting country that are concentrated in particular sectors of it. This is a point to which Mr. Cleveland alluded.

The important changes required are in the relations within the adjusting countries between prices in industries producing exportable and import-competing goods—that is, what we call tradeable goods—on the one hand, and prices in industries producing goods that are not traded or tradeable on the other hand. It is these changes that play the primary role in shifting demand and resources in the direction needed to remedy the imbalance in payments. For example, in a deficit country it takes a decline in prices of nontradeable goods relative to tradeable goods to induce people to switch purchases from imports to domestic goods, and to buy less exportable goods so that more are released for export. And it takes the same kind of price shifts to induce labor and capital to move from production of nontradable goods to production of exports and import-competing goods.

Such shifts are as much required when the mechanism of adjustment is a change of exchange rates as when, under fixed rates, it takes the form of a change in money incomes measured in the national currency. In a deficit country under flexible rates, if the price of its national currency falls, that does bring about the necessary shifts more easily than could the repression of aggregate demand that would be

necessary under fixed rates because a fall in the price of the currency raises the prices of tradeable goods and services measured in the national currency, whereas under fixed exchange rate the main market effect would be a downward pressure on the price of nontradeable goods.

But consider what happens in a surplus country under flexible rates. The price of the currency rises. This rise depresses the prices of its exportable and import-competing goods, because they are influenced greatly by prices in world markets. If it is resistance to decreases of prices and money costs that creates difficulties of adjustment for deficit countries under fixed rates, it seems inevitable that the same resistance will occur in surplus countries under flexible rates. Thus, while the difficulty that deficit countries have under fixed rates may not occur in deficit countries when rates are flexible, it is likely to arise in surplus countries.

Export and import-competing industries in surplus countries can be expected to resist currency appreciation. I think this point had ample confirmation in the resistance to appreciation of the German mark in 1968 and most of 1969. It is true that the resistance is likely to be less if the changes in currency values are small and gradual than if the upward valuation is as great as was required in the case of the German mark. Nevertheless, there is still reason to think that the problems of deficit countries under fixed rates would reappear in surplus countries under flexible rates.

Moreover, when deficits result from insistent demand by groups in a country for consumption and capital formation that add up to more goods and services than the economy can produce, the disequilibria are not monetary in character. Monetary measures can solve them only if they break down the insistence on excessive claims.

Insofar as the difficulties which have been experienced under a fixed-rate system are due to insistently incompatible real claims, that is to, claims for incompatible quantities of goods and services, not much easing of the adjustment problem can reasonably be expected from greater flexibility of rates.

These observations suggest, not that the greater flexibility of rates has no advantages, but that the advantages expected of it may not be realized in all cases.

At the same time greater flexibility may be less necessary than it appears to be, not only because, as I have noted, some of the difficulties wrongly thought to result from fixed rates are not inherent in it, and may not recur, but also because concern about conventional imbalances may be decreasingly justified in an increasingly integrated world. In such a world increasing cooperation is necessary in any monetary system unless the process of integration is thought undesirable and one wishes to reverse or at least impede it.

This appears clear if we consider some of the implications of increasing integration. In an integrated economy, payments imbalances exist among its various parts, but they do not appear as balances-of-payments "problems." The United States itself illustrates this point. Interregional imbalances do not appear as problems, partly because lack of statistics on interregional payments deficits and surpluses make them invisible, and partly because adjustment eliminates some of them,

and probably also partly because they are financed indefinitely and, therefore, do not need to be entirely eliminated or reversed, but merely held to limited proportions. From an economic point of view the world is becoming more like the United States. The question is whether the mechanisms that maintain and restore balance within a large country, clearly not all operative in the world economy now, are tending to develop in it too, and whether they should and can be encouraged.

It is said that these mechanisms cannot operate among countries because among countries mobility of labor is not great, but because there is not a unified fiscal policy, because there are many central banks, and therefore many monetary policies, and because the volume of financial assets that have an international market and therefore are transferrable between countries is too small in relation to the total volume of financial assets outstanding. Lacking the characteristics of a large country, the world is not an economy that can operate with one money, which is what really fixed exchange rates imply. That is true. But we are here talking about the direction in which we would like the system to evolve. We are now in an intermediate position between two states of affairs that are basically inconsistent: somewhat independent national states that like to think themselves as sovereign, and an increasingly interdependent world economy. Greater exchange-rate flexibility among individual countries is desired—by some, at least—as a means toward greater national monetary autonomy. The question is whether, in the face of technological forces making for greater economic integration, this is desirable or even feasible.

It is becoming increasingly questionable whether some causes of imbalance in international payments have any more economic significance and should be allowed to give rise to greater adjustment than imbalances in the payments position of individual economic enterprises. When companies are incorporated in one country, get their finance from another, use the money to build or buy capital equipment in a third country, import raw materials from a fourth, and sell their products in one or all of those countries and others besides, it is doubtful that there is much economic sense in allocating the various parts of their operations to the balances of payments of the various countries affected, or in basing the economic policies on those allocations.

Suppose, for example, that General Motors transfers a large sum from its bank in Detroit to one in New York, and thereby creates a deficit for the Chicago Federal Reserve District and a surplus for the New York District. Nobody would suggest that the Chicago District should pursue a tighter monetary policy and the New York District an easier one, or that the impossibility of tightening money in the Chicago District without attracting funds from New York and thus frustrating that policy should be overcome by allowing the value of the dollar in the Chicago District to fluctuate relative to its value in the New York District. That would be a return to the days before the Federal Reserve System, when there were in fact premiums and discounts in New York on dollar balances in the West. The world is becoming more subject to payments imbalances of that kind. Giant multinational companies readily move hundreds of millions of dollars from one financial center to another. In a rational world it seems to me that the implications of most such movements for economic policy in the countries concerned

should be regarded as about zero. The payments system should be adopted not to inducing better adjustment of real income and resource allocations to changes of that kind, but to developing institutions that enable us to ignore them, absorbing them through offsetting movements of private or official liquid assets. We should place greater emphasis on solving the payments problems that will exist with adequate growth of world liquidity by trying to reduce concern with short period imbalances set off by meaningless movements of liquid funds, and increasing coordination of the monetary and fiscal policies of major countries.

Efforts in that direction—that is to say, in the direction of greater cooperation in monetary and fiscal policies—do not seem to me incompatible with making necessary adjustments of exchange rates easier. They would reduce the need for such adjustments, and if successful, contribute to greater actual stability. But this direction for policy, which is far more in tune with the trend of fundamental developments than the direction that emphasizes national independence, has been given very little attention. I urge that it be given more.

The long-run forces making for increasing integration are not going to be reversed, they will go on apace. Efforts to offset them look to me like rearguard actions. If anything, the economic objectives of the next decade should be to move toward, not away from, a common money.

The underlying problem that I have been talking about has been very well stated by Harry Johnson. I want to quote something that he recently wrote. He said:

> In an important sense, the fundamental problem of the future is the conflict between the political forces of nationalism and the economic forces pressing for world economic integration * * * in the longer run economic forces are likely to predominate over political, and may indeed come to do so before the end of this decade. Ultimately, a world federal government will appear to be the only rational method for coping with the world's economic problems. But whether this judgment is correct or not, the main problems of the 1970's will, in one form or another, be concerned with whether the direction of evolution is towards global rationality and integration or division on the basis of national interests.

Thank you very much.

(The prepared statement of Mr. Salant follows:)

PREPARED STATEMENT OF WALTER S. SALANT

The panel's assignment is to discuss how events in the United States and abroad might influence the further evolution of the international payments system and how future reforms may affeect the United States and modify the international role of the dollar. Since the hearing is concerned with objectives for foreign economic policy in the 1970's, I interpret "events" to refer to trends that may be expected to persist for most or all of the decade, and not to specific incidents or episodes. How future reforms may affect the United States and modify the international role of the dollar I shall leave to others. I shall concentrate on a few developments that appear clearly foreseeable, and what they imply for the general direction in which we should seek to move the international payments system. The views I shall express are my own and not necessarily those of the Brookings Institution, its trustees, officers, or other staff members.

The developments on which I want to focus attention are, first, the increasing economic integration of the world, and, second, our newly acquired ability to control the level and growth of net international monetary reserves through the creation of special drawing rights in the International Monetary Fund. In discussing these developments, I shall implicitly take into account, even if I do not

refer to, other developments that also appear foreseeable, such as a continued rise in the world price level and continued growth of real income. I shall omit consideration of other possible developments, such as a change in the world role of China, or changing relations between non-Communist countries and the Communist countries of eastern Europe, the occurrence, nature, and implications of which are all equally unclear to me.

World Economic Integration

The prospective development that appears to be most fundamental for the evolution of the world's monetary system and the choice of objectives for it appears to me the continuation of the process of world economic integration, a process which has been going on for decades. The most dramatic facet of this development—or at least the one most publicized—is the rise of the multinational corporation. We have all heard the statement that American corporations in Europe are (or will be?) the third largest "country" in Europe, and have seen very high estimates of the volume of American production abroad. There are, of course, also multinational corporations with main bases in countries other than the United States. Thus, we have what has been called the internationalization of production. The process of economic integration, however, goes far beyond anything that can be accounted for by the rise of multinational corporations alone. That international trade has grown faster than total world production probably is not accounted for wholly by such corporations, if indeed they account for any of it. (To some extent they reduce such trade, substituting domestic trade for exports.) Over the years, international transport costs and tariffs have fallen relative to other costs, and other economic and institutional barriers to trade have been lowered. Revolutionary improvements have increased travel and improved communications. These changes, in turn, have increased the familiarity of nationals in one country with the markets, businesses, laws, and other institutions of foreign countries. These changes are reflected not only in the rise of international trade relative to world production but in other ways, some of which are equally dramatic.

They show up, for example, in the increased mobility of labor. Within Western Europe, we find vast movements of labor between countries, with some 1,600,000 members of the German labor force in 1970 being citizens of other countries and something approaching one-third of the Swiss labor force in 1968 consisting of foreigners.

Similarly, the volume of capital that moves across international boundaries has grown prodigiously, partly because the very large corporations with international operations move liquid balances and long-term funds readily across national boundaries, but not only for that reason. The general increase of information and speed of communication has increased the international mobility of capital owned both by businesses and individual investors. We have the enormous growth of Euro-dollars. The dollar liabilities of banks in eight European countries reporting to the Bank for International Settlements, which were less than $10 billion in 1964, amounted to $46 billion at the end of 1969. The liabilities of banks in nondollar currencies other than their own also quadrupled, having grown from $2½ billion to over $10 billion in the same period. Corresponding developments have occurred in the bond market. In short, the volume of internationally mobile capital has increased on an enormous scale.

These developments have made net balance-of-payments positions; that is, surpluses and deficits—much more sensitive to given changes in economic relationships between interest rates in one money market and another, between costs and prices of tradeable goods, or even wage rates, income taxes, and other economic variables. This development, in turn, has given rise to increased concern about national surpluses and deficits in international payments. It has also given rise to the objection by some countries that they have lost the capacity to control their own monetary polices, owing to the increased influence of outside forces and the political resistance to the conventional means of adjusting to them. This is a major factor in the dissatisfaction with a monetary system under which countries attempt to maintain fixed exchange rates.

These payments difficulties have given rise to intensified efforts to increase receipts from foreign sources and to reduce payments to foreigners by means that, in most cases, would reduce real world income even if they did not stimulate retaliation, and that, in addition, do induce retaliation and consequently are at

least partially self-defeating. Governments discriminate against foreign sources in their own procurement; they tie their development aid in open or concealed ways; they attempt to stimulate exports and restrict imports while remaining within the rules of the General Agreement on Tariffs and Trade by insuring various export risks, subsidizing export credits, subsidizing tourism, and impeding imports in various ways, not only to protect specific industries but to improve their balance-of-payments positions. Now they are attempting to stimulate exports and impede imports by changing the structure of domestic taxation not for normal reasons of tax policy, but, again, for balance-of-payments reasons.

MONETARY RESERVES

The second set of developments that I think important in setting goals for the international payments system has to do with the growth of net international monetary reserves. Here I refer to reserves such as gold and new SDR's, which, unlike national currencies, are not somebory's liabilities. During most of the 1960's, the persistence of deficits led most people to think that the process by which balance in international payments is supposed to be restored did not work. To a substantial degree, however, the persistence of deficits reflected not a failure of that process but rather a stringency in growth of world monetary gold stocks—their failure to grow rapidly enough in the years before 1965, and their actual shrinkage between then and early 1968, when the policy of selling gold from monetary stocks to the private market to stabilize the price was ended.

When world monetary gold stocks decline, the sum of deficit must, as a matter of arithmetic necessity, exceed the sum of surpluses, if surpluses and deficits are symmetrically defined. Even when they grow, if that growth falls short of the sum of the increases that individual countries desire enough to compete for, at least one loses out. The amount of total surpluses and deficits depends on the growth of net monetary reserves; surpluses are smaller or fewer, and deficits larger or more numerous, the smaller that growth. When these stocks diminish, at least one country must have a net deficit, no matter how well the adjustment process works. A single country with a deficit can get rid of it, but only by forcing it on another country. Such a situation is like a game of musical chairs; if there are fewer chairs than players, somebody is bound to be without a seat. It is true that if he were only more nimble he might get a seat, but it would be an illusion to think this would solve the problem of seating everyone, since he could get a seat only at the expense of somebody else.

The basic reason why changes in aggregate monetary gold stocks give rise to aggregate imbalances is that increases in them are exports for which there are no corresponding imports, and decreases in them are imports for which there are no corresponding exports, so that when you add up the net balances of all countries the result is not zero but a surplus (in the case of increases) or a deficit (in the case of decreases).

Furthermore, if monetary gold stocks actually grow, but are growing less rapidly than the surpluses of one group of countries, then all other countries taken together must, again as a matter of arithmetic necessity, have a deficit in their combined balances of payments, even though the combined surpluses of the surplus countries increase their reserves by no more than they need in the light of the growth of their economies, of their international transactions, or whatever other criteria are deemed reasonable in an expanding world economy. (I have explained the technical reasons for this result more fully in an article entitled "International Reserves and Payments Adjustment", published originally in The Banca Nazionale del Lavoro *Quarterly Review* for September 1969 and reprinted as No. 175 in The Brookings Reprint Series.)

The danger of decreases in monetary gold stocks ended in March 1968, when central banks stopped selling gold to the private market, and the means of creating necessary increases in net monetary reserves was provided by the agreement to create Special Drawing Rights. In the 1970's, therefore, it should be possible to satisfy the world's need for growth of net reserves, which was not the case during the 1960's.

I recognize that a problem may raise from the fact that SDR's will gradually become an increasing proportion of monetary reserves. This development, which some people fear will make SDR's less desired, will be mitigated, however, by the agreement between the International Monetary Fund and the Union of South Africa that the Fund will purchase moderate amounts of newly mined gold for

monetary purposes. In my opinion this provision for some growth of monetary gold stocks, which might otherwise not be possible so long as the official price of gold remains at $35 an ounce, is helpful, so long as the purchases remain moderate enough not to induce private speculation on a rise in the price. I am aware that some people, including at least one member of this Subcommittee, regard the agreement as deplorable, and I would myself have preferred an agreement that permitted the price in the private market to fall moderately below $35. I consider it constructive, nevertheless, because it both provides a supplement to SDR's as a means of increasing net monetary reserves and it slows up the decline in the proportion of total reserves consisting of gold, which is a good thing so long as many important monetary authorities regard gold as superior and so long as their willingness to hold reserves in dollars is likely to be influenced by the amount of gold reserves held by the United States, which would undoubtedly acquire part of the increase of gold stocks resulting from the agreement. There may still be problems concerning the composition of world monetary reserves, but it should not be too difficult to solve them along the lines suggested to this Subcommittee and the Subcommittee on International Trade and Payments in the past two years by Messrs. Bernstein, Machlup, and Triffin, and perhaps by others.

The main point, in my view, is that a means has been adopted to create net monetary reserves on the basis of a deliberate judgment of needs. That is important mainly because it will eliminate a source of imbalances that has confused the diagnosis of the world's monetary troubles. The confusion is between two different kinds of disequilibria, both of which prevailed during much or all of the 1960's. One is disequilibrium between the global demand for and supply of additions to net monetary reserves. The other is disequilibrium among currencies. Both kinds of disequilibria can induce surpluses and deficits, and the persistence of both appears to reflect failure of the mechanism for adjusting imbalances. But the mechanism for adjustment that concerns economists and monetary officials, and that changes in the exchange-rate system are intended to improve, is only the mechanism for restoring equilibrium in the relations among currencies. The two diseases have the same symptoms. Because the first one—imbalances between the demand for and supply of additions to net monetary reserves—was little recognized, the severity of the second disease was exaggerated, and so, therefore, was the weakness inherent in the system of fixed exchange rates. What should be different in the 1970's is that a way has been found to prevent the first disease. As a result, the deficits resulting from it should cease to be a problem, and the inadequacy of the adjustment mechanism, which is the major remaining cause of dissatisfaction with the monetary system, should not loom so large.

International Financial Role of the United States

Another point that needs to be taken into account in assessing the need for change in the monetary system is the world financial role of the United States. You will recall that increases in U.S. liquid liabilities to private foreigners, as well as to foreign monetary authorities, are not considered to be U.S. receipts under the liquidity definition but rather a means of financing the deficit. Some portion, although I do not say all, of what has been called a U.S. deficit in the 1960's, i.e., the liquidity deficit, and also some smaller portion of the less persistent deficit on the official-settlements definition, has reflected the provision by the United States of liquid assets to private foreigners in response to their demand for increased holdings of such assets as their transactions and their wealth grow. The U.S. financial community satisfies this demand on better terms than foreign institutions do; under normal conditions, it pays higher interest on short-term money than foreign institutions and provides long-term funds at lower rates. In other words, the United States has been an international financial itermediary. To this extent, the liquidity deficit reflects not a disequilibrium but the performance of a normal economic function. This is true even of that portion of the official-settlements deficit that reflects voluntary increases in holdings of dollar assets by foreign monetary authorities. Performance of this intermediary function, and failure to recognize it for what it is, has also led to exaggeration of the true adjustment problem.

Thus, both the inadequate growth in net monetary reserves and financial intermediation by the United States led the world to exaggerate the problem of disequilibria *among* currencies. The belief tended to justify itself, but it remains

true that part of the problem is a non-problem and that another part has been remedied.

Disequilibrium Among Currencies and the Exchange-Rate System

This does not mean, however, that there is no problem of payments adjustment in the true sense of maintaining and restoring equilibrium among currencies. There is. It arises mainly from differences in national movements of money costs per unit of output and in rates of growth of real national incomes. For present purposes, we can pass over the fact that the effects of differences in real growth on international payments depend partly on what sectors of the national economies provide the impetus for growth. The essential point is that in the major industrial countries, these differences develop gradually. Given adequate reserves, their payments effects do not call for dramatic remedies if the remedies are not unduly postponed and are pursued persistently.

Besides recognizing that there is a true adjustment problem, I also recognize that in some cases it is more easily solved when exchange rates have some flexibility. Clearly, when countries have allowed the general level of their money costs to rise too high relative to those of other countries, they may be unable to bring them down at existing exchange rates in an acceptable period of time by means consistent with domestic objectives. In such cases, a reduction in the foreign-exchange values of their currencies is necessary to restore equilibrium. And if such a rise in relative costs is in the making, gradual changes in the exchange rate may prevent serious disequilibrium from developing.

Nevertheless, but before we draw the conclusion that the flexible-exchange pasture—or one of the many such pastures—is greener, a number of points deserve fuller consideration than they have had. Experience has taught us the difficulties of fixed rates, but we have had very little experience with flexible rates. We should not put ourselves in the position of the judge in the two-girl beauty contest who awarded the prize to the second contestant after seeing only the first.

The difficulties of the fixed-exchange rate system result from the fact that its operation requires action which governments in the modern world often are unable or refuse to take. Deficit countries in which aggregate demand is no more than adequate or less than adequate to provide high employment in most cases resist the standard fixed-rate therapy of reducing aggregate demand. Surplus countries that already enjoy high levels of employment do not want to engineer expansions of aggregate demand because that is inflationary. We have all recognized these resistances. But there may be comparable resistances to exchange-rate adjustments as well.

In this connection I shall merely mention two points. One is that, while economists generally assume that the monetary authorities will allow the rates to move, governments of deficit countries may like declines in the prices of their currencies no better, or even less, than they like losses of reserves under fixed rates. Such declines are commonly regarded as harmful to national prestige.

A second problem arises because the adjustment of exports and imports generally needed to eliminate surpluses and deficits requires changes of prices in the adjusting country that are concentrated in particular sectors of it. The important changes required are in the relations within the adjusting country between prices in industries producing exportable and import-competing goods (tradeable goods) on the one hand, and prices in industries producing goods that are not traded or tradeable on the other hand. It is these changes in price relationships within the adjusting country that shift demand and resources in the direction needed to remedy the imbalance in payments. For example, in a deficit country it takes a decline in prices of non-tradeable goods relative to tradeable goods to induce people to switch purchases from imports to domestic goods and to buy less exportable goods so that more are released for export. Such a shift in price relations may also be needed to induce a sufficient movement of labor and capital from production of non-tradeable goods to production of exports and import-competing goods. Such shifts are as much required when the mechanism of adjustment is a change of exchange rates as when, under fixed exchange rates, it takes the form of a change in money incomes measured in the national currency.

In a deficit country, a fall in the price of its national currency in the foreign-exchange markets does bring about the necessary shifts more easily than could the repression of aggregate demand that would be necessary under fixed rates,

because it raises the price of tradeable goods and services measured in the national currency. In contrast, under fixed exchange rates the main market effect is downward pressure on the prices of non-tradeable goods. But consider what happens in a surplus country under flexible exchange rates. The price of its currency rises. This rise exerts downward pressure on the prices of its exportable and import-competing goods, because they are influenced greatly by prices in world markets. If resistance to decreases of prices and money costs creates difficulties of adjustment under fixed rates, it seems inevitable that the same resistance will occur in surplus countries under flexible rates. Thus, while the difficulty that deficit countries have under fixed rates not occur in such countries when rates are flexible, it is likely to arise in surplus countries. Export and import-competing industries in surplus countries can be expected to resist currency appreciation. This point had ample confirmation in the resistance to appreciation of the German mark in 1968 and most of 1969. It is true that the resistance is likely to be less if the changes in currency values are small and gradual than if the upward valuation is as great as was required in the case of the German mark. Nevertheless, there is still reason to think that some of the problems of deficit countries under a fixed-rate system would reappear in surplus countires under flexible rates.

The greater ease of adjustment in deficit countries that results from altering the exchange rate compared with repressing national money income is a form of "money illusion"—the mistaking of income measured in units of money for real income, i.e., income measured by what income can buy. A country may accept a reduction of its consumption and capital formation by having prices rise faster than money incomes when it would resist a similar reduction carried out through compression of money incomes with prices remaining constant. But what if the deficit in the balance of payments or in adjusting it is not due to money illusion but to insistent demands for consumption and capital formation that add up to more goods and services than the economy can produce, or earn by exports, or finance by borrowing?

In such cases, the disequilibria are not monetary in character. Monetary measures can solve them only if they can break down the insistence on excessive claims. Insofar as the difficulties that have been experienced under a fixed rate system are due to real claims that remain insistently incompatible, not much easing of the adjustment problem can be expected from greater flexibility of exchange rates.

These observations suggest that the advantages expected of greater flexibility may not be realized in all cases.

At the same time, greater flexibility may be less necessary than it appears to be, not only because, as I have noted, some of the difficulties wrongly attributed to fixity of exchange rates, are not inherent in it and may be over, but also because concern about conventional imbalances may be decreasingly justified in an increasingly integrated world. In such a world, increasing cooperation is necessary in any monetary system, unless the process of integration is thought undesirable and one wishes to reverse or at least impede it.

Implications of Increasing World Integration for the World Monetary System

This appears clear if we consider some of the implications of increasing economic integration. In an integrated economy, payments imbalances occur among its various parts, but they do not appear as balance-of-payments "problems." The United States itself illustrates what I have in mind. Interregional imbalances do not appear as problems, partly because lack of statistics on interregional payments deficits and surpluses makes them invisible, partly because adjustment eliminates some of them, and probably also partly because they are financed indefinitely and therefore do not need to be entirely eliminated or reversed but merely held to limited proportions. From an economic point of view, the world is becoming more like the United States. The question is whether the mechanisms that maintain and restore interregional balance within a large country, obviously now not all operative in the world economy, are tending to develop in it, too, and whether they should and can be encouraged.

We know that some of those mechanisms do and others do not have analogues in the world economy. The main mechanisms are changes in real income of one region relative to that of others, interregional movements of labor (because labor

has considerable mobility within the United States), changes in relative money wage rates (because mobility of labor is far from perfect), automatic redistribution of income through Federal revenue and expenditures (a fall in a region's exports and thus in its real income decreases its income taxes and may increase the flow of Federal funds to it), movements of transferable private financial assets as individuals and businesses in regions incurring deficits sell assets and those in surplus buy them, and movements of bank reserves.

It is said that these mechanisms can not operate among countries, because among countries mobility of labor is not great, because there is not a unified fiscal policy, because there are many central banks and therefore many monetary policies, and because the volume of financial assets that have an international market and therefore are transferable between countries is too small in relation to the total volume of financial assets outstanding. Lacking these characteristics of a large country, the world is not an economy that can operate with one money, which is what really fixed exchange rates imply. That is true. But we are here talking about the direction in which we would like the system to evolve. At present, we are in a world with a substantial and growing degree of economic integration, but consisting of nation-states with independent fiscal policies and which would like to pursue independent monetary policies. We are in an intermediate position between two states of affairs that are really inconsistent; somewhat independent national states that like to think themselves more soverign and would like to become independent in some respect, but that are in fact increasingly interdependent. Greater exchange-rate flexibility among individual countries is desired by some as a means toward greater national monetary autonomy. The question is whether, in the face of technological forces making for greater economic integration, this is desirable or even feasible.

It is becoming increasingly questionable whether some causes of imbalances in international payments have any more economic significance and should give rise to any greater adjustments than imbalances in the payments positions of individual economic enterprises, and therefore whether a nation's deficit or surplus always needs treatment different from that of an individual or enterprise, which is to say, it needs to be financed as long as it appears worthy of credit (or charity) but not thereafter. Indeed, when companies are incorporated in one country, get their finance from another, use the money to build or buy capital equipment in a third country, import raw materials from a fourth, and sell their products in one or all of these countries as others besides, it is doubtful that there is much economic sense in allocating the various parts of their operations to the balances of payments of the various countries affected, or is in basing economic policies on those allocations.

Suppost, for example, that General Motors transfers a large deposit from its bank in Detroit to one in New York, and thereby creates a deficit for the Chicago Federal Reserve District and a surplus for the New York District. Nobody would suggest that the Chicago District should pursue a tighter monetary policy and the New York District an easier one, or that the impossibility of tightening money in the Chicago District without attracting funds from New York to implement such a policy should be overcome by allowing the value of the dollar in the Chicago District to fluctuate relative to its value in the New York District. That would be a return to the days before the Federal Reserve System, when there were premiums and discounts in New York on dollar balances in what then were distant parts of the country. The world is becoming more subject to payments imbalances of that kind. Giant multinational companies readily move hundreds of millions of dollars from one financial center to another. In a rational world, the implications of most such movements for economic policy in the countries concerned should be zero. The payments system should be adapted not to inducing better adjustment of real incomes and resource allocations to such changes but to developing institutions that enable us to ignore them, absorbing them through offsetting movements of private or official liquid assets. We should place greater emphasis on solving the payments problems that will still exist with adequate growth of world liquidity—by seeking to play down concern with short-term imbalances set off by meaningless movements of liquid funds and by increasing coordination of the monetary and fiscal policies of major countries. If that both permits and leads to fixity of rates or unified currencies among groups of countries, it will be a movement with the trend of basic economic forces, not against that trend.

Efforts in that direction do not seem to me incompatible with making necessary adjustments of exchange rates easier; they would reduce the need for such adjustments and, if successful, contribute to greater actual stability. But this direction for policy, which is far more in tune with the trend of fundamental developments than the direction that emphasizes national independence, has been given very little attention. I urge that it be given more. Not only is it clear that independence of national policy is logically inconsistent with interdependence, so that compromises are required. It is also clear that the long-run forces making for increasing integration are not going to be reversed; they will go on apace. Efforts to offset them look to me like rearguard actions; if anything, the economic objectives of the next decade should be to move toward, not away from, a common money.

The underlying problem has been well stated by Harry Johnson. He recently wrote "In an important sense, the fundamental problem of the future is the conflict between the political forces of nationalism and the economic forces pressing for world economic integration . . . in the longer run economic forces are likely to predominate over political, and may indeed come to do so before the end of this decade. Ultimately, a world federal government will appear to be the only rational method for coping with the world's economic problems. But whether this judgment is correct or not, the main problems of the 1970's will, in one form or another, be concerned with whether the direction of evolution is towards global rationality and integration or division on the basis of national interests."

Chairman Boggs. Mr. Reuss, any questions?

Representative Reuss. Thank you, Mr. Chairman.

Mr. Salant, in your statement you just said that you think we would be a lot better off trying to coordinate monetary and fiscal policies of major countries rather than being concerned about meaningless movements of liquid funds and balance of payments statistics. Is that a fair statement?

Mr. Salant. Yes.

Representative Reuss. Then would it be a fair statement of your views to say that the International Monetary Fund is not a very useful institution insofar as it concentrates on wagging a forefinger at countries about their balance-of-payments positions? Would you say that the OECD, which through working party No. 3 and other units does make a stab at coordinating fiscal and monetary policy, is a more useful international organization, and that our friends of the press, for example, ought to have less of a fixation about the IMF and give more attention to the OECD?

Mr. Salant. I regard them as both very useful institutions. And I don't take the view, which I think is implied in your question, that what they are doing is inconsistent, although judging only from press accounts, I think I would have some reservations about the last annual report of the Monetary Fund. I say judging from press reports, because I have not had an opportunity to read it carefully. I believe that—perhaps this is a point that I didn't get across clearly enough in my statement and which may serve to reconcile what may appear to be inconsistencies between things I said and what some of the other panel members have said—we must make a distinction between disequilibria that are fundamental and have become imbedded in the system, or are tending to become imbedded in the system, and meaningless ones, economically meaningless ones. And I have been stressing the latter, and others perhaps have been stressing the former. I think the point which I made concerning the growth of net reserves as opposed to growth of gross reserves, was recognized at a much earlier stage by

the Monetary Fund than it was by most others, and that they performed very constructively. I think they have performed constructively on many other scores as well.

Representative REUSS. I wasn't suggesting that the IMF is totally useless. What I was putting to you was whether the IMF is earning its salary when it does its forefinger wagging—which it seems to be doing a good deal now. If the statistics on balance of payments are as phoney as you suggest they are, doesn't the IMF by its constant reliance on them, and by its constant basing of advise on those statistics, give them a credibility which they don't deserve?

Mr. SALANT. Well, one of the things they do on that score which I regard as extremely valuable, is completely to ignore the liquidity deficit, and to show the relationship between the sum of official settlements deficits of all countries and the changes in monetary gold stocks.

Representative REUSS. If I can't get you to fight with the IMF, which I apparently can't——

Mr. SALANT. I think not, because I think they have done some very valuable analytical work. If you were asking whether the fact that they have only the capacity to wag their collective finger is a deficiency, as contrasted with the situation in which pretty high level officials come from their own capitals to OECD meetings and may hatch up some forms of cooperation, which resident executive directors of the Monetary Fund in Washington do not do, I agree that there is something in that. I don't know enough about what goes on behind the scenes at the Monetary Fund to have a judgment about that. But I think the analytical work of the Fund, and most of the policy statements that have come from it insofar as the major world monetary problems are concerned, have been highly valuable. And this is, of course, aside from some very valuable work that they have done in connection with the concerns of some of the smaller countries.

Representative REUSS. Let me see, then, whether I can incite you against the press. Don't you think the press has contributed to the foolishness by taking the liquidity balance too seriously and writing alarm stories every quarter when the figures go one way or another?

Mr. SALANT. I can agree with that. You will not put me in the category, along with the Vice President, of major critics of the press because of that remark, I hope.

Representative REUSS. Your alliterativeness is nothing compared to his.

Mr. Fellner, you in effect have said that if the European countries are so all-fired worried about our balance-of-payments deficits, the constructive alernative is for them to revalue in unison, hopefully, against the dollar, and stop bellyaching; is that an inelegant way of expressing your views?

Mr. FELLNER. Yes. But I think that would be the equivalent of our option to devalue, an option which any other country would have.

Representative REUSS. My question is this: Is it necessary that there be a common European currency—the kind of thing the Common Market countries are now talking about, but which is surely some years off—for the Europeans to revalue their currencies in unison against the dollar? After all, the Germans and the Dutch and

the Belgians as I recall, did it practically in unison. When sterling devalues many others practically automatically go along. There is no reason why the Common Market six and anybody else who wanted to join couldn't arrive at a joint and coterminus revaluation of their currencies; is there?

Mr. FELLNER. I believe that that is quite right, and that it would be in their interest, and generally speaking in the interest of orderly procedure, that there should be close contacts between the other countries when such a step is taken. Now, just what that means institutionally I don't know.

I also don't know how precisely the situation developed that led to joint action in the case of the Germans and Dutch in 1961 and then in the case of a number of countries in 1967. But certainly something of that sort would be needed in order to shape this procedure in such a way that no disturbance should develop. Whether this requires very close institutional arrangements between these countries or whether the tradition of consulting with one another would be sufficient is something I cannot judge. I would not expect other countries to move by the same percentage in such a case. I would really expect that they would move differently. But they should know between one another what they are doing.

Representative REUSS. Thank you, Mr. Chairman.

Chairman BOGGS. Mr. Conable?

Representative CONABLE. Thank you, Mr. Chairman.

You gentlemen may not be as alliterative as the Vice President, as Mr. Reuss pointed out, but you have given us a heady experience this morning. You constitute an eclectic fraternity, certainly, to a group of generalists like Congressmen. I think we have found it very instructive.

Mr. Salant, I expected when I saw the subject of this morning's panel that we would be talking in very great degree about SDR's, and you are almost the only guy that mentioned them here. I wonder why that is? Is it true that it is virtually impossible to control SDR's because of large deficits we have been having, that this has considerably inhibited the development of SDR's as a vehicle for international adjustments?

Mr. SALANT. I think the persistence of imbalances has slowed the growth, that is to say, created a great deal of resistance to the adoption of them on the part of some countries. I don't think that SDR's are intended to be or should be regarded as a means of facilitating adjustment in the relationships among currencies. But I think they can eliminate what looked like an adjustment problem, but was in fact a liquidity problem in disguise.

As to why there wasn't more reference to them in the discussion of this panel, I think you might get a better answer if you addressed the question to those who omitted to discuss it.

Representative CONABLE. What is the future here? Are we going to continue indefinitely using the dollar as the major reserve? What do you see as the trend here?

Mr. SALANT. I think it it likely to continue to be used. And on that score I think there are certainly resistances on the part of some countries which feel that the United States is sort of abusing the position

of the dollar, or its own economic position. I think some of the points that are made which imply that that problem would be solved by a change of the monetary system result from misidentification of the problem. Here I agree with what Professor Fellner said, that some of what is attributed to the monetary system, some of the objections to the strong position of the United States that are attributed to its role in the monetary system, are not the result of that role at all, but just of the fact that it is a very, very big country in relation to others. And I don't foresee that its size relative to others is going to be reduced by changing the monetary system.

Chairman BOGGS. I wonder if some of the other panelists might like to comment on this?

Representative CONABLE. Dr. Aschinger?

Mr. ASCHINGER. May I make some remarks, Mr. Conable? First, I would say that the dollar, as the currency of the strongest economic unit in the world, in the Western World, will certainly persist not only as a transaction currency but also as a legal currency and as a reserve currency. I share the opinions that at least a billion or more would be used every year as a supplement to perform these functions.

On the other hand, I have to point to the fact that the SDR's have originally been designed to supplement the creation of foreign dollar balances which were at that time expected to be smaller in the future than they were in the recent past. Only under such conditions it is justified to speak of a deliberate creation of international reserves in connection with the SDR's. But if you have got a huge balance-of-payments deficit of the United States besides SDR's, then of course you cannot call this any more a deliberate creation of reserves. In the first allocation of SDR's there were two different preconditions that the balance-of-payments deficit of the United States should reasonably be diminished, and that the adjustment forces should be generally improved. Well, the first condition has not been fulfilled so far. And that gave rise in Copenhagen to the remark of several people. I quote Giscard d'Estaing, French Minister of Finance, who said that "under present circumstances, according to the statute of the fund, one could really discuss the question, if in the next year the SDR's should not be reduced." But he continued to say "that he would not put the decision into question today." I have also heard of other countries' delegates saying that they would be against a continuation of allocations of the SDR's in the present amounts if the balance-of-payments deficit of the United States should continue on a large scale.

Representative CONABLE. I would like to thank you, Doctor, for your very clear explanation of the responsibility we have here for a sound fiscal policy. We usually think we are in bad enough trouble with our constituents alone if our fiscal policy isn't good. You have made it quite clear that we have a responsibility that transcends the borders of our congressional district or of the Nation.

I would like to ask you about the balance of payments. The balance of trade you indicated may have improved somewhat this year. The balance of trade has gone against us, largely as a result of our commercial relations with Canada and Japan and Germany. Now, does that indicate that we should take some special measures with respect

to these countries to insure against a further deterioration of our balance of trade there in the event it doesn't continue to improve as it apparently has during this year?

Mr. ASCHINGER. In responding to your question I would say briefly that the balance of trade should be taken as an overall balance. It occurs to every country that there is a number of countries with which you are in deficit and with which you are in surplus. And we don't look at this picture any more from the bilateral angle. It should be viewed from the multilateral angle.

So if you improve your balance of trade with the world you do it in a way that you would improve the surpluses among some countries and decrease the deficits toward the other countries. I don't think that there is a special case for you on this basis to take specific restrictive measures toward the countries with which you are in deficit condition.

Representative CONABLE. I take it you are referring there to the restrictive trade package that is pending in the Congress at this point? Would there be general agreement among the members of the panel that that is an unfortunate thing from the point of view of world trade, the long-run international economic picture?

Mr. FELLNER. Certainly on my part; yes.

Mr. ASCHINGER. Certainly.

Representative CONABLE. Dr. Salant?

Mr. SALANT. If I may make an observation about that, I would say that efforts to eliminate bilateral imbalances should be damaging not only for world trade, but for the real incomes of the participating countries. I have a perfectly terrible deficit with the grocer, if one wants to look at bilateral payments relationships. But it would be very foolish for me to decide to grow my own vegetables as a result. I think the situation is analogous, and that perhaps brings it home.

Representative CONABLE. Thank you. Thank you all.

Chairman BOGGS. Thank you very much, Mr. Conable. I regret that our time is up. We are very grateful to all of you gentlemen. You have made a fine contribution to our understanding of these complex but vital issues.

I might remind all of you that the record will be open for some time, should you like to supplement your statements, and if so, we would be very happy to receive any additional information that you have available.

The subcommittee will adjourn, subject to the call of the Chair.

(Whereupon, at 12:15 p.m., the subcommittee was adjourned, subject to the call of the Chair.)