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ACTION NOW TO STRENGTHEN THE U.S. DOLLAR

REPORT

OF THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

TOGETHER WITH

MINORITY VIEWS

AUGUST 1971

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LETTERS OF TRANSMITTAL

AUGUST 6, 1971.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the members of the Joint Economic Committee and other Members of Congress is a report of the Subcommittee on International Exchange and Payments entitled "Action Now To Strengthen the U.S. Dollar."

The views expressed in this subcommittee report do not necessarily represent the views of other members of the committee who have not participated in the hearings of the subcommittee or in the drafting of this report.

Sincerely,

WILLIAM PROXMIRE,
Chairman, Joint Economic Committee.

AUGUST 6, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is a report of the Subcommittee on International Exchange and Payments entitled "Action Now To Strengthen the U.S. Dollar" together with additional views by Senator Javits, and a joint dissent by Representative Widnall, Senator Percy, and Representative Conable. Thus, this report has the endorsement of seven out of the ten members of the subcommittee.

The subcommittee wishes to express its gratitude and appreciation for the guidance it has received from the administration officials and the private experts on the U.S. balance of payments who appeared before it as witnesses.

Sincerely,

HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments.

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Recommendation 6.—The reserve assets of all IMF members should be entered in a mutual settlement account, and each IMF member should use all of its reserves proportionately in the settlement of payments deficits. As a logical outcome of this agreement to use reserves proportionately, the U.S. commitment of interconvertibility between dollars and gold would be eliminated, if this change has not already been accomplished. The Governors of the IMF should in September commission a study, to be completed in time for action at the 1972 annual meeting, on how a reserve settlement account can be appropriately instituted, and on the termination of the U.S. commitment regarding gold-dollar convertibility.

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Recommendation 7.—The International Monetary Fund and the International Bank for Reconstruction and Development should immediately undertake a joint study of feasible mechanisms for utilizing SDR creation to increase the flow of financial assistance to developing countries. This study should be prepared for presentation at the 1972 joint Fund-Bank annual meeting, or at an earlier date.

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ACTION NOW TO STRENGTHEN THE U.S. DOLLAR[1]

No one denies that according to almost any measure the United States suffers from persistent balance-of-payments deficits. Analysts and officials do differ, however, on the significance of these deficits and on what should be done about them. Moreover, spokesmen for the United States and other countries express disparate views about whether the United States or surplus nations should take the initiative in correcting the existing disequilibrium and whether or not fundamental reforms are required. Thus, we find ourselves bickering among one another and with our friends abroad over the external financial position of the United States. Meanwhile, the likelihood increases that an otherwise minor political or financial crisis will unhinge the international monetary system or precipitate a general resurgence of protectionism. How did this mess develop? Why does it appear so intractable? How can the situation be set right? The following report offers possible answers to these questions.

I. The Balance-of-Payments Mess

1. MEASURING OUR PAYMENTS DEFICIT

Part of the problem in evaluating the balance-of-payments position of the United States lies in the difficulty of selecting an appropriate measure. Most analysts and officials now appear to agree that the most relevant statistical series is the balance on current and long-term capital accounts. This balance gives the net result (adjusted for public and private remittances and gifts to foreigners) of sales to and purchases from foreigners of merchandise, services, long-term securities, and direct interests in productive enterprises. The liquidity balance was introduced after World War II as a comparison between U.S. liquid liabilities to all foreigners and our ability to pay off these liabilities from gold and other reserves. This measure has now lost much of its relevance because liquid liabilities to foreigners are currently over three times the U.S. reserve stock and because the dissolution of the gold pool and the establishment of the two-tier gold price system have relieved the United States of any obligation to intervene in private gold markets. The official settlements balance is supposed to measure the extent of official intervention in exchange markets that is required to maintain stable exchange rates, but the validity of this calculation has recently been impaired by monetary authorities' transactions in the Euro-dollar market.

The balance on current and long-term capital accounts—sometimes referred to as the basic balance—represents an effort to measure structural forces influencing the external position of the United States over the long run. This measure tends to be less volatile than either the liquidity or the official settlements balance, since it excludes international flows of most highly liquid assets. In 1970 the deficit on

[1] Note the appended additional view by Senator Javits and the joint dissent by Representative Widnall, Senator Percy, and Representative Conable.

current and long-term capital accounts totaled $3 billion, up slightly from $2.9 billion the previous year. (See table 1 on p. 3.) The deficit on this balance amounted to $3.2 billion in 1967, and the decline in 1968 to $1.3 billion appears to have been only temporary. In fact, Commerce Department spokesmen are predicting a substantial deterioration in the U.S. merchandise surplus this year and even mention the possibility of a trade deficit.

The actual state of the U.S. balance of payments is substantially worse than the $2.5 to $3 billion structural deficit the data indicate. Economists maintain that a nation's underlying or fundamental balance-of-payments position should be appraised without the benefit of special taxes or controls that may have been instituted to curtail net foreign expenditures. Since restrictions of this type frustrate the efficient use of productive resources, which is the object of unfettered trade and capital flows, the need for market adjustments to rectify an untenable position can be estimated only if the analyst takes into account the extent to which emergency taxes and controls mask the true underlying deficit.

2. PAST ATTEMPTS TO ELIMINATE THE DEFICIT

Beginning in the late 1950's, when U.S. deficits suddenly expanded, this country has introduced a number of ad hoc measures intended to cure the balance-of-payments problem. As is obvious from the experience of the past few years, the cure has failed. These palliatives must be subjected to critical reexamination. Just how bad is the U.S. balance-of-payments position? How and why were the existing taxes and restrictions introduced? What would happen if they were removed, as the administration has pledged?

In 1959, when about 40 percent of U.S. bilateral development assistance outlays were being spent in the United States for purchases of goods and services, we began to tie aid procurement and require beneficiaries to spend their receipts in this country. By 1964, 80 percent of U.S. AID commitments were tied to procurement in the United States, and the proportion rose to 85 percent in 1965.

One of President Kennedy's first responsibilities following his election was to quiet—with a firm declaration that the dollar would not be devalued—a flurry of foreign central bank requests for conversion of dollar balances into gold. The apprehensions of official foreigners at that time reflected 3 years of large reported payments deficits.

In 1961 the duty-free allowance for American travelers returning from abroad was reduced from $500 to $100. In the same year, the Executive instituted the gold budget for reducing foreign expenditures by Government agencies. The following year, the Defense Department established a procedure under which procurement would be made abroad only if the domestic price of comparable goods or services exceeded the foreign price by more than 50 percent.

In 1963 legislative authorization was requested for the Interest Equalization Tax to discourage sales of foreign stocks and bonds in the United States. The tax was subsequently enacted retroactive to the date of the President's request.

Table 1.—U.S. Balance of Payments: Current and Long-Term Capital Accounts

[Seasonally adjusted, in millions of dollars]

(Credits +; debits −)	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Merchandise trade balance	4,906	5,588	4,561	5,241	6,831	4,942	3,927	3,859	624	660	2,110
Exports	19,650	20,107	20,779	22,252	25,478	26,438	29,390	30,680	33,588	36,490	41,980
Imports	−14,744	−14,519	−16,218	−17,011	−18,647	−21,496	−25,463	−26,821	−32,964	−35,830	−39,870
Military transactions, net	−2,752	−2,596	−2,449	−2,304	−2,133	−2,122	−2,935	−3,138	−3,140	−3,341	−3,371
Travel and transportation, net	−964	−978	−1,155	−1,312	−1,149	−1,319	−1,382	−1,752	−1,558	−1,780	−1,979
Investment income, net	2,841	3,554	4,052	4,153	4,875	5,294	5,375	5,888	6,220	5,975	6,242
U.S. direct investments abroad	2,945	3,430	3,844	4,019	4,687	5,162	5,374	5,956	6,519	7,340	7,906
Other U.S. investments abroad	934	1,174	1,375	1,520	1,712	1,930	2,207	2,355	2,714	3,199	3,503
Foreign investments in the United States	−1,028	−1,050	−1,167	−1,385	−1,524	−1,798	−2,206	−2,423	−3,013	−4,564	−5,167
Other services, net	96	46	140	203	174	333	315	365	344	497	538
Balance on goods and services	4,126	5,615	5,150	5,987	8,600	7,130	5,300	5,220	2,489	2,011	3,592
Remittances, pensions and other transfers	−628	−659	−712	−825	−866	−1,028	−980	−1,278	−1,168	−1,266	−1,410
Balance on goods, services and remittances	3,498	4,956	4,438	5,162	7,734	6,102	4,320	3,942	1,321	745	2,182
U.S. Government grants (excluding military)	−1,664	−1,853	−1,919	−1,917	−1,888	−1,808	−1,910	−1,802	−1,707	−1,644	−1,739
Balance on current account	1,834	3,102	2,519	3,245	5,846	4,295	2,410	2,139	−386	−899	444
U.S. Government capital flows excluding nonscheduled repayments, net.	−1,158	−1,621	−1,775	−1,987	−1,800	−1,819	−1,963	−2,428	−2,538	−2,106	−1,837
Nonscheduled repayments of U.S. Government assets	54	695	680	326	123	221	429	6	269	−87	244
U.S. Government nonliquid liabilities to other than foreign official reserve agencies.	215	25	203	511	328	66	65	−2	107	263	−436
Long-term private capital flows, net	−2,100	−2,181	−2,607	−3,357	−4,470	−4,577	−2,555	−2,912	1,198	−50	−1,453
U.S. direct investments abroad	−1,674	−1,598	−1,654	−1,976	−2,328	−3,468	−3,661	−3,137	−3,209	−3,254	−4,445
Foreign direct investments in the United States	141	73	132	−5	−5	57	86	258	319	832	969
Foreign securities	−663	−762	−969	−1,105	−677	−759	−482	−1,266	−1,226	−1,494	−942
U.S. securities other than Treasury issues	282	324	134	282	−84	−357	909	1,016	4,389	3,112	2,190
Other, reported by U.S. banks	−147	−141	−121	−702	−853	9	525	413	430	477	199
Other, reported by U.S. nonbanking concerns	−39	−77	−129	149	−523	−59	68	−196	495	277	576
Balance on current account and long-term capital	−1,155	20	−979	−1,262	28	−1,814	−1,614	−3,196	−1,349	−2,879	−3,038

Source: Survey of Current Business.

From 1962 on the Executive has engaged in a number of special transactions designed to reduce the apparent dismensions of U.S. payments deficits. Chief among these special transactions have been the sale of special notes and bonds to foreign monetary authorities to absorb liquid dollar balances, negotiated prepayment of foreign debts, and similar advance payment by other countries for military purchases in the United States.

In 1965 voluntary controls were introduced to limit direct investment abroad by U.S. corporations and to restrict lending to foreigners by American commercial banks. At the beginning of 1968 the direct investment control program, administered by the Commerce Department, was made mandatory. At the same time, the ceilings on bank lending to foreigners supervised by the Federal Reserve System were lowered.

Also since 1960 the gold pool has been created and dissolved. The pool was a cooperative arrangement among several central banks of major industrial countries to intervene in the London gold market and prevent the emergence of any significant differential between the $35 per ounce official price and the private market price. The United States was the major participant in the pool. The decision to disband the group and sever the link between the private and official gold markets was taken in early 1968. At that time demands by private speculators for gold became so large that continued intervention in the market would have resulted in gold losses that were intolerable from the point of view of U.S. authorities and perhaps foreign monetary institutions as well.

The most recent initiative by the Executive to mitigate the effects of excessive dollar outflows consists of borrowings by the Export-

Import Bank and the Treasury of $3 billion in Europe to prevent these claims on the United States from further swelling the burgeoning dollar reserves of foreign central banks.

Despite this array of taxes, controls, purchasing guidelines, and other ad hoc attempts to reduce U.S. deficits, net payments to foreigners on current and long-term capital accounts increased from an average of less than $1 billion annually from 1960 through 1966 to a yearly average of $2.6 billion for 1967 through 1970. Returns for the first half of this year indicate that the 1971 basic deficit may be $4 or $5 billion, a substantial increase over last year. Moreover, the continuation of the Interest Equalization Tax and controls over capital exports mask the true deterioration in the international economic position of the United States.

In his testimony before the subcommittee on Federal Reserve limitations of bank lending to foreigners, Governor Andrew Brimmer said that if monetary conditions were eased in the United States when domestic demand for funds was not high—as is presently the case—the "combination of those circumstances * * * would produce a substantial outflow of bank credit from this country if the program were not there acting as a constraint." Mr. William V. Hoyt, Deputy Director of the Office of Foreign Direct Investments in the Commerce Department, testified that if the controls over foreign direct investment were abolished, such capital outflows would increase by $2 to $3 billion on a regular annual basis. In addition, Mr. Hoyt said that $5 or $6 billion of loans that U.S. corporations have obtained abroad rather than in the United States—because of the program—would be repaid following its termination.

Thus, the improvement in the U.S. competitive position that would be required to correct our balance-of-payments deficit in the absence of restraints on capital flows is perhaps twice as large as the present data indicate. The current account, because of our worsening trade performance, is today actually in deficit. Without a dollar realinement, no recovery in the U.S. current-account position is likely to be sufficient to finance normal levels of unfettered capital exports.

The foregoing history of over a decade of unsuccessful attempts to curtail U.S. payments deficits leads to one inescapable conclusion—the dollar is overvalued. It is not really worth as much in international transactions as exchange rates imply, and its foreign currency value is thus overstated. Overvaluation is manifested by (*a*) the persistence of payments deficits despite the imposition of the Interest Equalization Tax, capital export controls, and other ad hoc measures and by (*b*) a weak and deteriorating trade balance despite a domestic recession.

Dr. Edward M. Bernstein recently pointed out that—

> The really serious deterioration in the U.S. competitive position occurred between 1967 and 1970. On the basis of cyclical experience, imports should have increased much less between 1967 and 1970 than in the 3 preceding years.

> Actually, total imports, excluding automotive products from Canada, increased considerably more * * *. Imports of finished consumer goods (automobiles, other durable goods, and nondurable goods) increased by 94 percent from 1967 to 1970 compared to 57.5 percent from 1964 to 1967. It is impossible to escape the conclusion that in these very important industries, U.S. manufacturers have not been able to compete with foreign producers in our home markets.[2]

Dollar overvaluation impedes sales of U.S. exports abroad, stimulates purchases of imports here, encourages American firms to invest abroad, and retards foreign investment in the United States.

The difficulties of American manufacturers in meeting foreign competition are not confined to one or two industries; these difficulties are being experienced generally. Nor is the problem confined to economic relations between the United States and one or two of our major trading partners. As the following discussion demonstrates, the large size of the required improvement in the U.S. balance of payments means that this improvement must be distributed generally among other industrial nations.

3. THE UNITED STATES LACKS A PROGRAM TO END THE DEFICIT

The latest annual report of the Bank for International Settlements, published June 14, 1971, states: "Apart from technical measures to contain the outflow of funds, the administration had no plans for curing the U.S. payments deficit." Continued inattention to our deficit, the BIS suggests, violates the spirit and the letter of the "Bretton Woods system," under which international monetary relations have evolved since World War II.

When asked whether he agreed or disagreed with this statement, Under Secretary of the Treasury Paul A. Volcker replied that the administration did have a plan, and mentioned (*a*) efforts to curtail inflation and restore price stability in the domestic economy, (*b*) attempts to reduce military expenditures through a broader distribution of the costs of defense among our allies, (*c*) discussions with other countries to eliminate barriers preventing the entry of imports from the United States, and (*d*) easier access to credit for U.S. exporters through the Export-Import Bank and a reduction in the tax burdens of exporters under the proposed Domestic International Sales Corporation.

While most of the measures that Mr. Volcker mentioned are clearly desirable, their limited and somewhat delayed impact on the U.S. payments position are matters for concern.

(*a*) The rapid expansion of Government spending for the Vietnam war that began in 1965 and continued for over 2 years without a corresponding increase in taxes triggered a boom in the U.S. economy. Since the economy was already close to full employment when this bout of deficit spending began, the result was a sudden jump in the flow of imports entering the United States, and domestic inflation. This inflation, at first demand-pull and subsequently cost-push, has still not been defeated. During the early 1960's, the rate at which export prices increased in the United States was about the same as

[2] "Quarterly Review and Investment Survey," Model, Roland & Co., Inc., second quarter, 1971, p. 7.

that in other industrial countries, but from 1965 to 1970 export prices rose 16 percent in the United States, 10 percent in industrial Western Europe, and 9 percent in Japan. The United States is now left with a higher cost structure, relative to other countries, than if a noninflationary growth path had been followed.

The desirability of reducing inflation is obvious for both domestic and external reasons. What is uncertain is whether the administration's current program is capable of making significant progress toward price stability soon enough to effect a prompt improvement in our payments position. Since the beginning of this year, wholesale prices have continued to advance at an approximate 5 percent annual rate. It is conceivable, although hardly likely, that inflation in the United States will drop substantially below the rate in our major competitors. But even from 1960 through 1965, when wholesale prices rose hardly at all, this country experienced payments deficits, and the relative U.S. cost structure is now substantially higher than in 1965.

(*b*) American representatives have been talking burden-sharing with our NATO allies for almost a decade, and little has come of these conversations. A private witness before the subcommittee, Prof. Benjamin J. Cohen of Princeton University, asserted that on the basis of his analysis, reduction of the number of U.S. troops in Europe, a more equitable distribution of the costs of defense among our NATO allies and curtailment of U.S. involvement in Vietnam could bring a potential balance-of-payments savings of $1 to $1.5 billion annually. He concluded: "Bringing the troops home will not solve the balance of payments."

(*c*) No significant elimination of trade barriers is going to occur while the European Economic Community is adjusting to the admission of Britain and other new members, and while the Japanese adhere to their measured pace in the removal of import restrictions. The impact of such revisions in barriers to imports from the United States will most likely be marginal.

(*d*) By improving the terms under which U.S. exporters can obtain credit or by giving a tax break to exporters, our Government is essentially entering into competition with others in terms of the subsidies, explicit or implicit, that are disbursed to encourage sales abroad. Possibly other countries will not react to a United States move toward increased competition in this respect, viewing our action as merely an attempt to equalize the ground rules. On the other hand, if other governments do respond by giving larger or additional benefits to their exporters, the gains from the U.S. point of view will be minimal.

The basic trouble with the Treasury approach to the U.S. balance-of-payments problem is that it has not worked. For the past 10 years the external position of this country has steadily worsened.

4. INABILITY OF THE UNITED STATES TO ALTER EXCHANGE RATES UNILATERALLY

The current organization of the international monetary system, as it has evolved since World War II within the guidelines specified by the Articles of Agreement of the International Monetary Fund, denies the United States the latitude to alter the external value of its domestic currency that other Fund members enjoy.

In 1949, Secretary of the Treasury John W. Snyder, in a letter to IMF Managing Director Camille Gutt, committed the United States to maintain the external value of the dollar by buying and selling gold at $35 per ounce. Other countries are pledged to maintain the external value of their currencies by buying or selling dollars in exchange markets. Thus, the dollar is pegged to gold, and other currencies are pegged to the dollar. This is a sensible and convenient arrangement, since the dollar is the currency most widely used in international transactions and, therefore, the one most convenient for monetary authorities to use as an intervention currency.

One way to attempt to alter the foreign exchange value of the dollar would be to increase the dollar price of gold. But aside from the fact that this approach would have many undesirable side effects—such as producing windfall profits for the Soviet Union, South Africa, and gold hoarders, and fostering speculative expectations of another possible increase in the more distant future—a change in the dollar price of gold holds no assurance that dollar exchange rates would change similarly. Most other countries might alter the gold value of their currencies by the same amount, and thus maintain unchanged dollar parities. By intervening in exchange markets and purchasing dollars with their own currencies, foreign monetary authorities could prevent any decline in the foreign exchange value of the dollar.

The legal link between the dollar and gold and the role of the dollar as the chief intervention currency thus effectively limit any U.S. initiative to alter dollar exchange rates.

Another way by which the overvaluation of the dollar could be removed, with minimal disturbance to the international monetary system, is for the monetary authorities of other countries to voluntarily increase the dollar values of their respective currencies by the appropriate amounts. The preferability of this alternative over a change in the price of gold was discussed in the April 1971 annual report of the Joint Economic Committee (pp. 10–11).

But other countries have refused, by and large, to revalue their currencies against the dollar, preferring to maintain their export advantage. Their officials point to the mistakes of U.S. domestic economic policy that have enlarged our deficit in recent years. These foreigners maintain, therefore, that the United States should "set its own house in order" as a means of correcting balance-of-payments problems. The American reaction, on the other hand, has been to introduce the ad hoc palliatives described above, and to shrink—rightly—from the application of a dose of deflation sufficient to eliminate payments deficits.

Four European countries did increase the exchange value of their currencies in May. Dr. Klaus-Dieter Arndt, president of the German Institute for Economic Research in Berlin, told the subcommittee that the recent decisions by German and Dutch authorities to let the exchange value of the mark and the guilder float and the revaluations of the Swiss franc and the Austrian schilling will unfortunately not have a substantial impact on the U.S. competitive position.

The Japanese Cabinet recently adopted an eight-point plan of alternative measures in an effort to avoid revaluation. Martin Bronfenbrenner, professor of economics at Carnegie-Mellon University, testified that one reason it is difficult for the Japanese Government to revalue the yen is because of the losses that Japanese shipbuilders would suffer on contracts with sale prices denominated in dollars; for this reason, Japanese officials might be more willing to accept an exchange rate change initiated by others than to take the initiative themselves in bringing about such a realinement.

The first alternative—an increase in the dollar price of gold—has serious drawbacks, and the second—upward movements in the value of several foreign currencies—is beyond U.S. reach. The United States has thus no assured unilateral capability to modify exchange rates.

5. DIFFICULTIES ARISING FROM DOLLAR OVERVALUATION

The impediments the United States presently confronts in mounting any initiative to alter exchange rates, and the failure of other countries to revalue promptly, have several perverse effects. The consequent dollar overvaluation leads to the perpetuation of U.S. deficits and thus increases the risk of an international monetary crisis that would break the system apart.

As a result of our balance-of-payments position, foreigners often urge deflationary policies upon the United States. Fortunately, such advice seems to have had an impact on monetary policy alone.

Dollar overvaluation makes U.S. exports more expensive than they would otherwise be in foreign markets and so hampers sales. The misalinement of exchange rates also brings imports into this country at bargain prices. Both of these factors have had an adverse impact on domestic employment during a period when unemployment is already severe.

Finally, dollar overvaluation makes the acquisition of foreign assets and productive facilities less costly for American corporations than such investments would be if a sustainable set of exchange rates prevailed. High levels of foreign direct investment accelerate the export of American technology and increase foreign competition with American-made goods.

Commerce Department restrictions on U.S. capital investment abroad have not materially checked bargain-basement investment by U.S. firms in countries with undervalued currencies. In his testimony on U.S. foreign investment controls, Mr. William V. Hoyt, Deputy Director of the Office of Direct Foreign Investments, Commerce Department, said: "The purpose of the program is not to cut down on direct investment. The purpose of the program is to shift the financing of that direct investment abroad. We have never viewed ourselves as a program for restricting the actual activities of U.S. corporations abroad."

While foreign investments by smaller firms have perhaps been discouraged by the existence of the Commerce Department program, Mr. Hoyt is apparently correct in his assessment that the impact of the program has been to shift abroad the financing of investment, rather than actually to curtail the acquisition of U.S. subsidiaries abroad. The effect of the program has largely been to induce U.S. firms to borrow abroad rather than to export funds that could be obtained at lower cost in the United States.

The domestic reaction to a progressive weakening of the U.S. export position, to increasingly severe import competition, and to the transfer of manufacturing operations abroad, has been a burgeoning of protectionist sentiment among industry and organized labor and an intensive effort on the part of the Executive to persuade other countries to limit voluntarily their exports of various commodities to the United States. Unfortunately, resort to any type of trade restriction constitutes an attempt to correct one mistake with a further error.

II. Recommendations for Action

1. Managing the Euro-Dollar Market

Recently our payments deficit has consisted of (*a*) the underlying structural disequilibrium on current and long-term capital accounts and of (*b*) outflows of short-term capital in response to differences in interest rates between the United States and other industrialized countries. Expectations of a shift in the dollar value of any other major currency often stem partially from the first aspect but produce their major impact on the second. Speculative expectations can generate extraordinarily large flows of short-term assets into a nation possessing a strong currency. A phenomenon of this type occurred in late April and early May because holders of short-term assets became convinced, partly as a result of comments by officials and economic analysts, that the German mark would be revalued upward. The size of the subsequent inflows caused almost insurmountable problems for the conduct of domestic monetary policy in Germany, and some action was necessary to bring the movements to a halt. The German authorities, therefore, permitted the mark to float.

Certainly the flows into Germany would have been smaller, or the crisis would not have been so easily triggered, if there had been no widespread impression—as the result of German trade surpluses and U.S. payments deficits—that the mark was undervalued with respect to the dollar and that at some point a revaluation was probable. Thus, while the basic deficit of the United States persists, the danger will continue that a political crisis or some flurry in exchange markets will set off large speculative movements.

The Euro-dollar market in recent years has grown into a deep reservoir of finance available on flexible terms to facilitate international trade, domestic transactions, and short- and medium-term investment. But the huge size of the market suggests that cooperation among monetary authorities to discourage or neutralize massive international transfers of liquid assets is also needed. The market must be managed so that it will not frustrate the efforts of domestic monetary policy in countries that have access to it. On the other hand, any attempt to squeeze the market out of existence or drastically curtail its activities would be a mistake.

> ***Recommendation 1.*—The Treasury and the Federal Reserve should continue their participation in current international discussions to develop cooperative policy tools for managing Euro-dollar flows, and should share fully in their implementation.**

2. Rectifying Our Fundamental Deficit

Eliminating the difficulties that have been caused from time to time by capital flows channeled through the Euro-dollar market is not enough. A U.S. initiative to rectify our fundamental payments position is also necessary.

***Recommendation 2.*—The Executive should promptly evolve a comprehensive program to rectify the balance-of-payments position of the United States. This program should include (*a*) compensation by our European allies for the added costs of U.S. participation in NATO defense—which should be curtailed if necessary until a level of U.S. external costs is reached that our allies are willing to pay for—and a severe cutback of military expenditures in Asia; (*b*) an early return to full employment; (*c*) implementation of a domestic price-wage-incomes policy; and (*d*) an appropriate realinement of dollar exchange rates.**

(*a*) In the last decade, the economies of continental Western Europe have grown in strength and affluence. The United States continues to maintain approximately 300,000 troops in this area as protection for our European allies, as an advanced line of defense for our own territory, and as a reassurance to the U.S.S.R. and Eastern Europe regarding a recrudescence of German nationalism. For years, members of the Joint Economic Committee and others in the Congress have been requesting that at least the Germans—in whose country the bulk of U.S. troops are stationed—pay the full foreign exchange cost of maintaining U.S. military personnel in Germany.

The German response has been to purchase weapons in the United States and to extend loans to the U.S. Treasury.

It is questionable how much German weapons procurement in the United States has been in addition to the amount that would have been purchased here under any circumstances. Surely not all of the purchases are additional. More importantly, loans are not a satisfactory offset to the current costs of military defense. U.S. military expenditures in Europe do not purchase a productive investment that will yield profits in the future. There is no income from which to amortize a loan.

The West German Government has recently offered to make direct cash payments of $218 million over the next 2 years for the cost of maintaining American troops there, and to earmark an additional $98 million for renovating barracks and airfields used by our military in Germany. While this might establish a significant principle, and while we welcome any improvement, however small, the West German offer pales into insignificance beside our $1.8 billion annual balance-of-payments costs in NATO.

The only appropriate offset is a full and immediate NATO cash payment for the foreign exchange cost of keeping U.S. forces in Europe. No country's balance of payments should benefit or suffer as a result of obligations mutually agreed upon under the NATO structure. The budgetary costs to the United States of fulfilling our NATO commitments are approximately $14 billion. We should request immediate compensation for only the additional $1.8 billion that is paid to foreigners in order to maintain these troops abroad. If the NATO countries do not desire to compensate the United States for the added costs of keeping as many as 300,000 troops overseas, then the United States should reconsider the requirement for the number of personnel stationed in Western Europe in the light of the personnel contributions which should come from our European allies.

(*b*) As Chairman of the Council of Economic Advisers Paul W. McCracken pointed out in recent testimony before the Subcommittee on Foreign Economic Policy, the balance of payments of the United States tends to strengthen during periods of domestic prosperity and weaken when the economy slumps. This phenomenon occurs because when the U.S. economy is booming, investment here becomes more attractive to foreigners. The consequent capital inflows usually exceed the deterioration in the trade balance that results from increased demand for imports and reduced efforts to export. An early return to full employment and full production would significantly improve the U.S. balance of payments.

(*c*) Reducing unemployment to an interim goal of 4 percent, and lower over the long run, would almost certainly entail an unacceptable increase in the rate of inflation if the administration continues to reject a wage-price policy. Therefore, for domestic reasons, and also to avoid a steady deterioration of our ability to compete in international trade, implementation of a comprehensive domestic price-wage-incomes policy is required. On the basis of domestic considerations, a majority of the Joint Economic Committee endorsed the need for a permanent incomes-price board in its last annual report. The balance-of-payments position of the United States also demonstrates the need for such a board.

(*d*) Finally, a decrease in the external value of the dollar, at least against several major currencies, is required to rectify the U.S. balance of payments. The discussion below outlines different ways in which this restructuring of exchange rates might be accomplished. **The goal of the exchange rate changes should be to produce a U.S. balance of payments such that surpluses on current account are sufficient to finance normal levels of unfettered net private investment abroad.**

Reliance on the Interest Equalization Tax and capital export restrictions in a futile attempt to curtail U.S. deficits—rather than on exchange rate adjustment—masks the extent of the fall in the prices of American-produced goods relative to the cost of foreign goods that is required to achieve a tenable U.S. balance-of-payments position. Because we have failed to make any dollar exchange rate adjustment whatever, let alone an adequate one, we now are plagued with a depressed level of exports, burgeoning imports, and the excessive transfer of U.S. manufacturing operations abroad.

These capital controls, apart from their capacity to conceal how badly the dollar is overvalued, are innately undesirable. Net earnings from international portfolio and direct investment strengthened the U.S. balance of payments in 1970 by $6.2 billion. In discussing the adjustments required to eliminate persistent payments disequilibria, President Nixon in his first report entitled "United States Foreign Policy for the 1970's" (issued February 18, 1970) said: "Adjustment should not require countries to resort to prolonged restrictions on international transactions, for this runs counter to the fundamental objective of an open world." In an environment of less inflation in the United States, and of more expeditious exchange rate adjustment, the President continued, "The remaining restrictions on international transactions can be steadily reduced. We will do our share. That intent was plain in the actions we took in 1969 to relax our restraints on capital outflows for U.S. corporations and banks and to eliminate the most onerous restrictions on our aid to developing countries."

The same point had been made in the Presidential statement of April 4, 1969: "Fundamental economics calls for * * * ultimate

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dismantling of the network of direct controls which may seem useful in the short run but are self-defeating in the long run."

Little has been heard from the Executive in the past year about continued progress toward removal of these controls, or how their eventual elimination will be effected. The 1971 version of the foreign policy report makes no reference to any concrete steps toward the achievement of this goal. The Executive should promptly renew its commitment to abolish these controls, and do so over a 2- or 3-year period. As long as the controls remain in force, officialdom will continue to forgo essential exchange rate adjustments.[3]

How badly overvalued is the dollar? Over the past 3 years, our current account has on average been in deficit by a modest amount. Official witnesses indicated that long-term capital outflows would increase by $2 or $3 billion annually if existing controls were removed. Thus, total net long-term capital outflows might grow from about $3.5 billion in 1970 to $6 or $7 billion. Recently Secretary of Commerce Stans asserted that the United States could easily experience a merchandise trade deficit in 1971, after a $2.1 billion surplus last year. The current account might therefore be in deficit by $2 billion. Given the removal of capital export controls, an $8 or $9 billion basic deficit is quite conceivable.

Plainly, even Herculean accomplishments in reducing military expenditures abroad, in attracting foreign investment, and in containing domestic inflation cannot come close to achieving an improvement in our balance of payments sufficient to eliminate a deficit of these dimensions. The impossibility of achieving this target without exchange rate changes indicates fundamental overvaluation of the dollar. A significant decrease in the exchange value of the dollar would stimulate exports, raise the cost of imports, retard U.S. investment abroad, and attract foreign investment in the stock and bond markets and in American firms.

3. REALINING DOLLAR EXCHANGE RATES

The International Monetary Fund has adopted a largely passive attitude toward the growing problem of exchange rate misalinement. The Fund has expressed mild displeasure about the decisions of Canadian, German, and Dutch authorities to allow their currencies to float in exchange markets. But it has failed to indicate in any specific way how to eliminate the widening disparity between the external value of the dollar, on the one hand, and that of several European countries and the Japanese yen, on the other.

The failure of the Fund to adopt a more active role toward exchange rate disequilibrium is unfortunate. The alternative to a restructuring of exchange rates is agitation for protection from import competition and the proliferation of controls over capital exports, as has occurred. The ultimate purpose of a smoothly functioning international monetary system is to facilitate trade and capital flows and to permit the removal of impediments to these flows. Unfortunately, monetary au-

[3] Senator Humphrey feels that limitations on capital exports should be phased out only as the exchange value of the dollar is allowed to adjust downward and as other countries remove their existing restrictions on imports from the United States. He believes that these measures—plus the reduction of U.S. military expenditures abroad, the promotion of exports, and the introduction of a domestic incomes policy—are all essential and equally important ingredients in any successful policy to rectify the U.S. balance of payments.

thorities have begun to view the existing system and its preservation as an end in itself, rather than as a vehicle to achieve a larger goal.

The Fund, we believe, should take an active role in supervising and negotiating the realinement of exchange rates. The third purpose of the Fund, as stated in the first of the articles of agreement is—

> To promote exchange stability, *to maintain orderly exchange arrangements among members*, and to avoid competitive exchange depreciation. [Emphasis added.]

The sixth stated purpose is—

> To shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The United States, as has been explained above, suffers especially from the structure of the international monetary system as it has evolved in the postwar era. This country does not enjoy the same latitude as others to alter the external value of its currency. If American workers who have been forced into unemployment as a result of import competition are to find new jobs, if American labor and industry are to have available an effective means for improving their competitive position viv-a-vis foreigners, if demands within the United States for restrictions to limit imports and capital investment abroad are to be turned aside, and if this country is to resume the position of leadership that it ought to occupy in the world economy, a means must be devised to unfetter the United States from its chronic payments deficit.

> ***Recommendation 3.*—The exchange rates of industrial nations should be realined to eliminate the existing structural payments deficit of the United States. The International Monetary Fund should explicitly assume the responsibility for recommending to member countries exchange rate changes needed to correct any fundamental disequilibrium, particularly between the United States, as the country at the center of the system, and the remainder of the industrial world. The U.S. Governor should assure that the IMF does not avoid facing this responsibility. If the Fund does fail to meet its responsibility, the United States may have no choice but to take unilateral action to go off gold and establish new dollar parities.**

The International Monetary Fund has not been reluctant to recommend and even to insist that exchange rates be altered when the recipient of this advice has been the government of a developing country. The Fund has given wise counsel in many of these cases. But the IMF has shrunk from an equally active role in preventing the emergence of a basic payments disequilibrium between the United States, the center country of the international monetary system, and the remainder of the industrialized world. This apparent lapse on the part of the IMF is curious in that the potential damage to the international monetary system and to individual national economies throughout the world from a structural U.S. deficit is many times what can result from a disequilibrium limited to a much smaller economy.

Because of the threat to international monetary and trading relationships from the existing misalinement of exchange rates, the Fund must confront this issue. After the initial restructuring of exchange rates, the Managing Director and the Executive Directors should adopt a far more activist role than they have pursued in the past to prevent the emergence of persistent surpluses or deficits on the part of industrial countries.

The Fund should not hesitate to offer recommendations on exchange rate policy, and back them up if they go unheeded. In the case of recalcitrant deficit countries, the Fund can refuse to lend. In the case of recalcitrant surplus countries, activation of the scarce currency clause of the IMF Articles of Agreement should be considered. Activation of this clause would permit other Fund members to discriminate against the exports of a surplus member that refused to revalue its currency upwards.

If the membership of the Fund fails to confront this issue and does not specify a mechanism through which dollar exchange rates can be promptly restructured, the United States should then promptly consider a unilateral initiative to achieve this same result, perhaps by floating the dollar within specified limits.

1. The first step in this initiative could be an acknowledgment by the United States that it can no longer fulfill its obligations under the Articles of Agreement to stabilize the value of the dollar by purchasing and selling gold, and that it will fulfill its obligation, as do all other countries, by exchange operations. In reference to the obligations of Fund members to maintain exchange stability (Art. IV, Sec. 4b), the Articles state: "A member whose monetary authorities, for the settlement of international transactions, *in fact* freely buy and sell gold within the limits prescribed by the Fund * * * shall be deemed to be fulfilling this undertaking." [Emphasis added.] The United States does not—in fact—freely buy and sell gold in transactions with foreign monetary authorities, and has not for several years. The other way in which a member can satisfy its obligation to maintain exchange rate stability is to buy and sell foreign currencies in order to maintain spot exchange rates within 1 percent of parity. The United States can legitimately and legally exercise its privilege to shift this commitment from one requiring gold transactions to one based on intervention in exchange markets.

2. The second step should be to establish new dollar parities. The Fund can raise no objection to a change in dollar parities of up to 10 percent (Art. IV, Sec. 5c). Thus, a day or two after altering our stabilization obligation, we could announce a devaluation of up to 10 percent without Fund approval. During a period in which controls over capital exports were being progressively relaxed, however, calculation of an appropriate, sustainable new parity for the dollar would be virtually impossible. Therefore, either a transitional float or a controlled rate of depreciation until the reestablishment of an appropriate U.S. balance-of-payments position might be the most practical way to find a new external value for the dollar.

Such a unilateral float or controlled depreciation would not be a serious violation of the Articles of Agreement. The Fund tolerated a float lasting from 1950 to 1962 in the case of Canada, and now has taken note of, although it has not sanctioned, the current float of the Canadian dollar, the Netherlands guilder, and the German mark. Indeed, the drafters of the Fund's Articles seemingly anticipated that members would adopt floating exchange rates, at least from time to time, Article IV, Section 8b, states: "Whenever (i) the par value of a member's currency is reduced, or (ii) the foreign exchange value of a member's currency has, in the opinion of the Fund, depreciated to a significant extent * * * the member shall pay to the Fund within a reasonable time an amount of its own currency equal to the reduction in the gold value of its currency held by the Fund."

The delegates at Bretton Woods thus apparently recognized the possibility that at times some member countries would be able to find an appropriate new exchange value only by temporarily resorting to floating rates.

The question arises: What if other countries attempt to frustrate the United States' exercise of its rights under the Fund Articles to alter dollar parities in order to avert a fundamental disequilibrium? What if they persist in maintaining an unrealistically valued dollar?

The answer is a short one. The Fund has survived a quarter century, and hundreds of parity changes, without such an attack on its principles. The first country to launch such an attack might well find itself a monetary outlaw. Article IV, Section 4a of the Fund agreement states:

> Each member undertakes to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations.

4. ISSUING SDR'S IN ADEQUATE AMOUNTS

In 1970 and 1971 the bulk of additions to the reserves of other countries have been dollars acquired by foreign central banks as the counterpart of U.S. deficits. But if dollar deficits are to be reduced, as they must be to preserve the smooth functioning of the international monetary system and to achieve the freedom of trade and capital flows to which the system is directed, then an assured alternative supply of reserve assets must be available. Special drawing rights, created by the mutual agreement of the IMF membership, are the appropriate substitute. The present agreement to distribute SDR's will expire next year. Thus, the time is approaching when discussion must begin on the amount of SDR's to be created and allocated in 1973 and subsequently.

> ***Recommendation 4.*—Special drawing rights should continue to be distributed in 1973, and in subsequent years, at least at the current rate.**

5. PERMITTING GREATER EXCHANGE FLEXIBILITY

In their 1970 report on "The Role of Exchange Rates in the Adjustment of International Payments," the IMF Executive Directors promised to devote continued attention to the need for additional exchange rate flexibility within the context of the par-value system. The three possibilities mentioned were more frequent and hence smaller changes in parities, a slight widening in the margins of permissible fluctuations around parities, and the temporary floating of individual currencies in exchange markets.

Several IMF members have adopted floating exchange rates, either to prevent massive inflows of short-term capital or to discover what exchange markets might indicate regarding an appropriate new parity. Such action is technically illegal under the Articles of Agreement.

Therefore, it is essential that the Governors remove this contradiction between the letter of the Articles and the actions of Fund members by making appropriate revisions in the Articles or by reinterpreting them.

***Recommendation 5.*—In view of the apparent need of a growing number of IMF members to resort to floating exchange rates, and in order to prevent the emergence of structural payments surpluses and deficits, the IMF Governors should in September clarify the position of the Fund regarding alternative methods of achieving greater exchange rate flexibility, and should initiate procedures to accomplish any necessary revision of the Articles. The U.S. Secretary of the Treasury should press the other Governors to accomplish this end.**

6. CONSOLIDATING INTERNATIONAL MONETARY RESERVES

The impending decline in the exchange value of the dollar, and the possibility of further such modifications in the future, increases the likelihood that at some point a central bank holding appreciable amounts of dollars might insist upon exercising its right to exchange this currency for gold. A very substantial decline in the total stock of reserve assets held by central banks could occur if these institutions radically altered their preferences regarding the composition of these assets. Therefore, the Fund Articles should be amended to require each member to use all of its reserves proportionately in the settlement of payments deficits. Surplus nations would obtain additional reserves according to the proportionate composition of the reserve stocks of deficit countries. Several outstanding international economists, including Edward M. Bernstein and Robert Triffin, have offered schemes for the consolidation of reserve stocks under the aegis of the International Monetary Fund in order to prevent sudden shifts in reserve composition. In his testimony before the subcommittee, Federal Reserve Board Chairman Arthur F. Burns said: "It is essential to maintain an adequate growth in world monetary reserves and to insure that there are no destabilizing shifts among countries' holdings of gold, SDR's, and reserve currencies."

If the general membership of the Fund agrees that all the reserves of each country should be used proportionately in the settlement of deficits, then the option to exchange dollars into gold will lose its practical relevance. Surplus nations would be agreeing to hold what reserves they presently have and to accept whatever reserves the corresponding deficit countries were giving up. Thus, conversion of dollars into gold could not occur.

The U.S. commitment to freely buy and sell gold at the request of foreign monetary authorities has been a fiction for several years. For the monetary authorities of the world, convenience dictated that this fiction be overlooked. Official dollar holdings now total almost three times the $10 billion U.S. gold stock. Thus, it is impossible for this country to redeem dollar reserves held by other countries for gold if they should choose to initiate such an exchange. To continue to operate on the basis of a fiction is to court the danger that some unforeseen future crisis could prove disastrous.

***Recommendation 6.*—The reserve assets of all IMF members should be entered in a mutual settlement account, and each IMF member should use all of its reserves proportionately in the settlement of payments deficits. As a logical outcome of this agreement to use reserves proportionately, the U.S. commitment of interconvertibility between dollars and gold would be eliminated, if this change has not already been accomplished. The Governors of the IMF should in September commission a study, to be completed in time for action at the 1972 annual meeting, on how a reserve settlement account can be appropriately instituted, and on the termination of the U.S. commitment regarding gold-dollar convertibility.**

7. LINKING SDR'S AND DEVELOPMENT AID

The ability of the Fund to create internationally acceptable money should be used, as Robert Triffin has put it, in accordance with "internationally agreed objectives."[4] A portion of SDR distributions—the total amount of which must be determined according to the needs of Funds members for reserves—should be used to help foster more rapid economic development in low-income countries. This subcommittee and the full Joint Economic Committee are already on record in favor of utilizing some SDR's in this manner.[5] A linkage between reserve creation and development assistance is of great importance to the developing countries. To date, the IMF has failed to act in response to this interest.

***Recommendation 7.*—The International Monetary Fund and the International Bank for Reconstruction and Development should immediately undertake a joint study of feasible mechanisms for utilizing SDR creation to increase the flow of financial assistance to developing countries. This study should be prepared for presentation at the 1972 joint Fund-Bank annual meeting, or at an earlier date.**

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[4] "Linking Reserve Creation and Development Assistance," Hearing before the Subcommittee on International Exchange and Payments, Joint Economic Committee, U.S. Congress, 91st Cong., 1st sess., May 28, 1969, p. 35.

[5] "A Proposal To Link Reserve Creation and Development Assistance," Report of the Subcommittee on International Exchange and Payments, August 1969; 1970 and 1971 annual reports of the Joint Economic Committee.

MINORITY VIEWS

Dissenting Views of Representative Widnall, Senator Percy, and Representative Conable

We share the concern over our international economic position as reflected in this report. However, the report contains several sweeping recommendations with far-reaching implications for the international monetary system that have not received adequate analysis in the limited hearings held by the subcommittee and have not been fully discussed among its members. Under these circumstances, we are not prepared to associate ourselves with the recommendations contained therein concerning the position of the dollar.

Additional Views of Senator Javits

The minority members of this subcommittee are entirely correct in stating in their dissenting views that the report contains several sweeping recommendations with far-reaching implications for the international monetary system and that additional analysis and hearings are desirable and necessary.

On the other hand, it is an undeniable fact that the world has been buffeted by five serious monetary crises in the last 3½ years. The strains resulting from the worst of these crises, which erupted in May of this year, are still very much with us, and I do not yet consider the state of international economic relations between the major countries of the world to be particularly satisfactory. In addition to continuing monetary instability, trade relations between the industrialized countries of the world are in a precarious position, and the forces of regionalism and protectionism are daily gaining strength.

The present improper alinement between major currencies, and I refer in particular to the parity relationship between the dollar and the yen, presents serious problems for both countries and has led to a wide variety of actions ranging from voluntary quota arrangements to antidumping actions and growing requests for Congressional action in the form of restrictive quota legislation. In turn, the floating of the mark and the guilder, and the adjustments in other European currencies have caused strains among the members of the European Economic Community and put pressure on other currencies like the franc.

Therefore, while I share the concern of the dissenting views, I must welcome the innovative suggestions put forward by the report. For, in my view, the time is very much at hand for rethinking the basic premises of our international monetary system.

The type of reform that is needed will take bold and innovative measures if the international monetary system is to survive in the context of a liberal world trading community and freedom of international capital movements and travel.

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